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MAGAZINE
master investor
RESEARCH • ANALYSE • INVEST
THE UK'S NO.1 FREE INVESTMENT PUBLICATION

THE NEW ARMS RACE

15 STOCKS TO DOMINATE THE MODERN BATTLEFIELD

PLUS...

THE BITCOIN SURGE

A NEW ERA FOR MONEY OR A DANGEROUS BUBBLE?

DEFENSIVE FUNDS

PROTECT YOUR FUNDS IN A MARKET MELTDOWN

EARLY RETIREMENT

HOW TO REACH IT IN THREE SIMPLE STEPS

BRAND VALUE

WHY BIG BRANDS CAN EQUAL BIG RETURNS

WELCOME

Dear Reader,

The days are already getting noticeably shorter, and I am writing this sitting next to a fired-up radiator. Britain's summer with its brief interludes of sunshine has been great, but certainly not a period during which we spent weeks (or months) by the sea or in the mountains.

If you follow this e-magazine and its accompanying website and e-letters, you'll notice that your team at Master Investor has been using the past few months to implement further improvements to how we can serve you.

Going through this issue, you'll see that we have one thing and one thing only close to our heart: Providing you with guidance, inspiration and information to help you navigate through the treacherous waters of the financial markets.

As our regular contributor Nick Sudbury writes on page 26:

"The high valuations of many equities and bonds mean that the financial markets could easily experience a major correction. There are lots of potential catalysts that could trigger a large scale sell-off with one of the biggest concerns being the level of global debt that is significantly higher now than it was before the financial crisis 10 years ago."

While Nick sets out which funds you can mix into your portfolio to preserve your wealth in a market meltdown, on page 10 Victor Hill analyses how you can profit from the new global arms race that is appearing on the horizon.

You'll also enjoy Alan Steel's latest column aiming to set you on a path towards early retirement or (if you find that a dull prospect) financial independence and freedom. See page 76 for Alan's latest musings.

During the next couple of months, you'll learn more about the additional events we are going to host, and you'll see further innovations in our magazine and e-letters. If you haven't subscribed to the latter yet, I urge you to visit the website where you can choose between three different e-letters.

All of them are, of course, free of charge!

Best regards
Swen Lorenz
Master Investor, Editor

CONTACTS

ADVERTISING
swen@masterinvestor.co.uk

EDITORIAL ENQURIES
james.faulkner@masterinvestor.co.uk

SUBSCRIPTIONS
admin@masterinvestor.co.uk

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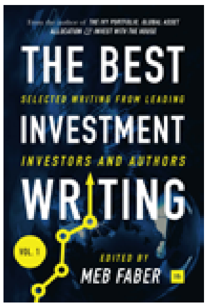

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Master Investor Ltd.
Suite 88
22 Notting Hill Gate
London W11 3JE
United Kingdom

EDITORIAL
Editor Swen Lorenz
Editorial Director James Faulkner
Creative Director Andreas Ettl

EDITORIAL CONTRIBUTORS
Filipe R. Costa
Richard Gill, CFA
Victor Hill
David Jones
John Kingham
Jim Mellon
Tim Price
Samuel Rae
Carl Shave
Alan Steel
Nick Sudbury

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ALL OTHER TOPICS

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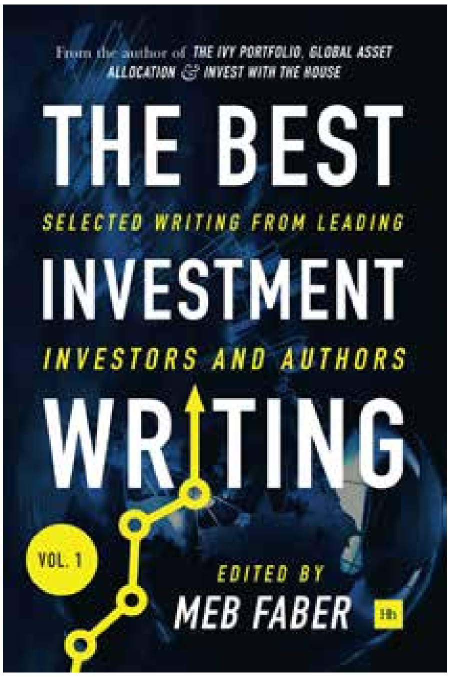

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BY JIM MELLON

MELLON ON THE MARKETS

This missive is being written on the Edinburgh to London train, as I return from a full week at the Edinburgh Festival. My friends Alan and Fran Steel of Alan Steel Asset Management, Scotland's most successful IFA (Independent Financial Adviser), asked me to speak to a selection of their clients during my visit, which I was more than happy to do.

Electric dreams

Aside from longevity, which is my theme du jour (and beyond), I commented on how I saw returns in different asset classes panning out over the next year or so. I pointed out how excessive the valuations of so called FANG (Facebook, Amazon, Netflix, Google) stocks are at the moment, with **Tesla (NASDAQ:TSLA)** a particularly glaring example. That particular vertiginously challenged stock capitalises each car it sold in 2016 at around $880,000, which compares to a capitalisation of just $5,000 per car sold at GM.

Mr Musk, bright though he is, will essentially have to sell all of the electric cars bought in the US for the next decade to come anywhere near justifying his company's valuation. Even he admits that the valuation of Tesla (and by implication Netflix, Facebook, Tencent, Alphabet et al) is crazy, and yet he has his begging bowl outstretched at every possible opportunity – in fact he just raised $1.5 billion in debt last week, adding to the monstrous amounts that have been hoovered up to sustain his electric dreams.

In my opinion, all of these sorts of stocks should be sold pronto – and if you don't believe me, read Elizabeth Kolbert's article on the internet in the most recent edition of the New Yorker magazine to get confirmation. She doesn't credit me, sadly, but I have been banging on for a while about how the big internet behemoths should be regulated as the monopolies that they are – and also made to pay for the data that the aforementioned Liz describes aptly that they extract and recycle.

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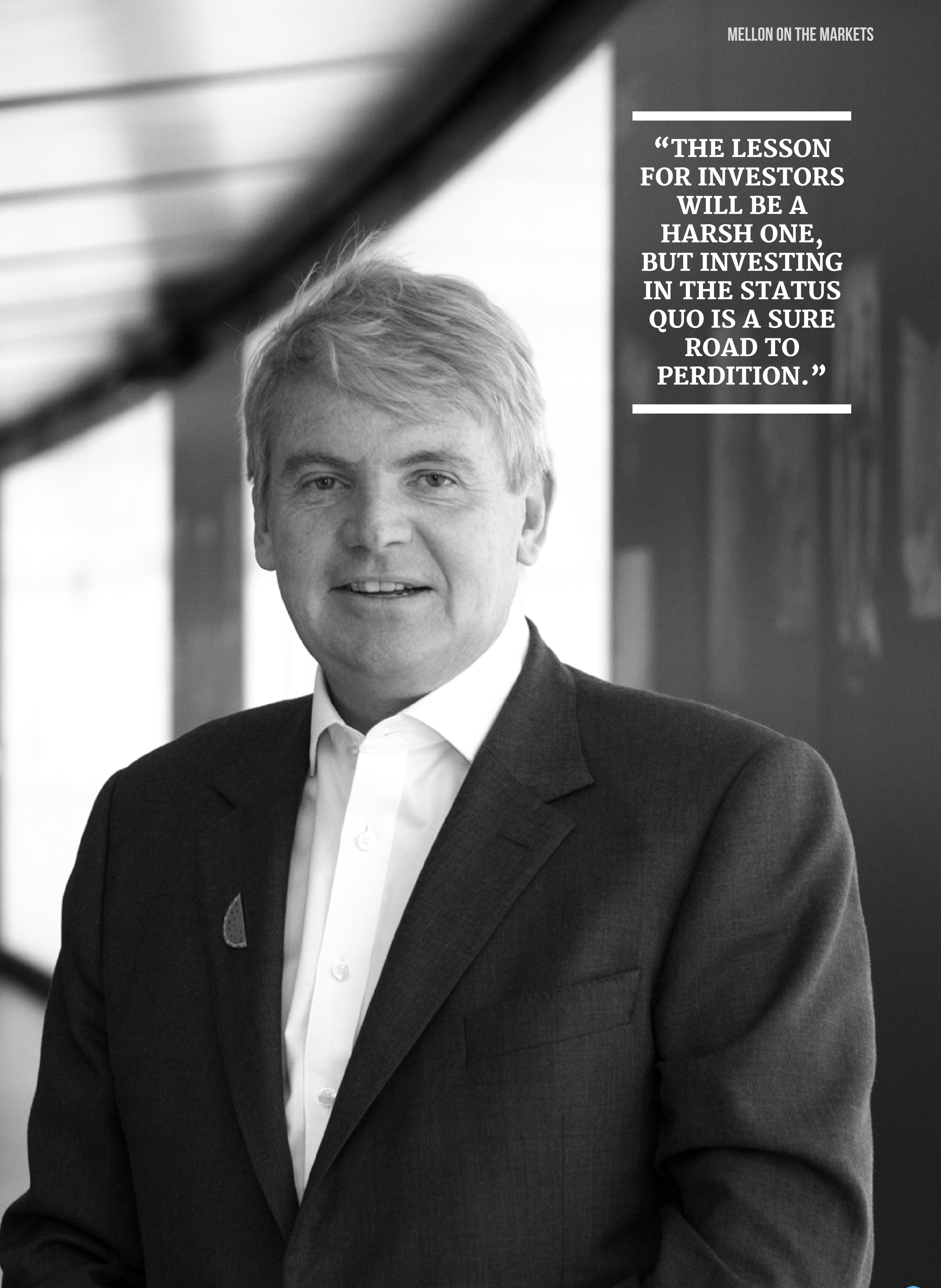
The road to perdition

There are going to be tears before bedtime – in fact, a floodtide of them – when the Silicon Valley companies get the shakeup that is surely coming their way. Oh, and in the case of **Google (Alphabet) (NASDAQ:GOOGL)** and **Facebook (NASDAQ:FB)**, there are distinct signs of a slowdown in advertising trends in the key youth markets that they currently dominate. The lesson for investors will be a harsh one, but



"THE LESSON FOR INVESTORS WILL BE A HARSH ONE, BUT INVESTING IN THE STATUS QUO IS A SURE ROAD TO PERDITION."

"IF, AS A FUND MANAGER, YOU SIT THERE AND IMAGINE THAT THE BPS, UNILEVERS, NEXTS AND ALL THE OTHER BLUE-CHIP STOCKS WILL MERRILY GRIND OUT GROWTH AND DIVIDENDS AD INFINITUM, YOU TOO, LIKE NEIL, WILL ONE DAY BE UNDONE."

investing in the status quo is a sure road to perdition.

And that brings me to Neil Woodford, whom I have never met and who by all accounts is a great guy and obviously a super smart investor. It won't have escaped the eagle-eyed attention of the Master Investor readership that Neil has been having some difficulties recently, with one Woodford Management company after another getting beaten up in the stock market. Our very own Evil Knievil, the best short seller in the UK and my co-owner of the as-yet-to-be best horse in the UK, Evergate, foretold of the travails of **Provident Financial (LON:PFG)** with timely precision.

On one day last week, Provident fell by 70%, which for a FTSE 100 company stuffed in many of the portfolios of the established fund managers is some going. My point at Alan's event was that Evil, amongst others, had noted that Provident's business model was outmoded and was being disrupted, and that was its undoing. If, as a fund manager, you sit there and imagine that the BPs, Unilevers, Nexts and all the other blue-chip stocks will merrily grind out growth and dividends ad infinitum, you too, like Neil, will one day be undone.

Fast-changing views for a fast-changing world

In this fast-changing world fast changing views are required; reading is required, analysis is required, hard work is required. We will do some of it for you at Master Investor, but suffice it to say that there is no company, no management, no financial instrument that is invulnerable to shock, and particularly now when we see the FANGs and their ilk at ludicrous levels.

I read an article last week that suggests the price of oil would fall to zero in the next twenty years; the author thinks this is a very bullish scenario for the big oil companies, because they will stop spending on exploration and will do what big tobacco companies have been doing for years – extracting cash and paying big dividends. Maybe, maybe not. But what I like about this author's work is that it represents a non-static view of the world. The author is challenging conventional wisdoms – firstly, the belief that there will always be a market for oil, and secondly that a low oil price is bad for the oil majors.

That sort of thinking is why we have to all redouble our efforts to review and refine our portfolio strategy. As for myself, I said in March at the Master Investor Show that this would be the year for gold; it has just broken out of an important upside barrier and I see $1,350 an ounce by the end of the year – at the very least. My gut instinct is to buy almost anything related to gold and silver and to do it now. My friend JY Sireau has been super keen on Bitcoin for the past while, and boy has he been right. It may be gold's turn now.

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I am also sticking with my view that the Nikkei/Japanese market is the best major market out there, and I also think sterling is now highly undervalued against the euro. I have been bullish on the euro dollar pair, but now I think it looks exhausted and the dollar might have a bit of a bounce – against everything except sterling and the Japanese yen.

In terms of company shares, I note that **Gilead (NASDAQ:GILD)** is today buying **Kite Pharmaceuticals (NASDAQ:KITE**); Gilead looks amazingly cheap to me. I also like **Editas (NASDAQ:EDIT)**, the leader in CRISPR technology.

The book (*Juvenescence* – Fruitful Publications) is less than a month away, and it would be great if you could pre-order it. My share of the royalties is all going to charity.

Thank you very much and Happy Hunting!

Jim Mellon

Click here to follow Jim's trades on Twitter

About Jim

Jim is a visionary entrepreneur with a flair for identifying emerging global trends enabling him to build a worldwide business empire. He is amongst the top 10% in the "Sunday Times Rich List" (Britain's equivalent to the Forbes list). He predicted the credit crunch of 2007-08 in a book entitled "Wake Up! Survive and Prosper in the Coming Economic Turmoil". Jim followed this with "The Top 10 Investments for the Next 10 Years" (2008) and then "Top Ten Investments to Beat the Crunch!" (2009). His monthly "Mellon on Markets" column has gained him cult status among investors. He holds a master's degree in Politics, Philosophy and Economics from Oxford University.

BY VICTOR HILL

OPPORTUNITIES IN FOCUS

THE NEW ARMS RACE

15 STOCKS TO DOMINATE THE MODERN BATTLEFIELD

Total military expenditure as a percentage of global GDP has been in steady decline over the last 60 years or so[i]. It fell from just over 6 percent in 1960 to 2.225 percent in 2016. That could be about to change. The absolute amount of money spent on soldiers, sailors, airmen and their increasingly technologically sophisticated kit has never been so high. *Defence*, in its many forms, is a colossal global industry.

The end of history has been postponed

I explained recently why Professor Francis Fukuyama's vision of *The End of History* did not quite come about after the dissolution of the Soviet Union on Christmas Day, 1991. But if the end of history has been postponed, there is only one power which can realistically challenge America as global hegemon this century – and that is, of course, China. That challenge is very slowly unfolding today; although it is unlikely to result in military confrontation in the immediate future for reasons that I shall explain.

The Chinese challenge to American hegemony is one thing; the rise of regional powers is another. In the early 21st century, deep-seated regional tensions, hitherto buried, have become more visible: Saudi-Arabia-Iran; India-China; India-Pakistan; Japan-China, and so on.

This more uncertain world reasserts *the military imperative* – the need to prioritise military expenditure. The Trump administration has certainly pressurised Europe to increase its defence expenditure – most notably at the G-20 summit in July. America spends 3.3 percent of its GDP on defence (down from 8.8 percent in 1960). Yet Germany, Europe's largest economy, spends just 1.18 percent. (That is still worth well over $40 billion).

Mr Trump wants all NATO allies to spend at least two percent of GDP on defence – otherwise, he argues with some reason, the Europeans are riding on America's coat tails. But note that one of the first acts of President Macron's government in France was to cut military expenditure, prompting the resignation of a senior general.

Modern weapons systems are so sophisticated and draw on the full

"THIS MORE UNCERTAIN WORLD REASSERTS *THE MILITARY IMPERATIVE* – THE NEED TO PRIORITISE MILITARY EXPENDITURE."

range of advanced technologies – from nanotechnology to artificial intelligence – that only a relatively small number of global suppliers can deliver the requisite top-of-the-range goods. Sophisticated investors need to know who those defence contractors are.

America versus Russia – and Russia versus Europe

When NATO forces conducted military exercises in eastern Poland and the Baltics in the spring of this year they were shadowed by Russian forces conducting their own exercises across the Russian border.

Russia under Mr Putin (since 01 January 2000) has succeeded in closing the yawning military gap between the quality of its military forces and those of the leading NATO countries. It now spends an estimated 5.4 percent of its GDP on the military – but remember that one dollar of military spending goes further in Russia than in the US because soldiers are paid less.

In 2008, with the world's attention transfixed by the Beijing Olympic Games, Russia invaded Georgia. (Dmitry Medvedev was President and Vladimir Putin was Prime Minister: so, technically, one should not say that *Mr Putin invaded Georgia* – though everybody knows this was a strategic move in the Putin playbook.) The western military elite held its breath as Russian tanks overran the regions of Abkhazia and South Ossetia – and then stopped... For the Russians had seized precisely what they wanted. And they are still there.

Georgia, then ruled by the eccentric President Saakashvili, who always appeared in front of an EU flag (though Georgia was never a member of the EU), appealed for European help. Gordon Brown and Angela Merkel were on holiday. President Nicola Sarkozy of France flew to Moscow "to negotiate a ceasefire" – even though the Russian guns had already fallen silent. Since then, the subject of Georgian membership of both the EU and of NATO has, ever so quietly, been dropped.

"ONLY A RELATIVELY SMALL NUMBER OF GLOBAL SUPPLIERS CAN DELIVER THE REQUISITE TOP-OF-THE-RANGE GOODS. SOPHISTICATED INVESTORS NEED TO KNOW WHO THOSE DEFENCE CONTRACTORS ARE."

And then, in March 2014, Russia plucked the fertile peninsula that is Crimea from its Ukrainian neighbour like a ripe fruit. Once again, Russia got exactly what it wanted for a relatively small price (targeted sanctions against senior members of the ruling elite – equivalent to the sanctions long since imposed on Zimbabwe, which have also been ineffectual). I am not going to get into a discussion about Russia's claim to ownership of Crimea: but let us just say that it is strategically vital for the operation of its Black Sea fleet.

Europe's nightmare is that Russia will come to the rescue of the Russian minorities in the Baltic States – Estonia, Latvia and Lithuania – all EU *and* NATO members. One of David Cameron's last acts as Prime Minister was to station a brigade of the British Army in Estonia as a token of solidarity against Russia.

President Trump's National Security Adviser, General HR McMaster, has emphasised that America's true strength lies not in night-time commando raids, nor below-radar drone strikes – useful though those are – but in superbly equipped land, sea and air forces working together to assert overwhelming military dominance. He believes that technology alone cannot deliver swift, clean military victories. America still needs boots on the ground.

In contrast, the chief of Russia's General Staff, General Valery Gerasimov, is a proponent of the Russian version of *hybrid warfare*[ii]. This technique has already been perfected in Ukraine and Syria. It consists of blending traditional military weaponry with powerful non-lethal combat tools such as cyber-warfare (including jamming), electronic surveillance (including drones), and the dissemination of elaborately targeted fake news. Before the Russians entered Georgia, Georgian government websites had already been disabled by hackers.

Writing in a Russian defence journal last year about lessons learnt by Russian forces in Syria (and also Chechnya), General Gerasimov wrote: *Indirect and asymmetric actions… allow one to deprive the opposing side of de facto control without seizing any territory*.

According to the *Wall Street Journal*, General McMaster is the author of a secret study analysing the lessons of Russian's destabilisation of Ukraine. Some Americans fear that the clever use of hybrid or *asymmetric* warfare – what some analysts call *the information war* – could rob America of the advantages offered by its massive portfolio of military assets.

It is, in my view, unlikely that Russian soldiers will march into the Baltic states one summer's morning (as they did in June 1940). Rather, Russian agencies will happily continue to hack, to disseminate aggravating fake news and to meddle in Western elections in subtle ways.

But if Europe were to fall prey to chaos – perhaps because of another major financial and banking crisis, potentially precipitated by the collapse of the Euro, which Nobel prize-winning economist Joseph Stieglitz foresees – then Russia might decide to sow chaos behind enemy lines before a shot was fired. Russian drones are already in the skies above Ukraine on a permanent basis – and they often encroach on Polish airspace.

"MR TRUMP WANTS ALL NATO ALLIES TO SPEND AT LEAST TWO PERCENT OF GDP ON DEFENCE – OTHERWISE, HE ARGUES WITH SOME REASON, THE EUROPEANS ARE RIDING ON AMERICA'S COAT TAILS."

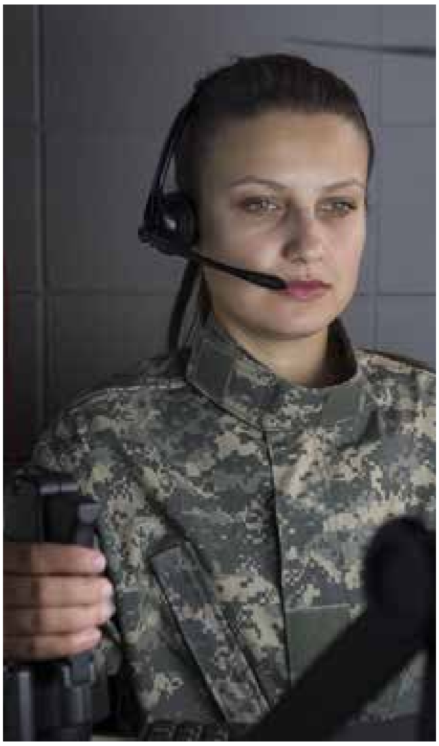
Germany is now highly dependent on Russian gas for its energy needs and the new Baltic gas pipeline will only accentuate this dependency. As such, its leverage over Russia is quite limited.

Peter Pomerantsev – author of *Nothing is True and Everything is Possible* – has written that Vladimir Putin's Russia is *the first post-modern dictatorship*, so adept at the manipulation of information that its citizens no longer know the difference between truth and *alternative facts*. Yet, I can hear my Russian friends asking: is that so very different from contemporary America?

America versus China

Mr Trump's most hostile rhetoric to date – bar his spine-chilling "fire and fury" exchanges with Kim Jong-un – has been levelled at China for its "unfair" trading practices. He has said that China is a *currency manipulator*. The rivalry between the United States and China is at root economic but is rapidly becoming military. China has used trade to develop its economy on the back of massive export surpluses; as it has done so it has begun the task of building a military apparatus to challenge that of the United States – although it has a long way to go.

In her book published this year, *Sellout*, Victoria Bruce argues that, because of globalisation, and with the blessing of the US government, once proprietary materials, components and technologies are increasingly commercialised outside the USA. Nowhere is this more dangerous than in China's monopoly control of *rare earth metals* (such as scandium and yttrium) which are essential for nearly all modern consumer electronics and weapons systems. She writes: *China could shut down*



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“THIS AGONISING GAME OF CAT AND MOUSE IS LIKELY TO CONTINUE FOR SOME TIME.”

exports on a whim and ultimately cripple the US armed forces.

The potential military flashpoints that could precipitate such action are twofold. First, China has adopted an increasingly belligerent attitude over its rights to disputed territories and territorial waters in the South China Sea – not least with regard to the Spratly Islands, an atoll which is also claimed by the Philippines, Vietnam and Malaysia. Secondly, China might react militarily to any US military response to North Korea (see below).

In the 1990s the Chinese were allowed to acquire **Magnequench** (Indiana)[iii], an American company that made magnets for the US military using rare earth metals. They shut down the American factory while retaining control of the firm's technology. The Chinese then set out to get control of rare earth metals all over the world – not least in Africa, where Chinese personnel are now ubiquitous.

As I wrote recently, the Trump administration looks increasingly ineffectual and incoherent. But it will very probably take action soon under Section 232 of the Trade Expansion Act (1962) against China – first on steel and then possibly on aluminium. And this is not just in defence of America's steel workers but in defence of America's future status as a superpower. By standing up to China, the Trump administration may even acquire a get-out-of-jail card.

That said, I do not envisage war between these two nations in the immediate future. China opened to the world in 1972; Mao died in 1976; then Deng Xiaoping first initiated market reforms in December 1978. Since then, China has been remarkably cautious – one might say restrained – in asserting itself outside its frontiers[iv]. My guess is that the Chinese leadership well understands the famous aphorism of the 6th Century BC military philosopher, Sun Tzu. *The supreme art of war is to subdue the enemy without fighting*[v].

The hot war will only take place in the early 2040s when President Trump (Ivanka by name – the Chinese understand better than anyone that The Donald's true role on Earth was to found a ruling dynasty) finally takes a stand against Chinese assertiveness. But that will probably be too late.

America versus North Korea

Objectively, North Korea is irrelevant. I mean by that that North Korea stands outside the modern states system, its economy is tiny, its share of world trade negligible and its cultural influence zero. It is not a small rising power surrounded by enemies, like Israel. That an appalling totalitarian regime, the only victim of which (thus far) has been its own wretched citizens, has been allowed to survive is a function of the unfinished business of the Korean War (1950-53). Even for China, North Korea is an irritating embarrassment – though China would not particularly welcome a united Korea, which would become a very significant neighbour, economically speaking – even though the Chinese leadership probably regards that eventuality as inevitable in the long term.

The fact remains, however, that North Korea is ruled by a third-generation dictator, very probably of unsound mind, who has presided over a nuclear weapons programme now coming to fruition (as he sees it). Moreover, he has leveraged his status internally and externally by threatening America verbally – much to Mr Trump's chagrin. What outcome might accrue to North Korea by getting into a nuclear exchange with the USA is not difficult to quantify: the country would be annihilated. Yet by putting the frighteners on his Asian neighbours, Kim probably calculates that he can get concessions in terms of trade and resources.

This agonising game of cat and mouse is likely to continue for some time. Kim is still only 33 years old (we think – no one is quite sure) and unless he is assassinated by his generals or succumbs to heart failure brought on by his reported passions for Camembert cheese, Johnny Walker whisky and YSL cigarettes, he is likely to be around for much longer. In fact, he will very probably outlast President Trump.

China is reluctant to tighten the screws further on North Korea for fear that there might be a flood of refugees across its border. (The borderlands with North Korea in Manchuria are largely Korean-speaking: North Korean citizens could relatively easily hide themselves if the leak became a flow...)

But my best guess is that US National Security Advisor, General McMaster, and the other high-ranking generals in the Trump administration would not allow the President to go for the first-strike option – even if he favoured it. Meanwhile, the North Korean people persist in a state of slavery with no prospect of relief.

India versus China

In May of this year a Chinese academic who works at the University of Wisconsin-Madison reported that India's pop-

ulation has already overtaken that of China's, which he thinks the Chinese authorities have overestimated by 90 million. Yi Fuxian – a demographic expert and admittedly a critic of China's one-child policy – reckons that China's population this year is 1.29 billion and India's is 1.33 billion[vi]. The two most populous nations on Earth share a long common border, much of which is disputed – and over which they have fought one major war (1962) and numerous minor ones.

Under Mr Modi, India has embarked upon a massive programme of military expansion in order to narrow the gap in military prowess as compared to China. In May, *Defence News* reported[vii] that Russia is delivering several thousand anti-tank guided missiles, hundreds of T-90 battle tank engines and other tank components to India. The Israelis are delivering drones and missiles for the Indian Navy. The French are supplying jet fighters.

The Indian Army wants to equip all of its 382 infantry battalions and 44 mechanised infantry units with a fourth-generation shoulder-fired anti-tank guided missile (ATGM) system. And the Indian Navy is constructing 12 *Scorpène* class submarines at the Mazagaon docks in Mumbai. This is a class of diesel-electric attack submarine designed by French state-owned naval defence company **DCNS**. They are expected to be operational by 2020.

India's state-owned Hindustan Aeronautics Limited (HAL) aims to double production of the indigenously developed Tejas Light Combat Aircraft (LCA) for the Indian Air Force from 8 to 16 units per year from 2019-20, the company announced on 23 August[viii].

If India wants to catch up with China, it has a very long way to go both in eco-

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“INDIA HAS EMBARKED UPON A MASSIVE PROGRAMME OF MILITARY EXPANSION IN ORDER TO NARROW THE GAP IN MILITARY PROWESS AS COMPARED TO CHINA.”

"INVESTMENT IN THE SECURITY APPARATUS IS LIKELY TO BE RAMPED UP TO MEET THE ONGOING CHALLENGE OF TERROR."

nomic and military terms. But there is a new strategic line-up emerging in the sub-continent. India is increasingly allied and supplied by the USA, Israel and France; while the Chinese are developing close economic and military links with India's adversary, Pakistan.

Could this fault line give rise to an earthquake? It could: the border dispute with China rankles, as does that with Pakistan in respect of Kashmir. But don't forget that India and China are also partners. China is the largest foreign investor in India by far. Such investment is worth more to India than sovereignty over a glacier the size of Switzerland. Ultimately, good relations between India and China will probably prevail so long as business-like relations between America and China obtain. Though, nothing is guaranteed.

Saudi Arabia versus Qatar and Iran

The current spat between Saudi Arabia and its Gulf Cooperation (GCC) allies on the one hand and fabulously wealthy Qatar on the other is really a side-show to the much more significant ongoing rivalry between the Kingdom of Saudi Arabia and the Islamic Republic of Iran for regional dominance.

Saudi Arabia is closely allied with America and Britain who supply it with arms on a grand scale; while Iran is increasingly aligned with Russia – who has become a major supplier of high-end weapons systems (including ballistic missiles) which Iran could not obtain elsewhere. Turkey, which seems to have resolved many of its differences with Russia this year, is inclining towards the Russia-Qatar-Iran axis. Egypt, a sworn enemy of the Muslim Brotherhood, which Qatar allegedly supports covertly, is lining up with Saudi Arabia.

This altercation within the Arab Sunni Islam world is a cause of embarrassment to countries such as Britain which are effectively being asked to choose between Qatar and Saudi Arabia. Qatar controls assets worth an estimated £40 billion in the UK, much of it in London property, not least the Shard, Harrods and large parts of Canary Wharf – plus six percent of **Barclays Bank (LON:BARC)**. They even own 20 percent of **International Airlines Group (LON:IAG)**, the holding company that owns British Airways. Not forgetting the Qataris provide 17 percent of Britain's gas via the LNG terminals in South Wales and Kent.

The allegation is that Qatar is using its massive offshore investment portfolio to finance jihadist groups in Libya, Syria, Iraq and elsewhere. The West seems quite confused about the veracity of this claim. President Trump denounced Qatar earlier this year as a sponsor of terrorism; but a few days later the Pentagon signed a $12 billion arms deal with Qatar – admittedly a minnow of a deal compared with the $110 billion one Mr Trump signed with King Salman in Riyadh[ix] at the end of May.

And Qatar is home to the 11,000-strong US air base in the Middle East at al-Udeid which has been instrumental in Coalition air strikes in Syria and IS-held territory in Iraq.

Saudi Arabia spent 9.8 percent of its GDP on its military last year and is currently one of the world's leading buyers of US weapons. Only 2 percent of production and repair take place in the Kingdom. In accordance with the *Saudi Vision 2030* development programme, over 50 percent of Saudi Arabia's military spending will be on domestic procurement, maintenance and R&D by 2030. The majority of manufacturing and repairs of military vehicles, aircraft, drones and missiles, currently

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Six giant American defence contractors

Boeing Corporation (NYSE:BA) is well known as one of the world's two major producers of commercial airliners. It is also engaged in the research, development and production of manned and unmanned military aircraft and weapons systems. On 22 August it was reported that The US Air Force has awarded Boeing a $349 million contract in respect of the next generation of intercontinental ballistic missile system (IBMS). The company's share price is up over 50 percent year-to-date at time of writing and is trading at a P/E of around 21.

Lockheed Martin (NYSE:LMT) is by most reckonings the world's largest defence contractor, specialising in military aircraft (including the best-selling F-35 Lightning fighter jet) with revenues of over $46 billion last year. The company's HQ is in Bethesda, Maryland. As I have mentioned in these pages before, it is also a global leader in robotics drawing on artificial intelligence. Its shares are up by over 20 percent year-to-date and are tipped to rise by another 14 percent[xiii]. It is currently trading at a P/E of around 24.

Raytheon (NYSE:RTN) is a corporation with a long history which these days specialises in aerospace and weapons systems. It is the developer and manufacturer of the US Navy's famous Tomahawk missiles, the 4,000th of which was delivered in August. The company had revenues of over $23 billion last year. The company's share price has risen by about 25 percent year-to-date but even at that level the dividend yield is impressive. It is trading at a P/E of around 24.

General Dynamics (NYSE:GD) is an aerospace and defence company with global reach headquartered in Virginia. It had revenues of $31.4 billion last year. It has four main business segments: Marine Systems, Combat Systems, Information Systems Technology, and Aerospace. General Dynamics' former Fort Worth Division manufactured one of the Western world's most famous jet fighters, the F-16 Fighting Falcon, until 1993, when production was sold to Lockheed. In 1999, the company re-entered the airframe business with its purchase of Gulfstream Aerospace. The company reported solid earnings in July but some analysts fear it may be over-valued, despite a consistent dividend history. The share price is up 16 percent year-to-date and trades at a P/E of around 20.

Northrop Grumman Corporation (NYSE:NOC) was the world's fifth largest defence contractor in 2015. Last year it generated $24.5 billion in revenues. It produces military aircraft including the B-2 Spirit (*Stealth*) strategic bomber which is invisible to radar systems. The Stealth bomber can deliver both conventional and thermonuclear weapons. Northrup's shares surged in the "North Korean rally" of mid-August 2017. At time of writing they are up about 17 percent on the year, trading at a multiple of about 21.

Rockwell Collins (NYSE:COL) designs, produces and supports communications and aviation navigation systems for commercial and military customers. Headquartered in Cedar Rapids, Iowa it had revenues of $5.25 billion last year. It recently contracted to supply displays and controls for the upcoming Boeing 777 aircraft – a deal expected to generate $2 billion in revenue. On 23 August *The Street* opined that Rockwell was *one of the hottest defence stocks*[xiv]. It is up 34 percent year-to-date on a multiple of 24.5.

undertaken by American contractors, will then be done locally.

On 23 June Saudi Arabia issued a 13-point ultimatum to Qatar. Doha was abjured to cut economic ties with Iran; to close a Turkish military base on its soil; to deport religious extremists and to close the Al-Jazeera TV station. One commentator likened this ultimatum to the one submitted by Austria-Hungary to Serbia in July 1914[x]. The deadline for the ultimatum came and went and the country was then effectively subjected to a blockade. As a result, the price of Brent Crude rose by ten percent in the first week of July.

The word is that Saudi Arabia's new 31-year old Crown Prince, Prince Mohammed bin Salman (affectionately known as "MBS"), is in a hurry to cement his position before his father the 81-year-old king dies. He calculates that President Trump will back his drive to challenge Iran (whose press still refers to America as *The Great Satan*) on every front. He has already masterminded the Saudi intervention in the long-running Yemeni civil war – one as bitter as Syria's. But, unlike most Saudi princes, MBS was educated entirely in Saudi Arabia and is thought to have only a loose understanding of global geopolitics.

The fear in the Saudi elite is that the Iranians might mastermind terrorist attacks in Saudi, possibly perpetrated by members of the Shia minority who reside in the coastal regions of the country's Eastern Province. Yet, ultimately, this is another information war. The Saudis resent the role played by Al-Jazeera in the Arab Spring and fear that a concerted internet campaign against the House of Saud could be their undoing. They are dismayed by the wiliness and rapidity with which the Qataris have acquired soft power through ownership of football clubs (Paris Saint-Germain) and Formula One – which the Saudis never imagined possible.

Europe, America, Russia and India versus Islamist fanaticism

The word *Islam* is a cognate for the Arabic word for *peace*; but then, surely, *all religions are religions of peace*. People who kill in the name of God *cannot be religious*. Can they? They are vicious charlatans. Yet, Islamist fundamentalist violence is self-evidently a major problem in the modern world.

Professor Richard Dawkins has helped us to see this problem in another light[xi]. *Memes* (forms of mimicked behaviour) can take hold of people and infect what they do. Teenage boys wearing their baseball caps backwards is a meme – or, if you prefer, an intellectual software virus, which is self-perpetuating; though one that is entirely harmless.

The idea that Muslims are justified in killing anyone who disagrees with their particular interpretation of Islam is also a meme or intellectual software virus – though one that has had catastrophic consequences.

Former MI5 chief Jonathan (Lord) Evans recently told BBC R4's Today programme the issue was *a generational problem* and that the UK needed to persevere with efforts to defeat it[xii]. He said we would probably continue to face the threat of Islamist terrorism *for another 20 to 30 years*. He thinks that we need to police the internet more effectively as it is this which is driving the radicalisation of young males of Muslim heritage in Western countries.

Donald Trump has changed his mind about Afghanistan. During the presidential election campaign last year he called for American forces to be pulled out. On 21 August he announced that US forces would remain in Afghanistan indefinitely: "Not to do nation-building, but to kill terrorists". So, 16 years after American forces first arrived in that remote and poverty-stricken country, which has few strategic resources,

Britannia rules (some of) the waves

BAe Systems (LON:BA) (aka British Aerospace), still very much a British company headquartered in London and Farnborough (Hampshire), is the number three defence contractor globally with revenues of nearly £18 billion last year. It builds the *Tornado* and *Typhoon* fighters for the RAF. And it has built the massive Queen Elizabeth class aircraft carrier, one of the largest in the world, currently undergoing sea trials, with a second behemoth under construction in Scotland. This aircraft carrier, when finally commissioned, will carry more than 70 aircraft, including Lockheed's F-35s. The company does not enjoy the same prestige at home that it inspires in many countries abroad – partly because of a number of bizarre business decisions, such as its decision to sell off its 20 percent stake in Airbus in 2006 for less than 20 percent of the current market value. Unlike the US defence contractors its shares have hardly moved at all this year and it is back on a P/E of around 17.5.

Rolls-Royce (LON:RR), as well as being the world's leading manufacturer of engines for commercial aircraft, is a major producer of military aero-engines and marine propulsion systems for military boats and ships. It had revenues of £15 billion last year. The share price bombed, however, due to a profit plunge and because of concerns about debt levels, which seem to have been resolved. This year Rolls-Royce shares are up by 36 percent.

Babcock International (LON:BAB) is a British engineering and defence support services company with revenues of £4.8 billion last year. In 2007 Babcock was selected to fit out the two new Queen Elizabeth class aircraft carriers at its Rosyth dockyards. Babcock also services the Royal Navy's fleet of four nuclear submarines which are equipped with Trident nuclear missiles. Its shares have not fared well this year – they are down over 14 percent on the back of fears about rising leverage and reduced interest coverage. The order book remains strong. It is currently trading at a P/E of just 13.

European Firepower

Leonardo SpA (BIT:LDO) (formerly Finmeccanica) is an Italian global high-tech company and a key player in aerospace, defence and security. Headquartered in Rome, the company has 180 sites worldwide. It was the ninth largest defence contractor in the world in 2014. Last year revenues amounted to €12 billion. The Italian government, its largest shareholder, holds 30.2 percent of the company's shares. Its shares are up about 8 percent year-to-date with a decent dividend and a P/E of around 17.

Thales SA (EPA:HO) is a French multinational company that designs and builds electrical systems and provides services for numerous sectors including aerospace, defence and transportation (e.g. air traffic control systems – a market that is growing rapidly). Its HQ is in La Défense, Paris. Last year it had revenues of just under €15 billion. The company has seen an increase in its order book despite uncertainty over the French defence budget. The share price has been flat overall this year and is trading at a multiple of around 22.

Dassault Aviation SA (EPA:DA) is the manufacturer of the *Rafale* jet fighter which is used by both the French Air Force and Navy. Dassault signed a contract with India last year to deliver 36 Rafale jets and further orders from India are expected. Egypt and Qatar have also ordered another 24 each. Talks are underway with the Malaysian Air Force. Last year the company had revenues of €3.6 billion. The shares are up by over 20 percent year-to-date and are trading on a P/E of around 20.

Saab AB (STO:SAAB-B) headquartered in Stockholm, Sweden, is the maker of the Saab JAS 39 Gripen multi-role aircraft which serves as a fighter-bomber and reconnaissance aircraft. The Saab Grippen is currently in service with the South African, Czech and Hungarian air forces as well as with the Royal Swedish Air Force. Saab AB also produces other military hardware including a range of anti-tank weapons. The company had revenues of SKR27 billion last year (about €3 billion). Its shares raced ahead in Q2 2017 on good news flow but have since fallen back and are now about 8 percent up year-to-date, trading on a multiple of 28.

"A DIVERSIFIED EQUITY PORTFOLIO SHOULD INCLUDE STAND-OUT DEFENCE CONTRACTORS."

there is no end in sight to their mission to cut out the cancer of Islamic fundamentalist violence. According to some reports the Taliban are resurgent.

Europe, America, Russia and India have all been victims of Islamic fundamentalist terrorism: and yet they have found it difficult to cooperate on the issue. Even the rise of Islamic State (IS) failed to galvanise a joint policy in Syria and Iraq. With American help, however, the Iraqis have defeated IS in Mosul; and with Russian help the Syrian Army is defeating IS on the border with Lebanon. But no one thinks the defeat of IS will signal the end of this pernicious ideology.

So the upshot is that investment in the security apparatus is likely to be ramped up to meet the ongoing challenge of terror. Until such time as the vicious meme of Islamic extremism dies – just as, eventually, people stopped believing in leprechauns and trolls.

Action

Military expenditure is likely to increase hereon as regional powers upgrade their defence capabilities. Europe is under pressure from the Americans to increase defence spending, though European budgets are tight. A diversified equity portfolio should include stand-out defence contractors.

Military expenditure is primarily a form of national-level insurance. It is therefore not unethical to invest in companies that make one's homeland more secure against aggression, loony-tune states and mind-corrupted terrorists.

That is what our ancestors did with swords and shields. But, going forward, we should reflect that the greatest danger facing us is probably not from bombs and missiles but from cyber-attacks. Cyber-security and defence are now one and the same.

And don't forget the Israelis!

Elbit Systems (NASDAQ:ESLT) is an international Israel-headquartered defence electronics company engaged in a range of projects across the world. The company develops and supplies a portfolio of airborne, land and naval systems and products for defence and commercial aviation requirements. It specialises in unmanned aircraft systems (drones). Its shares are up by nearly 40 percent this year and the company is now trading on a P/E of about 24.

Israel Aerospace Industries (state-owned) makes components, parts, and systems for military and commercial operations worldwide. Its defence-related products are sold to about 70 countries. Customers include British Airways, GE, and Lockheed Martin.

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.

i **See The Word Bank military data at:** http://data.worldbank.org/indicator/MS.MIL.XPND.GD.ZS?end=2016&start=1960
ii **See Wall Street Journal, 19 June 2017, In new cold Wat, two Generals Square Off, by Nathan Hodge and Julian E Barnes.**
iii **See:** https://www.marketplace.org/2017/06/26/business/big-book/why-us-buys-all-its-rare-earth-metals-china
iv **I am aware that supporters of Tibetan independence and the rights of other minorities within the People's Republic of China will object to this statement. But the Chinese leadership has been explicit and consistent in differentiating between what they regard as (historic) China and abroad. The territories disputed with India are all ones which used to be controlled by Tibet and which are therefore, *ipso facto* (in their terms), Chinese.**
v **Sun Tzu, *The Annals*.**
vi **The Times, Friday, 25 May 2017, page 38.**
vii **See:** http://www.defencenews.in/article/Indias-Massive-Military-Expansion---Pak-Media-251876
viii **See:** http://www.defencenews.in/article/HAL-aims-to-double-production-of-LCA-over-next-three-years-283844
ix **See:** http://fortune.com/2017/05/24/saudi-us-saudi-arabi-weapons-deal
x ***Ambrose Evans-Pritchard in The Daily Telegraph, Wednesday, 05 July 2017, page 5.***
xi **The word meme originated with Richard Dawkins' 1976 book *The Selfish Gene*.**
xii **See:** http://www.bbc.co.uk/news/uk-40890328
xiii **See:** https://www.benzinga.com/media/barrons/17/08/9953419/barrons-picks-and-pans-starbucks-lockheed-motorola-and-more
xiv **See:** https://www.thestreet.com/story/14281206/1/united-technology-rockwell-collins-deal-could-send-one-up-another-15-analyst.html

BY JOHN KINGHAM

DIVIDEND HUNTER

BAG A PREMIUM INCOME FROM THE INSURANCE MAJORS

As dividend stocks go, life insurance companies have a mixed track record. On the one hand, they operate in a sector which is relatively immune to the economic cycle (people don't typically cancel their life insurance just because there's a recession). On the other hand, dividend cuts are fairly common within the sector, despite its blue chip credentials. However, if you can spot the safest insurers and buy them at reasonable prices, I think the potential yield plus growth rewards can be worth the risk.

With that in mind, this month I'm going to pit two of the UK's biggest life insurers against each other to see who comes out on top.

Two high quality, high growth insurers

So why pick **Legal & General (LON:LGEN)** and **Prudential (LON:PRU)**? The main reason, other than that they're high profile large cap blue chips, is that they both have impressive histories of steady dividend growth. Okay, neither of them is perfect; Prudential cut its dividend after the market crash of 2003, and L&G cut its dividend after the market crash of 2008. But both companies rebounded quickly and, other than those two blips, their recent performance has been impressive, as the accompanying charts show.

Over the past decade both companies have grown at double digit rates, 11% for Prudential and 13% for L&G. Yes, L&G was recovering from a post-2008 slump, but its current dividend is still more than twice its pre-crisis high. In contrast, the FTSE 100 has only managed to grow earnings and dividends at about 2% per year, on average.

Consistency has also been good during that period, with both companies increasing their net asset values (an important measure for insurers), earnings and dividends more than 80% of the time. (That's also better than the FTSE 100's less consistent record, where earnings and dividends have increased only half the time.)

Another favourite measure of mine is profitability, or in the case of life insurers, ten-year average return on equity (ROE). As a group, UK-listed life insurers have managed an average ROE of about 13%, while Prudential has managed 19% and L&G 17%. In fact, they fill two of the top three slots for most profitable dividend-paying UK life insurer.

So that's the initial picture. These are two blue chip stocks with track records of highly profitable and

"IF YOU CAN SPOT THE SAFEST INSURERS AND BUY THEM AT REASONABLE PRICES, I THINK THE POTENTIAL YIELD PLUS GROWTH REWARDS CAN BE WORTH THE RISK."

mostly steady dividend growth. The next step is to find out how those financial results were achieved.

Same sector, different focus

Both companies operate in the life insurance sector, but they also generate significant profits from closely related areas such as annuities and investment management.

L&G focuses on the corporate retirement market, generating 43% of operating profits from managing retirement assets (mostly de-risking corporate pension schemes and underwriting annuities for corporate retirees), 19% from investment management (managing corporate pension funds and retail investment funds), 17% from life insurance and 13% from its capital investment business (directly investing long-term annuity assets into housing and infrastructure projects).

Prudential focuses on individuals rather than corporations, generating more than 80% of its operating profits from individual life insurance policies and variable annuities. The remaining 20% comes from its asset management businesses in the UK and Asia.

As well as focusing on different products and services, they also focus on different geographic regions. Legal & General operates primarily in the UK and generates about 80% of its profits here. Prudential is far more international, generating about 25% of its profits from the UK, 43% from the US and 30% from Asia.

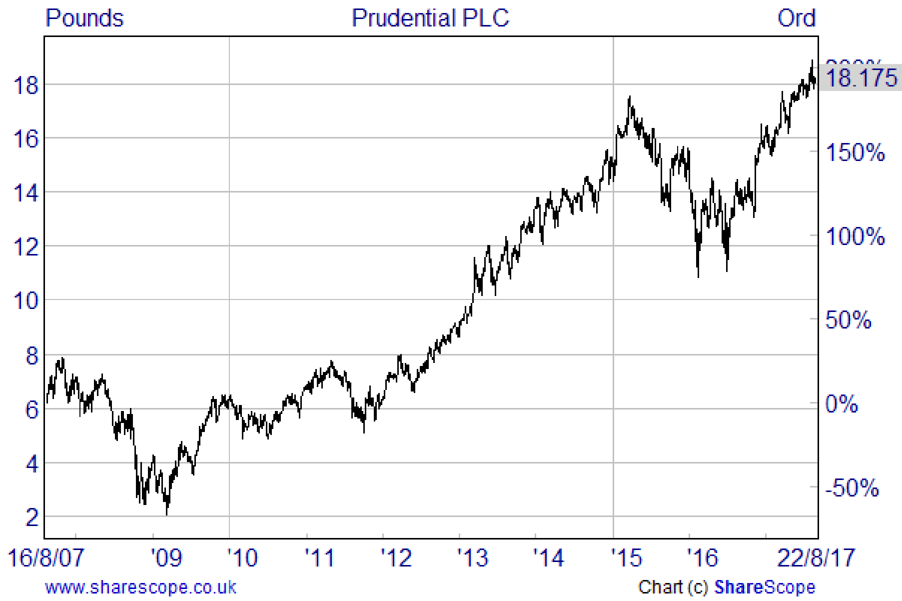
Despite these differences, both companies are fundamentally focused on later-life and end-of-life insurance, which is a market where changing demographics are creating huge opportunities.

Longevity, baby boomers and the emerging Asian middle class

Years ago the "average" man retired at 65, lived another 10 years and then died. Today the average retirement period for a man is over 18 years and could soon be as long as 20 years (the average retirement for a woman is even longer). Longer retirements require larger pension savings, which means more assets for asset managers and larger annuities for annuity providers; two areas which form a big chunk of L&G's and Prudential's businesses.

A longer average retirement also means the ratio of workers to retirees will continue to tilt towards retirees. At some point the working population will not be able to comfortably support the retired population and the state pension will have to shrink. That's partly why the UK government introduced pension auto-enrolment, where all employees have some of their wage redirected into defined contribution pensions by default. Total assets under management within UK defined contribution pensions are growing at double digit rates, which I'm sure makes L&G and Prudential very happy.

Another demographic tailwind is the baby boomer generation who, having been born in the two decades or so after World War II, are now beginning to enter retirement. With more than 40 million boomers expected to retire over the next decade in the US alone, this huge shift represents a once in a generation opportunity for retirement income providers like Prudential and L&G, as both companies have a large exposure to this market. L&G for example, currently manages more than £54 billion of annuity assets, while Pruden-



"TOTAL ASSETS UNDER MANAGEMENT WITHIN UK DEFINED CONTRIBUTION PENSIONS ARE GROWING AT DOUBLE DIGIT RATES, WHICH I'M SURE MAKES L&G AND PRUDENTIAL VERY HAPPY."

tial generates around 40% of its operating profits from its US annuity business, Jackson National Life.

One final tailwind, which relates primarily to Prudential but also to L&G to some extent, is the massive expansion of middle class wealth in Asia.

For both companies, this massive increase in wealth represents a huge opportunity. Millions of new middle class citizens are starting to save towards their retirement, and both Prudential and L&G are looking to manage those savings and investments. Prudential is well ahead of L&G in this respect as it has been operating in Asia for over 90 years and already generates about 30% of its operating profits from across the region. That percentage is likely to increase in future as Asia has long been the fastest growing area within Prudential. In 2010 for example, operating profits from Asia came to just over £500 million. By 2016 that figure had grown to more than £1.5 billion.

As a result of this rapid international growth, Prudential's UK and European business now generates just 25% of total operating profit. In fact, there's a lot of speculation at the moment about a potential split between Prudential's high growth US and Asia businesses and its low growth UK business. But for now that's just speculation.

Overall, I've painted a relatively rosy picture so far. These are two companies with long histories of high profitability, good growth and (usually) reliable dividends. They both have scale, market leadership and strong brands, and they operate in markets which could grow at a heathy rate for the next few decades.

However, there are always risks, two of which stand out in my mind.

Risk 1: Large and unpredictable regulatory changes

Finance is a heavily regulated sector and companies within it rely on regulatory stability in order to make long-term plans. Politicians, on the other hand, often make massive regulatory changes as they try to improve society and attract voters. These regulatory changes can have a dramatic impact, either positive or negative, on the affected companies.

A good example of this occurred in the UK recently, when the then Chancellor of the Exchequer, George Osborne, announced a raft of new pension freedoms in 2014. These freedoms included the freedom to not buy an annuity. Instead, retirees would be allowed to keep their pension pot invested and draw it down in whatever way they see fit (more or less).

This sparked a massive change in the UK annuity market and now more than 90% of L&G's defined contribution

pension accounts end up being transferred to cash rather than annuities. For UK annuity providers this change was a major headache, but not for L&G or Prudential as selling individual UK annuities is not a major part of either business.

Another example of regulatory change is the new US "fiduciary rule". This will classify any US financial professional as a fiduciary, with the obligation to act first and foremost in the client's best interest (which seems reasonable enough). In some ways it's similar to the Retail Distribution Review which took place in the UK a few years ago, as both rule changes make it harder for advisors to be paid a commission by financial companies in return for putting their clients' money in the hands of those companies.

> **"A ROBUST BALANCE SHEET WHICH IS ABLE TO WITHSTAND EQUITY MARKET DECLINES IS AN ABSOLUTE NECESSITY IF DIVIDENDS ARE TO BE SUSTAINED."**

Personally I think the fiduciary rule is a good thing, but how it will affect Prudential's very significant US annuity business is unknown. Either way, this sort of major regulatory change is a serious business risk.

Although regulatory change is a major risk, I think a far more important risk, and one which is far easier to quantify, is balance sheet weakness.

Risk 2: Volatile markets and an insufficient capital buffer

When you pay an insurance premium, the insurance company puts most of that money to one side, ready to cover the cost of any claims that arise. This means there is a large asset of collected premiums sitting on the company's balance sheet, which is largely

offset by the liability of expected future claims.

Rather than simply leaving your premiums in cash for a few decades waiting for you to die, life insurance companies will invest it in order to reduce the amount of premiums needed in the first place for a given amount of cover (which makes them more price competitive). And as a bonus, excess returns from these investments are often used to pay special dividends to shareholders.

This means life insurers are willing to invest in equities, which as we know can be volatile. The risk is that if equity values fall, the value of the premium assets may fall below the expected value of future claims, and that is a definite no-no as far as the regulator is concerned. If that were to happen, a dividend suspension and rights issue would be virtually unavoidable.

To avoid that unpleasant situation, the regulator insists that insurance companies have assets a certain amount above and beyond their liabilities, with that certain amount being known as regulatory capital. Each insurer will then look to hold surplus capital beyond their regulatory capital as this gives them a further margin of safety in case equity markets go down the pan.

But even then, things can go wrong, as Prudential cut its dividend in 2003 and L&G did the same in 2008. The eagle eyed will have spotted that both 2003 and 2008 were bear market years, and that's no coincidence. So a robust balance sheet which is able to withstand equity market declines is an absolute necessity if dividends are to be sustained.

Fortunately, insurers will report their capital surplus and capital requirement, so it's usually easy to work out their capital coverage ratio, i.e. the ratio between the two. Unfortunately, there is no obviously "safe" level for this ratio. Different insurers invest their premiums into different asset classes, with different hedging strategies and other complicating factors. So a capital coverage ratio of 150% may be safe for one company, but extremely risky for another.

A more usable ratio, in my experience, is the premium to surplus ratio. This is the ratio between net premiums written during the year (net of reinsurance premiums) and the surplus capital of

the company (i.e. the surplus of assets over liabilities, measured using net tangible assets). In my experience, a premium to surplus ratio of less than two is usually prudent, with values above that tending to be associated with companies that eventually cut their dividend.

INVESTMENT RULE: Only invest in an insurance company if its five-year average premium to surplus ratio is below 2

Using that ratio, L&G's balance sheet looks relatively cautious, with a five-year average premium to surplus ratio of 1.6. In terms of the regulatory capital cover ratio, L&G's is currently 171% and has averaged 204% over the last five years. So L&G typically has twice as much capital as required by regulation, and that's more than almost all of its peers.

> **"BOTH COMPANIES ARE FUNDAMENTALLY FOCUSED ON LATER-LIFE AND END-OF-LIFE INSURANCE, WHICH IS A MARKET WHERE CHANGING DEMOGRAPHICS ARE CREATING HUGE OPPORTUNITIES."**

Prudential does not come out quite so well, with a premium to surplus ratio of 11. That's way above my preferred maximum of two, which can only mean one of two things: either a) Prudential's balance sheet is recklessly undercapitalised or b) the premium to surplus rule of 2 is not applicable to Prudential for some reason or other.

To get a better idea of which it's likely to be, we can use the regulatory capital cover ratio as a sanity check. In this case, Prudential currently has a capital cover ratio of 201%, and over the last five years the average has been 244%. As with L&G, that's twice the regulatory minimum. In this case I think the regulatory capital cover ratio is more reliable than the premium to surplus ratio, which means I do not think Prudential is obviously undercapitalised.

Potentially good investments, but only at the right price

Having looked at the pros and cons of these two insurance giants, I would say that they're both potentially good investments. They both have good track records of highly profitable dividend growth, they both appear to have strong balance sheets and they both operate in markets with strong tailwinds. I would be happy to invest in either of them at the right price.

Of the two, L&G is more attractive at first glance. At 267p it has a 5.4% dividend yield to go along with its double digit growth rate. Prudential, at 1811p, has a yield of just 2.4%. That's below the FTSE 100's yield of 3.9%, which is what I'd normally expect for a high growth company. Looking at my stock screen, which favours stocks with the best combination of growth, consistency, profitability and value, L&G still comes out on top. Out of 223 dividend-paying stocks on the screen, L&G is ranked eighth while Prudential comes in at eighteenth. However, that's a tiny margin of victory for L&G, and both companies are comfortably within the top 50, which is where I look for new investments.

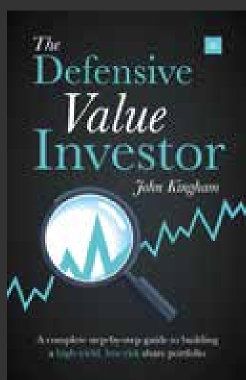
On that basis then, I think both companies are attractive businesses trading at attractive prices. If I had to choose one today then I would choose L&G. In fact, I've already chosen L&G as I bought it back in April when the yield was 5.8%, and if Prudential stays at its current price for much longer I might end up with another life insurer in my portfolio.

About John

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

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

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



BY NICK SUDBURY

FUNDS IN FOCUS

DEFENSIVE FUNDS TO PROTECT YOUR WEALTH IN A MARKET MELTDOWN

The high valuations of many equities and bonds mean that the financial markets could easily experience a major correction. There are lots of potential catalysts that could trigger a large scale sell-off with one of the biggest concerns being the level of global debt that is significantly higher now than it was before the financial crisis 10 years ago.

Higher interest rates in the US and elsewhere would place a major burden on heavily indebted consumers and businesses and could trigger a massive de-rating as the decade of ultra-low rates comes to an end. There are also plenty of other risks that could derail the markets including an escalation in the tension between North Korea and the US and its allies.

Whenever anything happens to threaten the markets it is the traditional safe havens that prosper. These include currencies like the US Dollar, Japanese Yen and the Swiss Franc, as well as core government bonds such as US Treasuries and the ultimate store of value, gold.

Most global multi-asset funds will normally provide some sort of exposure to these areas, although the weightings will often be dominated by holdings in more vulnerable asset classes, most notably equities.

If you are concerned about recent events and want to reduce the risk in your portfolio, it could be worth considering more defensively orientated funds. A good place to start would be the global investment trusts that explicitly aim to protect investors' capital as part of their mandate.

Invest alongside the Rothschilds

A prime example is the £3bn **RIT Capital Partners (LON:RCP)** that aims to deliver long-term capital growth, while preserving shareholders' capital. It began life as the Rothschild Investment Trust and was set up to manage part of the wealth of the UK branch of the Rothschild family.

"THE LEVEL OF GLOBAL DEBT IS STILL A MAJOR CONCERN – IT IS SIGNIFICANTLY HIGHER NOW THAN IT WAS BEFORE THE FINANCIAL CRISIS 10 YEARS AGO."

Between inception in 1988 and the end of 2016 the fund participated in 76% of market upside, but only 39% of market declines. This enabled it to generate an average annual NAV total return of 11.5%, which was well ahead of the 8.8% per annum achieved by the MSCI All Companies World index (in sterling terms) and the 9% annual return generated by the FTSE All-Share.

The portfolio is defensively positioned with the main emphasis being on capital preservation, and during the first six months of the year it delivered a NAV total return of 4%. At the end of June it had 10.5% invested in direct equity holdings, with 24% in long-only equity funds, 20.7% in hedge funds, 22.2% in Private Equity, and 23% in Absolute Return and Credit funds, with the remainder in real assets and bonds.

MikeDotta / Shutterstock.com

Unlike most of its peer group, the fund actively manages its currency exposure in an effort to add value. Over the last six months this saw the dollar weighting reduced from 62% to 37%, with sterling rising from 24% to 38% and the euro increasing from 4% to 16%.

RCP has an excellent long-term record with a 10-year share price gain of 105.6%, although the recent performance has been lacklustre because of the defensive positioning. Its shares are trading on a 7% premium to NAV because of the high demand during the current period of market tension.

Defensive mind-set

Another good defensive option is the £379m **Ruffer Investment Company (LON:RICA)** that operates alongside RCP in the global growth sector. The fund aims to achieve a positive total annual return, after all expenses, of at least twice the Bank of England Base rate. This is a pretty modest target given the current low rates of interest, but it has an excellent performance record with a 10-year share price total return of 148.7%.

The managers are concerned about the current market valuations and have been for some time. In their latest monthly update they said that asset prices are high across the spectrum and that investors are looking for securities that are less over-priced than others:

"Whilst this relative argument is not necessarily an indicator of an imminent end to the party," they argue, "it does suggest that prospective returns are likely to be low in most asset classes over any sensible timeframe and investors are readily accepting greater risk than they would previously have done in order to generate adequate returns."

At the end of July the fund had a 44% allocation to UK and international equities with the largest element being the 18% exposure to Japan. The rest of the portfolio was more defensively positioned and included a 39% investment in UK, non-UK and long-dated index-linked gilts. There was also 8% in cash, 5% in gold and gold equities, as well as 4% in options and other protective illiquid strategies.

If you prefer open-ended funds the firm also runs the £3.2bn Ruffer Total Return OEIC that provides exposure to a similar portfolio.

Gold and gold mining shares

The one asset class that you can virtually guarantee would do well in a crisis is gold and there are several ETFs that provide a cheap and flexible way to gain exposure. These include **ETFS Metal Securities Limited Physical Gold (PHAU)** and **db ETC plc Physical Gold (XGLD)**, both of which track the spot price and are backed by gold bullion stored in a secure bank vault and held by an independent custodian.

If you feel comfortable gearing up your potential returns you might want to consider a fund of gold mining shares. When the price of gold increases, gold mining companies often do even better. This is because a higher gold price means improved earnings and inflated corporate profit margins.

For example, a gold-mining company that has a cost of production of $600/oz. would make a profit of $700/oz. based on the current price of $1,300/oz. If the price was to increase by 15% to $1,500/oz., its profit would rise by 29% to $900/oz.

The reverse is also true and the 20% fall in the gold price over the last five years has resulted in funds such as **Investec Global Gold, BlackRock Gold & General,** and **CF Ruffer Gold** all making double-digit losses.

"THE ONE ASSET CLASS THAT YOU CAN VIRTUALLY GUARANTEE WOULD DO WELL IN A CRISIS IS GOLD."

Investec Global Gold was launched in April 2006 and has £84.7m in AUM. The fund mainly invests in the shares of gold mining companies, although it currently has 5.6% in silver producers. George Cheveley, the manager, has put together a concentrated portfolio of 30 shares and like its peer group it has been very volatile. In 2016 when the gold price rose strongly the fund made 84.1%, but over the last 10 years the annualised return is just 2%.

Market neutral

A steadier option would be a market neutral long/short fund. These use derivatives like CFDs to short sell stocks that the manager thinks will fall in value. By balancing the long and short books they are able to reduce their net market exposure to virtually zero so that the returns will be mainly driven by the stock selection decisions.

There are several of these funds available including: **F&C Global Equity Market Neutral, Kames UK Equity Absolute Return, Man GLG European Alpha, Old Mutual UK Specialist Equity** and **Absolute Insight Equity Market Neutral.**

In theory a market neutral fund should be able to generate positive absolute returns irrespective of the direction of the market, although it is entirely dependent on the stock picking ability of the manager.

The **Absolute Insight Equity Market Neutral** Fund is designed to deliver absolute returns with low volatility. It uses pairs of long and short positions to hedge out unwanted risk so as to generate returns from the relative performance of the companies.

The £356m fund invests in equities across different geographic regions to take advantage of the best long and short opportunities, but is always market neutral. It was launched in October 2007 shortly before the financial crisis and has held its value remarkably well with a modest cumulative return to date of around 23%. Over the same period the FTSE 100 initially fell by more than 40% and is currently only 14% higher than where it started.

The **Old Mutual UK Specialist Equity** fund takes long and short positions mainly in UK equities outside of the FTSE 100 index. It was launched in April 2016 and has done pretty well with a cumulative return since inception of 16.6%. Like the Absolute Insight fund the net market exposure is essentially zero.

About Nick

Nick Sudbury is an experienced financial journalist who has written extensively for a range of investment publications aimed at both private and institutional investors. Before moving into journalism he worked both as a fund manager and as a consultant to the industry. He is a fully qualified accountant and has an MBA with finance specialism.

"THE PERSONAL ASSETS TRUST (LON:PNL) IS ONE OF THE BEST DEFENSIVELY ORIENTATED INVESTMENT TRUSTS ON THE MARKET."

FUND OF THE MONTH – The Personal Assets Trust

The **Personal Assets Trust (LON:PNL)** is one of the best defensively orientated investment trusts on the market and aims to protect and increase (in that order) the value of shareholders' funds per share over the long term.

It is managed by Sebastian Lyon of Troy Asset Management, who also runs the Troy Trojan fund that has a virtually identical portfolio. Troy is an unusual investment firm as it prioritises the avoidance of permanent capital losses by having a cautious asset allocation policy and by only investing in 'high quality' companies.

Lyon is a long-term investor and will only buy companies whose business models he thoroughly understands and that he believes have enduring qualities that will allow the investment to compound in value as the years go by.

At the end of May, 46.1% of the fund was invested in a concentrated portfolio of equities with the top ten holdings accounting for about 70% of the exposure. These included the likes of BAT, Philip Morris, Microsoft, Nestle and Coca-Cola.

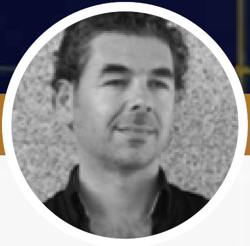
The rest of the portfolio consisted of an 18.8% investment in US Treasury Inflation Protected Securities (TIPS), with a further 14.2% in UK T-Bills, 9.7% in gold, 3.9% in UK Index-Linked Gilts and 6.6% in cash together with 0.7% in US T-Bills. These are all extremely defensive holdings and represent the majority of the fund's assets.

Lyon thinks that traditional diversification might not protect the portfolio to the same extent that it has in the past because conventional bonds and equities both look expensive. Using options to protect the portfolio would also be costly, so his preferred method is to invest in gold, hence the near 10% allocation.

The defensive positioning acts as a drag on returns during periods of market strength, hence the relatively modest 10-year return of 87%, but the fund is well-positioned to hold its value in the event of a sudden sell-off. Its shares normally trade close to their NAV.

Fund Facts

Name:	Personal Assets Trust (PNL)
Type:	Investment Company
Sector:	Global Growth
Total Assets:	£835m
Launch Date:	July 1983
Current Yield:	1.4%
Gearing:	0%
Ongoing Charges:	0.95%
Manager:	Sebastian Lyon from Troy Asset Management
Website:	www.patplc.co.uk



BY FILIPE R. COSTA

THE MACRO INVESTOR

THE BITCOIN SURGE

A NEW ERA FOR MONEY OR A DANGEROUS BUBBLE?

"I am in favour of gold coins so that the individual will be involved, so one will realise when the slightest inflation takes place. The fact that the individual citizen can see when the situation changes is one of the most important checks of the Constitution against inflation."

- Ludwig von Mises,
"The Free Market and its Enemies: Pseudo-Science, Socialism, and Inflation"

In recent decades, governments and central banks have come under fierce criticism for the way they manage our most important commodity – money. Money is supposed to be a simple and neutral way of facilitating the financial interactions necessary in all our lives; but it has become somewhat of a burden, and has often been blamed for creating deep financial and economic crises. A few decades ago, central banks were detached from the government and given responsibility for monetary issues in an attempt to limit government deficits and to give proper stability to the monetary system. But such a step has not been sufficient. Although inflation has been contained for the best part of the last few decades, there's still a feeling that central banks' management of the money supply is at the root of the boom-bust economy we live in.

Some argue that we should readopt gold as money and return to a gold standard. The main argument behind this proposal is that gold keeps the money supply tight, limiting central bank actions and ultimately keeping inflation at bay. History proves this to be right, as any attempt to expand the money supply would just be met by conversion of paper money into gold, thus effectively limiting the capacity of governments to get into debt. Others argue that reintroducing gold as money is insufficient because the government would still have a monopoly and could change its rules at will, as it has done several times in the past.

The advocates of monetary independence argue for a truly competitive monetary system, under which the creation of new money is not in the hands of a single entity. The best answer to their demands was given in 2008 in the form of a nine-page proposal outlined by someone named Satoshi Nakamoto. The document proposes the creation of a peer-to-peer electronic cash payment system, which relies on the power of open source, competition, and a cheap blockchain technology, instead of any single monopolistic entity. In the following year a money-prototype in the form of a cryptocurrency was born and named bitcoin. The first 50 units of bitcoin were introduced in 2009 and the first purchase of a real good occurred in 2010, when a pizza was bought for 10,000 bitcoin. Back then, the cryptocurrency was worth around 5 cents of a US dollar.

From an initial game played by computer geeks, the bitcoin concept started spreading. In 2010, bitcoin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> **"AT TODAY'S PRICES, THE PIZZA BOUGHT WITH BITCOIN IN 2010 IS THE MOST EXPENSIVE ON RECORD, WORTH MORE THAN $40 MILLION."**

was given a boost when it began being traded on the Japanese exchange Mt. Gox, which – quite aside from its original goal of serving as a platform to exchange cards from the fantasy game "Magic: the Gathering Online" – was turned into the major exchange market for the cryptocurrency. Over time, bitcoin has evolved from a 5-cent geek game to a $4,000 asset with a market capitalisation above $68 billion. At today's prices, the pizza bought with bitcoin in 2010 is the most expensive on record, worth more than $40 million.

But if bitcoin seems like the most exciting revolution of recent times, its price behaviour sometimes seems more like a bubble than anything else. The creation of cryptocurrencies has been the biggest step in recent decades in the direction of adopting modern money and changing the course of future monetary policy. But while bitcoin is a cryptocurrency, it is not alone in the field, and should therefore not be construed as representative of the cryptocurrency technology as a whole. While no one wants to be left out of this new trend, bitcoin should be placed where it belongs, with its risks and virtues properly identified. The goal of the "Macro Investor" today is to disentangle the connections between bitcoin and real money, while at the same time raise some fundamental questions about the nascent cryptocurrencies that can help us to understand the future direction of money.

A brief history of money

Since the beginnings of civilization man has been searching for ways to help exchange goods and services in an effective way such that each individual does not have to produce every product he needs, but instead can specialise in what he can do well and exchange the excess output for other products on the market. The inconvenience of barter was replaced by a much more efficient monetary economy, based on commodity-currencies. But while the commodity-currency could solve the main challenge posed by the need for a double coincidence of wants to proceed with a trade, it was still far from being perfect. Some of the commodities used as money were perishable (beans, barley), some were indivisible (cattle) or not heterogeneous (gold, silver), and most of them were too volatile in terms of quantities available and relative prices.

Society evolved over time and gold and silver were seen as the commodities with the best characteristics to become money, but this time with the help of a monetary authority (e.g. the monarch), who was responsible for standardising the metal used in coins. Under what was known as metallism, gold and silver could be used either as currency or metal, and thus the face value of coins and the intrinsic value of the gold that was part of them would always be equal. Later, when a gold standard was adopted, the key principles were kept untouched but paper money was put in circulation to facilitate the trade. Nevertheless, this paper money was fully convertible into the gold that was kept safe in vaults.

Under the pure gold standard, if at some point a government tried to increase the paper money in circulation for the same gold it held in vaults, it would lead to mass conversion of the debased paper for gold, as individuals would soon perceive the change in value. In technical terms, an attempt to increase the money supply would be ineffective, which means the government could not raise money at will to finance its expenses.

Unsurprisingly, it was not long before full convertibility was abandoned and convertible paper money replaced by fiat money, which no longer had any convertibility or intrinsic value. Under the new standard, governments could increase the money supply at will and finance all their expenses, with the population bearing the cost in the form of inflation.

Since the Great Depression of 1929, many theories have been advanced against paper money. With no intrinsic value and no convertibility, paper money could be issued by the Federal Reserve and other central banks around the world at will. The consequence is the creation of credit out of thin air instead of being the result

of savings. For credit to find its way towards the economy, interest rates needed to be pushed lower, resulting in suboptimal investment decisions. Too much credit leads to too much investment, unsustainable economic growth, and ultimately, financial crashes and economic havoc. Then comes the central bank again, expanding the money supply and planting the seeds of the next crash. In summary, paper money without intrinsic value just guides the economy from boom to bust, in a never-ending closed circular movement. This is the main reason why some people have been so enthusiastic about new forms of money. In truth, we need them.

What is money?

For the government, money is anything that has been proclaimed legal tender; for the population, money is anything that is generally accepted as a medium of exchange. There are many episodes in history when the population refused to accept payments in legal tender, in particular during periods of runaway inflation.

> **"THIS IS THE MAIN REASON WHY SOME PEOPLE HAVE BEEN SO ENTHUSIASTIC ABOUT NEW FORMS OF MONEY. IN TRUTH, WE NEED THEM."**

To be considered as money, an asset doesn't have to be tangible, but it needs to play three important roles or functions. It must serve as:

- **Medium of exchange.** This is the most important function. Money should facilitate transactions in the economy to overcome the problems associated with barter. When people are willing to accept some asset in exchange, there is no longer the need to be seller and buyer at the same time, and thus no longer the need for a double coincidence of wants, which was the main obstacle to trade. For this to be possible, the chosen asset needs to possess some characteristics, like being durable, divisible, hard to counterfeit, highly desirable, stable, and possess a high value-to-weight ratio.

- **Store of value.** This is also highly important because people don't spend everything at once. A part of their money is kept safe for future purchases. They then expect the asset to retain its purchasing power over time. This function is not exclusive of money though, as real estate, physical gold, equities, land, collectibles, along with many other assets, may be used as a store of value as well. The main threat is inflation, which is a general rise in the price of goods and services in money terms. If inflation is high, savings decline in real value and people will seek out alternative ways of storing value. On the other hand, deflation is also a threat to this function, because if the value of money increases too rapidly, no one will want to use it as a medium of exchange but rather prefer to hoard it and eventually use something else for payments. Thus, in summary, stability is the result of no inflation and no deflation.

- **Unit of account.** The third function requires the value of all assets to be expressed in terms of the asset chosen as money. Money should serve as a statistical yardstick against which everything else is priced. In the UK, the price of a coffee, corporate profits, government expenses, family debts, and everything else is expressed in pounds. The pound is therefore the unit of account.

Ultimately, money appears in very liquid forms because it should be easily traded for other assets. It usually includes physical money – cash – expressed in the form of coins and banknotes, and demand deposits, which can be accessed digitally or converted into cash.

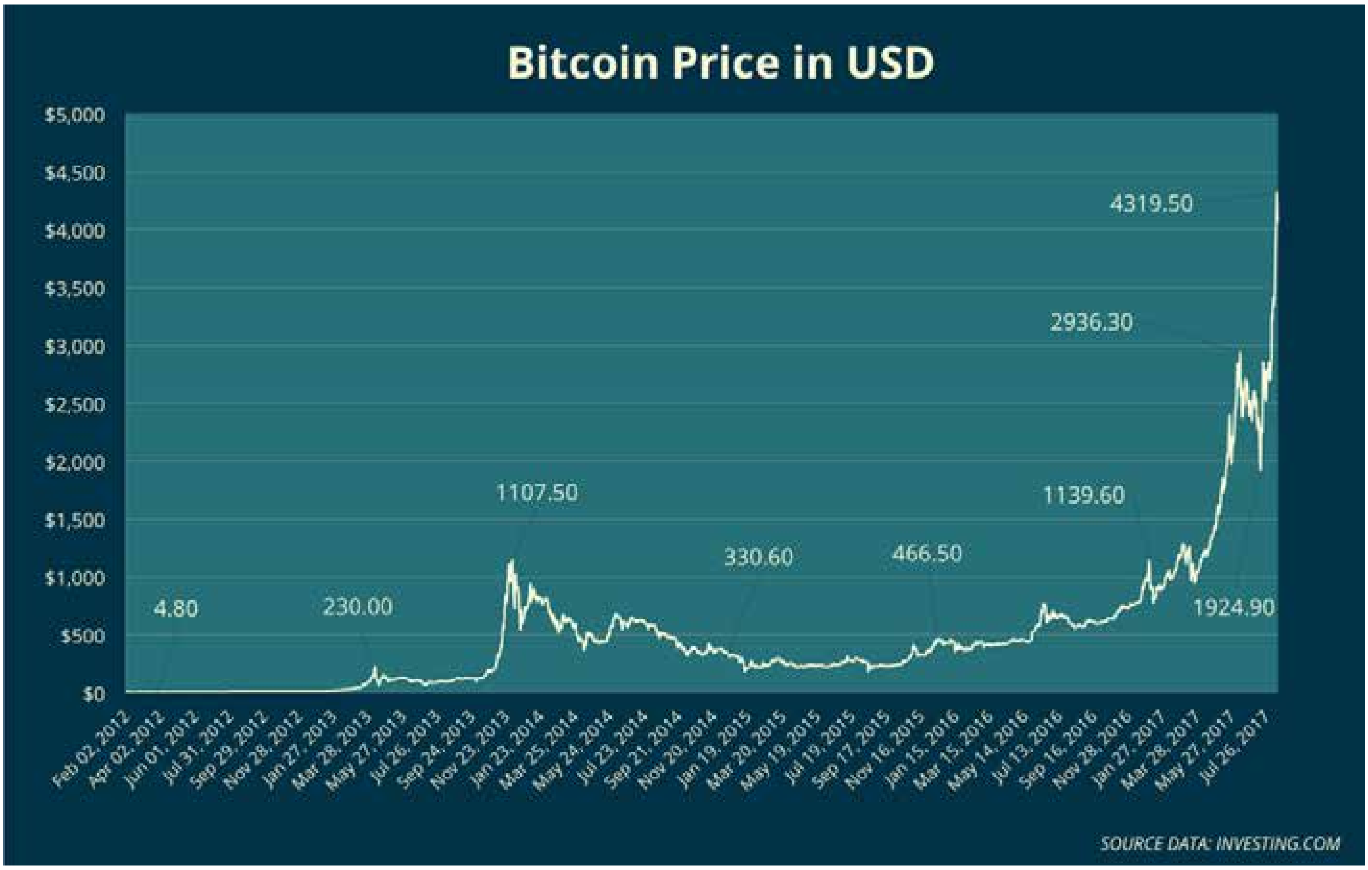
How bitcoin fits the functions of money?

With the three functions of money depicted above in mind, my goal now is to check how bitcoin fits in, to assess whether it can be considered as money or just as a tradeable asset.

Modern money, be it sterling, dollars, or euros, is 90% intangible. Only 10% of what is known as M1 (money in a strict sense) presents itself in the physical form of cash, because it is much easier to process payments using electronic means. On this front, bitcoin certainly stands out due to its intangibility. Bitcoin uses blockchain technology, which doesn't require financial intermediation to verify and approve transactions. Everything is recorded in a public ledger that is constantly verified by all participants in the network. In the progressive dematerialisation of money we have witnessed of late, bitcoin occupies the top of the chain.

But, as I mentioned above, the most important feature of money is its generalised acceptance by the population. On this front, bitcoin is well behind, as consumer transactions currently being conducted using bitcoin are negligible. Most of the time, if a consumer wants to purchase something using bitcoin it is necessary to first exchange bitcoin for the local currency before proceeding with the purchase. That makes the dollar and the pound mediums of exchange and bitcoin a store of value.

In terms of being a store of value, it is expected that the asset keeps its purchasing power over time, which means being stable. The relatively short track record of bitcoin shows an erratic climb full of ups and downs. Bitcoin was worth 5c on its first trade, before rising to around $5 in April 2012, and to an impressive $230 in April 2013. By November 2013, it hit $1,107. During 2014 and 2015, bitcoin's fate was less rosy, as its price was dragged down to hit $330 in November 2015. Bullish sentiment then returned and bitcoin rose to almost $3,000 in June 2017 and to $4,300 in August 2017. But, between these two very high price points, bitcoin crashed to $1,924 during July. That's a lot of action for a three-month period.



If we compare the volatility of bitcoin with the volatility of the euro and gold (evaluated in dollar terms), there is little doubt that bitcoin is a high-risk asset. While gold is more volatile than the euro, it is still several times less volatile than bitcoin. This evidence undermines the store of value function bitcoin should have if it is to claim currency status. An additional point of weakness regarding bitcoin stems from its lack of correlation with safe assets. A significant positive correlation of bitcoin with gold, the Japanese yen, and even the US dollar would be expected, but observation shows a correlation near zero. This puts bitcoin in a different asset class.

Regarding the third function of money, what we know is that retailers don't set their prices in bitcoin. At best they set the price in dollars or pounds and then convert this into bitcoin. The primary price is never set in bitcoin.

For now at least, bitcoin does not exhibit the three characteristics of money and thus can hardly be considered as money. It doesn't mean it doesn't carry its own merits; it just means it still isn't in a position to become a viable alternative to traditional money.

Demystifying a few fallacies

Some advocates and enthusiasts of bitcoin defend the idea that it is better than gold because gold is more difficult to use in transactions than something intangible like bitcoin. Of course, it would be possible to keep gold in vaults and issue paper money with full convertibility, which could also take the form of a digital currency, thereby solving that weakness. Advocates of open-source money would say that there is risk in such a setting because the system would depend on some third party. But third-party risk is something bitcoin is not isolated from, because the exchanges where bitcoin is traded are exposed to their own risk of failure and to security issues. This risk appears to be serious. Proof of this shortcoming can be found in the disappearance of 750,000 bitcoin from Mt. Gox in 2014 and the subsequent bankruptcy of the exchange.

Still, even if we accept the argument that bitcoin is not exposed to third-party risk, and therefore superior to any gold standard, one big weakness would still remain. Unlike gold, bitcoin is not truly unique. We can't replicate gold, but bitcoin is just one of an infinite number of cryptocurrencies that can appear and disappear overnight.

A search at coinmarketcap for digital currencies throws up 850 results. bitcoin is currently the digital currency with the highest market capitalisation, but there is also Ethreum, Ripple, bitcoin Cash (a split of the original bitcoin), Iota, Nem, and 844 others. If, at some point, this game becomes seri-

DAILY VOLATILITY AGAISNT USD (%)

Year	Bitcoin	Euro	Gold
2013	7.00	0.48	1.28
2014	3.92	0.37	0.79
2015	3.99	0.77	0.81
2016	2.57	0.55	0.97
2017	4.63	0.46	0.68

Source: FRED, Yahoo Finance

ous, what would prevent the government from launching its own cryptocurrency? Amazon could also launch a cryptocurrency and use its vast network of users and clients to make it generally accepted. Even if the idea of adopting a cryptocurrency as money is excellent, the infrastructure behind it is too vulnerable. The supply of money is relatively stable within bitcoin but virtually unlimited within the cryptocurrency world. And even within the bitcoin world, supply is just artificially limited, not physically limited as is the case with gold.

The above leads us to another big issue relating to bitcoin's design. One of the main concerns expressed by Milton Friedman and Anna Schwartz when they conducted a study on the monetary history of the United States was related to the exact design that should be given to money and monetary policy. Friedman was always a proponent of a liberal society with less government while being a ferocious critic of the Federal Reserve, but he was not an advocate of gold and – we can conjecture – much less of bitcoin. For Friedman, it is not desirable to have a limited money supply because that would generate deflation over time, and with it, recession and depression.

In a world where the money supply is limited and economic growth is positive, workers would need to accept a decrease in their nominal wages each year – otherwise their real wages would increase and dent business investment, and ultimately lead to unemployment and economic recession. The supply of bitcoin is expected to increase at a decreasing rate until hitting a limit of 21 million in 2140. A good cryptocurrency should be designed to allow its supply to grow over time at the same rate that the economy grows in the long term, to keep its function as store of value intact. While Friedman is sometimes quoted as being well disposed to some forms of digital money, he would have been unlikely to have lent his support to the current bitcoin design.

Apart from all the key issues, there remain a few other minor problems to solve. One of them is the high value bitcoin carries against common goods and services. At current valuations, one cup of coffee costs BTC 0.0005, a bottle

10

TOP 10 DIGITAL CURRENCIES

1 **BITCOIN**
MARKET CAP: $68,029,191,000
Price: $4,120.640

2 **ETHEREUM**
MARKET CAP: $27,250,671,326
Price: $289.800

3 **RIPPLE**
MARKET CAP: $5,923,548,413
Price: $0.154

4 **BITCOIN CASH**
MARKET CAP: $4,846,578,172
Price: $293.850

5 **IOTA**
MARKET CAP: $2,570,128,810
Price: $0.925

6 **NEM**
MARKET CAP: $2,415,069,000
Price: $0.268

7 **NEO**
MARKET CAP: 2,280,425,000
Price: $45.610

8 **LITECOIN**
MARKET CAP: $2,255,766,021
Price: $42.990

9 **DASH**
MARKET CAP: $1,634,108,634
Price: $218.030

10 **ETHEREUM CLASSIC**
MARKET CAP: $1,283,517,823
Price: $13.570

Source: coinmarketcap.com

"A LOT OF PRICE ACTION AND A LOW CORRELATION WITH OTHER ASSETS MAKE IT AN INTERESTING TARGET."

of water costs BTC 0.0003 and a meal at a restaurant costs BTC 0.00875. This requires merchants to quote prices of common retail goods out to four or five digits, which is a situation that doesn't line up with ordinary consumer reference points and makes it difficult for the adoption of bitcoin as a unit of account. A split to sub-units like milli-bitcoins or micro-bitcoins would solve the problem though.

Another weakness stems from the fact that, in contrast with almost every other financial asset, bitcoin violates the law of one price. An asset should trade at the same price everywhere, which is clearly not the case with bitcoin. Prices may diverge by up to 7% among exchanges.

Bitcoin as a speculative asset

Failing as money, bitcoin better fits the speculative asset class definition. To trade it, investors can use bitcoin exchanges or trade an investment vehicle that allows indirect exposure. In many instances, the best way to get exposure to some markets is through an investment vehicle that invests in the asset or that replicates its performance. Gold is an example of this. Not everyone wants to own and keep gold at home, and therefore buying an ETF that invests in gold is often the best option. But, in the case of bitcoin, there are no ETFs investing in the asset. While the SEC received some ETF proposals, it opted to reject them out of concern for the lack of regulation of bitcoin. In the near future the situation may change, but for now there is only one single alternative to direct exposure, which is provided by **Grayscale Bitcoin Investment Trust (OTCMKTS:GBTC)**.

The Grayscale trust holds bitcoin but suffers from some severe problems. while an ETF usually trades at a market price that is close to its net asset value, that's not the case with this trust. Currently, the trust has a market price per share of $685.01 and net asset value per share of $384.84, which converts to a price-to-NAV ratio of 1.78x. If the fund were to be dismantled today and its assets sold in the market, investors would immediately lose 44% in the trade.

The premium to net asset value has been fluctuating from 0% to 180%, which means investors are highly exposed to losses if buying at these prices. If the SEC approves an ETF on bitcoin, the premium of this fund is likely to fall to zero, leading to huge losses for investors. Investors wishing to get exposure to bitcoin should avoid this fund and instead buy bitcoin directly from an exchange. Actually, if it wasn't for the fact that short positions can't be opened on this fund, it would be an epic short.

A few final words

The development of the blockchain technology, allowing for the introduction of cryptocurrencies and new, more effective, forms of money, is one of the most prominent advances in monetary economics. It opens the door for the creation of a truly independent and competitive monetary system, which would be able to put an end to unlimited credit creation and the resulting boom-bust economy. But while the technology represents a huge advance with a promising future, bitcoin itself lacks many of the features effective money requires. Additionally, its tight supply loses some of its appeal when we add up the 849 other alternative cryptocurrencies. The lack of a hard asset behind it, the security vulnerabilities it has been exposed to, and its less than optimal design make bitcoin exposed to a highly volatile price journey which is much more suited to speculation than as a medium of exchange or store of wealth. But in the investment world a lot of price action and a low correlation with other assets make it an interesting target. Still, even in this field, there is much to be done. We need ETFs, futures, options, and one organised exchange.

About Filipe R. Costa

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 teaches courses on Financial Markets and Monetary Economics at the University of Oporto Faculty of Economics, helping traders maximise profits and better manage risk.

BY RICHARD GILL, CFA

FROM ACORNS TO OAK TREES

WHY BIG BRANDS CAN EQUAL BIG RETURNS

Developing a successful brand, or indeed a range of successful brands, is a key corporate goal for many businesses. Not only can a good quality brand deliver high margins and consistent cashflow, it can also help a company to create a valuable "economic moat". This refers to the ability of a business to maintain a competitive advantage over time, protect long-term profits and stop rivals from taking market share. As long as the moat doesn't eventually dry up, companies that have pricing power through their brand names can prove to be good quality investments for the long term.

The ultimate sign of a successful brand is when consumers are willing to pay a premium price for a product over an otherwise identical alternative. Take paracetamol for example. A generic pack of 16 supermarket own brand tablets, presented in uninspiring packaging, can be picked up for as low as 19p. But, despite containing pretty much exactly the same ingredients, a colourful packet of well marketed Panadol pills can cost up to £2, around 10 times more than the generic version.

Because of this powerful effect it's no wonder that investors, both amateur and professional, are attracted to companies with a variety of strong branded products.

Warren Buffett is famously a fan of buying and holding stakes in companies with a range of well known brands. Discussing the concept of the economic moat, in his 2007 letter to Berkshire Hathaway shareholders he commented, *"...a formidable barrier such as a company being the low cost producer (GEICO, Costco) or possessing a powerful world-wide brand (Coca-Cola, Gillette, American Express) is essential for sustained success."*

In the UK too, a number of popular fund managers have a penchant for brand based investing. Nick Train's Lindsell Train UK Equity fund (which has risen by 273% since launch in July 2006) is well-known for investing in consumer brands, some of its top holdings being drinks giant Diageo, conglomerate Unilever and Dutch brewer Heineken. Terry Smith's Fundsmith Equity Fund (up 240% since launch in November 2010) has a US bias with holdings including the likes of Microsoft, PayPal and tobacco company Philip Morris.

But there's no need to focus solely on blue-chip stocks when looking to implement a brand-based investment strategy. Here follows three small/mid cap companies which I believe have strong brands and currently provide good long-term opportunities for investors.

Nichols

Perhaps one of the best examples seen in recent times of how to build up a successful brand comes from AIM listed tonic and ginger ale seller **Fevertree Drinks (LON:FEVR)**. With a niche focus on the high-end of the mixers market, having a quality product and a good story behind the business to use in its marketing, Fevertree has come from nowhere to become a leading global name within just over a decade. But with the shares currently trading on an eye-watering multiple of 86 times forecast earnings for this year it is to another drinks company I turn.

With a history going back to 1908, when founder John Noel Nichols created flagship brand Vimto, **Nichols (LON:NICL)** has grown into a leading seller and exporter of a range of still and fizzy soft drinks. Vimto,

"WARREN BUFFETT IS FAMOUSLY A FAN OF BUYING AND HOLDING STAKES IN COMPANIES WITH A RANGE OF WELL KNOWN BRANDS."

Bloomicon / Shutterstock.com

whose name is a portmanteau of "vim" (meaning vitality) and "tonic", is a purple still or carbonated fruit based drink which today remains the company's flagship brand. Reflecting a key strength of a good brand name, Vimto has had its name applied a number of different products outside its core area of drinks, including chew bars, lollipops, candy spray and even a board game, with a special edition of Cluedo being commissioned to celebrate the brand's 100th anniversary.

Other brands in the Nichols' portfolio include **Feel Good Drinks**, a range of adult premium and health soft drinks; **Starslush**, a variety of frozen drinks sold in the UK; **Panda**, a range of flavoured water and still drinks aimed at mums and kids; **Sunkist**, a licensed-in brand of citrus based drinks; and **Levi Roots**, a selection of tropical carbonated soft drinks featuring the face of the popular entrepreneur and reggae musician.

While the UK remains Nichols' key market the firm has a long history of successfully exporting to international markets. Following its first overseas sale to Guyana in 1919 Nichols now sells its wares to 85 countries worldwide, having a particular following in certain Middle East and African markets. The brands, and Vimto especially, are often promoted with humorous advertising, including by colourful mascot, the Vimtoad (right).

More fizz than flat

Nichols' solid portfolio of brands, along with a strategy focussed on expansion in the UK and overseas, has allowed the company to grow significantly over the past ten years. From 2006 to 2016 Nichols' revenues grew from £51.5 million to £117.3 million (a CAGR of 8.6%), with pre-tax profits up from £7.2 million to £30.4 million (CAGR of 15.5%). Over that time the dividend has been more than trebled, from 9.25p to 29.3p per share.

Results for the six months to June 2016 showed further growth, with revenues up by 12.4% at £63.5 million. In the core UK market sales grew by 6.7% (well ahead of the 2.9% growth seen the wider UK soft drinks market), with sales of Vimto up by an impressive 10%. Overseas revenues grew by 33.5% to £16 million. At the bottom line pre-tax profits were up by a more modest 6.8% at £12.7 million as higher input costs had to be contended with.

On the balance sheet, net cash stood at £29.3 million at the period end, boosted by a £7 million cash inflow from operations – the cash flow performance was behind profits and lower than the previous year mainly due to changes in working capital. Nevertheless, as a result of the good performance Nichols increased the interim dividend by 12.2%. While the company flagged that market conditions will remain challenging in the second half, it is confident of meeting full-year expectations.

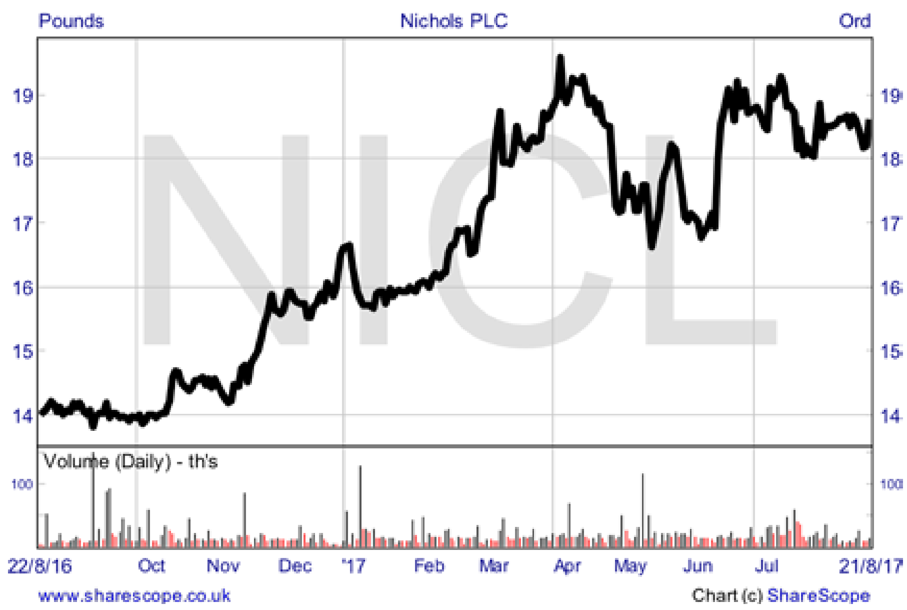
"Pop" the shares in your portfolio

Having first listed on the now defunct Manchester Stock Exchange in 1961, Nichols had a stint on the Official List of the LSE before moving to AIM in June 2004. Investors have been raising their glasses of Vimto in celebration, as since moving to the junior market shares in Nichols have risen by a juicy 1,285%. Currently capitalised at £673 million the company is the 23rd largest on AIM.

For the full 2017 financial year the markets are looking for Nichols to post earnings of around 71p per share. That values the company on a multiple of 26 times earnings – a premium price for a premium business. While that valuation looks high, it should be put in the context of Nichols' track record of growth, strong balance sheet and consistent record of outperforming the wider UK soft drinks market.

Dividend hunters were rewarded with a payment of 29.3p per share in the last financial year, which at the current share price of 1,853p equates to a modest yield of 1.58%. The policy has been progressive with earnings over the past five years, with the payment up by a CAGR of 15% over that time and covered a solid 2.3 times by earnings in 2016.

"SINCE MOVING TO THE JUNIOR MARKET SHARES IN NICHOLS HAVE RISEN BY A JUICY 1,285%."



Domino's Pizza

Another way that good brands can exploit their success is via a franchise model, in other words getting other people to pay fees to use the name of the brand in order to launch their own business. One of the most successful franchise operators of all time is **Domino's Pizza Group (LON:DOM)**, which since listing in London in late 1999 has grown to become worth £1.32 billion and a constituent of the mid-cap FTSE 250 Index.

Having been granted the Domino's Pizza Master Franchise Agreement for the UK and Republic of Ireland (ROI) in 1993, Domino's had a total of 1,037 stores in the two countries as at 25th June this year. As well as holding the exclusive master franchise for Switzerland, Liechtenstein and Luxembourg, it owns a strategic stake in the largest pizza delivery business in Germany, a controlling interest in the holders of the Domino's master franchises in Iceland, Norway and Sweden, along with a minority stake in Domino's Germany.

While having a few corporately owned stores the majority of Domino's income comes from the franchise based model. An initial fee is charged to franchisees when they set up their business and then an ongoing royalty is charged based on store sales. Equipment is also sold to franchisees, as are ingredients, which come mainly from a central commissary in Milton Keynes. A modest amount of income comes from rent charged on property and from finance leases.

The key brand proposition is that Domino's provides (and delivers) a consistently high quality pizza product, made on site at its stores with fresh ingredients. Boosting the success of the brand is the company's focus on advertising, with the firm's National Advertising Fund taking around 5% of retail sales from each store to spend on marketing. The past few years have seen a number of successful TV campaigns, including sponsorship of singing competitions the X Factor and The Voice, along with an increasing focus on digital channels.

“ANOTHER WAY THAT GOOD BRANDS CAN EXPLOIT THEIR SUCCESS IS VIA A FRANCHISE MODEL.”

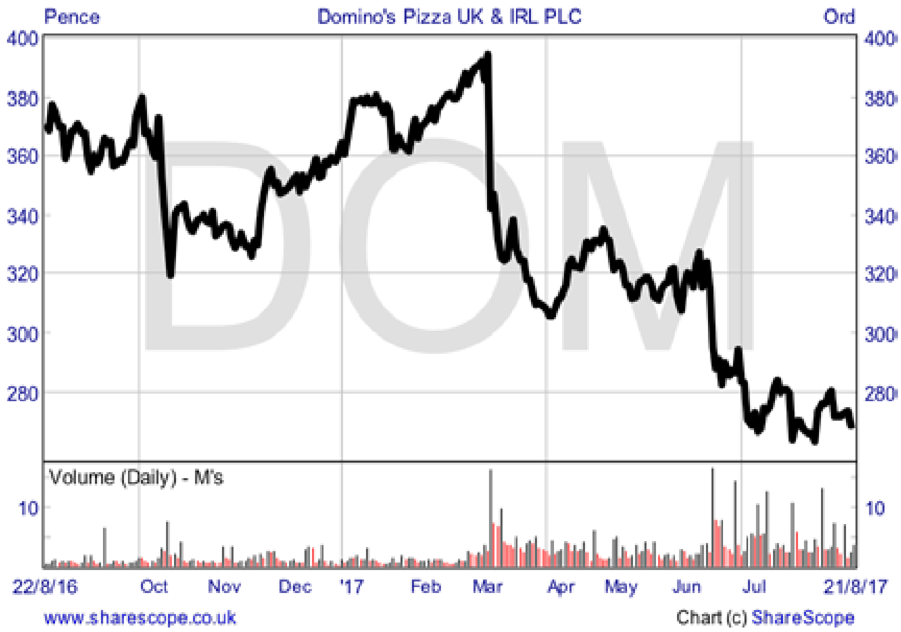
Growing like well kneaded dough

As a global franchisee, Domino's global vision is to be the number one pizza company in the world, as well as in every neighbourhood. To that effect, the UK listed Domino's has grown total store numbers from 190 at IPO in December 1999 to the current four-figure level. In November last year the company upped its long-term growth target and is now looking to have 1,600 stores open for business in the UK in the coming years. Outside the UK, the company has identified opportunities for a total of 400 stores, excluding the German JV.

The huge rise in store numbers has seen Domino's grow revenues from £20.7 million in 1998 to £360.6 million in 2016 – that's a compound annual growth rate of 17.2%. Reflecting the strong operational gearing inherent in the business model, pre-tax profits grew from £1.47 million to £85.7 million over the same period – a CAGR of 25.3%. Investors who bought the shares at the all time low of 3.49p in early 2001 (adjusted for a recent 3 for 1 share split) are currently standing on gains of almost 7,500% and have seen annual dividends increase from 0.27p to 8p per share over that time.

The most recent financial results – for the 26 weeks to 25th June 2017 – showed no sign of top line growth slowing down, with revenues up by 19.8% at £211.3 million. This was driven by an 11.5% surge in online sales, along with a range of new products including Meltin' Meatballs, Cinni Dippers and the bizarre Lotta-Chocca chocolate pizza, which to me sounds even less appetising than ham and pineapple!

Domino's



Underlying pre-tax profits for the period were up by a more modest 9.1% at £44.6 million as a result of higher distribution and administrative expenses. A record 40 new stores were opened in the UK in the period and to support the expansion to 1,600 a new £38 million supply chain in Warrington is being built and expected to open in Q1 2018.

Make some dough

Following their excellent long-term performance, shares in Domino's have had a torrid 2017, falling by around 26% in the year to date to the current 268.5p. The selling started to be seen in early March following the release of the 2016 finals, with investors concerned about slowing growth in UK like-for-like sales, along with increasing competition from the likes of **Just Eat (LON:JE.)** and other technology-driven fast food delivery firms.

At the current share price Domino's trades on an earnings multiple of 18.8 times consensus market forecasts for the current financial year. That seems good value to me for a business which has grown annual profits by around 25% for the last two decades and has further growth opportunities at home and overseas. Domino's remains the leader in the UK pizza market and with it planning to increase the store network by around 60% from current levels it looks set to deliver significant sales growth, combined with increased profits from further economies of scale.

Some investors may be concerned by the rising levels of net debt - £61 million as at 25th June, up from £34.6 million over six months due to the recent infrastructure investment. But with interest payments covered almost 70 times by operating profits in the first half, the position looks comfortable enough. There is also a reasonable dividend on offer, with the shares currently yielding just under 3% on a historic basis.

HOTEL CHOCOLAT

As reflected in the companies covered so far, good brands tend to be associated with consumer goods, especially food and other consumables. So what better way to finish than with dessert, and specialist chocolatier **Hotel Chocolat (LON:HOTC)**. The company is a relatively recent addition to AIM, having joined in May 2016 raising £9.5 million in order to advance its growth plans. Founded in 1993 and operating the Hotel Chocolat brand since 2003, the business is now a highly profitable, upmarket chocolate manufacturer and retailer.

Unlike other chocolate makers, Hotel Chocolat does not sell its products to supermarkets or other retail outlets, thus preserving the luxury nature of the brand. Its main sales channels are c.100 retail stores which are mostly located in the UK, with a handful in Copenhagen, Denmark. A number of stores have on-site cafes, with sales also made through a growing online operation, the subscription based "Tasting Club" and a small wholesale and corporate gift operation. In addition, Hotel Chocolat owns a cocoa plantation in Saint Lucia in the Caribbean which provides the core ingre-

“ GOOD BRANDS TEND TO BE ASSOCIATED WITH CONSUMER GOODS, ESPECIALLY FOOD AND OTHER CONSUMABLES.”

HOTEL
Chocolat.
BRITISH
COCOA GROWER & CHOCOLATIER

dient for the firm's super premium "Rabot 1745" range. Most products are manufactured at a dedicated facility near Cambridge, with another facility nearby providing distribution.

The Hotel Chocolat brand is positioned as a premium chocolate offering, providing a differentiated, cocoa-rich product which is an affordable luxury for consumers. The brand has the three core values of being original, authentic and ethical. Confirming its recognition amongst consumers, a 2015 survey of 2,800 nationally representative consumers carried out by food consultancy Allegra Strategies confirmed Hotel Chocolat as the 'nation's favourite premium chocolate brand'.

Choc full of cash

Hotel Chocolat's maiden annual results as a public company impressed the markets, reporting revenues up by 12% at £91.1 million for the year to 26th June 2016, with pre-tax profits surging by 181% to £8.2 million. Since then, interims for the 26 weeks ended 25th December 2016 showed sales up by a consistent 12% to £62.5 million and pre-tax profits up by 28% at £11.2 million.

Operational highlights of the first half included 23% year-on-year growth from the website, ten stores now having the Shop+Cafe format and capital investments in the factory increasing manufacturing capacity by 20%. Notable was the company's strong balance sheet, which at the period end showed net cash of £16.2 million. Hotel Chocolat is a very cash generative business, with a £22.1 million net inflow from operations in the first half, although this was boosted by a £10.8 million increase in trade and other payables – in other words, lengthening the time taken to pay bills.

A further trading update in mid-July revealed that revenues for the 53 weeks to 2nd July 2017 were £105 million. On a comparable basis, sales for the 52 weeks ended 25th June were £104 million (again up by 12%). A total of 12 new stores were opened during the year, with eight featuring the cafe format, which is said to be working well. In addition, a new website launched in early 2017 offering an improved experience on tablets and smartphones, with trading since the year end said to be in line with management expectations.

A sweet treat for your portfolio?

Currently trading at 292p shares in Hotel Chocolate are up by 97% since IPO but down on highs of 390p seen just three months ago. With no company-specific bad news having been announced since then, I put this largely down to profit taking. But even though the shares have fallen they remain, like the company's chocolate, highly valued.

The consensus market forecast is for earnings of around 8.4p for the current year to June 2018, putting the shares on a chunky multiple of 35 times – 33 times if we strip out the cash. Analysts at house broker Liberum see further to go however, having recently set a 340p target price implying 16% upside from the current price. While no dividend has yet been announced, the plan is for a maiden final dividend to be paid for the year just ended.

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.

BY SAMUEL RAE

FORENSIC FOREX

PLAYING THE TRUMP DUMP

The currency markets can be tough. With so many different inputs feeding into market sentiment and such a varying degree of sentiment driving buy and sell decisions, even the most carefully crafted fundamental analysis can seem futile.

At the end of 2017, subsequent to Donald Trump's election as US President, the US dollar surged to 14-year highs. Expectations that fiscal stimulus and business friendly tax reform would boost the economy sent the greenback surging and, against a backdrop of economic weaknesses in the majority of other global economies, the dollar looked a sure thing.

Around that time, I published my expectations for the currency against a basket of majors and my bias was firmly rooted in a continuation of the bullish trend. Fast forward ten months and things haven't quite worked out as expected.

Donald Trump's presidency, to date, has been littered with controversy and barely a week goes by without a revelation or policy update that adds to the mix. The US as an economy and, in turn, wider markets as a whole, are starting to shift their expectations of 'sure-thing' fiscal reform to questions over whether the Trump administration is going to be able to make some, or any, of its major campaign points a reality.

This isn't necessarily a failing of Donald Trump, of course. Sure, some of the more controversial inputs of the last six months are rooted in Trump comments, but the inability to push through things like healthcare reform or public works programmes is a failing of the party system more than it is rooted in the ability (or lack thereof) of an individual.

So this is a currency trading piece – why am I discussing US political problems here?

Dollar reversal

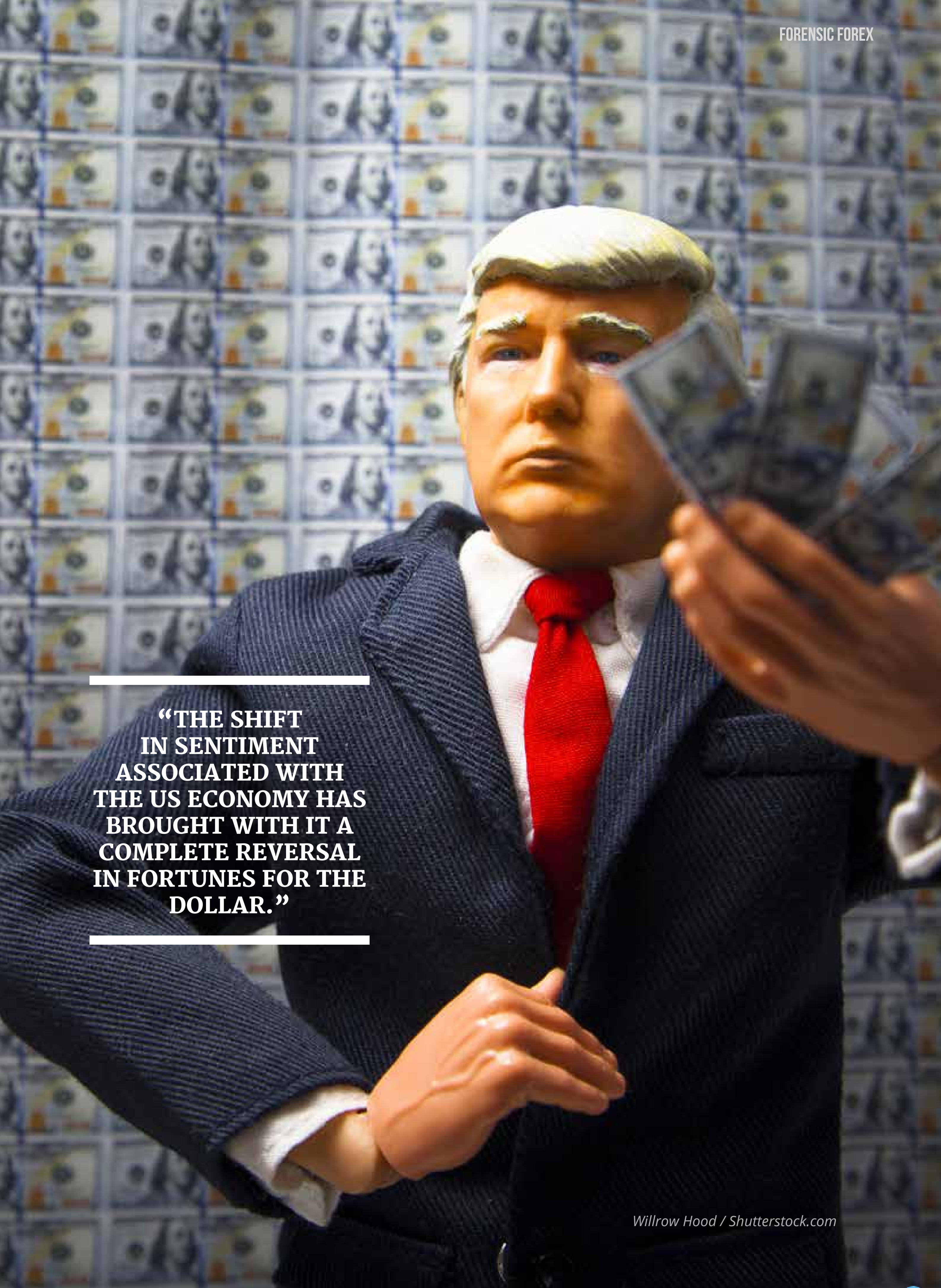
Well, because the shift in sentiment associated with the US economy has brought with it a complete reversal in fortunes for the dollar. The gains that took the currency to the aforementioned 14-year highs have now all but evaporated and the dollar is looking to be on the wrong end of a longer term trend against the majority of its major counterparts.

This has forced me to shift my bias and – in line with this shift – to alter my expectations for the remainder of 2017.

Specifically, I'm now looking for short opportunities in any major pair weighted against the USD. Readers familiar with my strategy will know that the root of my approach is risk management and my entries rely on traditional (and simple) candlestick patterns. This means that my fundamental bias (in this instance, my tendency towards a short USD entry) only has a limited impact on my operations. If I see a candlestick driven signal that highlights an entry against my bias, I'll still enter the trade. My fundamental analysis only comes into play from a risk management perspective.

Again, then, let's use the current USD situation as an example.

Take a look at the chart below. It's a daily USDJPY chart and it shows action dating back to early January.



"THE SHIFT IN SENTIMENT ASSOCIATED WITH THE US ECONOMY HAS BROUGHT WITH IT A COMPLETE REVERSAL IN FORTUNES FOR THE DOLLAR."

Willrow Hood / Shutterstock.com

"FUNDAMENTALLY, I FEEL THE US DOLLAR IS LIKELY TO WEAKEN OVER THE COMING MONTHS."

As illustrated, the yen has had a pretty volatile time against its US counterpart year to date, but the overarching trend (and I'm looking at the close highs in March, May and July to support this) is to the downside.

Price is currently trading in and around 108.73. This is just above a key level, both in terms of long-term support and psychological significance, at 108 flat. I'm flat in the USDJPY right now, but I'll be watching action around this level very closely in the hope of an entry signal. So what am I looking for and how will I play it?

So here's the trade...

The trade that is in line with my bias is a short entry on a break of the key level. If I see price break through 108 on the daily charts and we subsequently see a close of the candlestick below that level, I'll get in short toward a downside target of 106 flat. A stop loss on the position at 108.50 (which has served as a swing point this year) gives me a risk reward ratio of four to one (plenty of room for reward on the trade) and gives me a bit of wiggle room on a retest.

If we see a bounce from support (at 108) – and especially if the bounce gives us a pin bar on the daily chart – I'll be in long. On this position, a target of 109 and a stop at 107.50 works well. The first key thing to recognise here is that the more aggressive of the trades is the short entry, as this is in line with my expectations. I can leave a little more room for reward on this position because, fundamentally, I feel the US dollar is likely to weaken over the coming months.

The second is that I'm not averse to entering against my bias, but things have to stay a little tighter.

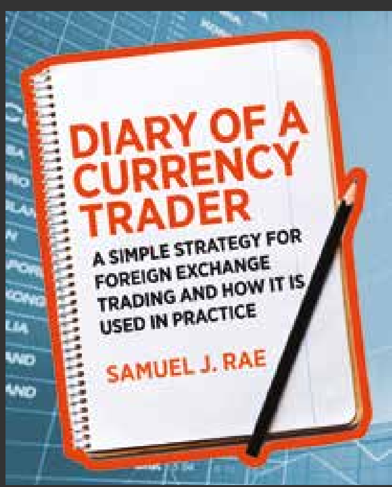
Let's see how things play out.

About Samuel

Having completed his Economics BSc Degree in Manchester, Samuel Rae quickly discovered that the retail Forex industry was for him. A short foray into the corporate world drove him to search for an alternative to the more traditional ways of making a living, and in becoming a retail trader he has achieved exactly that.

Through persistent market participation and extensive education he has grown to become a specialist in both fundamental and technical analysis.

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 *Diary of a Currency Trader*.

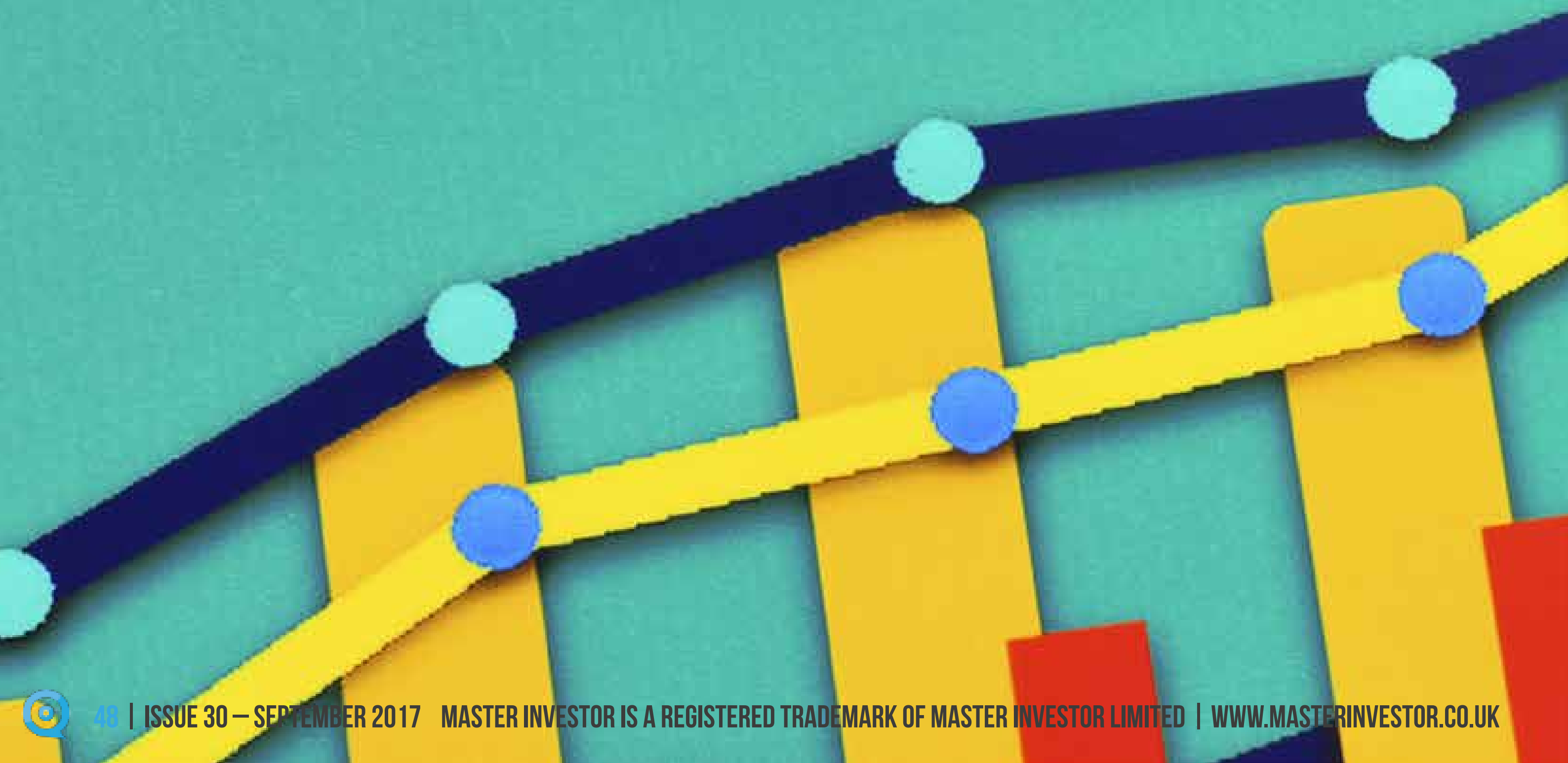


BY DAVID JONES

CHART NAVIGATOR

HOW TO USE THE MACD TO YOUR ADVANTAGE

One of the appeals – and drawbacks – to technical analysis for some are the many, many ways of analysing historical data on a chart. Before home computers and sophisticated investing software, many charts were either in paper format or on dedicated terminals, primarily used by City institutions. Now of course, you are only ever a couple of clicks away from constructing a chart bristling with indicators, candlesticks, moving averages and Fibonacci retracements.



The level of sophistication we have today would have been unthinkable to a new chartist like me back in the mid-1990s – but I think it comes with its own set of problems. I love the phrase "analysis paralysis" – where you have so many different techniques you are watching you can't actually decide whether you should be buying or selling. When even free software from brokers has multiple indicators, it is perhaps not too surprising that the novice chartist can quickly suffer from information overload.

So, is there a happy medium – a way of using a particular indicator to help with the decision as to whether to buy, sell or do nothing – and not end up with a price chart that looks like an impressionist painting? This time around we will take a look at a potential solution to this, and see where the MACD indicator could fit into an investing or trading strategy.

The MACD or, to give it the full title, the Moving Average Convergence Divergence indicator, is a popular approach for some. In a previous issue I talked about how moving averages have been used for many years to identify trends in markets – whether that is in shares, commodities or currencies. When the price crosses above the moving average this is a crude buy signal – and vice versa if the price falls below a moving average. A variation is to use two moving averages of the historical data – for example a 50 day and a 200 day. When the 50-day crosses above the 200 this is a buy signal – should it fall below then this is a sell signal. Whilst moving averages suffer from false signals in sideways moving markets, they often do very well when markets start to really trend.

MACD: A chartist's favourite

As its name suggests the MACD uses moving averages in its calculation – two moving averages to be precise, the 12-day and 26-day. What the MACD looks at first is how far apart these two moving averages are. This is then plotted and known as the "MACD Line". The next line for this indicator is what is referred to as the "Signal Line". This is simply a nine-day moving average of the MACD line. Lots of technical indicators use this approach – smoothing out a raw calculation to try to refine the signals and not be prone to too many signals in choppier markets. As usual, a picture speaks a thousand words

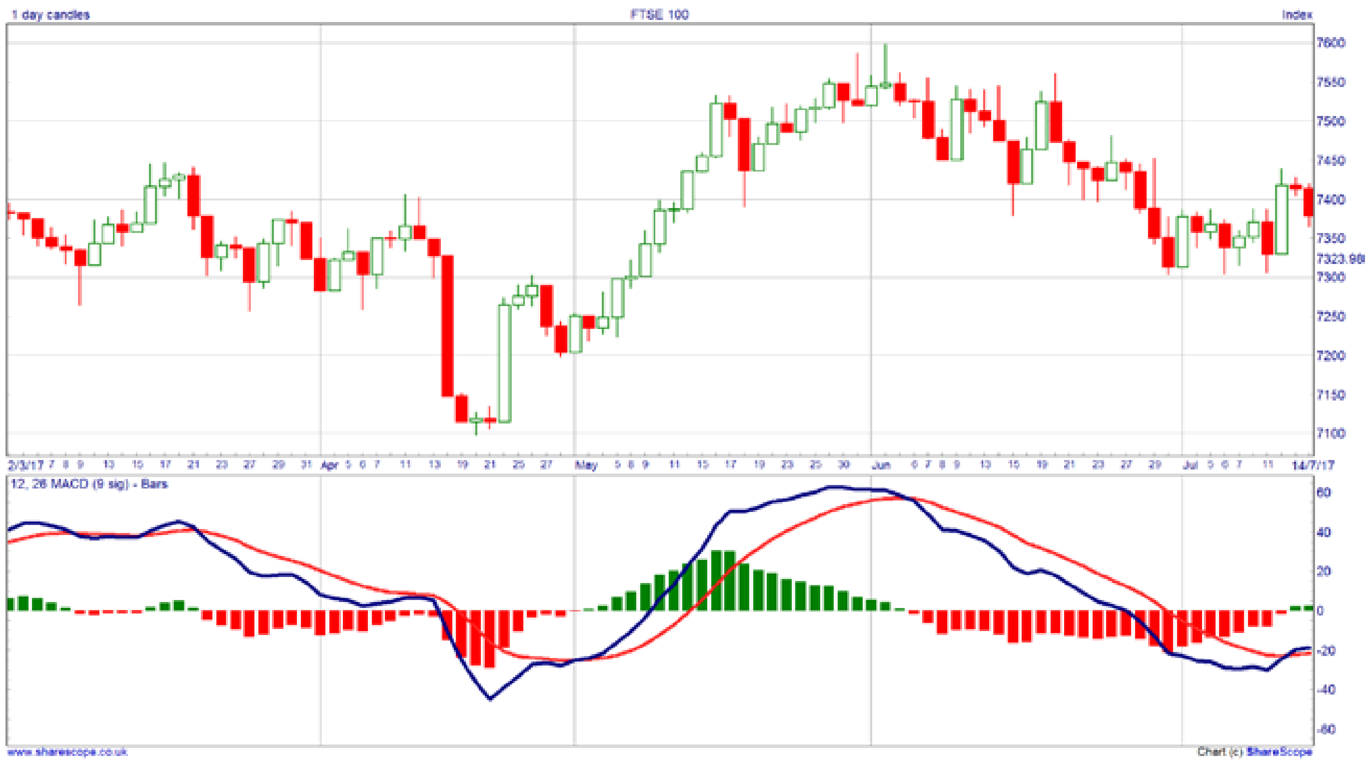
so here is the 12, 26, 9 MACD on the FTSE100 index.

The MACD is at the bottom of the chart. The blue line is our MACD Line – this is the difference between the 12 and 26-day moving averages. You should also notice the scale for the MACD. The centre line has a value of zero – when the blue line is above this it means the 12-day is above the 26-day moving average, suggesting the FTSE is in an uptrend. When the blue line is below then the 12 is below the 26-day indicating that price is in a downtrend.

The red line is the Signal Line – remember this is just a moving average of that blue MACD line. But for the MACD, when the blue line crosses above the red line that is considered to be a buy signal – the trend is turning up. And of course, vice versa when the blue line crosses below the red line. You can see from the chart that the signals generated at the beginning of May and June both worked well.

There is another component to the MACD that some may consider a little superfluous but let's show it anyway – it's the MACD histogram.

Isn't that pretty? We now look like proper chartists with lots of squiggly lines on our screen. I suppose the best way of describing the histogram is as a way of "second guessing" a signal is coming. As the two lines get closer to



"IF THERE IS AN OBVIOUS TREND IN PLACE, DON'T ASSUME THE MACD IS GOING TO CALL THE ABSOLUTE END OF THIS."

crossing, the histogram gets closer to the zero line, so can be used to anticipate a change in trend, before the two MACD flag it up.

Hopefully this all shows that the MACD is not that complicated an indicator, and tries to use the best bits of a simple trend following technique – a couple of moving averages – and then smooths these signals out to hopefully lead to more reliable outcomes. Let's look at some real-world examples.

GSK: A textbook example

This is the share price of FTSE100 pharmaceuticals company **GlaxoSmithKline (LON:GSK)**. The period shown is the end of February to the middle of August. Walking through the signals, the MACD seems to have done a pretty good job of calling the various swings for the share price. Starting off in March the MACD crossed over, giving a sell signal. The price took a little while to follow suit but did start to slide during April. The price bottomed out in late April and the MACD buy signal came in early May – you can see the histogram crossing the centre line, switching from red to green and signalling the crossover of the two lines.

Jumping forward to mid-June gives the next signal as the blue MACD line falls below the Signal line. Once again, the price stays stubborn for a couple of weeks but then turns lower. On the way down during July we almost get a buy signal as that histogram shows, but it never happens. The final signal on the chart happens in the last couple of days on the right-hand side as the two lines cross once more.

Whilst the GSK example above has turned out to be something of the textbook example, it would be remiss of me to leave it there! Nothing works all the time – let's see how the MACD would have fared on another FTSE100 company over the same period – this time

the mining business **Anglo-American (LON:AAL)**.

Anglo-American: You can't win 'em all

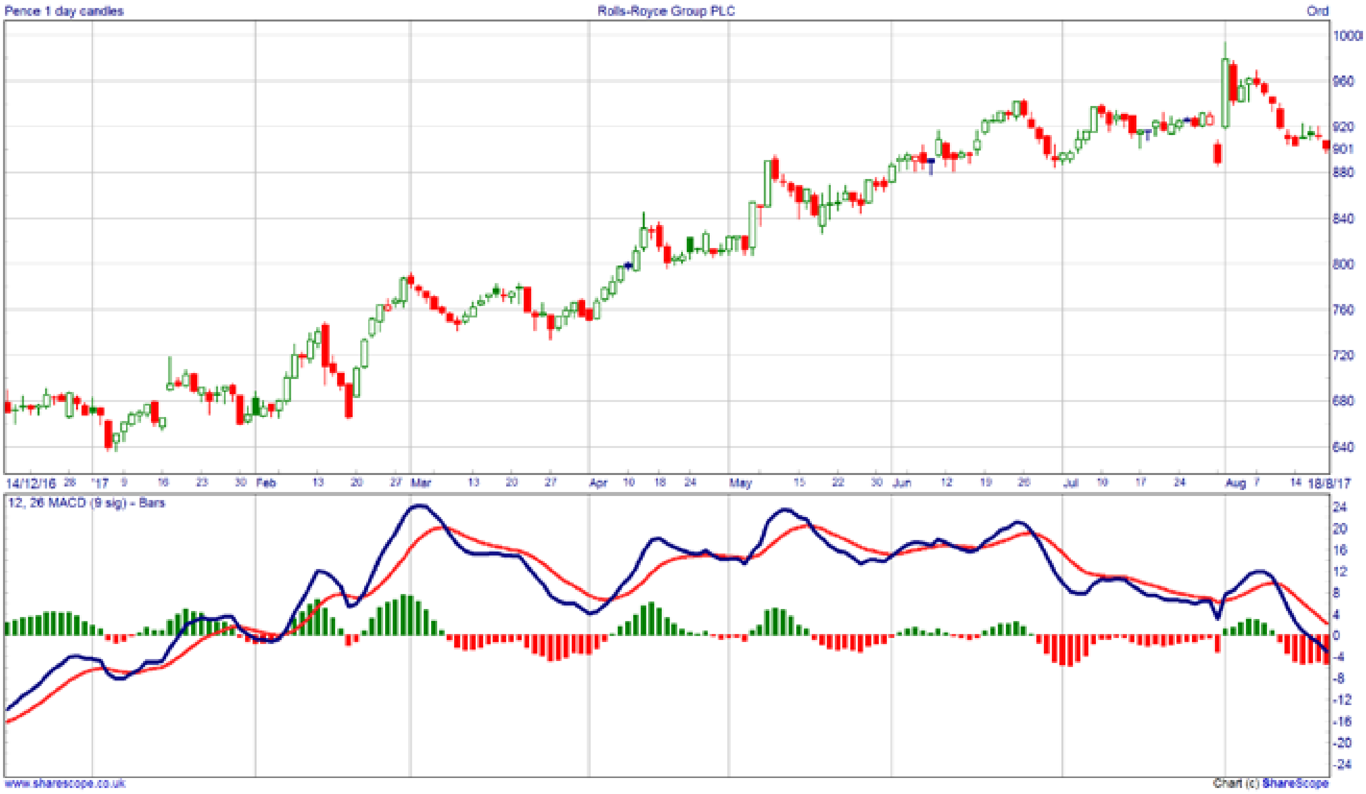
This has a much more mixed performance. There is a buy signal in March that proves relatively short-lived until the sell signal in early April. The MACD then gives a buy once more in early May but the Anglo-American share price struggles to rally by much before a sell signal comes along in June. This only lasts for a couple of weeks before a buy signal reverses it in late June – and this turns out to be a real winner, riding the share price up from the 1,050p area to 1,250p.

Even though some of these signals are mixed, the big winner at the end would have helped to mitigate the overall performance over the time frame shown. But it does show the importance of not following these sorts of signals blindly and hoping that everything works out profitably. The usual approach of having some sort of stop loss for the signal would be recommended. Also, if there is an obvious trend in place, don't assume the MACD is going to call the absolute end of this. If a share price has been in decline for a few years for example, it will take more than a MACD to change that! Perhaps taking the signals in the direction of the bigger trend is the more conservative approach here, leading us to the final example.

"THE TREND FOR MOST OF THIS YEAR HAS BEEN CLEAR TO SEE AND THE MACD HAS GENERATED PLENTY OF BUY SIGNALS."

Rolls-Royce: The trend is your friend

Of course, there are plenty of price charts that have exhibited strong trends in recent years as stock markets have pushed out to fresh-all time highs. But the one I have chosen is **Rolls-Royce (LON:RR.)**. The trend for most of this year has been clear to see and the MACD has generated plenty of buy signals. This is a classic trend following approach – if a market is mov-



ing higher then any weakness is used as an opportunity to jump on board the bigger move. In some instances, in the above chart, sell signals from the MACD only lasted a few days before the lines would hook north again, indicating a strong trend. In the face of a market move like this the sell signals would be ignored, until the market shows a clear change in trend.

Hopefully this all demonstrates that you do not need to have a plethora of different indicators if you want to add more objective analysis to your view of price charts. A relatively simple indicator like the MACD, based on traditional moving averages, can help you to possibly time a trend following system. Like all of these techniques, it is not perfect but coupled with a sensible risk management approach could still add something to your own investing style.

"WHILST MOVING AVERAGES SUFFER FROM FALSE SIGNALS IN SIDEWAYS MOVING MARKETS, THEY OFTEN DO VERY WELL WHEN MARKETS START TO REALLY TREND."

About David

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.

BY ALAN STEEL

DEATH & TAXES

3 STEPS TO AN EARLY RETIREMENT

I was recently interviewed about my life all the way back to when I was born. The goal was to find out anything that could have influenced my success as an independent financial advisor (IFA) helping thousands over the last forty odd years to aim for well-funded "want for nothing" retirements, early or otherwise.

When you come from a small industrial town where most folks just scrape by – and where your granny single-handedly brought up a family of seven in a house of two rooms lit only by gas mantles and with an outside toilet shared by neighbours – I reckon there was ample early motivation within me to "get on" in life. To be much better off. And to help others achieve as well.

Maybe that's why I read avidly at an early age about setting goals and visualising results. I remember it being said that to turn goals into reality you also need to turn bad habits into good ones – and keep these good habits constantly refreshed. Not easy! But that's probably why I got stuck in at my lessons at school, went to university and started my

"I WATCHED MY DAD WORK SEVEN DAYS A WEEK IN ALL WEATHER AS A BRICKLAYER UNTIL WELL INTO HIS SIXTIES: ENOUGH MOTIVATION TO MAKE ME STICK TO MY PLAN."

own business at the age of 28. And from then I committed to invest a quarter of my income in case the eggs in my business basket didn't hatch as expected.

My main initial goal was to be able to afford to retire early, perhaps at 55. I watched my dad work seven days a week in all weather as a bricklayer until well into his sixties: enough motivation to make me stick to my plan. It worked. I could have retired at 55 but didn't. But it's having the freedom to choose that surely matters. Ask those who have no choice.

So my "Mission Possible" this month is to suggest three steps to take if you'd like the possibility of early retirement. Despite my comments above I'm not sure I'm the right person to extol the virtues of early retirement, seeing as I'm 70 now and still "working". My Board suggested I work a TWAT week – Tuesday, Wednesday and Thursday. Mondays and Fridays are supposed to extend my weekend to do what I fancy.

So far, however, I've chosen to come to work. That's if you count reading, thinking, writing and having fun as work. (And it keeps me out of the Scottish rain.) So that's what I do for most of the week. As daft as it seems to others, I love what I do. No wonder my grandchildren think I'm not all there!

When I'm asked to speak to local business groups about investment, there's usually at least one cynic in the audience who asks "If you're so bloody clever at this why aren't *you* retired?" Good question. The sad thing is many of them don't believe my answer. It seems too few these days recognise passion or purpose. (Nor, for the record, do I play golf or spend my day obsessed by social media.)

Back in late 2008 in the Great Financial Crisis, I bumped into an old neighbour at our local opticians

"SURVEYS SUGGEST THE AVERAGE PRIVATE PENSION POT ON TOP OF THE STATE PENSION IS NO MORE THAN £50,000."

when we were having our eyes tested. He asked if I'd retired like him. I said I'd only consider it once our clients had recovered any recent investment losses, once the next bull market came along. He replied sarcastically that it was more than my eyes that needed testing – and followed up with his confident prediction there wouldn't be another bull market in our lifetimes. He was half right. He died before 6th March 2009.

To be honest, I don't like the words "early retirement". Never have. If I'm pushed I'll agree it's slightly better than "retirement" for obvious mathematical reasons. But both terms share an attraction quotient roughly the same as a Party Political Broadcast. Mention anything to do with retiring or pensions and most folks' eyes glaze over. Plenty of time to worry about that sort of thing eh?

Bad news and perspective

Well here's the bad news. Ask old timers what they regret most in life and many of them will say that they wished they'd started investing for their later years much earlier. Trust me, time flies by far too quickly. Older Baby Boomers will remember comedienne Hilda Baker, who was quoted as saying "When I was 40 I went into the kitchen to make a cup of tea. When I came out, to my horror I discovered I was 65."

Judging by the various surveys reported by the media over the last few years it's obvious that far too many reach retirement financially unprepared. Umpteen surveys suggest the average private pension pot on top of the State Pension is no more than £50,000. Use that to buy a guaranteed inflation proofed income with protection for your partner should you pop your clogs too soon, and you'll be lucky to receive £150 a month before tax.

With only another £600 a month or so from your State pension it doesn't sound like it's going to be much fun in retirement for most of us, does it? And with savers still relying on deposits for income and "growth", despite almost zero interest rates for eight years, you can safely predict further financial misery looming for millions.

Yet a survey conducted by Prudential found that nine out of ten over-55s have bucket lists, citing things like cruises, living abroad and safaris, among other goals. Another survey found that 60% of workers hate their jobs so much they wish they could pack it in to begin ticking off their bucket lists. So what's stopping all these unhappy people? Not enough money saved up – that's what. Simples.

When I first started giving advice on investment 44 years ago, I thought all I had to do was pack my brain with enough knowledge on investments, pensions small print and tax reliefs, then improve the circumstances of those I came across and walk away happy. But it wasn't enough. Clients said they were grateful but wished they could more easily see what all this meant in real terms when they stopped earning. Most of them said they wanted to be sure they'd have enough to have the opportunity to retire early and be free. But where should they start?

STEP ONE – Don't ignore the Rule of 72

It's not a bad idea to do what I did. Start with a goal. Express it in today's money – otherwise it's as useless as an ashtray on a motorbike. Perspective is crucial. When I did my calculations there were no personal computers or smartphones. There were electronic calculators but they were the size of microwave ovens. Thankfully all you needed was a set of compound interest tables and to grasp "The Rule of 72". And that's still all you need today. Why complicate matters?

Understanding compound interest and the Rule of 72 focusses your attention on why it's crucially important to grasp the impact that inflation and different investment returns make to your quality of life in retirement. Sadly most folk just don't get it. So let's take what's happened from 1950 to 2016 comparing UK inflation, deposits (the Building Society Index with gross interest reinvested) and UK shares (Barclays Equity Index with dividends reinvested).

Starting in 1950 with £100 in each case, inflation averaged 5.25% per annum (yes really!), Building Society Index returns averaged 6.1%, and the UK Equity Index averaged 11.4% total return. If to match inflation you needed to equal £3,314, and to beat the Building Society Index return you needed £5,560, what do you think 11.4% per annum in equities produced? When asked this question, the vast majority of investors are miles out – which goes a long to explain why so few reach carefree, well-funded retirements.

£182,494! Fact. Go check the Rule of 72. Divide your net returns per annum into 72. And learn how long it takes to double your money. One percent per annum in cash deposits? They double every 72 years. Hmmm. That's why you should start as soon as you can and invest in assets for the long term. It's never too late either. Warren Buffet built 99.2% of his invested wealth after he turned 50.

STEP TWO – Apply the "Change Formula"

Once you've decided you need to build a retirement kitty of over £1 million, next up you need to work out where you stand right now. Start with a full money audit, warts and all. How much are your pension funds, property investments, stock portfolios, ISAs and deposits, and any likely inheritances worth?

Add it up. Deduct that from your retirement fund goal you've decided you want expressed in today's terms. Now look at that gap. And how many years you have left to plug it. Ouch.

> **"THE MAJORITY OF INVESTORS SHOULD CONCENTRATE FIRST ON PRIVATE PENSIONS, WHICH ARE STILL AN UNPARALLELED TAX HAVEN."**

Now it's time to have a long hard look at what's there and how effective it all is. Not a bad time to introduce our "Change Formula".

I've found that most investors are content with what they have even though it's obvious to others that relying on deposits and Cash ISAs is a guaranteed recipe for failure. The only way to challenge your current way of thinking is to become unsure. And that isn't easy when we all tend to have our own behavioural biases. Why not ask yourself "What do I believe to be true that's actually false?"

The best way for quick results is to apply the change formula: C= D+V+F+E.

Change = Disquiet + Vision + First Steps + Energy

If you don't have disquiet you won't be open to change. Then you need a vision of something measurably better. But that gap is often too wide emotionally. So introducing a first step is always helpful. Such as, "Having asked you these questions, established what may need to be changed etc., why don't I take away all these jargon filled documents and details, analyse them for you, and report back with a plan?" Phew, that sounds nice and uncomplicated. Most folks can cope with that.

So far so good. But what happens to most investors if left to their own devices? Bad habits re-emerge. And that's why most successful savers have advisers – coaches if you prefer – to keep their investor clients on track year after year. To stop them emotionally reacting to Bad News at Ten and other media interference that plays havoc with our brains' amygdalae. That's the panic button that keeps us "safe" in the herd which was probably helpful thousands of years ago – but not now.

STEP THREE – Take advantage of tax breaks

By now you know your goal in today's money. You've established how long you have left to achieve it. You're aware of the gap between where you are now and where you want to be. You've a much better idea about compound interest and the massive difference a few extra percentages can make to your retirement kitty.

Now it's time to stir in the advantages accruing from simple tax planning. Doesn't it make sense to maximise any tax breaks where available? If you could bundle up all your current deposits and investments, then restructure them in order of tax effectiveness, and only then invest in the most effective investments, wouldn't that make more sense?

That's why the majority of investors should concentrate first on private pensions, which are still an unparalleled tax haven. Every contribution is increased by the lovely HMRC before your money's invested, at between 25% and 81% (depending on your tax rate). And if you're employed and your employer can be persuaded to chip in, that's more money for nothing. Once in the plan all investment gains roll up tax free. And "income" can be removed later with minimal taxes if you take good advice. It's possible to avoid Inheritance Tax too. No Brainer.

Next up there are a whole range of plans that offer either some tax relief and tax freedom on returns (like VCTs) or simply tax free gains to draw down later as tax free income like investment ISAs. The annual significant Capital Gains Tax exemptions are also seriously underrated by long-term savers despite the fact they offer further tax-free "income" opportunities.

We live in increasingly fraught times as investors. We are pounded daily with bad news and one reason after another why we should keep our money "safe". We can be easily pulled into the "safety" of the herd by a popular media who jump from one crisis to another day by day to catch our eye and sell more advertising.

If you want to be one of the few to reach financial freedom in perfect financial nick, recognising the benefits of an experienced independent eye to watch over you along the way, then maybe there's one more step to take: Go ask around and get yourself a coach. Better still, make it an experienced IFA.

About Alan

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

BY FILIPE R. COSTA

HOW TO INVEST LIKE... MARTIN ZWEIG

"Big money is made in the stock market by being on the right side of the major moves. I don't believe in swimming against the tide. It's rare for me to recommend stock purchases when my market-timing models are bearish, or a short sale when the reverse is true."

— **Martin Zweig,** *"Winning on Wall Street"*

A scientific value investing approach

While there are a few dozen sound investment strategies, we can separate them into just two distinct groups. The first group is the value school of investment, which can be roughly characterised by a series of investment strategies seeking out undervalued, neglected and unfashionable stocks. These strategies often set an investor against the herd. Investors like Ben Graham (issue 13 – April 2016), Joel Greenblatt (issue 24 – March 2017), and Joseph Piotroski (issue 29 – August 2017) are well-known contrarian investors of that type. The second group is the growth school of investment, which looks for momentum and is thus often in harmony with the market. Strategies based on growth usually seek out high-flying companies that exhibit sales and earnings growth well above the market. Philip Fisher (issue 19 – October 2016), and to some extent Peter Lynch (issue 15 – June 2016), are examples of growth investors.

But regardless of the group in which we place each investor, the similarities among them are greater than the differences, as they all seek to buy upside potential at reasonable prices. Some play with statistics while others prefer deep financial statement analysis; some are contrarian-motivated and others are momentum-driven. But, all of them screen stocks through an extensive check-list to make sure they really gain a significant edge over the market such that upside potential is maximised and risk is contained. For this reason, it is sometimes hard to distinguish growth from value and in that sense it isn't churlish to place all the above investors in the same group – the group of successful investors who are able to consistently beat the market through the use of a rigorous investment strategy. The rest is just a matter of angle and taste, which varies from investor to investor.

This month's investor, Martin Zweig, is best placed in the second group, as his technique attempts to capture high-flying stocks that are increasing profits and sales at very high rates. Developing his interests in investment at the early age of 13, Martin Zweig built an enviable career as a highly-respected analyst, investor, and professor. He was known for his thorough and timely market analysis, for his research on sentiment indicators, and for a highly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respected and profitable investment newsletter he created by accident – The Zweig Forecast.

The Zweig Forecast

Martin Edward Zweig was born in Cleveland in 1942 and died in 2013 at the age of 70. He was a very successful investor and analyst, sometimes also known for his eccentric and lavish lifestyle, including a penchant for collecting expensive and rare memorabilia such as a $52,000 pool, a Michael Jordan's Chicago Bulls rookie jersey and a Marilyn Monroe dress. In 1999 he bought the most expensive Manhattan house ever sold up until that point, for $21.5 million. It is situated atop the Pierre Hotel in the Fifth Avenue, and is still in the family and currently valued at around $125 million. But if there's a dose of eccentricity in Zweig, there's an even bigger dose of hard work. This helped turn him into a legendary investor, particularly for those who follow more growth-oriented investment strategies.

At the age of 13, Zweig received six General Motors shares as a birthday gift from an uncle, which attracted him into the magic of price action, dividend payments, and all other dynamics revolving around the stock market. He later went to the University of Pennsylvania from which he earned a degree in economics in 1964. By then he was a hard-working young adult with a thirst for knowledge. He headed for the University of Miami, from which he earned an MBA, and later to the University of Michigan State, where he completed his PhD in finance in 1969.

While a graduate student, Zweig performed ground-breaking research in the field of stock analysis which impressed many. His PhD thesis developed around the put-call ratio, which turned into a popular sentiment indicator often used by investors to predict the future direction of the stock market.

While Zweig is mostly remembered as a growth investor, a large part of his work was on sentiment and macroeconomic indicators to forecast overall market movements. In general, investors prefer to stay neutral to macro developments, as they find it extremely difficult to guess the direction of the overall market, but that wasn't the case with Zweig. While he didn't try to guess market tops and bottoms, he always believed in screening macroeconomic data before engaging in any

"'THE IDEA IS TO GET IN HARMONY WITH THE MARKET,' EXPLAINS ZWEIG. 'IT'S SUICIDAL TO FIGHT TRENDS'."

trades. *"The idea is to get in harmony with the market,"* explains Zweig. *"It's suicidal to fight trends".* His scientific mindset always led him to keep track of huge volumes of data from which he built sentiment indicators to anticipate broad market movements – something he did with great skill.

In the period between undergraduate and post-graduate studies, Zweig improved his investment strategy while working different jobs. He taught finance, worked as a consultant for the group that would later become the CBOE, taught brokers at E.F. Hutton about options trading, and worked for a small brokerage. But it was by accident that he started his most important activity – the creation of *"The Zweig Forecast".*

In 1970, Zweig sent a letter to Barron's critiquing a brokerage recommendation to sell AT&T stock that had just been published. His own research pointed in the opposite direction and he explained why he believed AT&T was a buy instead of a sell. Barron's editors liked the piece and published it. Zweig's research proved right and he was invited to write a few more pieces, making several successful predictions and then becoming a regular writer.

Given his success, the small brokerage firm for which he was working asked him to start writing an investment newsletter for clients, using his Barron's articles as a starting point. But soon after starting the newsletter, the brokerage firm went under. Undeterred and confident in the value of his work, Zweig decided to contact readers who had written to him in response to his Barron's pieces to ask them whether they would be interested in receiving an investment newsletter from him. Zweig got enough subscribers and created "The Zweig Forecast",

"JUST A FEW DAYS BEFORE THE MARKET CRASH OF 1987, ZWEIG WAS ASKED HIM WHETHER HE BELIEVED THE BULL MARKET WAS DEAD. *'I HAVEN'T BEEN LOOKING FOR A BEAR MARKET PER SE. I'VE BEEN REALLY, IN MY OWN MIND LOOKING FOR A CRASH'*, ZWEIG ANSWERED. THE FOLLOWING MONDAY THE OVERALL MARKET CRASHED, DECLINING 23% IN A SINGLE SESSION."

Tutti Frutti / Shutterstock.com

which would remain active between 1971 and 1997. For the 15-year period between 1981 and 1995, Hulbert Financial Digest ranked Zweig's newsletter number-one for risk-adjusted performance, by then showing an annualised performance of 15.9%.

Zweig's public profile grew rapidly during these years. In the 1980s and 1990s he was a regular at one of the most popular financial shows, the *"Wall Street Week"*, with Louis Rukeyser. In one of his appearances, just a few days before the market crash of 1987, Zweig was asked whether he believed the bull market was dead. *"I haven't been looking for a bear market per se. I've been really, in my own mind looking for a crash"*, Zweig answered. The following Monday the overall market crashed, declining 23% in a single session.

Over time Zweig turned more of his attention towards money management. In 1986, he introduced his first investment fund – The Zweig Fund – with an initial offering of $340 million. Two years later he introduced The Zweig Total Return Fund, with an initial offering of $603.75 million. Several others followed and by 1997 Zweig decided to put an end to his investment newsletter as he was running more than $7 billion in partnerships and getting more than 98% of his income from them.

Zweig's Strategy

Unlike Greenblatt's strategy (issue 24 – March 2017), which is relatively simple and straightforward to set, Zweig's strategy requires judgement and is more difficult to implement. In his book, *Winning on Wall Street*, Zweig explains his strategy in detail and depicts the workflow behind it, but leaves it open-ended for interpretation, rarely providing exact thresholds. That means there are several different potential implementations. An example of this subjectivity comes with his view on the price-earnings ratio, which Zweig clearly claims should not cross certain levels whilst giving no specific thresholds for the upper and lower limits. Investors seeking out the original Zweig strategy through books and web resources should be aware that all they will find are Zweig-inspired strategies rather than the original Zweig strategy. Additionally, even Zweig claims that he *"cannot possibly list all the variables [he uses] for picking stocks because it would get hopelessly complicated"*.

But while the proper fine tuning will be left to the investor, the main features of Zweig's strategy can be easily captured. The strategy is well described in his own words:

"My stock-picking procedure involves a search for the following variables: strong growth in company earnings and sales; a reasonable price-to-earnings ratio given the company's growth rate; buying by corporate insiders, or at least the lack of heavy selling by insiders; and relatively strong price action by the stock itself. In other words, I tend to favour buying strength and selling weakness."

According to Zweig, in order to implement a successful investment strategy, investors can follow one of two different techniques: the *"shotgun"* approach and the *"rifle"* approach. As the name suggests, the *"rifle"* approach is much more refined and targeted. However, it is unavailable to most investors because it involves a full-time analysis of the market and an in-depth look at several variables at the company level, including fundamentals, accounting practices, management changes, tax law changes, and several other micro variables. Most investors just don't have the resources and ability to proceed this way. The *"shotgun"* approach involves collecting large amounts of publicly available data and screening through the numbers using some pre-determined criteria. It is much more mechanical, less time-demanding, and easier to test. If the right criteria are chosen, the strategy will outperform the market averages, even when picking unfavourable stocks from time to time. It's a matter of playing with statistics.

"AS AN ACADEMIC (AT LEAST IN PART), ZWEIG CONSIDERS THE PRICE-EARNINGS RATIO TO BE ONE OF THE MOST IMPORTANT SINGLE FIGURES."

Zweig's *"shotgun"* approach usually starts by digging through the earnings section of a newspaper with the help of a calculator to evaluate earnings growth. We can then summarise the main points from his strategy in eight filters.

1) Earnings growth

Zweig starts his analysis by looking at quarterly figures for earnings. He seeks out positive quarterly earnings growth, always using the same quarter in the prior year as a comparison to avoid seasonal effects. If the latest quarterly earnings report is 2Q2017, he uses as comparison 2Q2016. If there are items that are extraordinary, it is preferable to use some fully-diluted earnings measure from continuous operations. The proceeds from selling a factory may help increase quarterly earnings at some point but are just one-time revenues not expected to continue over time. These operations inflate earnings but tell little about the earnings potential of the business and therefore should be discarded.

In summary, this filter requires that the latest earnings figure be not only positive but also greater than in the same quarter one year ago.

2) Earnings persistence

Growth in quarterly earnings give a good short-term perspective, but to invest Zweig also requires good longer-term growth. In this regard, a stock should also show positive annual earnings growth. One way of using a filter here is by defining a minimum threshold for the annualised earnings growth rate. For example, one might require this rate to be at least 15% for the last three to five years. Additionally, an investor could use another filter by requiring earnings to have risen in every single year, for example. But again, there's margin for interpretation as Zweig hasn't defined any rigid threshold. The main objective is to separate companies that are experiencing strong growth in earnings from those that aren't or that are faltering at some level.

3) Sales growth

While earnings is the ultimate figure investors care about and the variable on which any growth investing strategy should rely, sales is still the primary driver for earnings. When that isn't the case, a red flag should be raised. In a similar fashion to what is required for earnings, this filter also requires same quarter sales to be positive and rising.

4) Earnings growth versus sales growth

Analysing sales gives a layer of protection against earnings management, as it is more difficult to manage the first than the second. In a similar fashion to John Neff's strategy ([issue 28 – July 2017]()), Zweig requires that substantial earnings growth be accompanied by substantial sales growth. Cost-cutting and non-recurring sales are examples of activities that aren't long-lasting and may lead to diverging figures for earnings and sales. A strong business is driven by strong sales. At least one filter should require sales growth and earnings growth to be similar.

Again, Zweig leaves the exact threshold open for interpretation. One potential implementation is to require the annualised sales growth for the last three to five years to be at least 85% of the same growth for earnings. Nevertheless, Zweig ignores this filter in cases where earnings growth is 30% or more, because he believes that figure to be too good to be missed. Such a situation would require further research to identify the source of the discrepancy. The introduction of new products is good justification to accept differences. An increase in competition, price cutting, and deteriorating margins, are examples of worrying factors.

5) Price-earnings ratio

As an academic (at least in part), Zweig considers the price-earnings ratio to be one of the most important single figures, because of the extensive academic research showing that the simplest most naive strategy of just picking low price-earnings stocks outperforms the market. *"In summary, the data going all the way back to the 1930s show conclusively that stocks with low price/earnings ratios outperform stocks* *with high price/earnings ratios over the long term",* he claims.

A low price-earnings ratio means that investors are paying less for earnings. But a low ratio may be the result of one of two different situations: a company experiencing financial difficulties, or a company part of a neglected industry. In general, value investing tries to capture companies belonging to the second group. After screening for severe financial conditions, value investing strategies always try to screen stocks with the lowest price-earnings ratios. But, from the perspective of a growth strategy, picking the lowest ratios isn't a sound strategy. We should never forget that growth screens require earnings and sales to be rising substantially. A company filtered this way, and still showing a very low price-earnings ratio is most likely to be in deep financial trouble. Thus, a naive definition ranking stocks by price-earnings ratio would mean trouble here. In any case, investors should always avoid extremely high price-earnings ratios. While a very high ratio may be the result of very high potential growth, a very small miss in estimates is enough to deliver a crash in the stock price. This way, for the sake of downside protection, there should always be an upper limit for the price-earnings ratio in a sound growth strategy.

While Zweig doesn't provide an absolute limit for the price-earnings ratio, investors looking for a numerical procedure could impose a filter requiring the ratio to be equal or greater than 3x and less or equal to 25x. Alternatively, the data could be divided into deciles and stocks in the top and bottom deciles excluded.

6) Relative price strength

Contrary to value investing strategies, growth strategies look for momentum in order to pick the ongoing trend instead of any potential for reversion. Nothing is more useful when it comes to confirming a growth strategy than the recent price movement. Zweig expects that if a company is as good as it appears, it should perform at least as well as the overall market. Then, he filters away all stocks that have been performing below the market. A simple way of implementing this is to require that a stock price percentage change over the last three months must be at least equal to the percentage change of the relevant country index. The filter can be tweaked to be more or less stringent.

7) Financial position

Zweig also cares about financial distress and the impact it may have on stock prices. He believes investors shouldn't pay too much for indebted companies and should avoid companies pushing leverage to the limits. But because debt levels vary widely across industry, a filter should be set in relative terms. A bank, for example, usually runs on very high leverage compared to the market average. But the reason for this high leverage is the nature of the business. A way of filtering the dataset is to require the debt-to-equity ratio or the net gearing ratio to be below the industry average.

8) Insider activity

Insiders know more about their business than anyone else, and as such may send the market buy and sell signals when trading their company's stock. Zweig looks at insider trades for the latest three months and considers a buy signal when three or more insiders buy stock within that period and no insider sells. Conversely, he considers a sell signal when three or more insiders sell stock and no insider buys.

Academic research supports the idea that an investor may gain an edge by using the insight gleaned from insider trading. But these studies also point to the fact that buy trades are much more informative than sell trades. The main reason for this is because insiders are often partially paid in stock options and they release cash from time to time by selling stock. The value of insider activity has also been shown to be more valuable for the lowest market capitalisations[i].

When trying to replicate Zweig's strategy, we can set a filter to exclude any stocks with more than three insiders selling and none buying over the last three months.

8

MARTIN ZWEIG'S STRATEGY CARD

1. **EARNINGS GROWTH**
Quarterly earnings for the most recent quarter should be positive and higher than one year ago.

2. **EARNINGS PERSISTENCE**
Annualised earnings growth of at least 15% for the last five years.

3. **SALES GROWTH**
Quarterly sales for the most recent quarter should be positive and higher than one year ago.

4. **EARNINGS GROWTH VS SALES GROWTH**
Annualised sales growth at least equal to 85% of the annualised earnings growth for the last five years.

5. **PRICE-EARNINGS RATIO**
Price-earnings ratio between 3x and 25x or, alternatively, price-earnings ratio not in the highest and lowest quantiles.

6. **RELATIVE PRICE STRENGTH**
Share price percentage change at least equal to the relevant index percentage change for the last three months.

7. **FINANCIAL POSITION**
Net gearing (or debt-to-equity) below the relevant industry's average.

8. **INSIDER ACTIVITY**
No more than three insiders selling shares or, at least one insider buying, in the last three months.

STRATEGY CARD INSPIRED BY MARTIN ZWEIG'S STRATEGY EXPLAINED IN "WINNING ON WALL STREET"

Developing a strategy in the real world

In practice, it is relatively simple to understand the key principles of Zweig's strategy but difficult to replicate them. Implementation of the Zweig strategy requires judgement and choice among several potential alternatives, which may result in different outputs depending on the choices taken. The starting point is respecting Zweig's key principles: the company (1) shows strong growth in earnings and sales; (2) trades at a reasonable price-earnings ratio; (3) shows absence of heavy insider selling; and (4) shows a favourable price action.

A simple screen for stocks trading on the London Stock Exchange generates the results showed in the table to the left.

These results show just three stocks. A point to note is that a good strategy is not expected to throw up all that many buying candidates – otherwise it would prove the market to be highly inefficient.

"IN PRACTICE, IT IS RELATIVELY SIMPLE TO UNDERSTAND THE KEY PRINCIPLES OF ZWEIG'S STRATEGY BUT DIFFICULT TO REPLICATE THEM."

Winning on Wall Street

For over twenty years, Zweig attributed ratings to a list of more than 3,000 stocks, in a highly effective way.

The ratings system he developed gives a score between 1 (best) and 9 (worst) according to the criteria of his strategy. In his book, *Winning on Wall Street*, he reports the total performance an investor would achieve by investing in the stocks of each ratings group. The top group achieved a performance of 10,432.1%, corresponding to an annualised performance of 26.3% which compares with 13.6% for the whole

AN APPLICATION OF ZWEIG'S STRATEGY TO UK SHARES

Symbol	Asset	Market Cap. (£m)	P/E Ratio	Annualised 5y EPS Growth (%)	Annualised 5y Turnover Growth (%)	3-Month Relative Performance (%)	Net Gearing	Industry
BOOT	Boot (Henry) PLC	£404.30	14.5	26.9	21.8	19.1	14.2	Industrials
CVR	Conviviality Retail PLC	£657.40	23.1	18.9	31.6	21.6	44.4	Consumer Services
GMAA	Gama Aviation PLC	£105.40	6.6	30.6	52.6	14.5	34.7	Industrials

group. It is clear from the table that the higher the rating, the higher the performance, which is ample proof that Zweig's technique makes a difference when grouping stocks.

Zweig is an example of determination and hard work. Starting out at a very early age, he always worked hard to learn everything he could about investing, to then carefully craft an investment strategy that has proved to be highly profitable over the years. Zweig's extensive use of the "shotgun" approach is evidence that in order to be a successful investor there's no need to be a professional analyst dedicated full-time to financial statements analysis. All it requires is hard work and a carefully crafted strategy that can take no more than a few minutes every day.

THE ZWEIG PERFORMANCE RATINGS

Performance-Ratings Group	% of Stocks in Group	% Returns in 239 Months	Annualised % Performance
1 (best)	5	10432.1%	26.3%
2	8	6313.4%	23.2%
3	12	2486.5%	17.7%
4	15	1976.7%	16.5%
5 (average)	20	1099.5%	13.3%
6	15	682.3%	10.9%
7	12	415.2%	8.6%
8	8	225.6%	6.1%
9 (worst)	5	39.4%	1.7%
All Stocks		1156.5%	13.6%

Source: Adapted from "Winning on Wall Street"

i For an exhaustive review on insider trading see for example "Investment intelligence From Insider Trading" by H. Nejat Seyhun.

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.

BY CARL SHAVE

BRICKS & MORTAR

PEER-TO-PEER PROPERTY LENDING EXPLAINED

WHICH PLATFORM IS RIGHT FOR YOU?

Over the past decade, the peer-to-peer (P2P) lending sector has gone from strength to strength. A number of government measures have shown just how much they are behind the idea – not least with the introduction of the Innovative Finance ISA (IFISA) from April 2016, for the first time allowing tax exemption on interest and gains from P2P loans. For many, investment in P2P property lending has become an attractive alternative to investing in property directly through buy-to-let, or indirectly via a real estate investment trust (REIT).

P2P property lending has seen a great level of innovation, and that means that there are a variety of different approaches on the market. As with any type of investment, potential returns are intrinsically linked with risk levels. The types of property involved, the nature of the lending, and the lender's track record all come into play; lending on residential properties or buy-to-let, for example, typically carries less risk than bridging finance or property development loans. I'm going to take a look at three examples of P2P lenders, at various levels of risk and potential return.

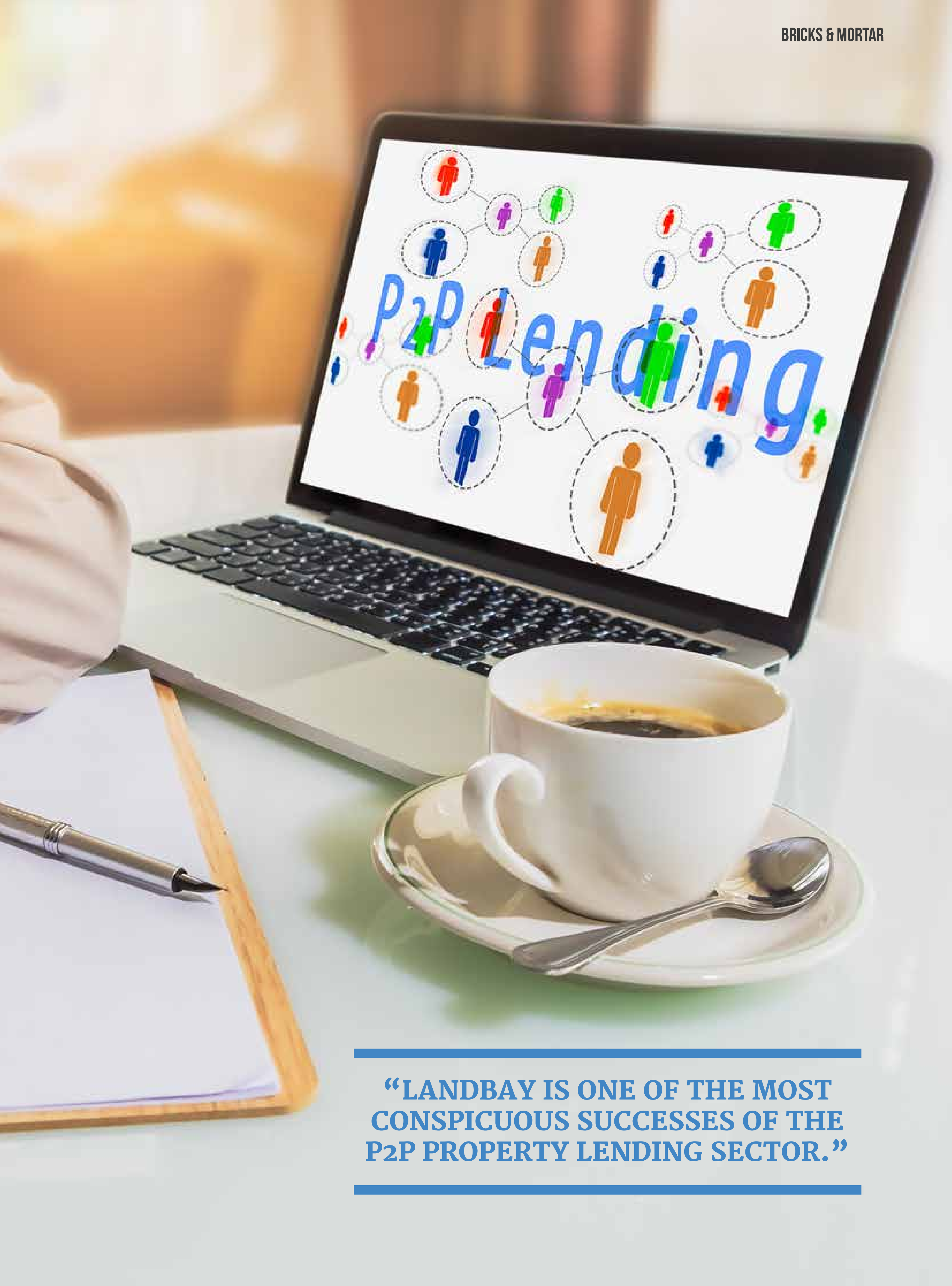
Higher risk – FundingSecure

Formed in 2012, FundingSecure offers both property and non-property P2P loans. They describe themselves as a "pawnbroking platform", specialising in offering asset-based lending to borrowers without a credit check; this means potentially lending to people who have had previous credit problems, up to and including bankruptcy. All loans are for a six-month period, with interest rolled up and repaid with the capital at the end of the loan term. In terms of property lending, they offer development loans and short-term bridging finance for both residential and commercial property. This places FundingSecure at the riskier end of the lending spectrum. FundingSecure limits the risk by applying a maximum loan-to-value ratio of 70%.

Unlike some other P2P lenders, you choose which loans to invest in directly, rather than the investment being diversified by default across multiple loans to spread the risk. The return offered varies depending on the level of risk: low-risk loans can pay as little as 10%, while higher-risk lending could pay up to 15%. Most FundingSecure lending typically attracts an annual return of 12–13%; larger investments (generally £10,000+) may qualify for bonus rates. In common with other P2P platforms, capital investments are not protected by the Financial Services Compensation Scheme.

Medium risk – LendInvest

Since 2008 LendInvest has lent just under £1 billion on over 3,000 properties across the UK, with the majority (over 83%) in London and



"LANDBAY IS ONE OF THE MOST CONSPICUOUS SUCCESSES OF THE P2P PROPERTY LENDING SECTOR."

Lender	Lender Losses	Avg LTV	Interest Rates	Min lend Value
Landbay	None Reported	68%	0.0375	100
Proplend	None Reported	50% - 75%	6.9% to 11.1%	1000
HNW Lending	Small number of loans "suffering problems"	55%	6% - 12%	10000
Assetz Capital	Very low or zero	65%	3.8% - 15%	1
FundingSecure	less than 0.1% - 1.5% expected	58%	11%+	25
CapitalStackers	None Reported	51%	5%-20%	400
Wellesley & Co.	None Reported	No information supplied	2%%	10
Lendy (formerly Saving Stream)	None Reported	70% Max	0.12	100
ThinCats	2% per year	No information supplied	0.09	1000
Folk2Folk	None Reported	60% Max	0.06	25000
Mintos	Very Low	40%	0.09	10
MoneyThing	History not provided	70%	0.12	1
FundingKnight	None Reported	58%	0.085	25
BridgeCrowd	None Reported	60%	0.12	5000
EstateGuru	None Reported	58%	0.12	50
Relendex	None Reported	53%	0.0825	500
Invest & Fund	No information	60%	0.085	500
CrowdProperty	No information supplied	No information supplied	0.08	500
Crowdestates	No information supplied	No information supplied	0.06	10000
JustUs	None Reported	60%	0.1	10
Kuflink	None Reported	70% Max	0.06	100

Source - https://www.4thway.co.uk/candid-opinion/property-peer-to-peer-lending/

"MANY HOUSING MARKET ANALYSTS HAVE SUGGESTED THAT BREXIT COULD BE THE PIN THAT FINALLY POPS THE PROPERTY BUBBLE IN LONDON AND THE SOUTH-EAST."

the south-east. They offer borrowers a range of non-mainstream lending solutions including both short-term (up to 12 months) and longer-term (three years) bridging loans, as well as property auction finance. They also offer various modes of finance to property developers, including refurbishment and exit finance. As of April 2017, the split between bridging and development lending is 78%/22%. All finance applications are manually assessed by a team with over 75 years of combined mortgage underwriting experience, and potential borrowers are also subject to external credit agency checks. Lending is limited to 75% of the property value.

> "THE LAUNCH OF THE IFISA IN 2016 SENT A VERY CLEAR MESSAGE THAT THE GOVERNMENT IS BEHIND P2P."

LendInvest has had an unusual history, having actually withdrawn its application to the Financial Conduct Authority to act as an authorised P2P lender. Rather than true P2P, all investment is now channelled via an FCA-regulated alternative investment fund. LendInvest offers a variety of ways to invest in lending, including building your own portfolio via their online investment platform, and investing into their Capital Funds. Returns on individual investments vary depending on risk, but have typically been in the range of 4–8%. In July 2017, LendInvest also offered their first limited five-year retail bond, paying a 5.25% annual return on investments of at least £2,000.

Lower risk – Landbay

Landbay is one of the most conspicuous successes of the P2P property lending sector, and its track record alone makes it a potentially attractive investment proposition. Since it was founded in 2014, Landbay has lent over £51 million in low-risk residential buy-to-let mortgages to experienced, creditworthy landlords with, to date, zero arrears or defaults. Mortgages have been lent on properties across England and Wales, with the lion's share (54%) in Greater London. The company reduces investor risk by diversifying individual investments across multiple loans; the lender also maintains a Reserve Fund, equivalent to 0.6% of the total outstanding P2P loan balance, as contingency cover against potential arrears and defaults.

Landbay makes it easy to invest, with no investment or account opening fees and a minimum investment amount of just £100 in the Classic Investment Account, or £5,000 if you opt to invest in their tax-free IFISA (which they call the Property-Backed ISA). Investments start earning interest within 24 hours of allocation of funds, with the option to either withdraw or reinvest the monthly interest payments. At the time of writing, funds invested in the Classic Investment Account have an estimated annualised return of 3.75% on fixed-rate lending, and 3.34% on tracker mortgage lending. The Property-Backed ISA currently has an estimated annualised return of 3.75%. In each year of Landbay's operation to date, the actual annual return on loans has matched the estimated return.

What next for P2P?

The emergence of P2P lending over the past decade or so has been fairly disruptive, with multiple players offering a wide variety of different investment options. The launch of the IFISA in 2016 sent a very clear message that the government is behind P2P, and it's fair to say that this is just part of a wider diversification of the financial industry that is unlikely to stop any time soon. In that sense, P2P lending seems likely to only solidify its place as an option for those looking to invest in property.

That said, Britain's withdrawal from the EU could change the landscape for property investment in the UK. Many housing market analysts have suggested that Brexit could be the pin that finally pops the property bubble in London and the south-east, where many P2P lenders' secured assets lie. A sharp downward correction of house prices in the region could make property investment in general a more risky proposition than has been the case for some years. Would-be property investors will do well to keep a close eye on both national and regional housing market fluctuations, and use that information to inform which, if any, types of property you opt to invest in.

About Carl

Carl is a seasoned commentator on financial matters and one of the minds behind Just Mortgage Brokers. He has worked in the mortgage industry for over 20 years, first working for a high street lender, before departing to set up and run his own branch of mortgage brokers back in 2002.

AUGUST 2017

YOUR VIEW

We invite reader comments and discussions on our social media channels as well as in the comments section below each blog article. Readers can post using their real name or a pseudonym.

Every month, we pick some of the most interesting comments and exchanges, and print them in our magazine.

Thanks to the calibre of our readership, we get some incredibly insightful, thought-provoking and informative comments and emails. By passing some of them on, we hope that readers are also able to connect and learn from one another – and maybe catch up in person at one of the events we organise!

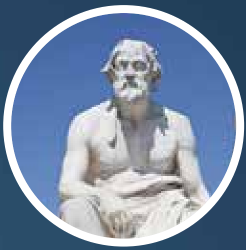
All comments reflect the individual reader's view. They have been edited for grammar, spelling and punctuation.

Biofuels could transform the energy landscape – and your portfolio

Biofuels like plant-based aviation fuel could be one answer to climate change. Some players are already making money out of them, writes Victor Hill.

"A very informative article, although I am surprised it didn't mention Crop Energies AG of Germany, capitalised at about €700 million and trading on a EV/EBITDA of about 5 and a P/E of about 10 (having just doubled its dividend)."

- David Jacobi



Thucydides, Spreadsheet Phil and the coming Crash

The Greek experience teaches us why the Brexit talks will most likely break down by October. The resulting market correction will not just affect London.

"An advertising campaign in European newspapers pointing out that we import far more from the EU than we export to them could be effective. Just point out to their citizens, as the German elections come close, what is going to happen to their car industry, wine producers etc. if we decide to take the no deal option and just leave."

- J Lyons

"I'm pleased to see that someone has translated Yanis's brilliant expose of the EU duplicity in dealing with Greece (as described in Adults in the Room) into the Brexit scenario.

The most important lesson learned by Yanis was the impossibility of negotiating a debt repayment if the lender doesn't care if they get their money back.

Reading the book made me realise the EU will be ruthless in ensuring no other member will risk leaving the EU by making Brexit extremely painful for the UK even if it also damages their own economy."

- Michael Griffiths

Inflation-linked income from supermarket real estate

Nick Sudbury looks at a new investment trust offering inflation linked income from supermarket real estate.

"Supermarkets are NOT a growth story consequently it's unlikely rents will be inflation proof with any existing or new tenant only occupying at a lower rent. I anticipate time will prove this to be a slowly declining real income.

Only potential buyers are investment managers using someone else's money as they do not care about long term performance just annual fees.

Surely a better buy is F&C Commercial Property Trust with reusable property assets."

- J D Innes

Is there a mathematician out there that can set me right?

Simon Cawkwell, AKA Evil Knievil, with his latest trading and gambling exploits – writing exclusively for Master Investor.

There's a slightly different risk profile in buying puts and shorting stock, but overlooking that the options should be priced using market interest rates and disregard the spread firm's 3% charge. They should therefore be mathematically cheaper, but your liquidity may be very poor. Try a synthetic short by buying a put and selling a call and if the calculated forward price is better than the short stock plus financing charge, then that is the way to go.

- W Butler

Austerity – or Catastrophe...?

Victor Hill thinks the Tories should resist the temptation to join the Tax-and-Spend brigade. To do so could be catastrophic.

"You'll never balance the budget by cutting public spending, because you're destroying wage growth and creating an economy where wages can never go up. Combined with all the tax cuts, you're ensuring tax receipts will keep declining and that we'll never be able to afford public services.

In short, you're creating neo-feudalism and slavery, and at the end of it all you'll have done is cut the budget deficit three times more slowly than you would have if you'd just borrowed and invested in high-skilled public sector jobs."

- Mark Richardson

"Where is the money going to come from for your public sector "investment", a.k.a. pay splurge, when the country is already on a terrifyingly high debt-to-GDP ratio of almost 90%? You've completely failed to engage with Victor Hill's arguments: for example, "capped" public sector pay (which it isn't, because most workers – like my wife, an NHS Band 7 specialist professional – are also on a pay scale with guaranteed annual increments) and work-related benefits like pensions have actually held up very well and are still more generous than equivalent roles in the private sector; so-called austerity has been mild so far, with many departments of state operating on protected budgets; and what happens if overseas investors decide to stop buying our never-ending issuance of gilts to fund our excessive expenditure?

Ultra-low interest rates are not some inevitable, guaranteed off-shoot of Labour's Money Tree: they have only been permitted because the money markets trust the government to keep bearing down on the UK's huge fiscal deficit. This is very, very basic economics, and describing as "cruel" anyone who says the UK should aim to live within its means and ultimately reduce its National Debt is just the politics of the playground. And I've no idea what you mean by "all the tax cuts": taxes overall have *risen* as a percentage of national income since 2010; the cut in highest-rate income tax has raised more revenue, not less; and are you opposing the introduction of the National Minimum Wage and the increase in tax-free allowances, which have so benefited the low-paid?"

- matchmade (in reply to Mark Richardson)

BY RICHARD GILL, CFA

READ TO SUCCEED

THE BEST INVESTMENT WRITING

SELECTED WRITING FROM LEADING INVESTORS AND AUTHORS FROM JESSE LIVERMORE TO WARREN BUFFET & BEYOND

EDITED BY MEB FABER

The way that the typical punter on the street can get involved in the stock market has changed substantially over the past few decades. Back in the 1970s if a retail investor wanted to research a stock they might have to spend weeks waiting for an annual report to be delivered to their home, trek down to the local library to read financial publications and obtain price information from out of date newspapers. And if they were lucky enough to have access to a broker, trading commissions could be many hundreds of pounds for just one trade.

All that has changed following the "Big Bang" of 1986 which opened up the financial markets, along with the effect that the internet has had on investment research and trading. Pretty much anyone can now open up an online trading account in minutes, with commissions at the lower end of the market being in single figures for a single trade. Some providers now even offer free trading. On the research side, investors now have instant access to annual reports, company news and stock prices.

But one way that the internet has not improved things for investors is via the creation of information overload.

While in the past information on a company was limited to a few select sources, the internet now provides a platform for literally anyone to give their views on a stock – whether they have proper credentials to do so or not – thus creating conflicting opinions. Just read a thread on an internet bulletin board discussing a popular stock and you'll see what I mean. Should you listen to *bigboy1234*, who says that Huge Resources plc are the next potential ten-bagger, or pay heed to the thoughts of *trustmeimanoctopus*, who thinks the company's directors are crooks?

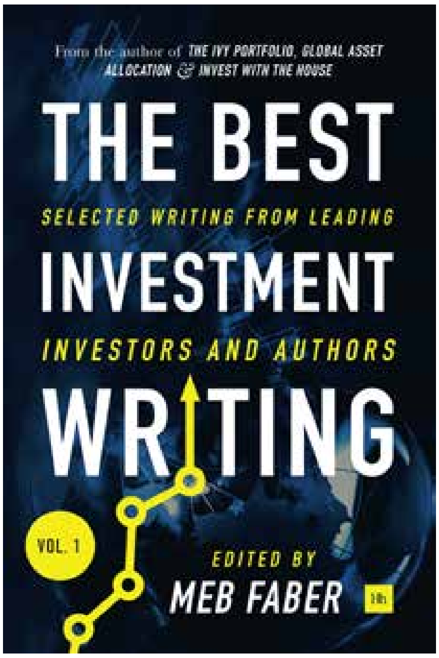
The problem with having too much information is that it can lead to bad investment decisions. Investors with too much information can have an illusion of control and feel more confident over their decisions, which can lead to more aggressive trading and a focus on the short term. This problem is all the more concerning given the ease with which investors can now place trades.

> **"THE PROBLEM WITH HAVING TOO MUCH INFORMATION IS THAT IT CAN LEAD TO BAD INVESTMENT DECISIONS."**

So wouldn't it be good to be able to cut through all the noise and only listen to the advice of a few true investment professionals. By reading *The Best Investment Writing*, you can do exactly that.

Expert Views

The Best Investment Writing does not have one author, but instead is a collection of over 30 articles published by leading investment professionals



"DOING YOUR RESEARCH AND BECOMING A TRUE EXPERT IN YOUR FIELD OF INTEREST CAN GIVE YOU A KEY ADVANTAGE OVER YOUR RIVALS."

over the years. Their works come from years of research and experience in the financial markets. The book has been put together and edited by Meb Faber, the co-founder and the Chief Investment Officer of Cambria Investment Management. Faber is the manager of Cambria's ETFs and private investment funds, has authored numerous white papers, five books and is a frequent speaker and writer on investment strategies.

Divided into five sections covering various investment concepts, the book kicks off with several articles focussing on Investment Strategies & Edges. The first, written by financial columnist Jason Zweig, demonstrates how doing your research and becoming a true expert in your field of interest can give you a key advantage over your rivals. In "A Portrait of the Investing Columnist as a (Very) Young Man", he describes his experiences as a teenage antiques collector, working in his family's dealing business. His attention to detail was second to none, for example going through encyclopaedias to write down and memorise the dates of when first editions of literary classics were published. This gave him an advantage over other collectors who were interested in the same items. Meb Faber himself also contributes to this section, writing an informative article on how markets revert to their mean over time and how this suggests some sectors could be looking at high double-digit returns over the coming years.

The other sections of the book look at risks & returns, pricing & valuation, behavioural investing and personal finance & wealth building. My own two particular favourite articles come from the final section. The first is written by Jonathan Clements, Director of Financial Education at Citi Personal Wealth Management. He suggests a three pronged strategy on how to make the most of your money, whether investing it or spending it – reflect, pause and focus. One of the key points here is that we should reflect on how spending money makes us happy, rather than accumulating wealth for wealth's sake. After all, you can't spend it when you're dead.

In my other favourite column, Ben Carlson, an institutional portfolio manager, highlights his top 20 personal finance rules. While a wealth of information has been written about this subject, Carlson's score of top tips sum up everything that is important. Some of the rules are obvious on the face of it, like avoiding credit card debt and building up a savings account. Others are more interesting however, with the author suggesting that we get ahead financially by living below our means, not within them, and not focussing on retirement but instead on becoming financially independent.

A wealth of benefits

There are a number of false prophets within the investment markets, amongst them journalists, dodgy share tipsters and other self proclaimed gurus. But *The Best Investment Writing* cuts through the rubbish and allows readers to learn from the cream of the crop of the investment world. So it's no wonder that the editor says you could think of the book as a Masters in investing.

Most of the material is aimed at those with a good degree of financial knowledge, with many of the articles containing quite detailed technical language. But the articles have been carefully chosen to ensure that they are well written and easily understandable by anyone who is interested in finance. There is no doubt that by reading this book your knowledge will increase, making you a better investor, with the practical advice given likely to be beneficial to your portfolio. And with "Vol. 1" written on the cover, suggesting that a sequel is in the pipeline, investors can likely look forward to another edition in the near future.

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.

BY TIM PRICE

THE FINAL WORD

IS YOUR PENSION POT EXPOSED TO AN INTEREST-RATE REVERSION?

Ten years since it began, who is to blame for the Global Financial Crisis? I tend towards the 'Murder on the Orient Express' conclusion: *they all did it*.

You cannot have a banking crisis without bad banks and bad bankers. It is clear, with the benefit of hindsight, that senior executives at the larger banking organisations had no clue what their own companies were doing. 'Sir' Fred Goodwin at RBS needed to have collateralised debt obligations (repackaged mortgages where the risk was sold on by the originators) explained to him with the aid of a diagram, by which time it was already too late.

As a sign of just how close the system came to complete meltdown, consider the conversation that Jamie Dimon, head of JP Morgan, had with his fellow directors on the weekend that Lehman Brothers failed. Lehman filed for Chapter 11 bankruptcy protection at midnight on 14 September 2008. Dimon arranged a teleconference call on the morning of 13 September, and this is what he said:

"You are about to experience the most unbelievable week in America ever, and we have to prepare for the absolutely worst case. Here's the drill. We need to prepare right now for Lehman Brothers filing [for Chapter 11 bankruptcy protection]. And for Merrill Lynch filing. And for AIG filing. And for Morgan Stanley filing. And potentially for Goldman Sachs filing."

The author Andrew Ross Sorkin, who recounts this story in his excellent account of the crisis, *Too Big to Fail*, adds a brief response by Dimon's fellow directors:

"There was a collective gasp on the phone."

Nor has the banking system – especially in Europe – been healthily restructured. The 2016 annual report of Deutsche Bank totals 478 pages. I have no idea whether Deutsche Bank is actually insolvent, as many fear – but I suspect that neither does its Board.

"THERE IS ONE IRON LAW IN FINANCE: IF INTEREST RATES GO UP, WHATEVER HAPPENS TO THE STOCK MARKET, BOND PRICES GO DOWN."

Drowning in debt

But we cannot blame the banks without laying at least some blame on their customers, too. During the property bubble, borrowers engaged in reckless behaviour and some were caught out. The problem is that we are all living with the legacy.

And we cannot blame the banks without including their ultimate regulators, the central banks, who we can only conclude were asleep at the wheel while the credit markets were allowed to swell beyond all reasonable parameters – and then exploded.

We now seem to have reached some form of end-game. Monetary policy rates cannot realistically go (much) lower than zero. Here in the UK the Bank of England's base rate hovers at 0.25%. In the eurozone, policy rates have gone negative. But in the US, the Federal Reserve is trying to "normalise" monetary policy by raising rates, albeit in baby steps. Even by making modest tweaks to the Federal Funds target rate (at which prime money centre banks lend to each other), the Fed runs the risk of choking off the recovery – an error it is believed to have made in 1937, during the Great Depression.

The Fed raised rates eight years after the Great Crash of 1929, following eight years of accommodative monetary policy – and the Dow Jones Industrial Average promptly fell by 49%. Could history be about to repeat itself?

There is one iron law in finance: If interest rates go up, whatever happens to the stock market, bond prices go down. This is intuitively obvious, in that most bonds carry fixed coupon (interest) payments, hence the designation 'fixed income' to describe bonds. If monetary policy rates rise, they make those (fixed) income payments comparatively less attractive, so the price of bonds falls, to compensate.

Here is a brief snapshot of 10 year government bond yields throughout Europe:

Country	Nominal yield
UK	1.10%
France	0.72%
Holland	0.55%
Germany	0.43%
Switzerland	-0.18% (!)

The eurozone inflation rate is currently 1.3%. Assuming no change in the rate of inflation, every single investor in European bonds is guaranteed to make a loss in real terms if those bonds are held to maturity. Who on earth would make that bet?

The UK inflation rate is currently 2.9%. Again, assuming no change in the rate of inflation, an investor in 10 year UK government bonds is guaranteed to make a loss in real terms (of 1.8%) if those bonds are held to maturity. Who on earth would make that bet, either?

Answer: just about every pension fund in the UK and Europe.

According to research by pension fund consultants Mercer, in 2003, UK pension funds had 68% of their assets in stocks, and 31% in bonds. (The other 1% was held in alternative assets.) Now that interest rates are at their lowest level in recorded history, UK pension funds have 49% of their assets in bonds, and just 29% in stocks. Pension funds are significantly exposed to a turning in the interest rate cycle, which no longer seems fanciful. Reminder: when interest rates go up, bond prices go down.

Return-free risk

It is not, however, as if pension funds have any real choice, in that they are obligated by their own regulator to hold the preponderance of scheme assets in bonds, especially government bonds, which are deemed the only "risk free" asset which can safely match the liabilities represented by their current and future pensioners. But is a guaranteed loss in real terms really a "risk free" return? Or is it closer to being return-free risk?

Mercer also suggest, in their Asset Allocation Survey, that the majority of European pension funds intend to reduce their exposure to stocks and raise their holdings in government and corporate bonds in the months and years to

"PENSION FUNDS ARE SIGNIFICANTLY EXPOSED TO A TURNING IN THE INTEREST RATE CYCLE, WHICH NO LONGER SEEMS FANCIFUL."


Joseph Sohm / Shutterstock.com

come. This might seem like an accident waiting to happen, and it is.

In medicine, there is something known as an iatrogenic illness. An iatrogenic condition is one that is caused by the doctor himself. This is, essentially, the role that regulators have played in their oversight of the financial system. Banks that should and could have been allowed to fail in an open, if inevitably painful, free market process were instead bailed out by their own regulators, using our money, in an international outbreak of what we can call crony capitalism, as opposed to the real thing. There was never a reckoning for bondholders, who could and should have shouldered some of the costs. Taxpayers were left to pay the bill. The process of bailing out the banks added immeasurably to the growing global debt load and essentially caused a corporate sector debt crisis to metastasise aggressively, transforming itself into a sovereign debt crisis for which there may now be no cure – because there is no entity anywhere in the world with the capital to underwrite such a heavily overleveraged banking and financial system.

Winston Churchill advised us never to let a good crisis go to waste. Lax regulation triggered the crisis in the first instance, and the regulators then poured fuel on the fire by encouraging the authorities to double down on the banks and throw everything but the kitchen sink at their salvation.

Regulatory inattention and incompetence was harmful enough. For the crisis to reach truly pandemic proportions, however, the financial system needed an even more powerful monetary enabler – the central banks themselves.

"WHY DO WE ALLOW A MONETARY POLICY COMMITTEE POPULATED BY TECHNOCRATS TO DICTATE THE MOST IMPORTANT PRICE IN THE ECONOMY, NAMELY THE PRICE OF MONEY ITSELF?"

Starve the beast

It is quite remarkable that, after a century in which the failings of central planning were displayed quite publicly in the collapse of the Soviet Union and Communist China, central planning continues to hold sway in one last outpost of our economy: the Bank of England.

Why do we allow a monetary policy committee populated by technocrats to dictate the most important price in the economy, namely the price of money itself? We let free markets set the prices of everything else.

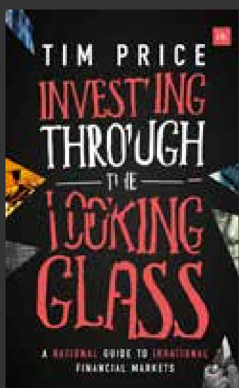
How to resolve this predicament is not easy, not least because it will require a change in political mindset. But the signs are that a disgruntled electorate is hungry for change, and I suspect that in the months to come we will see no shortage of interest in new political parties willing to stake their claim for a centre ground that incorporates a belief in sound money, small government, and truly free market capitalism.

In the meantime, how should investors respond to the acute challenge of our times: ultra-low interest rates, no meaningful deposit rates, and elevated prices for most financial assets?

I think the answer lies in a pragmatic return to first investment principles, notably those advocated by the legendary value investor Benjamin Graham, tutor to Warren Buffett and many other extraordinarily successful investors besides. Avoid indices. Avoid overpaying for quality businesses. Seek out principled, shareholder-friendly corporate management who are adept at capital allocation, and then only buy the shares of their companies when they can be purchased at a discount to their inherent value. As for bond investments, the government and the Bank of England would dearly love you to purchase some of the fine government bonds whose generous supply, by their recent actions, they have ensured. Starve the beast. Don't invest in grotesquely overpriced government bonds – invest in high quality, good value stocks instead, and back honest entrepreneurs instead of the dead hand of the State.

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'.



MARKETS IN FOCUS

AUGUST 2017

GLOBAL EQUITIES

Index	Last Month %	YTD %	Proximity to 52w High*
Russian Trading System	8.7	-4.7	
Bovespa	7.5	18.0	
Hang Seng	2.4	27.0	
NASDAQ 100	1.8	23.0	
FTSE 100	0.8	4.0	
Dow Jones	0.3	11.0	
S&P 500	0.1	10.0	
S&P/ASX 200	-0.1	0.9	
CAC 40	-0.2	4.6	
Euronext 100	-0.4	6.2	
DAX Xetra	-0.5	5.0	
Nikkei 225	-1.4	2.8	
IBEX 35	-1.9	10.0	

COMMODITIES

Commodity	Last Month %	YTD %	Proximity to 52w High*
Natural Gas	8.1	-19.0	
Copper	6.6	24.0	
Platinum	6.3	11.0	
Iron Ore	6.2	-0.6	
Palladium	5.8	37.0	
Silver	5.1	10.0	
Gold	4.2	15.0	
Crude oil (Brent)	0.2	-7.3	
Sugar (No. 11)	-3.4	-26.0	
Soybean	-6.1	-5.8	
Crude oil (Light Sweet)	-6.3	-13.0	
Cocoa	-6.5	-11.0	
Coffee	-7.1	-4.5	

FOREX

Pair/Cross	Last Month %	YTD %	Proximity to 52w High*
EUR/GBP	2.8	8.0	
EUR/USD	0.8	13.0	
EUR/JPY	0.5	6.6	
EUR/CHF	-0.1	6.7	
USD/JPY	-0.2	-5.8	
USD/CAD	-0.3	-7.1	
AUD/USD	-0.8	10.0	
USD/CHF	-0.8	-5.8	
GBP/AUD	-1.2	-4.9	
GBP/USD	-2.0	4.8	

CENTRAL BANKS - RATES & MEETINGS

Central Bank	Key Rate	Next	After
BOE	0.25%	Sep 14	Nov 02
ECB	0.00%	Sep 07	Oct 26
FED	1.25%	Sep 20	Nov 01
BOJ	-0.10%	Sep 21	Oct 31
SNB	-0.75%	Dec 14	---
BOC	0.75%	Sep 06	Oct 25
RBA	1.50%	Sep 05	Oct 03
RBNZ	1.75%	Sep 28	Nov 09
BOS	-0.50%	Sep 06	Oct 25
BON	0.50%	Sep 21	Oct 26

FTSE 350 TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
Evraz PLC	41.0	51.0	
Ferrexpo PLC	26.0	120.0	
NMC Health PLC	20.0	76.0	
Intertek Group PLC	19.0	47.0	
KAZ Minerals PLC	17.0	140.0	

FTSE 350 BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Provident Financial PLC	-57.0	-69.0	
Dixons Carphone PLC	-36.0	-51.0	
AA Ltd	-35.0	-42.0	
Carillion PLC	-22.0	-81.0	
IP Group PLC	-19.0	-35.0	

FTSE 350 SECTORS TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
Industrial Metals	35.0	70.0	
Mining	7.3	20.0	
Food Producers	7.0	11.0	
Beverages	6.5	25.0	
Forestry & Paper	5.9	27.0	

FTSE 350 SECTORS BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Oil Equip, Serv & Dist	-7.1	-34.0	
Fixed Line Telecom	-6.0	-19.0	
Media	-3.6	-7.2	
Real Estate Inv & Serv	-2.7	8.1	
Banks	-2.4	7.5