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MAGAZINE

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# HOW TO INVEST IN 2018

## PLUS...

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WHERE THE MASTER INVESTOR IS PUTTING HIS MONEY IN 2018

### THE POUND REBOUND

WHY 2018 COULD BE A STERLING YEAR FOR THE POUND

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WE REVEAL THE FUNDS THE EXPERTS ARE BACKING IN 2018

### THE NEW ARM

COULD THIS SMALL COMPANY BE BRITAIN'S NEXT TECH TITAN?

# WELCOME

Dear Reader,

Staying true to our name, we are giving you access to the ideas and insights of some true masters of their respective fields. In this New Year issue, you'll find 2018 investment outlooks authored by:

- Jim Mellon (page 6): Our original Master Investor and one of the world's best prognosticators for long-term trends gives you specific investment ideas from around the globe, mixed with his views about subjects such as bonds, Brexit, and gold.

- Victor Hill (page 10): Thanks to his seemingly never-ending globe-trotting, Victor has been able to assemble an extremely comprehensive analysis for us, with particular reference to the impact of the Trump tax cuts in the US and elsewhere.

- Manish Singh (page 34): A well-known face through his frequent mainstream media appearances, I managed to get the Mayfair-based investment expert to very generously share his unique view of the world.

That's not to forget the myriad other articles you get to enjoy in our publication this month. Once again, available to you at no cost!

Our magazine is an integral part of a growing series of events, with the most prominent being the yearly Master Investor Show. Our flagship event will next take place on March 17th, at our usual venue, the Business Design Centre in Islington, London.

Have you booked your ticket yet? If not, you should use discount code "M0118" to secure your complimentary ticket by visiting https://masterinvestor.co.uk/tickets.

This year's event is going to feature a few novelties. For example, we'll have high-profile comedian Dominic Holland deliver a finance-related comedy show at the very end of the day. This is bound to be "standing room only" for those who don't get there early.

I hope this month's issue will inspire you to take charge of your own investment decisions in 2018. The entire team hopes to see you at the Master Investor Show on March 17th!

Best regards,

Swen Lorenz
Editor, Master Investor

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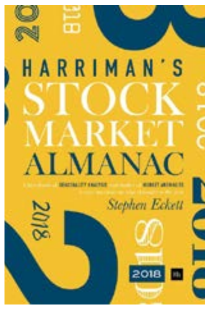


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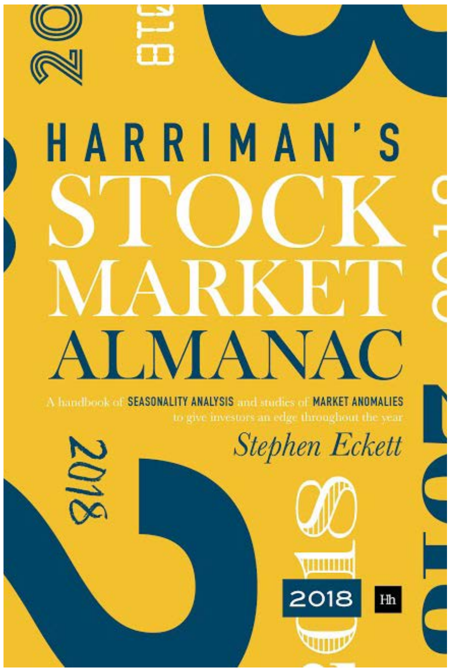
# ALL OTHER TOPICS










BY JIM MELLON

# MELLON ON THE MARKETS

**It's that time of the year again: when the pundits look back and either tell you "I told you so", or "mea culpa", or some variant in between. I don't really like looking back – except where the past holds some lessons for the future – but it sure has been an "interesting" year.**

Bond yields have remained pretty flat over the past twelve months, but there are now clear signs of stress in credit. One indication is the severe flattening of the US yield curve, and another is that high yield debt is now coming under pressure. World money supply is no longer growing, and there is mounting evidence of a looming shortage of US dollars emerging, which could put the US currency bear phase into reverse next year. All the usual caveats – China, North Korea, Catalonia, Trump and Brexit, inter alia – still can't hold back the enthusiastic wave of dumb money. This wave has, in the words of Professor Scott Galloway of NYU, led to unprecedented multiples and zero accountability in the FANG world, of which I have written about at length for the past year (and will come back to later in this piece).

Bull markets around the world look increasingly narrow, with ever more rapid-paced rotation taking place, a phenomenon which normally marks a top formation. And of course, there is the cryptocurrency mania, which defies rational explanation – unless you believe that there are enough tax dodgers, dark web buyers and money launderers out there to justify the sprouting of the various offshoots of bitcoin, which now proliferate like colourful new tulip bulbs.

I take a neutral (i.e. ignorant) view on bitcoin, as what can't be readily understood cannot be properly judged.

**"BULL MARKETS AROUND THE WORLD LOOK INCREASINGLY NARROW, WITH EVER MORE RAPID-PACED ROTATION TAKING PLACE, A PHENOMENON WHICH NORMALLY MARKS A TOP FORMATION."**

Indignation (of not understanding it) is usually envy dressed up with a halo, and I don't want to fall into that particular trap. My mole in the crypto world – he who has made a lot of money for his investors (me included) by being a committed bull – is even now taking some money off the table (only with difficulty can the coins be converted into spendable cash). This tells you a lot of what you need to know. It's not time to jump into the pool, just as it is beginning to drain. By this, I don't mean that the price has peaked – it may not have done – but the upside from $100 to $20,000 is a lot greater than any potential upside from here. It is estimated that just 1,000 people in the Bay Area own about 40% of all bitcoin, adding to the weight of money that no doubt will one day see San Francisco sink into the sea. That is, if the earthquake doesn't get them first.

But, it is a fact that bubbles can go on for a lot longer than even veterans of such things can imagine; and they can deflate and reflate as well. For instance, Amazon was $70 a share in 1999, fell to $6 in 2001, and is now (at time of writing) above $1,150. Who knows what the trajectory of bitcoin et al will be? At this level, who cares, except for those playing the game?

Much more importantly, how can we make money in 2018? Here are a few observations. These are not of the famous ilk of the "outrageous" predictions, which are from time to time promulgated as Festive Crackers by a friend of mine, but rather practical ones to advise what one can do in a (mostly) low return world.

**"MY BEST GUESS IS THAT THE EURO FALLS AGAINST THE DOLLAR AND THE POUND IN THE NEXT YEAR, BY AS MUCH AS 10%."**

1. Bonds, with the possible exception of index linked UK gilts, remain a near universal sell. There is no upside in lending to governments or corporations at a time of increased debt loads, insidious and mounting wage pressures (which are bound to be inflationary) and increased credit risks. If I were the UK government, I would (well done, Jeremy Corbyn) borrow vast amounts of money to invest in infrastructure, education and science – money repayable at the longest possible duration. It is most unlikely that the return on the debt would be less than the cost of the borrowing. Even the dumbest government officials – and there are plenty of those – must be thinking along these lines. I expect that the Germans and others are also so ruminating.

2. The eurozone, fuelled by massive but decreasing money printing, will not remain the momentum machine it is now hyped up to be. It still has vast problems, and my best guess is that the euro falls against the dollar and the pound in the next year, by as much as 10%. The combination of turbulent political issues, most notably the German coalition of the unwilling – which is being tortuously stitched together – as well as a probable slowdown in export growth, will put the euro under pressure.

   Certainly, some European stocks, notably **Unibail Rodamco (UL:NA)** (the company buying Westfield at the moment), **Total (LON:TTA)** (the French oil company), and the British firm **GlaxoSmithKline (LON:GSK)** (which has got an excellent new drug prospect in Multiple Myeloma, as well as a 6% plus yield) are all interesting in Europe/UK. I also continue to favour **Novartis (VTX:NOVN)**, the Swiss drug behemoth which boasts a reasonable yield and is the most advanced major in terms of pro-longevity science.

**"JAPAN REMAINS A BUY, AND MY TARGET IS NOW 30,000 FOR THE NIKKEI IN 2018."**

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3. This *will* be the year of the FANG denouement. Ian Bremmer of Eurasia, a very respected commentator, believes that Facebook, Google et al's lawyers can outsmart any government lawyers – and anywhere – but I am not so sure. I think the weight of public opinion against these companies is becoming heavier and heavier. This is because of their low tax loving cultures (in the past 10 years Amazon has paid less that $2 billion in taxes, whereas for Walmart, its major competitor in the US, it has been over $64 billion!). The FANGs are not deliberately doing bad stuff; they are just being given the opportunity to give capitalism a bad name. They are carefully avoiding the label of being media companies, claiming to be technology platforms, when in fact they are the principal source of "news" for many, many people. The rectification of this clear anomaly, plus fines for monopolistic behaviour, and the imposition of normalised taxes – as well as questioning as to whether they are beginning to saturate their markets – make them the clearest fundamental sells I have ever seen.

4. Japan remains a buy, and my target is now 30,000 for the Nikkei in 2018, up from my previous target of 25,000, which is now close to being achieved. The PE of the Japanese market is about 14x forward, balance sheets and corporate governance are improving, and the yen is undervalued. If you want to hold a major market (and cash is not a bad alternative to any market) consider Japan. The banks there look particularly attractive, as there is a vague hint of rising interest rates in the air.

5. Gold and silver are up by about 8% in 2017. Normally, that would have been a lot more, but I feel that bitcoin has diverted a lot of speculative activity away from the precious metals complex. I am pretty sure that the yellow metal will regain lustre in the coming year, and I make a bold forecast of at least $1,600 on gold by year end 2018.

6. US stocks to buy – well I remain committed to **Gilead (NASDAQ:GILD)** – cash rich, innovative, aggressive and cheap US leader in biotech – and I also think that **Editas (NASDAQ:EDIT)** in the gene editing space and **Adaptimmune (NASDAQ:ADAP)** in the cancer immune therapy area look interesting.

7. In the mining area, among the smaller companies I follow/and or invest in, I like the look of **Zenith Minerals (ASX:ZNC)** in Australia, with interesting upside in lithium and gold assets. Recall that previous Master Investor winners from this same stable have included **Syrah (ASX:SYR)**, **Triton (ASX:TON)**, and **Critical Elements (CVE:CRE)**, all of which have provided more than 10x returns.

I would like to give a recommendation for each of the Twelve Days of Christmas, but I have run out of ideas and space, so I will just wish all readers a Happy Christmas instead. Don't forget to book your entry to the Master Investor show taking place on 17th March next year. It's going to be amazing, and there is nothing else like it in the UK.

**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

# PREPARE YOURSELVES FOR A BUMPER YEAR

**In the January 2016 edition of Master Investor Magazine I penned an article entitled *2016: The year of living dangerously.* That was the year of the Brexit referendum and the triumph of Mr Trump. Populism appeared to be rampant and the Eurozone was under severe strain.**

**But Europe did not fall to the populists. It was the Anglo-Saxons who set out on a post-globalist agenda of economic nationalism. That makes for divergence between the English-speaking world and the Europeans which threatens to undermine the post-1945 states system. And yet, in many ways, this understanding of reality is completely misleading. In fact, the "post-globalist" Anglo-Saxon economies are likely to remain far more open than the increasingly federalist EU, which, in my view, is likely to turn in on itself and adopt *de facto* protectionism.**

**This all takes place at a time when China and Russia are challenging America. Recently I speculated that this challenge will take the form of state monopoly digital currencies which will be used to trade, amongst other things, oil. Though it will take time for this trend to play out.**

**So how come I am so optimistic about the outlook for the US and the UK markets in 2018? In fact, I foresee that the Dow will continue to climb towards the 30,000 level during 2018 and may even surpass it. The FTSE-100 will move in its wake and, buoyed by a reduction in Brexit angst, will surge towards the 8,000 level. There is much to be optimistic about this year in the English-speaking world – as I shall try to explain.**

## America

**Can the US markets keep climbing?**

On Wednesday, 20 December a slew of American corporations announced one-off bonuses for their employees. **AT&T (NYSE:T)**, the telecommunications giant, promised to pay each of its 200,000 staff a $1,000 bonus. **Comcast (NASDAQ:CMCSA)** the country's largest cable TV operator, said that it would give its 100,000 staff the same. **Wells Fargo (NYSE:WFC)**, one of America's largest banks, promised to raise its minimum wage to $15 per hour, as did **Fifth Third Bancorp (NASDAQ:FITB)**. A number of companies announced new charitable programmes amounting to billions of dollars. What is behind all this corporate largesse? American business, after Mr Trump's tax cuts, is feeling extremely bullish about 2018.

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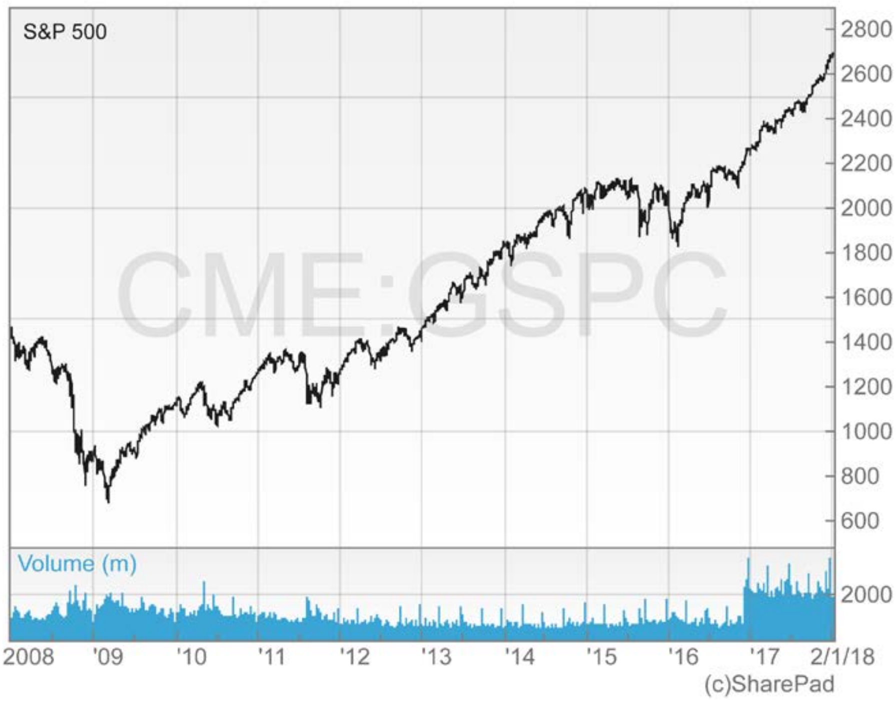
**"AMERICAN BUSINESS, AFTER MR TRUMP'S TAX CUTS, IS FEELING EXTREMELY BULLISH ABOUT 2018."**

True, Goldman Sachs recently went bearish on its US market outlook. In a recent note they pointed out that for an investor with a 60 percent equity and 40 percent bond portfolio this has been the longest bull market since the 1920s. The bank envisages either "slow pain" (a gradual adjustment) or "fast pain" (a sudden market correction) as values adjust to historic norms.

The conventional wisdom is that the Cyclically Adjusted Price-Earnings Ratio (CAPE) has hit a record high – which suggests that the US markets have peaked. Certainly, Jim Mellon thinks so. But let me give you two reasons why that may not necessarily be the case.

Firstly, the CAPE figures use averaged-out earnings numbers over normally a ten-year time horizon. That does not capture the sudden upsurge in corporate profits that has occurred relatively recently and which are likely to accelerate further in 2018. Obviously, one has to take a view as to whether earnings growth will revert to the mean over the medium-term: but 2018 promises to be a bumper year.




Secondly, one should remember that the surge in US stocks over the last year or more has been patchy. To be sure, the tech giants – especially **Amazon.com (NASDAQ:AMZN)**, **Facebook (NASDAQ:FB)**, **Apple Inc. (NASDAQ:AAPL)**, **Microsoft (NASDAQ:MSFT)**, **Netflix (NASDAQ:NFLX)**, **Alphabet/Google (NASDAQ:GOOG)** – have surged into the stratosphere. But, as I reported in [the November edition of the Master Investor magazine], some sectors of the US market have declined markedly. I cited bricks-and-mortar retailers (such as the department store chain **Macey's (NYSE:M)** and **Nordstrom (NYSE:JWN)**) which were down by 30 percent or so and which I speculated might be undervalued. If such Cinderella sectors recover in the face of strong consumer demand, the US market may have much further to go.

But ultimately, one has to assess the economic fundamentals – and these are sanguine.


**The state of the American economy**

The US economy grew at its fastest pace for two years in Q3 2017, largely driven by robust business spending. GDP in the world's largest economy grew at an annualised rate of 3.2 percent, according to the Commerce Department. The question is whether this momentum can be sustained. Those who support Mr Trump's package of tax cuts think that it can.

A key indicator, business equipment investment, was up by an impressive 10.8 percent – the fastest in three years. Consumer spending, which accounts for about two thirds of the US economy, was up 2.2 percent. This renewed emphasis on investment will be music to Mr Trump's ears.

Other data released on 21 December showed that new claims for unemployment amounted to 245,000 in the week before Christmas. This was the 146th consecutive week that new claims were below the psychologically significant 300,000 threshold. With strong growth and a tight labour market the US economy is in fine fettle.

**Mr Trump's tax give-away**

During the week before Christmas President Trump signed into law the tax reform bill which had spent nearly two months going through Congress. Despite numerous amendments – the final rate of corporate tax was set at 21 percent rather than the proposed 20 percent – Mr Trump got more-or-less everything he wanted.

The initial reaction from the markets was entirely favourable – despite siren voices warning that the measures will increase America's fiscal deficit by another trillion dollars or more over the next ten years. This was both a tactical victory and a moral one in so far as it is the first time that the President has got a major reform package through Congress. Whatever you may think of Mr Trump – he has delivered on one of his principal electoral promises.

Do the tax reforms justify the enthusiastic market sentiment? The fact is that we won't really know the answer to that for about two years. If the corporate cash cows (like **Apple Inc. (NASDAQ:AAPL)**) repatriate a significant portion of their offshore cash balances to the USA and if growth peps up, the tax measures will look like a great success. US corporations are reckoned to hold about $2.6 trillion in offshore tax havens, of which Apple accounts for $252 billion. On the other hand, if the *a priori* fall in the tax-take is not counterbalanced by more economic activity, then the tax reforms will be judged a failure.

It is estimated that the cut in corporate taxes alone will provide an additional $200 billion of stimulus to the economy in 2018 alone. Nearly every company which operates in America will feel the effect of lower taxes and profits and the extra spending power of American consumers. This could add up to an additional 1.3 percent of

## British companies poised to do well from lower US corporate taxes

**Intercontinental Hotels (LON:IHG)** told shareholders on 21 December that Mr Trump's cut in corporate taxes from 35 to 21 percent would slash its tax bill by "mid to high single digit percentage points in 2018". Intercontinental, which owns the *Holiday Inn* brand amongst others, generates 64 percent of its earnings in the USA. **Morgan Stanley** instantly upgraded its earnings estimates for the company for 2018 by 10 percent.

**Ashtead Group plc (LON:AHT)**, the industrial equipment company, is a British multinational which derives 85 percent of its £2.3 billion sales from the USA – more than any other FTSE-100 company. Similarly, **Shire PLC (LON:SHP)** has the second largest proportion of US sales out of the FTSE-100 with 67 percent generated in America. Smaller UK listed companies with huge sales in America include **BBA Aviation (LON:BBA)** (87 percent) and **Indivior (LON:INDV)** (81 percent).

Other British companies to note which are big in America include **Ferguson (LON:FERG), Pearson (LON:PSON), National Grid (LON:NG), Experian (LON:EXPN), Compass (LON:CPG), Bunzl (LON:BNZL)** and **Worldpay (LON:WPG)**.

**"US CORPORATIONS ARE RECKONED TO HOLD ABOUT $2.6 TRILLION IN OFFSHORE TAX HAVENS, OF WHICH APPLE ACCOUNTS FOR $252 BILLION."**

economic growth in 2018 according to some estimates.

Critics of Mr Trump's tax bill claim that it was railroaded through Congress without adequate scrutiny and that it will have to be extensively amended and refined. Tax accountants will be poring over the small print of this legislation throughout 2018 – and perhaps much beyond. Questions have even been raised as to whether the IRS, the US government tax agency, will have the wherewithal to apply the legislation correctly. In particular, "related party" expenses will be governed by a chapter in the legislation called BEAT (Base Erosion Anti-Abuse Tax) which could prove arduous to apply.

## US business sectors that will profit most

According to a study by the University of Pennsylvania US **mining companies** are likely to benefit from a 60 percent cut in their effective tax rate. This is followed by **administrative support and waste management** (-47 percent), **accommodation and food services** (-46 percent) and **transport** (-41 percent).

Another new rule states that interest expense deductions will amount to no more than 30 percent of EBITDA. That will negatively impact foreign corporations which finance their US operations with inter-company loans. It is thought that this could affect a number of foreign financial services companies.

**Political reality check: the mid-term elections**

November 2018 will see the return of America's two-year electoral cycle with the House of Representatives and one third of the Senate up for election. Since the defeat of the pro-Trump Judge Roy Moore in the Alabama Senatorial election on 12 December, the Democrats have sensed that the tide may have turned in their favour. But the truth is that no one can be sure what will be the electoral mood come next November. My best guess is that Mr Trump will be riding high.

I was interested to hear Tina Brown, the veteran magazine editor who has her fingers on the pulse of American politics, predict recently that Mr Trump will win a second term in 2020. Be that as it may, it is unlikely that the Democrats storming Congress in November 2018 would make much difference to market sentiment. The US markets surged in the 1990s under President Clinton even though he faced resolute opposition from a Republican Congress.

**America: the social divide**

While corporate America and investors continue to prosper there are reasons to be concerned that this newly created wealth is not being diffused through American society as a whole. In 2016, 42,000 Americans died of opioid overdoses alone, a 28 percent increase on the previous year. Opioids are either prescription pain-killers or far more nefarious synthetic opioids such as fentanyl which is 50 times more potent than heroin. Partly as a consequence of that, US life expectancy fell for the second year running. I regard life expectancy as a very good proxy measure for the economic well-being of a country.

This is a rare but not unprecedented statistic in an advanced country. The US recorded a similar two-year fall in life expectancy after the influenza epidemics of 1962 and 1963. And in 1993 there was a single-year drop during the Aids epidemic. Sustained falls in life expectancy are only normally experienced by countries in wartime.

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That said US life expectancy has risen from just 70 in the early 1960s to just under 79 today. But that is well short of European and Japanese levels.

President Trump chaired a symposium on opioid abuse at the White House in October, so it is very much on policy-makers' radar. Critics will say, however, that there is no coordinated policy on how to reduce deprivation in America.

According to the World Inequality Lab's *World Inequality Report 2018*, since 1980 income inequality has increased markedly in North America and Asia, increased moderately in Europe and has stabilised (though at an extremely high level) in the Middle East and Brazil. Between 1980 and 2016, in North America the top one percent captured 88 percent of the aggregate rise in real incomes. In Europe the top one percent captured "only" as much as the bottom 51 percent. This differential is partly explained by the fact that US asset prices have risen faster than in Western Europe. But the underlying message is clear: in the third industrial revolution (aka the *communications revolution*) inequality has accelerated – especially in America.


**"A RETURN OF CONFIDENCE WILL WORK WONDERS FOR THE UK MARKETS."**

## Britain

### Beyond Brexit jitters

We have now passed beyond the period of maximum post-Brexit uncertainty. 2018 will be the year in which Britain's role and post-Brexit potential will come more clearly into focus. As it does so there will be a renewed sense of optimism – something so desperately lacking in 2017.

The FTSE-100 hit an all-time high just before Christmas with the markets in festive mood. The *Santa rally* pushed the index to above 7,600 for the first time. While the US stock markets have posted a succession of record highs during 2017, the FTSE-100 actually had a pretty lacklustre second half of the year, having only exceeded May's peak in October before retreating again. A return of confidence will work wonders for the UK markets.

### Top-performing UK sectors in 2017

**Housebuilders.** The likes of **Taylor Wimpey (LON:TW)** have had an excellent year, buoyed by government-funded schemes such as the *Help to Buy* scheme to help first-time buyers. But they were negatively impacted in December by the government's clamp-down on "feudal" leasehold practices. Under government proposals housebuilders will not be permitted to sell new-built leasehold homes and ground rents in England will be set at zero. Leaseholders will be enabled to buy out their freeholds more easily. As a result Taylor Wimpey set aside £130 million in provisions to cover potential disputes with leaseholders. Retirement home specialist **McCarthy & Stone (LON:MCS)**, for which ground rents are intrinsic to its business model, lost nearly 10 percent of its stock price as a result of this on 21 December. **Berkeley Group (LON:BKG)** and **Persimmon (LON:PSN)** were also impacted.

**Online fashion brands.** In 2017 fast fashion giant **Asos (LON:ASC)** and youth-friendly **Boohoo.com (LON:BOO)** powered ahead. RBS Capital Markets believes that **Asos** has formidable competitive advantages, not least customer loyalty, which will enable it to sustain its current high levels of growth.

### Mrs May: Terminator IV

Mrs May is not only a survivor but we learnt last year that she is indestructible. Nothing can destroy her, like *the Terminator*. If she falls into a cauldron of molten metal, the little metallic pieces of which she is made will just re-cohere into a functioning android. If she is frozen at a temperature of absolute zero and shattered with a sledgehammer – no problem. Once again, the shards have the ability to find each other and re-assemble themselves. If thermonuclear war breaks out with *Little Rocket Man,* Mrs May will be found stalking the smouldering ruins, muttering to herself about *strong and stable government.*

Even her most ardent critics in the Tory Party have understood this – which is why there will be no leadership chal-


**"THE EUROPEANS WILL COME UNDER INTENSE PRESSURE TO STRIKE AN AGREEABLE TRADE DEAL WITH THE UK, GIVEN THE VALUE OF BRITISH MARKETS TO THEIR EXPORTERS."**

lenge in 2018 – nor in 2019. So we can expect more steely stares into the middle distance as the trade negotiations with Monsieur Barnier get hairy during 2018.

But, seriously, this is important. One of the reasons why the Phase I Brexit talks stalled and nearly came to grief was because, back in October, the Europeans – who have always been badly informed about the UK – thought that Mrs May was a goner and that they would soon be dealing with Mr Johnson – or something even worse. The European *nomenklatura* then came collectively to the view that it was better to deal with the devil they knew. The result was that the Phase I negotiations ended on a harmonious theme, with Mrs May receiving applause from the EU-27 leaders at the December Brussels summit. (True, there is a school of thought that this applause was sarcastic – like that for *Florence Foster Jenkins* after one of her song recitals.)

**Why there will not be a second referendum**

The Liberal Democrat leader, Sir Vince Cable, is just one of many amongst the ultra-Remainers who wish to scupper Brexit by holding a second referendum. Messrs Blair and Clegg have also been manoeuvring in this direction. Just before Christmas the Lib Dems tried to pass a Commons amendment to the Brexit bill now going through parliament that would have obliged the government to hold a referendum on the final Brexit agreement in December 2018. Those who wish to precipitate a second referendum which they believe would reverse Brexit were emboldened by the government's defeat in the House on an amendment drafted by Tory Remainers on 13 December.

Labour's policy on Brexit is in constant evolution but is consistent in that it amounts to doing anything that might discomfort and thus topple the government. (Mr Corbyn really believes that there will be another election in 2018 and that he will win – there won't be one, period.) In the week before Christmas Labour's deputy leader argued for a second referendum while Ms Abbott, Shadow Home Affairs Spokesperson, ruled it out.

Certainly, the scarier that Brexit can be made to look, the greater the challenges exaggerated, the more the potential benefits ignored, the greater the chance that the public can be panicked into vetoing Brexit at the very last moment. But to promise a second referendum now would be folly in so far as it would incentivise the EU to offer Britain the worst deal imaginable in the expectation that the British public would reject it. If, on the other hand, the UK commits to leave the Single Market and the Customs Union with no question of a second referendum, the Europeans will come under intense pressure to strike an agreeable trade deal with the UK, given the value of British markets to their exporters.

Moreover, a second referendum would just prolong the agony. In the run-up to such a referendum there would be an additional layer of uncertainty; and if the referendum resulted in a rejection of the proposed deal, that would plunge business into inordinate confu-

## Is London Real Estate looking cheap?

While pundits foresee doom for the City of London, if you take the trouble to go down there you will see more cranes than ever. From the observation deck at Tate Modern I counted more than 20 last month. That suggests that the construction companies are bullish about City property even if there is downward pressure on rents – hence the fall of share prices in real estate investment trusts (REITs) and property companies.

Indeed, share prices have fallen so much that opportunistic M&A activity has begun – such as **Hammerson's (LON:HMSO)** offering to acquire rival **Intu (LON:INTU)** last month. The combined group would own 17 of the UK's 25 biggest shopping centres. **Intu's** shares surged by 20 percent though **Hammerson's** fell on fears that the combined group would be too exposed to UK retail which is supposedly in structural decline.

Some analysts speak of a "double discount" on UK REITs. Firstly the underlying assets are undervalued; second the REITs are trading at a dramatic discount to Net Asset Value (NAV) per share. For example, **Land Securities (LON:LAND)** NAV per share was £14.68 on 30 September while its share price just before New Year was 1,000 pence. Less dramatically, for **British Land (LON:BLND)** the NAV was 939 pence at the end of September compared with a share price as I write of 685.50 pence. Then there is the "triple discount" from the perspective of foreign investors by virtue of the cheap pound.

There is no shortage of foreign interest. Last March the Chinese developer **CC Land Holdings** paid £1.15 billion for 122 Leadenhall Street (popularly known as *The Cheesegrater*). That was about 26 percent above the building's book value and was China's largest investment to date in UK real estate. About two thirds of the £4.8 billion invested in UK real estate in Q3 2017 came from Asian buyers, according to CBRE.

Similarly, **Land Securities** sold the "Walkie Talkie" building on Fenchurch Street to a Hong Kong investor for £1.3 billion – an estimated 13 percent above the asset's book value. Moreover, rental yields remain attractive given current ultra-low interest rates. China's **Cheung Kei Group** bought the former London base of Bear Stearns in Canary Wharf for £270 million, representing an initial net yield of 5.2 percent according to Capital Real Estate Partners.

If I am right that we shall enter a calmer, less agonised phase of Brexit in 2018 then UK REITs and property could turn out to be major beneficiaries.

**Stop Press: Residential London property.** I also note that residential property prices have been softening in the outer London boroughs since the summer including those that will be transformed by end-2018/early-2019 by the partial opening of the **Queen Elizabeth Line** (aka **Crossrail**). From the end of 2018 passengers alighting in the aspirational community of Abbey Wood will be able to reach Whitechapel in eight minutes, Tottenham Court Road in 14 minutes and Heathrow in about 40-50 minutes. (Maidenhead – the fief of Mrs May – will benefit somewhat later.) I do not think that Londoners – or investors – have understood how transformative this quiet infrastructure project – the biggest in Europe, delivered on-budget and on-time – will be. And yet few commentators are talking about it. If you are still not bowed by Mr Osborne's heavy-handed changes in stamp duty designed to restrain buy-to-let, check out the outer London Boroughs of Bexley and Hillingdon.

sion. Sterling and UK financial markets would undoubtedly suffer.

As the Brexit bill steers through the House of Lords where the Tories are in a minority, there is a significant risk that their lordships will seek to add the provision for a second referendum. But we don't need to worry. Under the Parliament Act 1949, the Commons can just ignore the House of Lords and pass a bill without its consent one year later.

**How Brexit will pan out**

It is significant that Phase I of the Brexit negotiations was finally concluded – but nearly foundered – on a form of words which created the right degree of *constructive ambiguity*. This taught us that most of the trade negotiations in Phase II of Brexit will be about language rather than substance.

On 26 December, Sigmar Gabriel, Germany's acting foreign minister, said that a smart Brexit deal, but one which takes the UK out of the Single Market and the Customs Union, could be a model for the EU's relations with, amongst others, Turkey and Ukraine. The period of teeth-sucking and tut-tutting has given way to a more practical mood in Europe where a more Federalist internal agenda is developing by the week. Many Europeans, President Macron amongst them, regard Brexit as the welcome removal of a brake on European integration.

Of course, I do not underestimate the technical complexities of negotiating the fine details of trade in automotive and aerospace components. Not to mention the issue of *passporting rights* for British banks (though, I shall explain shortly why this is not as big a deal as it is made out to be). But both sides know that mutually acceptable solutions have to be found.

There will certainly be a *transitional* or *implementation period* from 29 March 2019 to 31 December 2020 during which time the UK will have to adhere to all EU regulations and pay all of its dues as before. I do not think that the fervent Brexiteers should get too perturbed about this: Britain has already signed up to the EU budget commitments to end-2020. Further, it is likely that the gross contributions paid by Britain to the EU over this period will be netted off the notional £39 billion Brexit Bill.

# "POSITION YOURSELVES FOR A BUMPER YEAR! DON'T MISS OUT ON THE TRUMP BOOM AND THE UK BOUNCE."

That Brexit Bill will come to be seen for what it is: a shibboleth rather than real cash. Come 01 January 2021, the UK will be able to forge international trade deals and to embark on radical new policies in the field of agriculture, industrial policy, environmental protection, animal welfare and healthcare. Rather that become an *unregulated country* post-Brexit the UK could emerge as *the most effectively and humanely regulated country in the world.*

All this will gradually become apparent during 2018. A new mood of cautious optimism will displace the extreme apprehension of 2017. Business sentiment will respond accordingly.

**UK government finances**

I wrote extensively during 2017 about the condition of UK government finances. While the overall picture was somewhat depressing, with the debt-to-GDP ratio edging persistently upwards, there was some heartening news in December. Before Christmas the Treasury announced that public borrowing was £48.1 billion for the first eight months of the financial year. That was the lowest recorded eight-month figure since 2007 – before the Credit Crunch. Tax receipts in November were five percent up on the previous year, with strong growth in income tax and VAT receipts. The best month for tax receipts is January when self-employed people have to cough up for their hard-earned gains. The Treasury is anticipating a beneficent January 2018 – despite the soothsayers at the OBR who, like the old crone in *Up Pompeii!* foresee *Wo, wo and thrice wo!*

Analysts think that full-year borrowing by the end of March 2018 is unlikely to be *significantly* below its budget forecast of £49.9 billion. However, there is a decent chance that, if tax receipts continue on-trend, then new borrowing should fall at a faster rate than the OBR expects. Continued falls in unemployment (now down to a 42-year low of 4.3 percent) mean that more people pay tax and, correspondingly, the state saves in transfer payments, cutting the deficit from both sides.

Of course, the national debt, at about 84.6 percent of GDP, is still uncomfortably high and, as I wrote in my analysis of Mr Hammond' budget, there is no firm date set as to when the government books will finally balance. But if Mr Hammond could demonstrate a downward onward trend in that metric over 2018-19, the markets are likely to take comfort from that.

You may recall that the OBR was established by Mr Osborne in the very early stages of the Coalition government (2010-15) because, under Gordon Brown, the Treasury had begun to spin its own numbers in a kind of *Brownian motion.* But what we have today is a bunch of recusant Remainers who are determined to prove that the British economy has no future. They have been wrong, arguably, on every single economic prediction since their inception. It would do everyone a favour if they were quietly put out of their misery.

## Action:

Position yourselves for a bumper year! Don't miss out on the Trump boom and the UK bounce. At the very least the UK market will not turn south so long as the US markets continue to head north. You may as well enjoy the party.

I will be explaining soon why I am still cautious about Europe and why I think Emerging Markets will come out of the shadows in 2018 in upcoming articles. 2018 will be a year of opportunity. May you prosper!

**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.

THE SELECT 50


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Personal Investing

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BY NICK SUDBURY

FUNDS IN FOCUS

# THE BEST FUNDS FOR 2018

**Despite all the dire threats and warnings 2017 turned out to be another strong year for the markets with each of the main equity regions posting healthy gains. The most profitable areas to invest in were the Far East and the Emerging Markets with 11-month returns to the end of November of 27% and 21% respectively, although the US, Continental Europe and Japan all managed to achieve double digit increases with only the UK lagging behind at 8%.**

The solid performance right across the board helped the average investment trust discount – excluding hedge funds, direct property funds and private equity – to narrow from 5.4% at the start of the year to 4.3% at the end of November, although things could change if there was a significant shift in investor sentiment.

Last year's top performing investment trusts included **Pacific Horizon (LON:PHI)**, **Atlantis Japan Growth (LON:AJG)** and **BG Shin Nippon (LON:BGS)**, which all benefited from strong local market returns, while **Scottish Mortgage (LON:SMT)** was bolstered by the surge in US technology stocks, with all of them up by more than 40% in the 11 months to the end of November.

At the other end of the scale, the worst performers all tended to be dragged down by bad stock selection decisions rather than anything at the macro level, with the main culprits including **Northern Investors (LON:NRI)**, **Ranger Direct Lending (LON:RDL)** and **British & American (LON:BAF)**.

## Investment trust recommendations

Ewan Lovett-Turner, Director of Investment Companies Research at Numis Securities, says that with many investors concerned about market valuations, a couple of investment trusts worth considering are **RIT Capital Partners (LON:RCP)** and **Troy Income & Growth (LON:TIGT)**.

"RIT has an exceptional long-term track record through an unconstrained investment approach that seeks to deliver long-term capital growth, whilst preserving shareholders' capital. I believe its return profile is attractive to many private investors, having historically participated in much of the market upside, whilst limiting exposure to downside."

Troy Income & Growth is a UK Equity Income investment trust that is run by Troy Asset Management, who have built up an impressive track record based on a cautious investment approach.

"The portfolio is heavily focused on defensive sectors including Consumer Goods companies that have strong brands/franchises and the pricing power to maintain margins. There is also a high weighting in Utilities. This cautious approach means that the fund has typically outperformed in tough markets, whilst lagging in strongly rising markets," explains Lovett-Turner.

Emma Bird, Research Analyst at Winterflood Securities, says that with

**"THE SOLID PERFORMANCE RIGHT ACROSS THE BOARD HELPED THE AVERAGE INVESTMENT TRUST DISCOUNT - EXCLUDING HEDGE FUNDS, DIRECT PROPERTY FUNDS AND PRIVATE EQUITY - TO NARROW FROM 5.4% AT THE START OF THE YEAR TO 4.3% AT THE END OF NOVEMBER."**

**"IN THESE CIRCUMSTANCES IT WOULD MAKE SENSE TO STICK WITH EXPERIENCED MANAGERS WITH EXCEPTIONAL TRACK RECORDS WHO HAVE NAVIGATED THROUGH SIMILAR PERIODS IN THE PAST."**

bull markets around the world looking 'long-in-the-tooth' and valuations in many markets looking full, they have decided to recommend the **Capital Gearing Trust (LON:CGT)**, which seeks to achieve absolute returns through active asset allocation across equities (via investment trusts), bonds and commodities.

"The aim is to preserve capital over the short run and generate strong risk-adjusted returns over the long-run and the fund has an impressive record of delivering strong absolute returns with considerably lower volatility than equity markets."

## Safe pair of hands for a more challenging year

Ryan Hughes, Head of Fund Selection at AJ Bell, says that calling the top of the market is just a guessing game and that some of the most experienced investors are at odds over the outlook for equities.

"For private investors running their own portfolios the best course of action will be to have a clear understanding of how much risk they are prepared to take at the moment, position their portfolio accordingly and sit tight."

Last year was a surprisingly benign one for world equity markets, but there is every chance that 2018 could be a lot more challenging given the higher valuations. In these circumstances it would make sense to stick with experienced managers with exceptional track records who have navigated through similar periods in the past.

One such is Neil Woodford, although it feels like a contrarian recommendation given the recent poor performance that has seen his £8 billion **CF Woodford Equity Income fund** return virtually zero in the last 12 months.

Laith Khalaf, Senior Analyst at Hargreaves Lansdown, says that Woodford has an uncanny knack of getting the big macroeconomic calls right, as well as the ability to add value for investors through stock selection.

"He has been down on his luck in 2017 and performance has disappointed, but his long-term track record is exceptional, and while some investors have given up the ghost, we think that patience will be rewarded."

Woodford has recently said that the stock market is in a bubble that will inevitably burst. He sees echoes of the


tech bubble and says that there are so many warning lights that he is losing count.

Khalaf also likes **Lindsell Train Global Equity**, which is managed by Nick Train who runs a concentrated portfolio of high conviction investments.

"Train looks for quality companies that are global brands and in charge of their own destiny. Like Woodford, he has a long and successful track record of delivering outperformance for investors."

If you are optimistic about the outlook there are plenty of higher risk opportunities in the strongest performing regions.

## Emerging Markets

Darius McDermott, MD of Chelsea Financial Services, says that despite having done well last year, he believes many areas within emerging markets are attractively valued relative to many of their developed market counterparts and the asset class could continue to do well in 2018.

One way to take advantage would be to invest in the **Lazard Emerging Markets fund**. This is heavily weighted towards the Financial and Information Technology sectors, with the largest geographic allocation being Emerging Asia at 56% of the portfolio.

"The fund benefits from a well-resourced emerging market team based in New York. We like their strong value discipline and the fact that they are trying to identify the global brands of the future," explains McDermott.

He also suggests **M&G Global Emerging Markets**, run by Matthew Vaight since its launch in 2009. The manager has a strong focus on corporate governance and aims to find companies that other managers have missed.

Patrick Connolly, a Certified Financial Planner at Chase de Vere, Independent Financial Advisers, says that investors who are comfortable with the high risks associated with the region might want to consider **JPM Emerging Markets**.

"The fund has one of the largest, most experienced and well-resourced emerging markets investment teams with 39 managers and analysts. It is likely to be as close as investors will get to a safe pair of hands in the region, especially given the focus on investing in high quality companies that can demonstrate consistent growth."

## Japan

Japan's main stock market index, the Nikkei 225, had a successful 2017 and there is a good chance that the bull market could continue given the business-friendly reforms being pursued by Prime Minister Shinzo Abe following his recent re-election.

"Japan had a strong year in 2017 as the economic reforms that have been taking place over the past few years continue to bear fruit. The tailwinds remain in place for 2018 and coupled with a rapidly improving shareholder focus from company management this should help the Japanese market to move higher this year," explains Hughes.

He suggests **Baillie Gifford Japanese**, which has one of the strongest management teams in the region. It is one of the oldest funds in the sector and has delivered excellent returns in the most difficult market conditions.

Another option from McDermott is **T. Rowe Price Japanese Equity**, which holds around 60 to 100 Japanese companies of all sizes, albeit with a notable overweight to smaller firms.

"The manager aims to find businesses he believes can deliver sustainable growth before other investors recognise their potential. He will adapt his investing style as needed to suit changing market conditions, which has helped him to outperform in different environments."

## Continental Europe

2017 was also a good year for Continental Europe where improved economic growth and falling unemployment helped bolster investor sentiment and supported a pick-up in M&A activity.

McDermott believes that there are still pockets of value that can be captured by selecting the right managers with one example being **Henderson European Selected Opportunities**.

"The fund provides exposure to a high-conviction portfolio of 50 to 65 mega and large-cap stocks that has neither a growth nor a value bias. We like the manager's pragmatic approach and the fact that he takes the macroeconomic environment and sector trends into consideration, as well as looking at individual companies."

Hughes prefers **Crux European Special Situations**, which is managed by the veteran Richard Pease, who focuses on companies that have exceptional management teams and a market leading position.

"Pease uses his many years' experience to identify good management teams and is happy to invest in a high conviction manner away from the

**"'TRAIN LOOKS FOR QUALITY COMPANIES THAT ARE GLOBAL BRANDS AND IN CHARGE OF THEIR OWN DESTINY. LIKE WOODFORD, HE HAS A LONG AND SUCCESSFUL TRACK RECORD OF DELIVERING OUTPERFORMANCE FOR INVESTORS.'"**

benchmark. This approach typically finds more opportunities in medium and smaller companies and while it can be more volatile than its competitors, it is proof that talented bottom-up stock pickers can add significant value."

## Bonds

The prospect of rising inflation and higher interest rates would normally put people off from investing in bond funds, but that wasn't the case last year with the sector experiencing record-breaking inflows in August, September and October.

Connolly says that bonds should have an important role to play in many portfolios, although many fixed interest assets look expensive and could potentially be subject to falls, especially if interest rates rise.

"**Rathbone Ethical Bond** is a high conviction fund that has a good quality manager in Bryn Jones. It typically pays a competitive yield, which is currently 3.8%, and invests in many underlying holdings that aren't usually found in other funds, meaning it provides strong diversification benefits."

Hughes suggests **Fidelity Strategic Bond** because of the cautious nature of the manager, Ian Spreadbury, and the flexibility offered by the mandate that allows him to invest in different parts of the fixed interest market.

"With the extensive resources at Fidelity, the team now look to add value through relative value trades around the world, as well as traditional UK gilts and bonds giving an extra source of potential return. The extensive experience of Ian Spreadbury could well prove beneficial over the coming months."

Another defensive option would be **AXA Sterling Short Duration Bond**, which only invests in high-quality corporates with maturities of less than five years. These are less vulnerable to higher interest rates, especially as about a fifth of the holdings mature each year, although the downside to this is that it is only yielding 1.8%.

### 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.

## FUND OF THE MONTH

**RIT Capital Partners (LON:RCP)** aims to capture greater participation in up markets than down markets, in the belief that this will lead to both long-term outperformance and capital preservation. It has many of the attributes of a family office due to the influence of its founder and largest shareholder, Lord Rothschild.

The fund has developed a strong long-term track record through a top-down investment approach and exposure to some of the world's leading investment managers. At the end of September the main portfolio weightings were: Quoted Equities 32%, Absolute Return and Credit 24%, Hedge Funds 21%, and Private Investments – Funds 13%.

If markets continue to rise RIT should capture a decent element of the upside, whereas if they fall it should protect against the worst of the declines. This is a highly unusual and valuable characteristic, which explains why it is trading on a small premium to NAV. The fund is recommended by both Numis and Winterflood Securities.

### Fund Facts

| | |
|---|---|
| Name: | RIT Capital Partners (LON: RCP) |
| Type: | Investment Trust |
| Sector: | Global Growth |
| Total Assets: | £3,293m |
| Launch Date: | 1988 |
| Current Yield: | 1.6% |
| Gearing: | 20% |
| Ongoing Charges: | 1.14% |
| Website: | [www.ritcap.com](http://www.ritcap.com) |

BY JAMES FAULKNER

## AN INTERVIEW WITH

# SCOTT GRANT

## OF LONDON SOUTH EAST

**Master Investor interviews Scott Grant, director and co-founder of London South East, the UK's leading web portal for private investors. 2018 is set to be a landmark year for the company's flagship website, lse.co.uk. We talked to Scott to get a better idea of what's in store...**

**James Faulkner: Hi Scott. Many of our readers will already be familiar with London South East as one of – if not the – most popular investor chat rooms in the UK. For those who aren't, can you provide a brief introduction?**

**Scott Grant:** *Hi James. London South East's flagship website is www.lse.co.uk. It currently attracts over 1.1 million unique visitors each month, to whom we 'serve' over 32 million pages to (across all devices). We are the go-to portal for Private Investors – part of their daily trading/investing routine. The gamut of information and tools offered runs from a moderated Chat Forum to free live RNS to Level 2 data (a subscription service) – and the list goes on and on!*

**JF: So this is essentially a one-stop-shop for private investors of all creeds. I understand that 2017 has been a landmark year for lse.co.uk. Can you put the year into perspective and give us a flavour of what changes you've been making?**

**SG:** *2017 has been all about reliability for us. We were not a site that suffered huge swathes of unreliability anyhow, yet when you provide services such as (paid-for) Live Prices and Level 2 consoles, up-time is of paramount importance. In October, for instance, we had 100% up-time, which is great to see, and credit to the team of Developers. Beyond that, we have fixed bugs when they have arisen, plus tried to improve as many features as possible and implement Member/Visitor suggestions. We have had to balance this with working on the new site iteration – to arrive in early 2018.*

**JF: So users can look forward to an updated version of the website in 2018. What new features can they expect to enjoy?**

**SG:** *There are new features to look forward to – such as publishing the 'Short' positions held on individual shares; NEX and BATS data; Media/IR/Events sections; and much more. However, harking back to my answer to the previous question, at least an equal weight has been placed on working to secure reliability and increase speed across the website, in order to deal comfortably with the 'load' that our many visitors place on our infrastructure. To this end, many things that we have wanted to resolve for a long while – such as re-designing the way News is handled and presented, and the searchability and look of our Blogs section – have now been addressed.*

**JF: Let's talk a little more about your recent involvement in investor relations and events. What drove you to delve into these areas?**

**SG:** *With the large audience we have – and seemingly the trust the Private Investor and Trader community has in us – it seemed sensible to start to build a bridge between them and listed compa-*

> **"WITH THE LARGE AUDIENCE WE HAVE – AND SEEMINGLY THE TRUST THE PRIVATE INVESTOR AND TRADER COMMUNITY HAS IN US – IT SEEMED SENSIBLE TO START TO BUILD A BRIDGE BETWEEN THEM AND LISTED COMPANIES."**

*nies. We have not gone hell-for-leather into this market, yet have now held five or so Private Investor events that have been well received. The success of our 'Share Views' video on YouTube (youtube.com/lsecouk) has also been fantastic to see, with companies such as Cabot Energy and Columbus Energy attracting over 11,000 views! We recently undertook an eight-company Pharma video shoot in conjunction with Edison Research, so will look to build on this and our Investor Relations (IR) presence in 2018.*

LONDON SOUTH EAST

**JF: How does your presence at the 2018 Master Investor Show fit into all this?**

**SG:** *Master Investor Show 2018 will be our third consecutive appearance, with London South East being a key event partner for the second consecutive year. We are keen supporters of this event as it provides what I have previously alluded to: a 'bridge' between those individuals interested and active in the stock market and listed companies/major financial organisations/investor services. As we find when hosting our smaller Private Investor evenings, there is no substitute for face-to-face contact. In our case, it is between us and the site user; whereas at MIS it is also between the Private Investor and Listed Company. In terms of profile, it is also fantastic to be associated with all the other great companies at the event, and we enjoy being the headline sponsor of the 'Rising Stars' stage, show-casing 20+ dynamic up-and-coming companies presenting to the MIS audience.*

**JF: As private investors we must take advantage of all the resources available to us, and the Master Investor Show and lse.co.uk are great examples of such resources. Can you suggest a couple of useful tools/features on lse.co.uk that readers may have overlooked or simply not be aware of?**

**SG:** *Membership of lse.co.uk if free. Once logged-in, you can access our 'Quick Picks' feature. This allows you to 'pin' shares you are interested in to the left-hand side of the page as you travel around the website. This provides a snapshot of the share price – whether it is up or down, and by what percentage or monetary amount. Live Regulatory News Service (RNS) company updates are also free to Members. If you are Subscriber to any of our paid services, we have adjusted them so all packages contain our popular dashboard tool 'myTerminal'.*

**JF: Let's say I'm a private investor who's new to lse.co.uk. How can I ensure I get the most out of the site from day one?**

**SG:** *Explore, explore, explore! There is no substitute for 'playing' with the website and learning as you go. Alternatively, if a new user has any queries, they can contact our excellent (I am biased!) Customer Service Team via 'info@lse.co.uk' or Tweet to '@LondonSouthEast'. We hope to introduce some material to the site in the near future which helps users on their journey around lse.co.uk.*

**JF: What would you say to those investors who eschew chat rooms as hives of share rampers?**

**SG:** *Share Chat Forums have their place. I believe, as anywhere in life where people are found en-masse (e.g. Twitter), you have to be judicial in what and whom you put store by We offer, to my knowledge, the only moderated Share Chat Forum in the UK. This can help with the quality of the boards, alongside the features we provide which offer the ability to report posts and filter (not see) other users and their posts. Above all, the old adage of 'DYOR!' (do your own research) holds as true today as it ever did.*

**JF: Indeed! Scott, I'd like to thank you for taking the time to speak with Master Investor today, and I'd also like to urge our readers to go over to lse.co.uk and check out all the resources available there. It really is a great resource for PIs.**

**SG:** *Thanks, James. Wishing you and the Master Investor crew success in 2018 – especially with the Show!*

**About James**

Our Editorial Director, James Faulkner, began investing in the stock market in his early teens. With over a decade of experience covering the stock market under his belt, he has also been a judge at the Small Cap Awards, and is an Associate of the Chartered Institute for Securities & Investment.

BY FILIPE R. COSTA

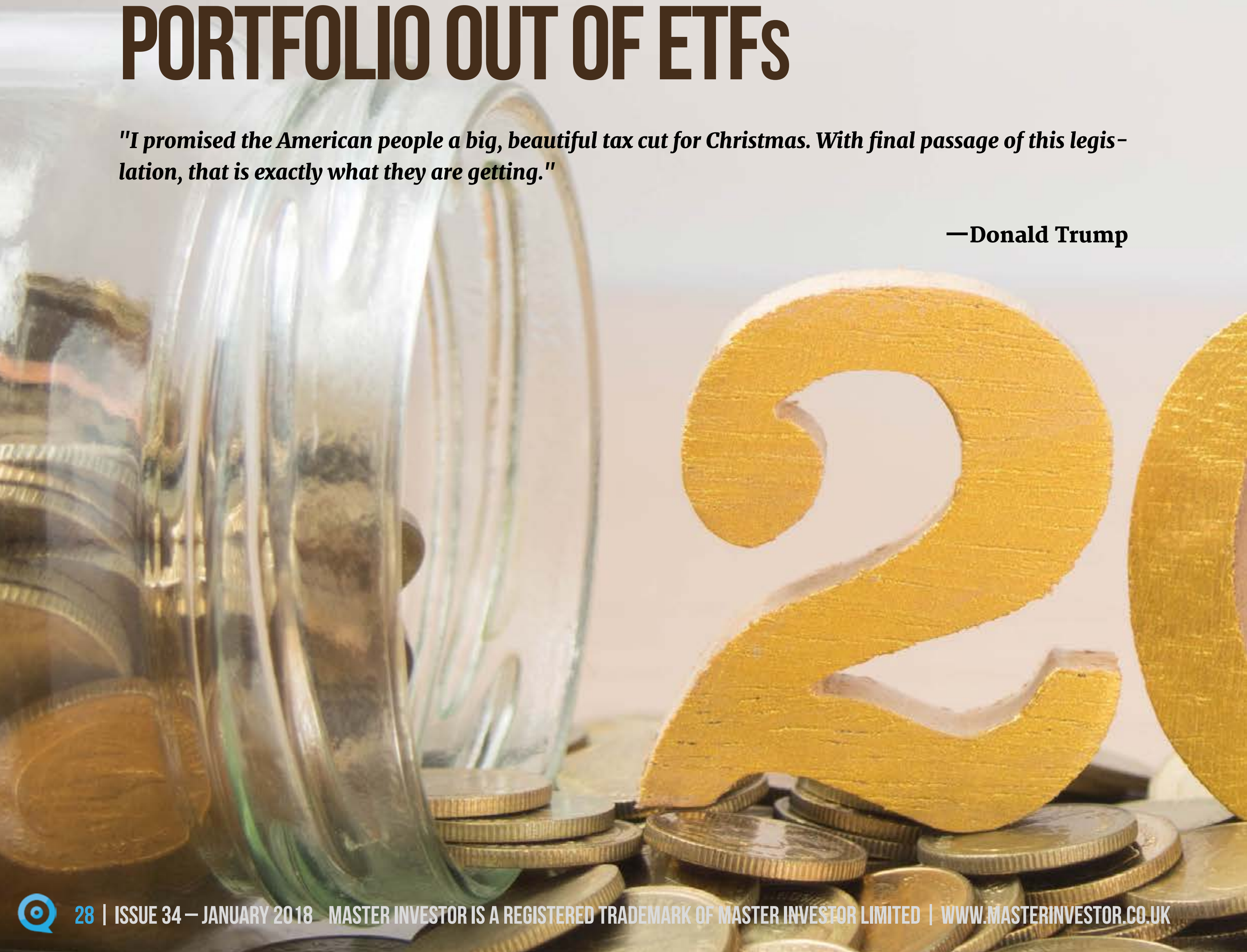
## THE MACRO INVESTOR

# KEY MACRO THEMES FOR 2018

## HOW TO BUILD A THEMATIC PORTFOLIO OUT OF ETFs

*"I promised the American people a big, beautiful tax cut for Christmas. With final passage of this legislation, that is exactly what they are getting."*

**—Donald Trump**



## Main themes for 2018

Nine years into the bull market in the US and many commentators are questioning whether such strength is going to stretch on into 2018 or give way to a bear market. Most investors are still optimistic and another positive year is the most predicted outcome for 2018. But recent developments in the global economy and politics may suggest that a more restrained view is in order. Valuation metrics are still not bubbling over, and thus the odds for a sudden crash are low, but market corrections may occur.

> **"MOST INVESTORS ARE STILL OPTIMISTIC AND ANOTHER POSITIVE YEAR IS THE MOST PREDICTED OUTCOME FOR 2018."**

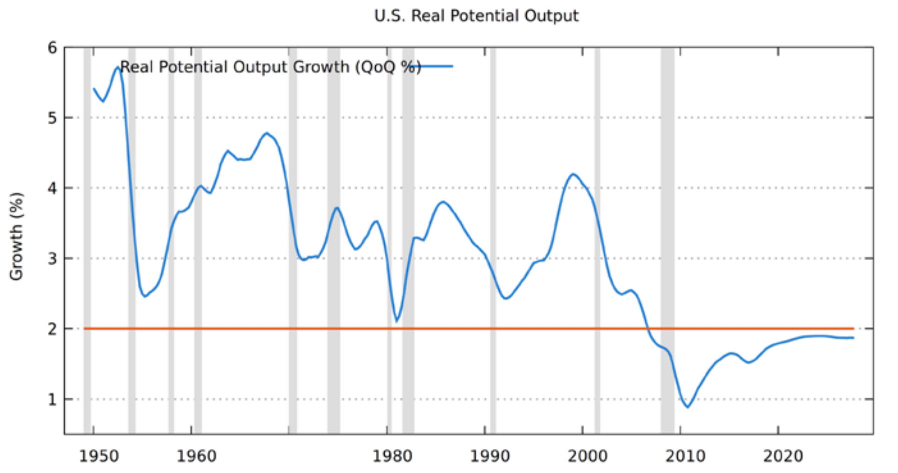
Active investors need to be more selective than ever. The real matter regarding equities is not about whether there is room for the asset class to rise further but which parts of the asset class are more likely to appreciate the most. Financials, for example, may still benefit from the prospect of rate hikes, as banks find better uses for their money when rates are above water. But the opposite happens in the real estate business, which will most likely suffer from rate hikes.

Passive investors enjoy easier decisions but still face one major challenge in the coming year: to decide on the exact allocation between equities and bonds. On the one hand, the momentum factor in equities is losing its lustre and thus pointing to an increase of bond holdings. But on the other hand, bonds may suffer from interest rate hikes, in particular those with a longer duration, which argues towards a decrease in bond holdings. Moreover, With Trump just passing his tax cuts into law, bond prices look vulnerable either from surprise interest rate hikes or accelerating inflation.

A prolonged bull market for stocks, record low interest rates, the expansionary fiscal policy in the US, the European recovery, Brexit, South American political trouble, and many other geopolitical events that will emerge during the year are all points to consider before allocating capital within a portfolio this coming year.
In this edition, The Macro Investor goes through the major investment themes for 2018 and builds a portfolio out of ETF products. In a month when the "How to Invest Like..." column in this magazine is dedicated to Charles Ellis, a man best known as a fierce advocate of passive investing, the Macro Investor transposes his views into Ellis' investment world.

## It's always about Trump

With the US being the most influential economy in the world and Trump being such an ebullient president, the number of risk events emerging from the country has increased at a fast pace. This time, we have the Tax Cuts and Jobs Act (TCJA), a bill that just passed through Congress and is considered the deepest tax overhaul since the time of Ronald Reagan during the 1980s. Such an event is expected to induce effects over many years and will certainly be a pivotal event in 2018, when the largest tax effects are expected.




**"WHILE THE TAX CUTS WILL DELIVER AN IMPACT TO THE WHOLE ECONOMY, ITS INTENSITY WILL VARY ACCORDING TO THE SECTOR AND THE ECONOMIC AGENT."**

The TCJA carries $1.5 trillion in tax cuts that will impact both individuals and corporations. With the US economy operating near full capacity, and with full capacity being a mere 1.87%[i], Trump expects to deliver a positive shock to the economy in the form of a boost to business investment (capital spending). If such a boost is significant enough, it can push potential output higher and accommodate a higher real GDP growth rate without wages and prices being pressed higher.

While the tax cuts will deliver an impact to the whole economy, its intensity will vary according to the sector and the economic agent. In terms of corporate America, the cuts are very welcome, as the country is not competitive in terms of its tax code for businesses. Such cuts should have been introduced long ago to avoid capital outflows from companies seeking out friendlier jurisdictions. In terms of the developed world, the US is currently the most punitive jurisdiction. By cutting corporate taxes from 35% to 21%, Trump is improving the operating conditions for businesses and consequently setting the scene for higher capital spending.

According to Penn Wharton[ii], the budget research entity, the tax cut will lead to a decline in the corporate effective tax rate from 21% to 9% in 2018. Additionally, the law allows for immediate expensing of some capital spending. On the negative side, the law imposes limits on the deductibility of interest expenses. From the lower tax rate and increased interest expenses comes our Portfolio Investment Selection no. 1.

- **Portfolio Investment Selection no. 1 – Selective U.S. Equities**

US companies with higher tax bills are expected to benefit the most from tax cuts, while companies with higher interest expenses will be penalised. Barclays estimates that in 2018 US corporate earnings per share will increase by 6.3%; with consumer staples, financials, and industrials being among those benefiting the most, and real estate and healthcare being at the other extreme. In general, companies with higher effective tax rates are those that rely the most on tangible assets that cannot be moved with ease. Healthcare companies rely on large loads of intangible assets that are often moved to the most favourable jurisdictions with ease. This is why the sector isn't expected to benefit from the approved law, as it is already benefiting from a very low effective tax bracket.

In terms of profiting from the opportunity, one passive way of trying to capture the most out of this theme is by tilting portfolio returns towards the consumer staples, financials and industrials sectors. Both SPDR and Vanguard offer exposure to each of these sectors through ETFs. Investors may choose the **SPDR Select Sector Consumer Staples (XLP)**, **Financials (XLF)** and **Industrials (XLI)**; or the **Vanguard Consumer Staples (VDC)**, **Financials (VFH)**, and **Industrials (VIS)** ETFs. The Vanguard offer carries lower ongoing fees and higher Morningstar ratings, with the exception of the industrials ETF which is pretty similar for both.

For active investors, the solution is to implement a strategy of filtering companies with the largest tax payments and lowest interest expenses from a list of US companies. The following table shows a simple implementation, retrieving a few companies that may benefit the most from the tax overhaul.

Although the TCJA is a good attempt at improving potential output at a time when the output gap is near zero, there are many reasons that lead us to question whether the TCJA will deliver as promised or if the effects will just fade out sooner rather than later. Penn Wharton estimates the TCJA will deliver an annual increase in GDP between 0.06% and 0.12%, which is not significant. The institution expects GDP to be between 0.6% and 1.1% higher by 2027 than it would have been without the tax cuts. At the same time, the impact on tax revenues and overall debt is not negligible. By 2027, accumulated debt may have increased by $2.2 trillion as a direct consequence of the loss in revenues. Only time will tell how GDP

**TABLE 1 – EXPECTED EFFECTS OF THE TAX CUTS AND JOBS ACT (TCJA)**

| | 2018-2027 | | 2028-2040 | |
|---|---|---|---|---|
| | Optimist | Pessimist | Optimist | Pessimist |
| Impact on Average Annual GDP Growth | 0.12% | 0.06% | 0.03% | 0.01% |
| Cumulative Effect on Budget Revenue | -$1.8 Tn | -$2.0 Tn | -$1.5 Tn | -$2.4 Tn |
| Cumulative Effect on Debt | $1.9 Tn | $2.2 Tn | $2.2 Tn | $3.4 Tn |

*Source: Penn Wharton Budget Model*

## "WILL BUSINESSES INCREASE CAPITAL SPENDING AS A RESULT OF THE TCJA? THAT'S THE REAL QUESTION."

**TABLE 2 – SHORTLIST OF S&P 500 COMPANIES WITH LOW DEBT AND HIGH TAX DISBURSEMENTS**

| Ticker | Asset | Effective Tax Rate (1Y) | Effective Tax Rate (5Y Av.) | Industry | Debt to capital | Interest paid | Turnover | Interest paid / Turnover |
|---|---|---|---|---|---|---|---|---|
| ISRG | Intuitive Surgical Inc | 25.0 | 24.1 | Health Care | 0.0 | 0.0 | 2704.4 | 0.00% |
| MNST | Monster Beverage Corp | 34.0 | 37.2 | Cons. Goods | 0.0 | 0.0 | 3049.4 | 0.00% |
| SCHW | Charles Schwab Corp | 36.9 | 36.8 | Financials | 1.3 | 171.0 | 7473.0 | 2.29% |
| BLK | BlackRock Inc | 28.9 | 27.4 | Financials | 2.3 | 205.0 | 11155.0 | 1.84% |
| CTSH | Cognizant Technology | 34.2 | 27.2 | Technology | 7.4 | 19.0 | 13487.0 | 0.14% |
| BK | Bank of New York Mellon | 24.9 | 28.3 | Financials | 7.6 | 446.0 | 15237.0 | 2.93% |
| ROST | Ross Stores Inc | 37.4 | 37.5 | Cons. Services | 11.1 | 19.6 | 12866.8 | 0.15% |
| COF | Capital One Financial | 31.3 | 31.6 | Financials | 16.7 | 2018.0 | 25501.0 | 7.91% |
| LUV | Southwest Airlines Co | 36.7 | 37.5 | Cons. Services | 19.9 | 75.0 | 20425.0 | 0.37% |
| VLO | Valero Energy Corp | 24.0 | 30.6 | Oil & Gas | 21.1 | 446.0 | 75659.0 | 0.59% |
| INTU | Intuit Inc | 29.0 | 34.0 | Technology | 22.4 | 31.0 | 5177.0 | 0.60% |
| RTN | Raytheon Co | 28.3 | 28.4 | Industrials | 22.6 | 232.0 | 24069.0 | 0.96% |
| PSX | Phillips 66 | 25.0 | 30.8 | Oil & Gas | 23.7 | 338.0 | 85777.0 | 0.39% |

Source: Sharescope

will fare and thus how bad the debt increase will be. But there are concerns regarding GDP.

*Will businesses increase capital spending as a result of the TCJA? That's the real question.*

For the equity market to continue rising, the TCJA needs to induce a boost in business capital spending. If not, and if growth continues at the current pace, we may observe a quick upturn in consumer prices. In theory, it seems logical that lower taxes lead to higher capital spending. But the evidence shows that this is not always the case. A company expands its business, in the form of new plant, machinery, producing processes, and so on, when it faces (or expects) increased demand for its products. The cost of capital is certainly a key variable to take into account, but is still secondary. Firstly, a company needs demand to expand; secondly, the company seeks out expansion opportunities; and thirdly, the company invests, if the cost to expand is low enough. At a time when interest rates are near zero and companies sit on piles of cash, it doesn't seem likely that the money saved through reduced tax payments would be spent in business expansion.

We must look elsewhere for the money, in particular in the form of increased dividend payments and share repurchases. From this thought comes Portfolio Investment Selection no. 2.

- **Portfolio Investment Selection no. 2 – Dividend Payers**

Investors should look for companies sitting on piles of cash that are already paying good dividends. These companies don't really need the extra money that will be saved through the TCJA and will eventually disburse it to investors.

One way of playing this is via buying an ETF featuring the companies with a stellar track record regarding dividend payment. Examples of ETFs tilted to dividend payers include the **Vanguard Dividend Appreciation ETF (VIG)** and the **SPDR S&P Dividends ETF (SDY)**.

But in case corporate America doesn't increase capital spending, there is also a higher likelihood of inflation rising, which has the potential to increase the pace of the Federal Reserve interest rate hikes. Inflation is the greatest enemy of bonds, an asset class which is expected to do badly in general. But many investors need or want to add bonds to their portfolios. From this comes Portfolio Investment Selection no. 3.

- **Portfolio Investment Selection no. 3 – Inflation-protection**

Investors purchasing bonds should avoid the longer-term spectrum of the market. The longer the maturity (or the duration of a bond portfolio), the larger the negative impact of rising inflation and interest rates. Bond holdings should thus feature shorter maturities or prioritise inflation-linked securities. Investors looking for the short-end of the yield curve may opt for the excellent **PIMCO Enhanced Short-Maturity Strategy Fund (MINT)**. Alternatively, an inflation-linked portfolio may be built with the **iShares TIPS Bond ETF (TIP)** or the **SPDR Citi International Government Inflation-Protected Bond ETF (WIP)**. The second option constitutes a bet on a global increase in consumer prices. With central banks around the world keeping record low interest rates for years and stretching their balance sheets to never before seen amounts, higher inflation may be just around the corner. One last option, on the speculation side, would be to sell Treasuries and/or sell high-yield corporate debt. That being the case, the best option is selling short a long bond ETF, rather than buying an inverse ETF. The main reason for this is the fact that inverse ETFs are great at mirroring the daily performance of what they track but miserable at doing the same over longer periods of time.

## The FED and other central banks

The introduction of tax cuts that are expected to trim the corporate effective tax rate from 21% to 9% is similar to an expansion of the FED's central bank asset purchase programme, in the sense that it puts a lot more money in the hands of companies and individuals. At a time when the economy is operating near its potential, it may lead to inflation pressures if that money doesn't follow its way toward capital spending, as mentioned above.

**"THE FED IS EXPECTED TO HIKE ITS KEY RATE THREE TIMES NEXT YEAR, BUT MAY WELL GO STEEPER ON RATE INCREASES IF IT FEELS THE TCJA PUTS PRESSURE ON WAGES AND PRICES."**

The FED is expected to hike its key rate three times next year, but may well go steeper on rate increases if it feels the TCJA puts pressure on wages and prices. A fourth hike should not be discarded and the likelihood of the path followed by the central bank being flatter is now lower. Besides creating the opportunities in terms of bonds covered in Portfolio Investment Selection no. 3, there are other effects that are worth considering.

A first line of effects that derive from the expected rate hikes in the US is an increase in monetary policy divergence among central banks. Europe and Japan are recovering well but remain far beyond the US. Neither the BoJ nor the ECB is expected to hike rates soon. Any unexpected acceleration on the path of rate increases in the US will increase the rate differential and lead to an appreciation of the dollar. From this comes Portfolio Investment Selection no. 4.

**TABLE 3 – Performance of U.S. Markets During Trump Tenure**

| | Dow 30 | NASDAQ 100 | S&P 500 |
|---|---|---|---|
| Last Price | 24754.8 | 6480.7 | 2681.5 |
| Price on Election Day | 18332.7 | 4804.9 | 2139.6 |
| **Return (%)** | **35.0** | **34.9** | **25.3** |
| 52-Week High | 24792.2 | 6513.3 | 2690.2 |
| 52-Week Low | 19732.4 | 4863.6 | 2238.8 |
| Proximity to 52-Week High | 0.9926 | 0.9802 | 0.9807 |

*Source: Sharescope*

- **Portfolio Investment Selection no. 4 – US dollar**

In order to play a potential bullish dollar there are several options available. The first would be to buy the currency directly against some other currency. Another option is through currency ETFs. The **Proshares DB USD Index Bullish Fund (UUP)** offers a good exposure against the currencies of major economies like the Eurozone and Japan, which fits exactly on the divergence explained above. Another excellent option that is more broad-based comes in the form of the **WisdomTree Bloomberg US Dollar Bullish Fund (USDU)**, which additionally includes exposure to the Mexican peso, the Brazilian real, and other emerging currencies.

## Global equities

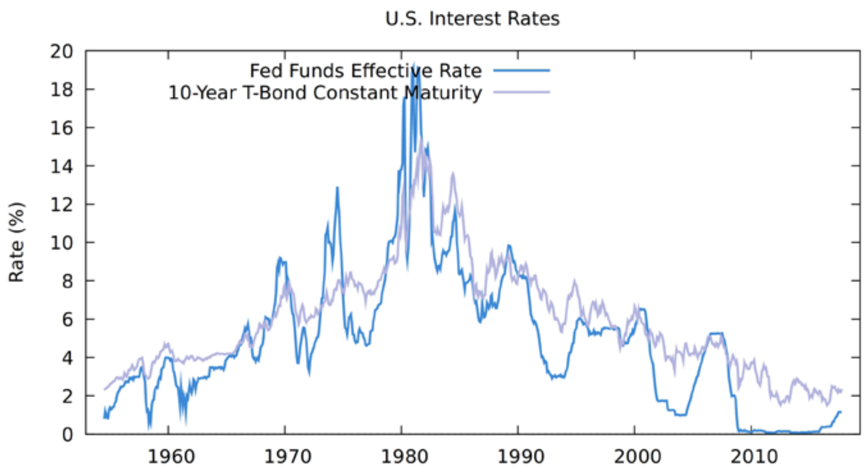
Investors looking for equity exposure need to be more selective than ever. As mentioned above, the US market still presents opportunities but needs careful stock picking. But Europe and Japan still offer good broad value. The Nikkei climbed 20% in 2017, but with interest rates still at record lows, the market has margin for further rises in 2018. In Europe, the bull market has been contained, with the Euronext 100 up just 11% and the French CAC up 10%. From this comes Portfolio Investment Selection no.5.

- **Portfolio Investment Selection no. 5 – Japanese and European Equities**

I'm suggesting two ETFs to capture the remaining juice from Japan and the Eurozone. For the first, the **iShares MSCI Japan ETF (EWJ)** and for the second, the **iShares MSCI EMU ETF (EZU)**.

## Craft everything together

The general consensus is that 2018 will still bring opportunities to invest in equities. But after nine years of a bull market, the juice is drying up, particularly in the US. Trump's proposed tax cuts will make their way through the economy during the year and no



doubt lend a hand to equities, but the tax overhauls will impact sectors differently. Companies with less debt, more cash and higher tax rates may be favoured. At the same time, many of these companies are also defensive stocks, which makes them a perfect play, at a time when the risks of a market setback are increasing.

While Trump's cuts are welcomed by corporations, they will also press consumer prices and wages, which may put the FED on guard. After all, this will cause monetary policy divergence across the world and open opportunities to invest in equities in the Eurozone and Japan while opening the door for the dollar to recover.

Here is the final portfolio:

**Portfolio Investment Selection no.1**

- **Vanguard Consumer Staples ETF (VDC)**
- **Vanguard Financials ETF (VFH)**
- **Vanguard Industrial ETF (VIS)**

**Portfolio Investment Selection no.2**

- **Vanguard Dividend Appreciation ETF (VIG)**

**Portfolio Investment Selection no.3**

- **PIMCO Enhanced ShortMaturity Strategy Fund (MINT)**
- **SPDR Citi International Government InflationProtected Bond ETF (WIP)**

**Portfolio Investment Selection no.4**

- **WisdomTree Bloomberg US Dollar Bullish Fund (USDU)**

**Portfolio Investment Selection no.5**

- **iShares MSCI Japan ETF (EWJ)**
- **iShares MSCI EMU ETF (EZU)**


## "INVESTORS LOOKING FOR EQUITY EXPOSURE NEED TO BE MORE SELECTIVE THAN EVER."

i **Estimate obtained from the St. Louis Fred database GDPPOT series. The presented value is the quarter on quarter percentage change of the series.**

ii **For more about Penn Wharton Budget Model, please check http://budgetmodel.wharton.upenn.edu/**

**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 SWEN LORENZ

## 10 QUESTIONS FOR...

# MANISH SINGH

## CROSSBRIDGE CAPITAL CIO REVEALS ALL

**Manish Singh, CFA, is Chief Investment Officer of Crossbridge Capital, a wealth management firm founded in 2008 with the backing of Banque Julius Baer, the leading dedicated private bank in Switzerland. Supported by a team of over 30 professionals, Crossbridge Capital has established itself as a recognised wealth management force in three of the world's top financial centres – London, Singapore and Monaco – entrusted with over $3 billion of client assets. Manish publishes a monthly newsletter setting out his personal views and insights on a far-reaching range of topics.**

**Master Investor had a chance to pick his brain on global mega-trends, little-known Chinese shares, and the future of the pound sterling. Be warned – this interview is a rapid trip around the world!**

**Swen Lorenz: You grew up in Jamshedpur, but now you are managing the fortunes of the world's super-wealthy from an office in London's Mayfair district. What I love about your newsletter is its broad range of subjects. How did you end up in the enviable position of having seemingly lots of time to read and write, while successfully managing money for the world's super-wealthy?**

**Manish Singh:** *Reading has been a long-standing habit carefully nurtured by my mum who would subscribe me to any newspaper or magazine I wanted – be it sports or cartoons or just newspapers. One of the first books she bought me was 'The Hardy Boys and the Mystery of the Aztec Warrior'. Hardy boys were tasked with delivering the handwritten will of a deceased world-traveller. The hunt leads the boys to Mexico City, to the Pyramids at Teotihuacan, to the tombs of Oaxaca where Chet Morton, the Hardy's buddy, is nearly buried alive by foul play.*

*Travel and knowing about the world we live in, it's past and present, has always fascinated me. I am and will be a lifelong student of history. It's my firm belief that to be useful in life one has to master the knowledge of two subjects – maths and history. Maths for everything rational and history for everything irrational. It has helped me a great deal all through my life. The problems of the world are not new. So, a good knowledge of history gives one a firmer grounding and helps one develop one's convictions and views by taking cue from events of the past. A good grip of numbers on the other hand makes one methodical and systematic. Knowing what has come before you and why things are as they are helps one find one's own place in the continuum called life in which it's so easy to get lost and lose one's bearing. The next book on my reading list is historian David Can-*

**"IT'S MY FIRM BELIEF THAT TO BE USEFUL IN LIFE ONE HAS TO MASTER THE KNOWLEDGE OF TWO SUBJECTS – MATHS AND HISTORY. MATHS FOR EVERYTHING RATIONAL AND HISTORY FOR EVERYTHING IRRATIONAL."**

*nadine's 'Victorious Century: The United Kingdom, 1800–1906'.*

**SL: In one of your recent articles, you threw out some fascinating statistics about China and its rapidly changing economy. Can you give our readers some of the highlights?**

**MS:** *Of course. To quote from my September newsletter, China strides ahead. The emergence of large companies such as Huawei, Xiaomi, Tencent, Alibaba and Baidu has paved the way for other local firms to follow. According to figures tallied by KPMG, last year China received $31 billion of venture capital investments, three-quarters of the US total. The sector has tripled in size since 2014 (US venture capital grew by only 20% during that period).*

*According to a recent article in Wired magazine, fifteen years ago, China claimed none of the top 500 supercomputers in the world. Today, it not only has more supercomputers than everyone else — including the United States — but its best machine boasts speeds five times faster than the best the US can muster. Additionally, in a first, it achieved those speeds with chips made purely in China. Due to China's massive purchasing power, world auto-makers rightly view China as the industry's new centre of gravity. According to a report by McKinsey, China makes and sells more light vehicles than any other nation; so many in fact, that in 2016, 40% more cars were sold in China than in all of Europe – and all at a time when the vehicle penetration in China remains low. Per 1,000 people, only 131 people in China have passenger vehicles compared to 850 in the US. There are 609 billionaires in China compared with 552 in America. China is also rapidly becoming a cashless society. The volume of mobile payments shot up almost fourfold last year, to $8.6 trillion, compared with just $112 billion the US. It might take a couple of years before the wider world wakes up to Chinese innovation and advancement in technology, but the experts are already well aware of it.*

*China wants to be the world leader in Artificial Intelligence (AI) by 2030, aiming to surpass its rivals' technologically and to build a domestic industry worth almost $150 billion. To build great AI, you need data, and nothing produces data quite like humans. This mean's China's massive 1.4 billion population (including some 730 million internet users) might be its biggest advantage. These citizens produce heaps of useful information which can be mined by the country's tech giants. On a Purchasing Power Parity (PPP) basis, China's GDP is already larger than that of the US, as announced by the IMF in 2014. Moreover, GDP per capita in China is still one quarter that of the US.*

*It's no surprise then that even the US National Intelligence Council warns that the era of Pax Americana is "fast winding down". US President Donald Trump talks about coal and steel and tariffs, whilst President Xi Jinping and China concentrate on robots, solar panels, electric vehicles and One Belt One Road (OBOR) – a network of ports, pipelines, railways, industrial parks and ancient maritime lanes that will span 65 countries and open markets that are currently beyond the economic reach of Chinese firms.*

*The Chinese are following their own path and for the moment it's working. We in the western world are following ours and you can judge for yourself the success of that! The ramifications of this Chinese growth are significant. America will almost certainly come out second best if it doesn't change tack – with Europe a long way behind. To the Western eye the ascendant power of Beijing may seem a disruption to the status quo, but to students of world history and China, it is the restoration of a millennia-long equilibrium. China was the biggest economy in the*

**"IT MIGHT TAKE A COUPLE OF YEARS BEFORE THE WIDER WORLD WAKES UP TO CHINESE INNOVATION AND ADVANCEMENT IN TECHNOLOGY, BUT THE EXPERTS ARE ALREADY WELL AWARE OF IT."**

*world for most of the past 2,000 years, only overtaken by Europe in the 19th Century. When Adam Smith published 'The Wealth of Nations' in 1776, he described China as "one of the richest, best cultivated, most industrious, and most populous countries in the world," and "much richer than any part of Europe."*

**"IF YOU ARE EXCITED ABOUT CHINESE GROWTH AND THE CHINA STORY THEN YOU HAVE TO INVEST IN CHINA'S SILICON VALLEY STOCKS."**

**SL: Following your view on China striding ahead, there must be Chinese shares that few Europeans investors would have heard of, but which represent sizable Chinese companies. Any ones in particular you recommend our readers take a look at with a view to long-term capital growth?**

**MS:** *If you are excited about Chinese growth and the China story then you have to invest in China's Silicon Valley stocks. US tech companies have struggled to get a foothold and that is unlikely to change. Uber got torched, Apple and Amazon are flailing and Google isn't even there. Invest in the Google, Amazon, eBay, Facebook, Cisco and Apple of China and they are Baidu, JD.com, Alibaba, Tencent, Huawei and Xiaomi respectively. Alibaba controls 60% of China's e-commerce market and is on track to grow sales 35% in the next fiscal year after a 60% rise this year. Alibaba and Tencent are revolutionising mobile payments and both trade at cheaper valuations than Amazon. Mobile payment is one area where China is way ahead of the US. All these stocks offer long term growth and they will grow as China grows. Things are changing in the browser market too. Alibaba's UC Browser, a mobile browser barely known let alone used in the west is outflanking Google's Chrome and Apple's Safari. According to the web analytic firm StatCounter, over the past year UC Browser accounted for 51% of India's mobile browser market compared with 30% for Chrome. In Indonesia, UC Browser led Chrome by 41% to 32% during the same period.*

*Bank stocks in China will also do well eventually but since the majority of them are state controlled in contrast with tech companies, I prefer the latter. If you prefer ETFs over stock picking then these are the three China ETFs you should look at GXC – SPDR S&P China ETF (up +50% YTD), MCHI – iShares MSCI China ETF (up +53% YTD) and KWEB – KraneShares CSI China Internet ETF (up +70% YTD).*

**SL: Last year, you were one of the few people who publicly predicted the victory of Trump. Having had the opportunity to get to know you over one or two beers in the pubs of Mayfair, I know you as someone who takes an objective look at the evidence, instead of letting political bias or peer pressure from politically correct interest groups influence you. Have you been following Steve Bannon's recent threats about a US-China trade war, and is that an issue that features on your investment radar screen for 2018 and 2019?**

**MS:** *Love him or hate him Steve Bannon is a nationalist and he has the ear of the President of the United States, Donald Trump. Therefore, when Bannon says – "We're at economic war with China", one has to take him seriously. The US would probably win a trade war with China in the short term but it shouldn't try it.*

*At a press conference in Washington DC on March 29, 2000, US President Bill Clinton said that granting China Permanent Normal Trade Relations (PNTR), which allowed China to gain entry into the World Trade Organization (WTO), would be a great deal for America. "We do nothing," Clinton said. "They have to lower tariffs. They open up telecommunications for investment. They allow us to sell cars made in America in China at much lower tariffs. They allow us to put our own distributorships there. They al-*

# "A TRADE WAR WILL ONLY PUSH CHINA TO ACHIEVE GREATER SUCCESS AND AT AN ACCELERATED PACE ONCE IT HAS DEALT WITH THE INITIAL SETBACK."

*low us to put our own parts there. We don't have to transfer technology or do joint manufacturing in China anymore. This a hundred-to-nothing deal for America when it comes to the economic consequences."*

*It didn't quite work out that way.*

*A trade war will only push China to achieve greater success and at an accelerated pace once it has dealt with the initial setback. China senses it has an upper hand and it's because for decades now the profit-seeking western capitalist system has put money before national interest. China's economic success means it will soon have more middle-class consumers than the entire U.S. population, giving Beijing huge market power over western companies who want to sell products in China. The US's chief trade negotiator, Robert Lighthizer, says he gets "an awful lot of complaints" from chief executives forced to share technology with joint venture partners. But those CEOs are reluctant to go public for fear of retaliation from China and losing access to their most promising market.*

*Therefore, the risk of trade war will hang like the sword of Damocles in 2018 and beyond. However, the realities may keep the sword from coming down on US-China trade relations. A tariff on Chinese imports will hit US consumer hard too by raising the price of pretty much everything on sale in Wal-Mart, from sneakers to washing machines. Trade sanctions will cut both ways.*

**SL: The Trump Presidency no doubt has many unknowables, but there are also some aspects that seem pretty clear. Since the 1980s, he has held consistent views about countries requiring fair trade agreements with each other; and in the absence of trade being done in a fair way, he argues in favour of putting tariffs in place. Assuming the US goes down the route that Trump proposes, are there any areas of the US equity market you see benefiting from this? Or any that are particularly at risk, e.g. if China decides to strike back?**

**MS:** *As I have mentioned above, a US-China trade war would be mutually harmful. China will most certainly retaliate by putting up barriers to US aircraft, grain and other products. Boeing would be particularly hard hit and Airbus could benefit. Chinese customers are expected to take delivery of 30% of all Boeing's top-selling 737 models. China will need 6,810 planes, worth more than $1 trillion, through 2035, according to Boeing. Boeing deliveries to China support about 150,000 jobs in the U.S. Broadcom and Qualcomm have over 50% of their sales in China and Texas Instruments and Micron Technology over 40%.*

*Moreover, Chinese consumers angered by Trump could easily target visible US brands – Starbucks, Apple, McDonald's, Yum (owners of Burger King). We saw that in the case of South Korea. South Korean businesses faced boycotts and bans due to Seoul's THAAD defence system deployment. Retail, tourism, electronic and auto industry all got hammered. Tourist arrivals from China to South Korea nearly halved in the first seven months of this year, dropping to 2.5 million from 4.7 million in the same period in 2016. Lotte, the giant Korean retailer that was asked by the South Korean government to provide the land for the missile defence system, saw sales at its supermarket business in China nosedive 95% in the second quarter. Hong Kong, highly reliant on trade-related logistics and services, would see a significant downturn so the Hang Seng Index would be a good short if a trade war starts. Of course, any downturn would be* *short lived as both sides would probably choose to be pragmatic after the initial sabre rattling.*

*I am a great believer that pragmatism always prevails in the end and conventional wisdom is often wrong. Both 2016 and 2017 were bad for people/investors who pinned their hopes on conventional wisdom. In 2016 conventional wisdom said Brexit wouldn't happen and Trump won't win. Both happened and fortunately I got both calls correct because I relied on data and ground reality more than headline news. 2017 was supposed to be when Trump would childishly disband NATO, attack North Korea, impose trade sanctions on China and Germany, tear up NAFTA etc. Nothing of the sort happened and the world is still at peace. Equities rallied, proving the point that investing based on headlines is bad for your portfolio. My own global equites portfolio is up +20% YTD. I stayed invested all through the hysteria relying on the strength of the underlying data I was seeing. I intend to do the same in 2018. Underlying data is strong and the Tax cuts in the US will be stimulatory, which may end up helping Europe and Emerging Markets too if US growth were to hit over 3.5%, which I suspect it will.*

**SL: It was recently the 25th anniversary of Britain leaving the European Exchange Rate Mechanism (ERM). This decision led to short-term volatility at the time, but then started a decade and a half of growth and prosperity. Interestingly, what you might call the establishment – publications like the Financial Times and the Economist, as well as politicians like John Major and Gordon Brown – argued it was a grave mistake to leave the ERM. We are now facing a not too dissimilar discussion about Brexit. At the risk of asking a fairly broad question, as someone who runs a business from the UK but is very, very international in outlook and background, how do you feel Project Brexit is currently going?**

**MS:** *Brexit was and continues to be a very divisive topic. Influential media such as the ones you've mentioned above opposed Brexit and got squarely rejected by the voters. Former British Prime Minister William Gladstone believed that ordinary voters ensured the morality of government; but today, some prominent "experts" imply that only those with university degrees and "liberal" outlook have opinions worth listening to.*

*If you were to read only the FT and the Economist you would be misled to believe that the Brexit negotiations are not going well. The reality is something different. Brexit negotiations are on track and we have moved on to the critical stage of the UK's trade and future relationship with the EU. Unfortunately, we have seen the Remain supporting "experts" abandon critical faculties when considering statements coming out of Brussels while cranking them up to full dial when parsing utterances from 10 Downing street. It's a sad indictment of how "political" and "biased" the media and experts have become. This is eroding trust in the independence of institutions so vital to the smooth functioning of a democracy.*

*The private briefings and presentations that I have attended make me believe the Brexit negotiations are going well. It shouldn't come as a surprise. A successful negotiation is in both the UK's and the EU's interest despite the desperate attempt by some to make out that the UK will lose more than the EU if talks were to fail. Business and industry, both in the UK and on the continent, want a deal. It's only the Eurocrats representing Brussels who are more concerned about making a political point to scare other rebellious populations in other EU nations from voting against the EU super state project. Such an attempt is going to be futile. I have never had a doubt that the UK and the EU will finalise a deal and I continue to believe so even more firmly now.*

*The Brexit vote really is a simple case of the metropolitan class versus the poorer*

**"IF YOU WERE TO READ ONLY THE FT AND THE ECONOMIST YOU WOULD BE MISLED TO BELIEVE THAT THE BREXIT NEGOTIATIONS ARE NOT GOING WELL. THE REALITY IS SOMETHING DIFFERENT."**

*class. The liberal and the metropolitan classes who overwhelmingly support staying in the European Union, and specifically the Single Market, benefit from all the perks it brings – rising asset prices, rising job opportunities and wages and cheap domestic labour. Poorer people dislike it because they think they bear the costs of it – wage compression at the lower end, destruction of the social environment, pressure on public services such as healthcare and education. Brexit is an opportunity for the UK to restore some of the social progress that was made between the end of the war and the adoption of the Maastricht Treaty. Britain needs all-inclusive growth; otherwise the disadvantaged will run out of patience and turn up on the doorsteps of the privileged and the metropolitan middle class.*

SL: **The pound sterling is the obvious financial interest to play Brexit. Any advice how to potentially make some money off the political developments of the next 12-18 months? Any other Brexit plays you recommend? What about the risk of Corbyn coming to power?**

MS: *For over the last twelve months I have been saying the same thing – pound sterling will be range bound, with a range of 1.28-1.35. I don't see that changing much over the next twelve months. On a purchasing power parity (PPP) basis pound sterling should be at 1.41. However, the overhang of Brexit will not let it go there anytime soon. So, I am afraid you have to trade GBP in this range to make any money. There is no obvious long or short trade on sterling at the moment. If, like me, you take a long-term view to investing, then I would be a buyer of sterling. The FTSE 100 will continue to do well as it has and that's because the underlying data is good. The dire economic predictions in light of the Brexit vote were a "Michael Fish" moment and the economics profession is in crisis. According to the data compiled by David Smith of the Sunday Times, Economists at Barclays capital predicted that the UK economy in 2017 would grow by a paltry 0.7%, Bank of America 0.9%, RBS 1%, Morgan Stanley 1%, EU Commission 1%, IMF 1.1%, OECD 1.2%. The UK economy in 2017 grew by 1.7%. A monkey with a dartboard couldn't have done worse at predicting UK GDP growth in 2017. Unfortunately the Brexit forecasts were used by the economists to signal their "Remainer" credentials.*

*Labour leader Jeremy Corbyn is an old time Marxist socialist and one wonders how he missed the course on the last hundred years of world history and sufferings under Marxist socialist regimes. I see Corbyn popularity in the last general election as a protest vote. I am very sanguine that upon knowing Corbyn's views on almost every topic, when push comes to shove, people of this country will not vote him into Downing Street. How many of the 39% of Financial Times readers who voted Labour at the last election really want John McDonnell as Chancellor and in charge of the UK Treasury? For all the press around Corbyn one has to realise he has not united the party. It's the Labour campaign group Momentum that have united the party by the strict discipline bordering on fascism and that has its limits to success. Corbyn has been given a nice and proper trim and taught how to tie a tie, but deep beneath he is still the same man who has not been considered fit for high office for so many years. Having said that, it's incumbent on PM Theresa May and her government to prove to the people that they deserve to be in office and address the social, educational and economic issues that plague the country.*

SL: **In your long-term planning for your clients, what potential shocks or Black Swan events do you think investors need to be prepared for in order to protect their nest egg?**

MS: *As a long-term investor, one has to keep the secular trends in mind, invest for the long term and not try to time the market. The best time to invest in the market is always NOW. Here is an example:*

*From January 1, 1988 to December 28, 2017 – i.e. over the last 29 years – the S&P 500 (SPX) generated an average annual-*

*ised return (price return) of over +8.1%. However, during the worst five-year period from March 1, 2004 to Feb. 28, 2009, the S&P compounded at a rate of -5% p.a. While at the other extreme, the S&P 500 compounded at +26.2% over five-year period of January 1, 1995 to December 31, 1999. If you were unlucky enough to exit the market at the end of 2009 or enter at the start of 2000 the "timing" would have cost you a fortune. However, if you invest "now" and stay the course you will reap a rich harvest over the long term.*

*To me the big trends are as follows:*

- *Emerging markets' weight in the allocation should keep on increasing in line with its contribution to global GDP growth.*

- *Equity is the best asset class to be in given the stage of rate cycle we are in – i.e. at the cusp of an upswing.*

- *Oil prices are not going to see the levels we have seen in the past and dare I say in a few years you will see the US and Russia come to loggerheads over who controls the oil market. US oil production will keep increasing. For Russia the oil price and the ability to impact the market is a critical foreign policy issue.*

- *In more immediate terms, US tax reform is a critical issue both for the US and Europe. While the US economy will benefit from it, low US corporate tax is a big risk for European companies. A 21% federal rate in the US will be impossible to ignore, given the incentives it creates for European companies to invest in the US instead of at home. The US also happens to be a big market for many European companies. Commenting on the impact of US tax reforms, Germany's Center for European Economic Research press release was rather bluntly titled: "Germany Loses Out in U.S. Tax Reform." I think this is going to be the main theme in the market and the world economy in 2018. EU politicians' main pre-occupation so far has been that the EU companies aren't paying enough. So how will they adjust to this new reality of 21% corporation tax in the US? Europe (ex UK) believe that the primary purpose of taxation is to fund a heavily redistributive welfare state, never mind the consequences this has on growth. Things will have to change.*

**SL: Do you have a view on cryptocurrencies? Is this a subject that even features in the thinking of a serious wealth management firm?**

**MS:** *At the end of December 2017 bitcoin lost one-fourth of its market value in 24 hours as a wave of selling hit the broader cryptocurrency market just before the Christmas holidays began. Bitcoin is not a crypto-currency but a klepto-currency. Bitcoin has more bounce than a bouncy castle at a Saturday fare. Despite the skyrocketing prices (or perhaps because of it), it has never crossed my mind that I should buy bitcoin. If you don't understand or have no yardstick to value an asset just don't buy it. Bitcoin could go to $1,000,000 or $0 and it woouldn't surprise me. Bitcoin is not an investment, it's pure speculation and one that I would not consider for my investment portfolio. I outlined my view on bitcoin in the August newsletter where I wrote that "I can't define irrational exuberance for you, but I know it when I see it." Bitcoin buyers are well advised to read up on the Tulip Mania (1636-37), a period in the Dutch Golden Age during which contract prices for bulbs of the recently introduced tulip reached extraordinarily high levels and then dramatically collapsed. Professional traders, cobblers, carpenters, bricklayers and woodcutters were all indulging in frenzied trading of tulip bulbs. Some bulbs even changed hands up to 10 times during the course of a single day. In January 1637, the price of a single bulb of Semper Augustus Tulip stood at 10,000 Guilders. Historian Mike Dash in his book 'Tulipomania' puts the sum in context: "It was enough to feed, clothe and house a whole Dutch family for half a lifetime, or sufficient to purchase one of the grandest homes on the most fashionable canal in Amsterdam for cash, complete with a coach house and an 80ft (25m) garden – and this at a time when homes in that city were as expensive as property anywhere in the world."*

## "DO NOT CONFUSE PRICE WITH VALUE. BITCOIN HAS NO INTRINSIC VALUE. IT ONLY HAS A PRICE."


*Do not confuse price with value. Bitcoin has no intrinsic value. It only has a price. It doesn't exist except in cyberspace and is always quoted in a real currency such as US dollars. However, I highly value blockchain – the technology that bitcoin uses. Just as shipping containers revolutionised the international goods trade in the 1960s, blockchain is the new database technology that will revolutionise data processing over the Internet.*

**SL: Last but not least, can our readers somehow sign up to your newsletter?**

**MS:** *I am always happy to hear from the readers. Readers comments and feedback are always very useful. If your readers wish to subscribe to the newsletter or get in touch with me, they will be advised to send me an email at manish.singh@crossbridgecapital.com.*

**SL: Many thanks!**

**About Swen**

Swen is CEO of Master Investor Ltd. and regularly serves as an advisor and board member to public and private companies. His work has been featured in publications like the Financial Times, Private Eye, and the Economist. He welcomes readers connecting with him on LinkedIn.

BY JAMES FAULKNER

## STOCKS IN FOCUS

# IQE: BRITAIN'S NEXT TECH TITAN?

**On 30th August 2016, investors in microchip designer ARM Holdings – at the time the UK's largest independent technology company – overwhelmingly backed a £24 billion takeover by SoftBank of Japan. Among the many voices of dissent was Hermann Hauser, one of the people involved in the founding of ARM, who described the event as "a sad day for British technology". But setting aside the arguments for and against foreign ownership of 'strategic' assets such as ARM, it was clear that British technology investors had lost their stock market darling.**

ARM shares were a top performer for UK investors, having put in a 20-fold rise since the depths of the financial crisis until the firm's eventual takeover last year. A major draw was ARM's licensing approach whereby it would design a product and then licence its manufacture to OEMs (original equipment manufacturers), enabling it to achieve a consistently high return on capital and a generous operating margin. ARM rode the wave of the smartphone boom, as devices began to require more numerous and sophisticated microchips to make them tick.

But the smartphone revolution was just the tip of the iceberg. Explaining the logic behind the deal, Softbank's CEO, Masayoshi Son, referred to the Internet of Things (IoT) and the "paradigm shift" that the new technology will engender. In short, Mr Son was making a £24 billion bet on the future of a technology that looks poised to permeate almost every aspect of modern life. His conviction was such that he paid 50 times earnings before interest, tax, depreciation and amortisation to get his hands on ARM. Given the whopping 43% premium to the prior trading day's closing price, it is perhaps unsurprising that ARM shareholders opted to take the cash and walk. But given the lack of any obvious successor to ARM on the UK stock market, it is equally unsurprising that many were left scratching their heads as to where to park their windfall.

## Silicon valleys

Some of them have alighted on a small Welsh company called **IQE* (LON:IQE)**. Formed by the merger of two leading silicon wafer foundries in 1999, IQE floated on AIM in 2000 at the height of the tech bubble, during which time its shares reached the dizzy heights of 800p. But until relatively recently, the share price performance was unimpressive, with the stock trading as low as 16.5p as late as July 2016.

But in the meantime, IQE had been busy building a portfolio of IP that would constitute much of the bricks and mortar of the next technology revolution. The company specialises in compound semiconductors, which overcome the traditional limitations of conventional silicon wafers by combining two or more materials. Its products are essential for smart phones, 3D sensors, driverless cars, lasers and pretty much all the technology relating to the IoT. Not that the market was paying attention to all this; it was more interested in a cyclical downturn in the smartphone market that had taken the wind out of the sails of the firm's dominant Wireless division. Of course, this provided an excellent opportunity for canny investors to get on board at bargain prices – IQE was trading on single-digit price-to-earnings mul-

“IQE HAS BUILT AND CEMENTED A DOMINANT MARKET POSITION THROUGH A CAREFUL STRATEGY OF SELECTIVE ACQUISITION COUPLED WITH ITS OWN PRODUCT DEVELOPMENT AND R&D EFFORTS.”

tiples (PEs) as recently as 18 months ago.

One reason for the lowly valuation was that IQE had long been mistaken for a supplier of commodity products. Indeed, it is true that IQE is one of several suppliers of compound semiconductor wafers for the non-captive (outsourced) market. However, IQE has built and cemented a dominant market position through a careful strategy of selective acquisition coupled with its own product development and R&D efforts. This has led to the firm growing its market share of the non-captive wireless market from c.10% in 2005 to over 55% today. Moreover, its IP portfolio includes many trade secrets and over 100 patents. Its depth and breadth of experience, as well as its ability to develop bespoke solutions for its customers – which are believed to include many of the world's leading OEMs – has enabled it to solidify its market position as the largest outsourced supplier of compound semiconductor epitaxy wafers (see panel) globally.

## VCSELs

VCSEL stands for vertical cavity surface emitting lasers. VCSELs differ from conventional edge-emitting lasers, which emit light from the side of the chip once it has been cut, in that they emit a beam of light at right angles to the top of the chip. You may have already come into contact with this technology without even knowing it if you have interacted with the new generation of facial recognition technology displayed by some smartphones.

In fact, the range of potential applications for this technology is huge. In addition to consumer electronics (laser focusing, 3D imaging, facial recognition, proximity sensing, hand and body tracking, gesture recognition) there are applications in the automotive sector (pedestrian detection, collision avoidance, parking assistance, traffic sign recognition, lane departure warning) and industry (illumination, 3D printing, drying and curing plastics and sintering metals) to name but a few.

A recent report by Zion Research noted that the global VCSEL market was worth $760m in 2015 and forecasts 21.3% CAGR between 2016 and 2021. As the first company to offer larger diameter VCSEL wafers, IQE has become the preferred outsourcing supplier for VCSEL epitaxy, often working directly with OEMs rather than chip or component vendors. This is a key competitive advantage when it comes to securing large scale contracts.

## iPhone X and beyond...

The IQE share price began a gentle ascent from August 2016, no doubt helped along by a steady flow of redeployed cash from investors' ARM proceeds. However, the real step-change in the market's perception of the stock came in July when management revealed they had approved a capacity expansion plan to meet higher levels of expected demand for H2 2018 than previously anticipated. Results for the full year were now expected to exceed market expectations and investors were teased with the prospect of "a more significant upgrade to current market expectations" that could be delivered for 2018.

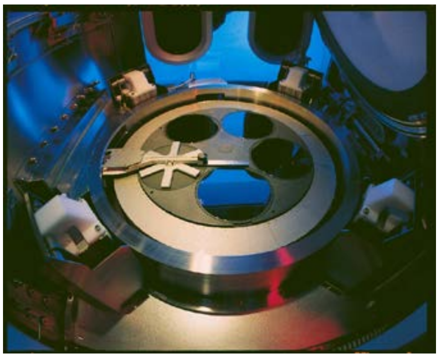

Key to the improvement in trading conditions was the group's engagement in a range of programmes which provide "significant upside potential" to its near and mid-term growth expectations. In particular, "The start of the mass-market ramp for VCSEL [see panel] wafers marks an inflection point in the commercialisation of this technology." IQE added that it had "secured multiple, multi-year contracts for this VCSEL ramp which reflects its strong competitive advantages including its technology leadership and its proven track record in delivering wafers into high volume consumer markets."

By this time speculation was rife that IQE was a major supplier for Apple's new iPhone X (IQE always maintains strict customer confidentiality). This inference appeared to be confirmed at the time of a £95 million placing in November, which was undertaken by IQE in order to help expand capacity on the back of "material demand for its VCSEL wafers from a leading global consumer electronics company for use

> **"SPECULATION WAS RIFE THAT IQE WAS A MAJOR SUPPLIER FOR APPLE'S NEW IPHONE X."**

## Internet of Things

The easiest way to understand the Internet of Things (IoT) is as the next wave of the Internet. In the past, only computers and certain mobile devices were connected to the internet; whereas in tomorrow's world, pretty much everything and anything will be connected in some way or another. This may seem far-fetched, but it's already happening. Consider that insurance companies now offer plans whereby drivers can reduce their premiums by having sensors installed in their cars to monitor their driving; fitness-minded people wear devices that monitor their physical activity, heart rate and blood pressure etc.; and homeowners control their heating from their mobile phone and monitor appliances' energy usage with a smart meter. According to Boston Consulting Group, the IoT market will grow at a compound annual growth rate (CAGR) of 20% between 2015 and 2020, at which time it will be worth $267 billion.



**"THERE IS ALSO GOOD REASON TO BELIEVE THAT CURRENT MARKET FORECASTS ARE SIMPLY TOO CONSERVATIVE."**

in one of its mass market consumer products."

A placing often has a negative impact on a company's share price, but shares in IQE soared on the back of the announcement. Notwithstanding the apparent confirmation of the market's suspicions regarding Apple, the placing was conducted at par with the previous market close price, rather than at the usual discount needed to tempt in investors. It was also conducted solely with institutional investors, all of whom will have carried out extensive due diligence and must therefore have satisfied themselves of the attractions of IQE's growth prospects. A placing also enables the firm to maintain a healthy balance sheet while pursuing its expansion plans.

## Time to cash in your chips?

IQE shares have soared by a factor of four in the past year alone. At a share price of 150p at time of writing they trade on 46 times research house Edison's 2017 forecast earnings per share, falling to 42 times for 2018. On the face of it, the shares are expensive. There is not much here that would appeal to a traditional value investing approach. That said, the company is a different beast to its prior incarnation of a primarily smartphone driven chip supplier. It is now a key technology enabler straddling many verticals with a dominant market position and a clear pathway to growth. As management observes, "IQE has developed an unparalleled breadth of materials IP, which position it to prosper from the inflection that is taking place in our industry." That prospect could make it a tempting target for larger players such as Intel, which has been rumoured to have made a tentative approach for IQE in the past.

There is also good reason to believe that current market forecasts are simply too conservative. Edison has conducted a scenario analysis modelling a faster than expected ramp-up in VCSEL volumes, which stretches to 2018 EPS of 10.7p in the most optimistic scenario. If IQE came anywhere near to that kind of number the shares would look cheap. It strikes me that management would not have made such a bold move as they did with the recent placing were demand not going through the roof. What's more, I believe we are at the tip of the iceberg when it comes to the adoption of the technologies that IQE caters for. We could be witnessing a new UK technology star in the making.

** James Faulkner owns shares in IQE.*

## What is compound semiconductor epitaxy?

Conventional silicon semiconductors have a fixed set of electronic characteristics; whereas compound semiconductors, which are made from combining several elements in different proportions, can exhibit a diverse range of characteristics, which makes them amenable to tailoring for different market segments. IQE itself has specialised in the epitaxy stage of the production process, whereby wafer foundries take very thin discs of substrate (compound semiconductor, sapphire or silicon) and deposit a succession of thin layers on them. Up to 300 epitaxial layers may be deposited, each of which may be just a few atoms in thickness. By controlling the composition and thickness of these layers, IQE is able to produce a product that meets the specific needs of the customer. Until relatively recently most semiconductor manufacturers carried out the epitaxy process in-house, but recent years have seen a trend towards outsourcing as OEMs recognise the benefits of gaining access to a wider range of technology.

**About James**

Our Editorial Director, James Faulkner, began investing in the stock market in his early teens. With over a decade of experience covering the stock market under his belt, he has also been a judge at the Small Cap Awards, and is an Associate of the Chartered Institute for Securities & Investment.

BY JOHN KINGHAM

## DIVIDEND HUNTER

# IS AN 8% YIELD ENOUGH FOR A HOUSEBUILDER?

**Neil Woodford's team have written several times about their fondness of UK cyclical stocks, based on attractive valuations. One area of special focus has been construction and housebuilding. Following the financial crisis, housebuilders fell a long way out of favour, and for good reason. Many cut their dividend, suspended their dividend or diluted existing shareholders by issuing new shares to strengthen their balance sheets.**

That period of gloom and doom is largely over, and Woodford's team now see a potentially bright future for large housebuilders. This has a lot to do with the fact that both major UK political parties have promised to fix the broken housing market and finally increase supply to a more sensible level (although how credible those promises are is another matter). If supply is increased then it will involve the building of lots of houses, which should obviously play into the hands of housebuilders.

I'm not sure I agree with that optimistic viewpoint, but it's an interesting scenario and so this month I've decided to look at **Galliford Try (LON:GFRD)**. It's currently the highest yield housebuilder with a dividend yield of 8%. That's a very high yield, but is it enough to offset the risks of this notoriously cyclical industry?

## Galliford Try PLC

- **Price: 1,200P**
- **Sector: Household Goods & Home Construction**
- **PE: 7.4**
- **Yield: 8%**

At first glance, an 8% yield should set off all sorts of alarm bells ringing in your head. After all, a cyclical company with an 8% yield sounds like a classic value trap. Investors buy because of the high yield, only to find that the dividend is cancelled and the share price collapses. But before we make such sweeping judgements, let's have a look at the details first.

## Growth in recent years has been rapid

Starting with the company's revenues, earnings and dividend payments for the last decade, the first thing that jumps out is how rapidly they've grown.

Revenues have grown at an average rate of 11% per year, (normalised) earnings per share by 25% per year and dividends per share by an astonishing 36% per year. That's the sort of growth rate I'd expect to see from a disruptive high-tech business, not one involved in the boring old econ-

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omy of bricks and mortar. There are several reasons for this impressive growth rate.

One reason is the timing of the financial crisis. Unsurprisingly, housebuilding and construction fell off a cliff after the financial crisis as banks stopped lending and homebuyers stopped buying. Galliford's revenues fell by 30%, profits turned to losses and the dividend was cut in half. A large part of the company's impressive growth from 2008 to 2017 is simply because its revenues, earnings and dividends were depressed at the start of that period.

Another reason for the company's impressive growth in recent years was its decision to go on a land acquisition spree immediately after the financial crisis. In 2009, Galliford announced a £119 million rights issue and used the funds to buy land at fire-sale prices, increasing its land bank by 25% in a single year. That land was subsequently used for development, and as a value investor myself I'm always happy to see companies buying productive assets at discount prices.

A third reason for Galliford's impressive recent growth is the post-crisis housing boom. Thanks to super-low mortgage rates, endless support from the government and a positive feedback loop between rising prices and rising demand, the UK housing market (especially London and the south east) is more expensive now than it was at the peak of the 1995-2007 boom. Very high house prices are of course good for housebuilders, and so in many ways Galliford is just one of many (housebuilding) boats being lifted by a rising (house price) tide.

## A cyclical business with unavoidable ups and downs

Housing booms are always followed by housing busts and peak housebuilder profits are always followed by some combination of declining profits, losses, dividend cuts and rights issues. Galliford Try is no exception.

For example, in 1990 (a previous housing cycle peak) Galliford's earnings per share had grown to 8p but during the long housing bust that followed those earnings faded away to nothing. In fact, by 1994 (the bottom of that housing cycle) the company was making a loss. The next housing cycle began around 1995 and Galliford's earnings started to recover. However, it still took the company seven years to sustainably exceed its 1990 peak. By 2007 (the top of the 1995-2007 cycle) its earnings had ridden the mother of all housing booms all the way up to 102p.

Once again boom was followed by bust and in 2009 Galliford's profits turned to losses. I suspect that under normal circumstances those losses and weak profits would have lasted for more than a decade as the biggest housing boom in UK history unwound. Instead, quantitative easing, near-zero interest rates, Help to Buy and other forms of government support have acted like a shot of adrenaline to both the UK housing market and Galliford's earnings. But even with all that help, it still took Galliford eight years to exceed its 2007 peak.

The positive impact of high house prices becomes even clearer when you look at Galliford's individual business units. The operating profits from its housebuilding business have gone from a 2008 peak of £54 million to £170 million in 2017. Meanwhile, the combined operating profit from its other businesses (regeneration, building, infrastructure and Public Private Partnerships) has never exceeded its 2008 peak of £43 million. In other words, Galliford's housebuilding business has tripled during the post-crisis housing boom while its other businesses have gone nowhere for a decade.

The question of course is what will happen when the current housing boom finally reaches its inevitable end? It's impossible to know for sure, but if history is anything to go by then a decade of weak profits, losses and dividend cuts seems very possible.

Although that's a rather negative outlook, I wouldn't automatically avoid investing in housebuilders in general, or Galliford Try specifically. Instead, I would be happy to invest in this company, but only when we're near the bottom of its valuation cycle.

## Does an 8% yield suggest we're near the bottom of the cycle?

With a dividend yield of 8%, it seems that Galliford's shares are incredibly cheap. Surely that means we're near the bottom of its valuation cycle? Not necessarily. You see, cyclical companies often raise their dividends to unsustainable levels and then cut them as soon as their business cycle turns downwards. This means an 8% yield can quickly become a 4% yield if the dividend is cut in half, or a zero percent yield if it's suspended.

Personally, I think it's very likely that Galliford will cut its dividend during the next housing bust, so I don't think yield alone is a reliable indicator of value. Instead, I'm more interested in how its share price compares to the average dividend and average earnings generated by the company across an entire business cycle. If the shares appear to be cheap relative to the average earnings and dividends of the last cycle, then perhaps they're cheap relative to the average earnings and dividends of the next cycle too.

For this "cyclically adjusted" valuation I use the PE10 and PD10 ratios. The PE10 ratio is the ratio between the share price and the company's ten-year average earnings, while the PD10 is the ratio of price to ten-year average dividends. I have a couple of rules which I apply to any company I'm thinking of investing in, with the aim of avoiding overvalued stocks:

- **Only invest in a company if its PE10 ratio is below 30**
- **Only invest in a company if its PD10 ratio is below 60**

These limits are quite accommodating. They allow me to invest in all sorts of dividend-paying companies, including high quality, high growth companies that have above average PE ratios and below average yields. However, they are low enough to rule out the most enthusiastically priced stocks.

In recent years I have learned that these ratios are too accommodating for highly cyclical companies. Companies that operate in cyclical industries, like miners, oil services companies or housebuilders, can give the appearance of being attractively valued at the peak of their cycle. At the peak of the cycle earnings are high and dividends are high, and this can make the share price look attractive.

**"I WOULD BE HAPPY TO INVEST IN THIS COMPANY, BUT ONLY WHEN WE'RE NEAR THE BOTTOM OF ITS VALUATION CYCLE."**

But these companies are cyclical, and with cyclical companies, what goes up will usually come back down. So when boom turns to bust, high earnings and dividends collapse, taking the share price with them. What appeared to be an attractive share price turns out to have been little more than a castle built upon sand.

For highly cyclical companies like Galliford Try, I use the following modified rules:

- **Only invest in a highly cyclical company if its PE10 ratio is below 10**
- **Only invest in a highly cyclical company if its PD10 ratio is below 20**

These lower ratios are very demanding. Very few successful companies trade at less than ten-times their ten-year average earnings, or twenty-times their ten-year average dividends. The exception is successful but highly cyclical companies which are at or near their cyclical lows.

For example, in the near-recession of 2003 you could have invested in Galliford Try at 150p per share. At that price its shares cost 6.5-times its ten-year average (normalised) earnings per share (the PE10 ratio) and 17.5-times its ten-year average dividend (the PD10 ratio). With hindsight, 150p turned out to be a good price as the shares subsequently increased by more than 800% in just four years.

Contrast that with the 1,200p needed to buy Galliford Try shares at the peak of the last cycle in 2007. At that time the PE10 and PD10 ratios were 25 and 92 respectively, far above my preferred limits of 10 and 20. By looking at the share price relative to ten-year average earnings and dividends, rather than just the peak earnings and dividends of 2007, it was obvious that 1,200p in 2007 was a very high price to pay for a very cyclical company.

One good thing about highly cyclical companies is that their share prices are highly volatile. This is good because it means the share price can come down from excessive highs very quickly, and it can go up from excessive lows very quickly.

An example would be 2008 and 2009, when Galliford's shares fell from 1,200p to around 250p. At 250p the investment case made sense once again, with the PE10 and PD10 ratios falling to a very attractive 3.5 and 13.5 respectively. At that level is was clear, quantitatively at least, that Galliford Try was very cheap. Once again, that turned out to be correct as the shares increased by more than 500% over the following six years.

We can also apply the same thinking to the 2015 peak price of 1,800p. At 1,800p the PE10 and PD10 ratios had increased to 26 and 60 respectively, which would be high for a defensive company like Unilever and is borderline insane for a highly cyclical company like Galliford Try.

So how do these ratios stack up today, now that the share price has fallen from 1,800p back down to 1,200p? Today the PE10 and PD10 ratios are 14.8 and 26.6 respectively, which puts them slightly above my maximum acceptable values of 10 and 20. So despite Galliford Try's very enticing 8% dividend yield, I don't think the shares are attractively cheap when you take the firm's cyclical nature into account.

You could argue, as Woodford's team do, that we are about to enter a golden era for housebuilders, driven by the government's commitment to increasing the UK's housing stock. That would, of course, be very good for Galliford and could easily justify the current share price. However, it's also highly speculative and one thing I hate to do is speculate.

I would much rather rely on history, and history suggests that buying highly cyclical stocks at low points in their cycle (as indicated by exceptionally low PE10 and PD10 ratios) is a good idea, and that buying them at other times is not such a good idea (unless you can time your exit at the peak of the cycle, in which case, good luck to you).

## If an 8% yield is not enough, how high does it have to go?

If I think 1200p is too high a price, what price would I invest at? It would be the price at which the PE10 ratio and PD10 ratio fell below my preferred maximums of 10 and 20 (and assuming the company was still fundamentally sound).

Under those conditions I would be happy to invest in Galliford Try at anything below 800p. You might say that 800p is a ridiculously low price and that the shares will never get there because the yield would be 12%, and you could be right. Remember though, that the shares briefly touched 800p in the days following the Brexit vote in 2016. Or better yet, remember that the shares were 300p in 2011, just a few short years ago. If the housing market nosedived, perhaps because interest rates started to rise, or the government ran out of funds to continue stoking the house price fire, I can easily imagine Galliford's shares falling to 800p and perhaps far, far lower.

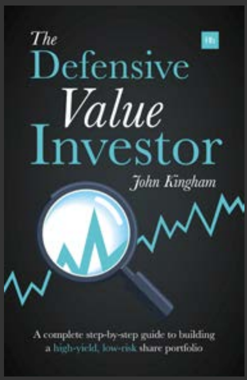
What the dividend yield would be at that time is impossible to know. The dividend would almost certainly be cut, but as long as it wasn't completely suspended for years on end, I think 800p or lower could prove to be a very reasonable entry point for the next year or two.

**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.



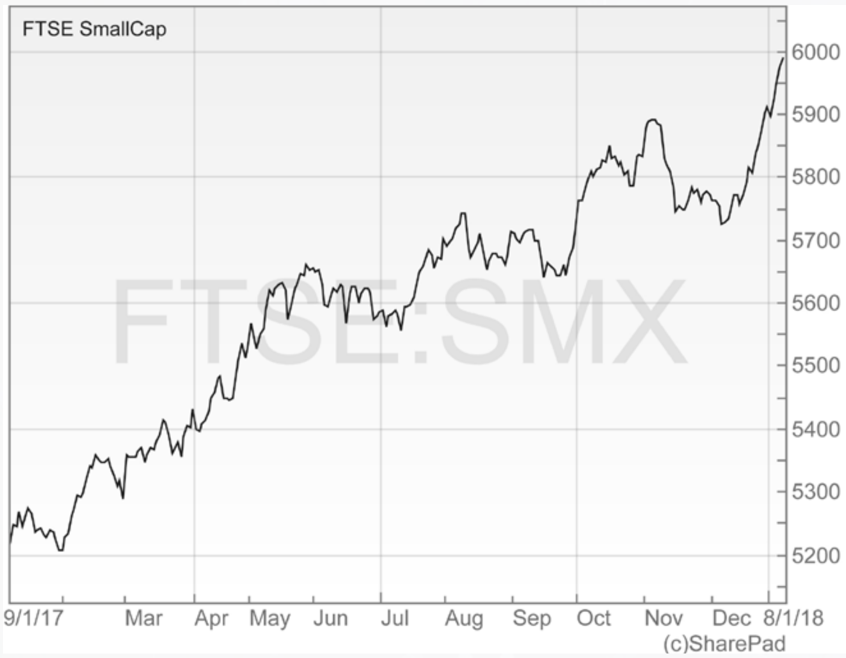
BY RICHARD GILL, CFA

FROM ACORNS TO OAK TREES

# FOLLOW THE FUND MANAGERS FOR A PROFITABLE 2018

**As we say goodbye to 2017 and enter a new year it's time for my annual review of how the UK small cap markets have performed and to provide a few investment ideas for 2018.**

Small cap investors had an excellent year in 2017, with the FTSE AIM All Share putting in a gain of 24.3%. At 1,049.6 it closed the year at levels not seen since before the market crash of 2008. The FTSE Small Cap Index was slightly behind but still put in a decent gain of 15.2% to reach an all-time high by the year end.



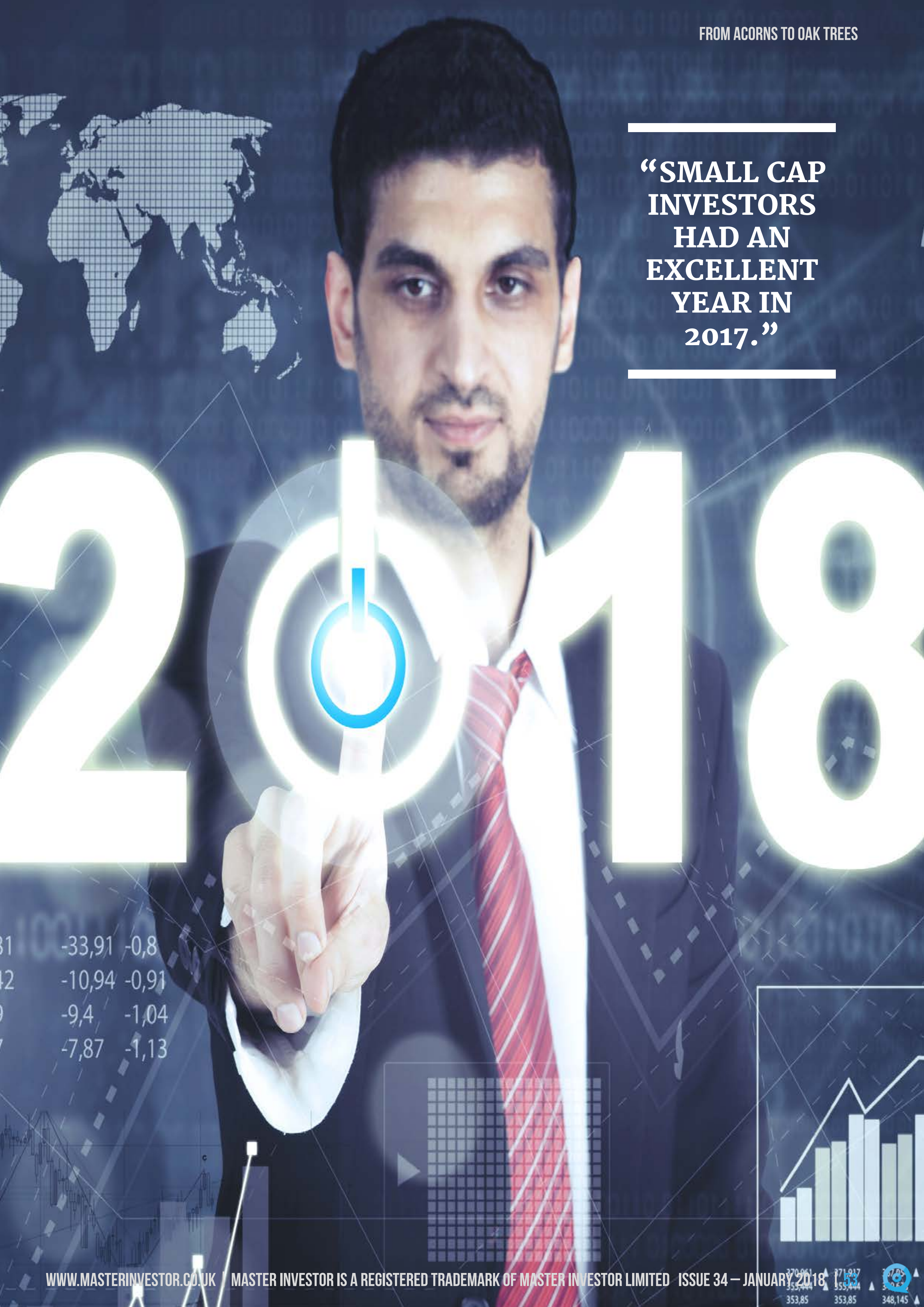

*Source: Sharescope*

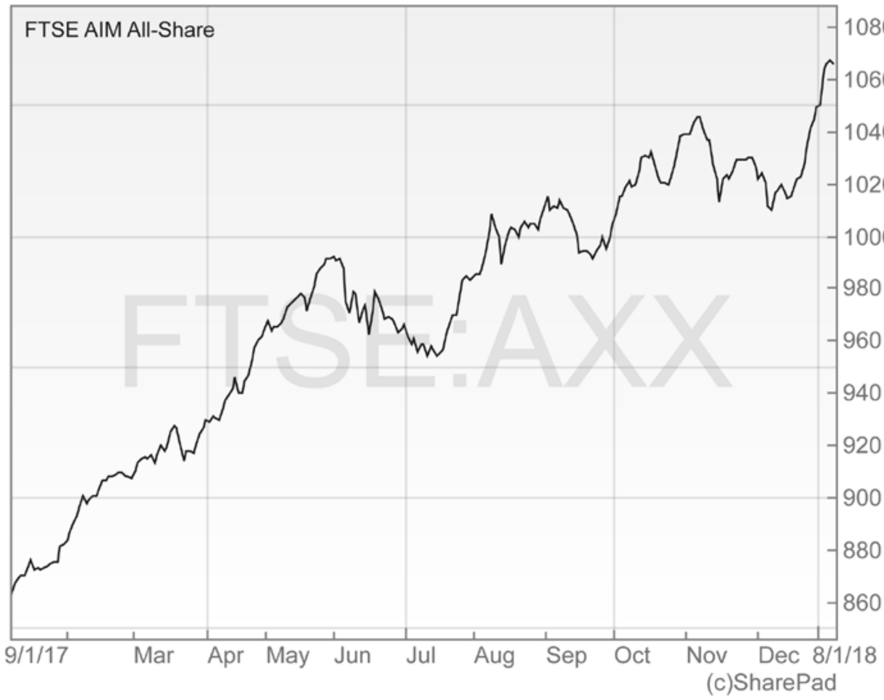
Despite reaching its own all time high at the end of the year the FTSE 100 underperformed small caps, nevertheless delivering a decent gain of 7.6% as housebuilders outperformed following a bad year in 2016. Performing better were mid-cap shares, with the FTSE 250 up by 14.7% and smashing through the 20,000 level for the first time to deliver yet another trading peak.

## AIM's blue-chips stocks drive small cap returns

As was the case in 2016, the performance of the AIM All Share index (which is weighted by market cap) was driven by a strong showing from its larger constituents. The FTSE AIM 100 index, which represents the larg-

"SMALL CAP INVESTORS HAD AN EXCELLENT YEAR IN 2017."






*Source: Sharescope*

est AIM companies by market capitalisation, rose by 32.9%, with the AIM UK 50 index up by 30.1%.

Online fashion business **ASOS (LON:ASC)** was once again a major contributor to the All Share's performance, rising by 35% over the period to now capitalise the company at £5.6 billion. The second largest index constituent, biotech business **Hutchinson China Meditech (LON:HCM)**, compensated for a poor 2016 by rising by 147%. Continuing to defy gravity was third placed constituent **Fevertree Drinks (LON:FEVR)**, which rose by just under 100% over the period. Shares in the posh tonic maker now trade on a multiple of 60 times forward earnings estimates.

Other prominent performances amongst AIM's bigger businesses came from online estate agent **Purplebricks (LON:PURP)** and semiconductor wafer producer **IQE (LON:IQE)**, shares in which rose by 195% and 261% respectively, taking both their valuations through the £1 billion market cap barrier – there are now 16 AIM listed companies valued at £1 billion or higher.

Perhaps a more accurate way of reflecting small cap performance, compared to looking at the AIM All Share, is by taking an equal weighted approach – in other words assuming that an equal amount of money was put into each AIM company at the start of the year. The largest 10 AIM companies currently make up around 25% of the total market cap of the AIM All Share out of a universe of over 800, so the index's performance is highly dependent on their share prices.

To do this I take all AIM companies which were listed on the market at the beginning of 2017 and remained listed for the whole year (new listings during the year or those which left the market are excluded). There are 916 qualifying companies, to which I give each an equal weight in my theoretical index.

Of these, 464 companies (50.7%) finished the year with a higher share price, 7 (0.8%) were flat and 445 (48.6%) lost value. So a throw of a dart at a list of AIM companies at the start of 2017 would have been just slightly more than likely to hit a winning stock than a losing stock. The average gain per share was 19.3% as once again a number of lower capitalisation small cap stocks delivered triple digit percentage gains.

## Top performers

For the second year in a row oil & gas and mining companies were well rep-

| Company | Capital (£m) | Price change 2017 (%) | Sector |
|---|---|---|---|
| ASOS | 5,616 | 35.27 | General Retailers |
| Hutchison China Meditech | 3,720 | 146.7 | Pharmaceuticals & Biotechnology |
| Fevertree Drinks | 2,624 | 99.91 | Beverages |
| Burford Capital | 2,399 | 101.22 | Financial Services |
| boohoo.com | 2,164 | 39.89 | General Retailers |
| Abcam | 2,161 | 37.55 | Pharmaceuticals & Biotechnology |
| RWS Holdings | 1,260 | 32.16 | Support Services |
| Clinigen Group | 1,260 | 45.07 | Pharmaceuticals & Biotechnology |
| Breedon Group | 1,248 | 20.84 | Construction & Materials |
| Purplebricks Group | 1,136 | 195.21 | Real Estate Investment & Services |
| First Derivatives | 1,066 | 96.56 | Software & Computer Services |
| Phoenix Global Resources | 1,047 | 87.5 | Oil & Gas Producers |
| IQE | 1,035 | 260.53 | Technology Hardware & Equipment |
| Plus500 | 1,035 | 136.28 | Financial Services |
| Globalworth Real Estate Investments | 1,030 | 32.96 | Real Estate Investment & Services |
| Dart Group | 1,010 | 37.2 | Travel & Leisure |

*AIM's billion pound businesses. Data source: Sharescope*

| Company | M. Cap (£m) | Price change (%) | Sector |
|---|---|---|---|
| Greatland Gold | 55.9 | 997.06 | Mining |
| Wey Education | 48 | 880.85 | Support Services |
| Trinity Exploration & Production | 40.9 | 673.33 | Oil & Gas |
| Vela Technologies | 9.6 | 666.67 | Media |
| Echo Energy | 49.7 | 598.72 | Oil & Gas |

*Table: 5 biggest AIM risers in 2017*

| Company | M. Cap (£m) | Price change (%) | Sector |
|---|---|---|---|
| Kin Group | 1.5 | -99.3 | Leisure Goods |
| Monreal | 1.1 | -96.22 | Alternative Energy |
| Flowgroup | 6.8 | -94.18 | Electronic Equipment |
| Proxama | 3.7 | -94 | Financial Services |
| People's Operator Holdings | 12.3 | -92.87 | Mobile Telecoms |

*Table: 5 biggest AIM losers in 2017*

resented in the best performing AIM shares of 2017, with 12 out of the top 20 operating in one of the two sectors.

Australian gold explorer **Greatland Gold (LON:GGP)** was the number one AIM share of the year, rising in value by 997% after the company appointed a new CEO, identified new anomalies to explore at its properties and strengthened its finances. In second place was virtual classroom group **Wey Education (LON:WEY)** which finished up by 881% after it made a maiden profit and significantly expanded its operations. Third was **Trinity Exploration and Production (LON:TRIN)**, shares in which soared by 673% after the oil & gas junior returned from suspension, refinanced and grew productions from its assets in Trinidad and Tobago. A total of 88 AIM stocks doubled in value or more over 2017.

At the other end of the market 18 AIM shares lost 80% or more of their value over the year. The worst performer was **Kin Group (LON:KIN)**, the former Fitbug Holdings, shares in which fell by 99.3% after the business appointed administrators to its key operating subsidiary. Down by 96.2% was **Monreal (LON:MORE)**, previously the low carbon energy business Cogenpower, which entered into a Company Voluntary Arrangement (CVA).

**"IT WAS AN EXCEPTIONAL 2017 FOR SMALL CAP FUND MANAGERS, WITH DATA FROM TRUSTNET'S UNIVERSE OF 48 UK SMALL CAP FUNDS SHOWING ALL MADE A POSITIVE ABSOLUTE RETURN. OF THOSE, 34 BEAT THE BENCHMARK RETURN OF 23.8%."**

## Follow the fund managers

It was an exceptional 2017 for small cap fund managers, with data from Trustnet's universe of 48 UK small cap funds showing *all* made a positive absolute return. Of those, 34 beat the benchmark return of 23.8%.

So will it pay off to follow the professionals in 2018? I note that my three selections at this time last year **Patisserie Holdings (LON:CAKE)**, **Fulcrum Utility Services (LON:FCRM)** and **Bioventix (LON:BVXP)**, made respective gains of 12.1%, 22.9% and 83.3%, for an average of 39.4%. Here follows two stocks which some of last year's top performing small cap funds are hoping will perform well in 2017.

| Fund | Manager(s) | 2017 gains (%) |
|---|---|---|
| Old Mutual UK Smaller Companies Focus | Nick Williamson | 46.8 |
| Jupiter UK Smaller Companies | James Zimmerman | 39.6 |
| Old Mutual UK Smaller Companies | Daniel Nickols | 36 |
| Threadneedle UK Smaller Companies | James Thorne | 35.2 |
| TB Amati UK Smaller Companies | Paul Jourdan, Douglas Lawson, David Stevenson | 34.4 |

*Data source: Trustnet. Note: Performance measured from 1st January 2016 to 27th December 2017*

## CHARTER COURT FINANCIAL SERVICES

A 2.7% holding in the top performing Old Mutual UK Smaller Companies Focus fund is **Charter Court Financial Services (LON:CCFS)**. Despite the tough conditions in the UK buy-to-let mortgage sector the challenger bank made the decision to list on the Main Market of the LSE in September last year. The IPO, which valued the business at £550 million, saw the company raise £20 million for itself and £200 million for selling shareholder Elliott Management, which retains a 48% stake. A number of new institutions came on board at IPO, with various Old Mutual funds subscribing for £100 million worth of shares.

Founded in the depths of the financial crisis in 2008, Charter Court is a specialist lender serving the UK residential mortgage market through intermediaries and has an online retail savings bank offering products directly to consumers. It operates through three core brands:

**Precise Mortgages** – since inception in November 2008 Precise Mortgages organically originated £6.7 billion in mortgage loans by the IPO date, substantially all of which are distributed via more than 17,000 intermediaries, focussing on buy-to-let mortgages, specialist residential mortgages, bridging loans and second charge mortgages. Only prime and near-prime borrowers are targeted.

**Charter Savings Bank** – provides retail savings products directly to customers, exclusively online, having £4 billion in retail deposits as at 30th June 2017 and having attracted £5.7 billion in retail deposits cumulatively since March 2015.

**Exact Mortgage Experts** – provides Fitch-rated mortgage administration services and other services (including specialist analytics and credit consultancy) in relation to mortgages originated by selected third parties, including other specialist lenders. As at 30th June 2017, Exact Mortgage Experts managed mortgage assets with a value of £5.5 billion in aggregate.

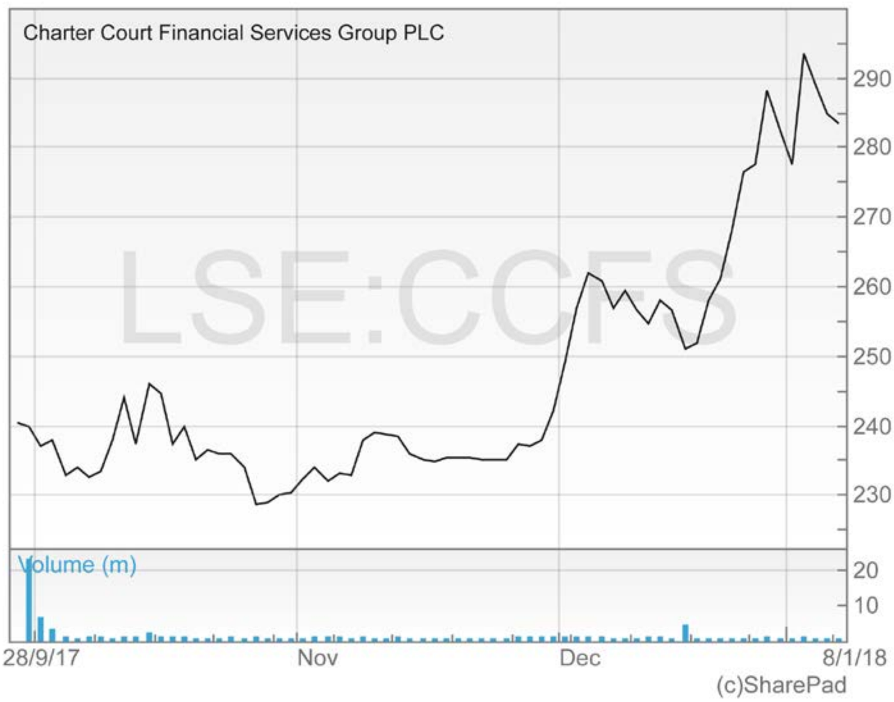
Reducing risk, the mortgage lending activities are predominantly funded by fixed-term deposits originated entirely through the retail savings business. Additional funding is provided by a securitisation programme using the Precise Mortgage Funding and Charter Mortgage Funding vehicles. Additionally, the company joined the Bank of England's Funding for Lending and Term Funding programmes in 2016, and has access to other Bank of England liquidity facilities and a warehouse facility with a commercial lender.

### Banking gains

Driven by the rapid expansion of its loan book revenues and profits have soared over the past three years. From the year to December 2014 to 2016 total net income grew from £18.8 million to £93.3 million, with net profits up from £2 million to £37.3 million. Further, in the six months to June 2017 net income was £86 million with net profits soaring to £43.6 million, that's 17% higher than in the whole of the previous financial year although boosted by a £17.7 million gain on the sale of loans.

In its first trading statement as a public company Charter Court announced in early November that as at 30th September 2017 the loan book was up 46.6% year-on-year to stand at £4.8 billion. New loan originations were stable year-on-year at £0.7 billion in Q3 and up 8.3% year-on-year to £2 billion in the nine months to 30th September. These were supported by customer deposits which were up 34.6% year-on-year at £3.9 billion.

During the quarter, the group closed a £0.3 billion mortgage securitisation at a spread of 0.5% above 3-month LIBOR, representing the lowest funding rate it has achieved in the wholesale markets. A total of £0.9 billion was drawn down under the Bank of England's Term Funding Scheme at the end of the quarter. On the outlook, Charter Court said that it was on track to deliver its 2017 targets outlined at the time of the



**"CHARTER COURT AIMS TO MAINTAIN NET LOAN GROWTH OF AT LEAST 20% PER ANNUM."**

IPO. It added that it remains well capitalised, with its CET1 ratio comfortably above its minimum threshold.

In terms of strategy, Charter Court aims to maintain net loan growth of at least 20% per annum in the medium-term while maintaining a cost-to-income ratio of around 30% or slightly above. It is looking for a return on equity (ROE) in the mid-20% level having achieved an underlying return on equity of 26.4% on an annualised basis over the first six months of 2017, and will look to maintain a minimum fully loaded CET 1 regulatory capital ratio of at least 13% over the medium-term.

**An interest-ing investment**

Shares in Charter Court have performed well since IPO, rising from 230p to the current 289p to capitalise the company at £691 million. Despite the rapid growth in profits being delivered the markets are valuing the company very cheaply, with the shares on a multiple of just 7.5 times market consensus earnings forecasts for 2018. In contrast, rival challenger banks **Aldermore (LON:ALD)** and **OneSavings (LON:OSB)** currently trade on multiples of around 12 times.

In terms of dividends, the company is currently targeting an initial payout ratio of at least 15% of net profits, with the aim of increasing the payout ratio over time. On that basis, investors are looking at a yield of around 2% for 2018. The maiden payment is expected to be announced for the first half of 2018, with there being a one-third/two-thirds split between the interim and full-year payout.

While some investors may not like the high exposure to UK buy-to-let mortgages, I believe that shares in Charter Court look attractive. The business is well run, conservatively financed and growing fast.

## TED BAKER

While being promoted as "small cap" funds, many often make a foray into the mid-cap arena in search of growth. On that note, making up 3.1% of the Threadneedle UK Smaller Companies is shirt seller **Ted Baker (LON:TED)**.

Founded in Glasgow in 1988 by entrepreneur Ray Kelvin, the company has grown from a single store selling men's shirts into a successful, and quintessentially British, global lifestyle brand. From the initial focus on menswear Ted Baker now offers ranges across the areas of womenswear, formal, accessories, lingerie, childrenswear, fragrance, footwear, watches and many others.

At the core of the business are the company's retail outlets, which made up just over three quarters of total revenues in the last financial year. At the end of March 2017 Ted Baker had 490 stores and concessions worldwide, with 192 in the UK, 98 in Europe, 111 in the US and Canada, 80 in the Middle East, Africa and Asia and nine in Australasia. These are supported by a rapidly growing e-commerce business, with localised e-commerce sites for the UK, Europe, US, Canada and Australia.

Making up the reminder of revenues is the wholesale business which operates in the UK and serves countries across the world, particularly in Europe, and a wholesale business in the US. Classified as "other revenues", Ted Baker also makes a modest, but highly profitable, amount of income from providing territorial and product licences to its brand and IP. The territorial licences cover the Middle East, Asia, and Australasia, through which the company operates licenced retail stores and wholesale operations.


### Looking sharp

Ted Baker has delivered exceptional growth as a public company, rising from being a microcap stock upon listing in 1997 to be a constituent of the FTSE 250. In the past five financial years alone revenues, net profits, earnings and dividends have all more than doubled as the company has delivered on its strategy to expand its brand across the world. In the 52 weeks to 28th January 2017 revenues smashed through the half a billion barrier for the first time, with net profits reaching a record £46.6 million.

Growth continued through 2017, with revenues rising by 14% in the 28 weeks to 12th August and pre-tax profits up by 18% at £25.3 million. More recently the company revealed that revenues grew by 7.3% in the 13 weeks to 11th November 2017. Notably, the performance was delivered despite *"challenging trading conditions across some of our global markets"* and against growth of 14.8% in the comparative period a year earlier.

On the retail side sales were up by 4.6% for the period, with e-commerce sales up by a more pronounced by 30.5% and representing 19.2% of total retail sales. On the store front, average retail square footage rose by 5.6% to 404,864 sq.ft, with new stores opened in Oxford and Chicago and further concessions opened in premium department stores in Canada, Germany and the UK. Wholesale sales increased by 14.2% with low double-digit growth in sales expected for the full year. Both retail and wholesale gross margins were in line with expectations.

### Ted Baker, money maker?

While shares in Ted Baker have performed exceptionally well during the company's 20 years on the market, they have slipped back from all time highs of £35.55 seen at the end of 2015. At the current price of £27.64 the company is capitalised at £1.23 billion, with the shares having delivered a compound annual growth rate of c.16% Since IPO plus substantial dividends along the way. Investors are currently valuing the shares on a multiple of 22 times forecast earnings for the year to January 2018, falling to 19.5 times for 2019. The respective dividend yields on offer are 2.2% and 2.5%.

The current valuation may look relatively high but is deserved in my opinion given the track record of the business, its strong brand, rising international presence and further opportunities for growth. While net debt was £73.4 million at the end of August last year, net interest payments for the first half were covered a comfortable 22 times by operating profits. Analysts at Jefferies have a £31 target for the shares, implying 12% upside from here. That may not look like much but should the company continue to deliver its historic growth rates the outlook looks bright.

**"TED BAKER HAS DELIVERED EXCEPTIONAL GROWTH AS A PUBLIC COMPANY."**

**About Richard**

Richard Gill is an investment analyst with over a decade's experience of analysing small/mid cap equities. He is the Head of Research at Align Research. Richard qualified with the Chartered Financial Analyst (CFA) designation in 2012 and was awarded PLUS Markets Financial Writer of the Year at the 2008 PLUS Awards. He has been a judge at the Small Cap Awards from 2013 to 2017.

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BY DAVID JONES

CHART NAVIGATOR

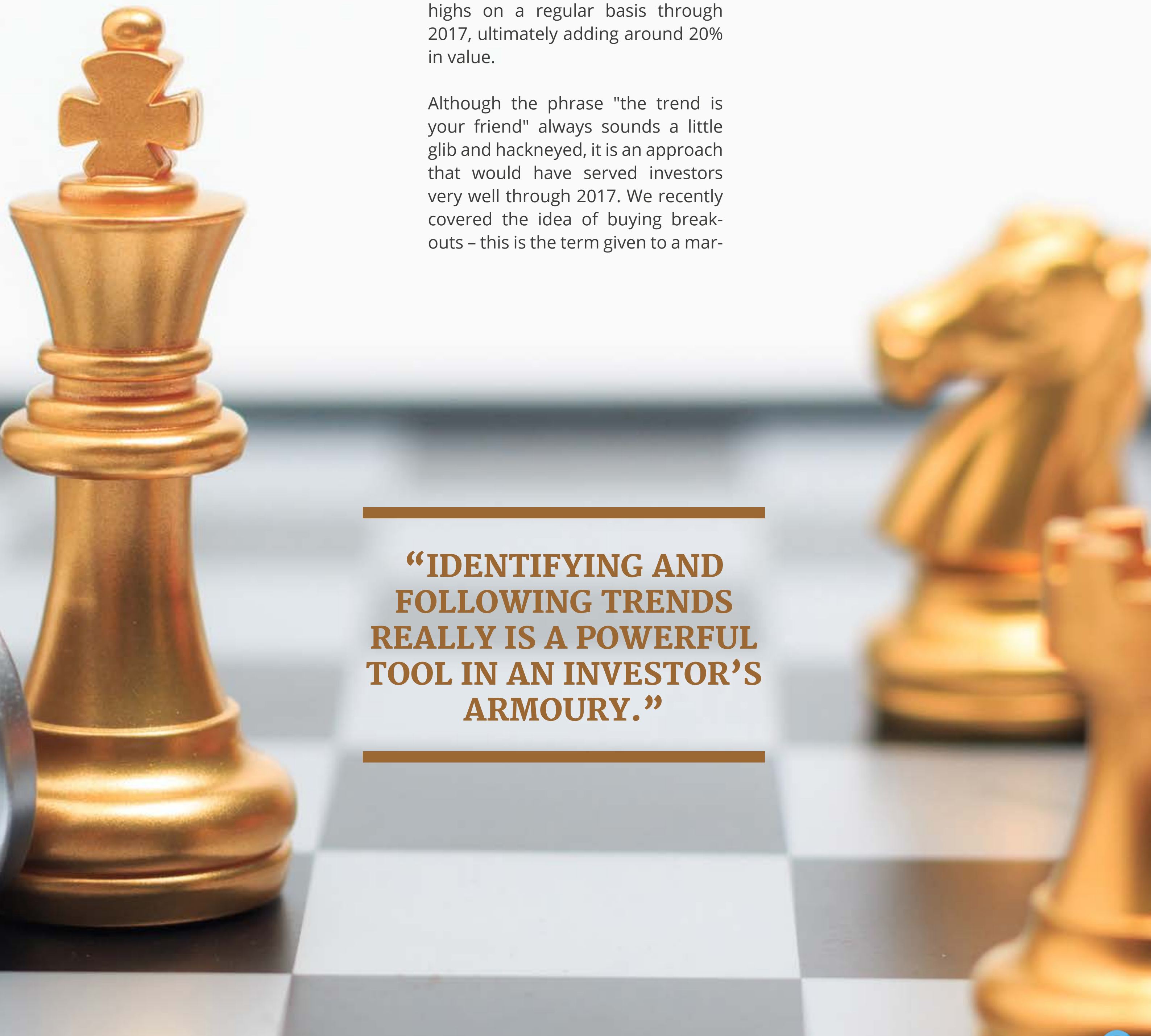
# 2017 WINNERS & LOSERS WHAT CAN WE LEARN?

**At the beginning of a new year it is of course traditional to look back at the winners and losers from the year before and see what we can learn. Far be it from me to stand in the way of tradition – so this month's column is going to blindly follow that trend. Now, Hindsight Investing – or Tardis Trading – is the financial markets equivalent of "here's what you could have won". But lessons can definitely be learnt by examining past performance – even if they end up just reinforcing what we know already. So let's kick things off with the broader market performance and choose as our benchmark the USA's S&P 500 index.**

## S&P 500 – The trend truly was your friend

What a year for the US stock market. Most commentators were wrong-footed by the immediate performance following the US election, where significant falls were expected if Donald Trump won. There was a slight wobble on election results day but this didn't last long and markets recovered. And then, proving that the post-election strength was not just a flash in the pan, the US index continued to set fresh highs on a regular basis through 2017, ultimately adding around 20% in value.

Although the phrase "the trend is your friend" always sounds a little glib and hackneyed, it is an approach that would have served investors very well through 2017. We recently covered the idea of buying breakouts – this is the term given to a market that moves through a previous high. This usually suggests strength in a market and that a new leg higher could be underway. This breakout approach would have worked well on the S&P last year as the chart below highlights.



**"IDENTIFYING AND FOLLOWING TRENDS REALLY IS A POWERFUL TOOL IN AN INVESTOR'S ARMOURY."**


## S&P – buy the breakouts

I have highlighted some of the major highs that were set – and then broken – throughout 2017. When these eventually got breached the market did carry on higher – although not necessarily straight away. Nevertheless, trend followers were well rewarded by this market over the last year, and at the time of writing, it was a trend that was still very much intact.

Let's bring things a bit closer to home and look at some of the best and worst performers in the FTSE350.

## Sophos – A slow burner

Software business **Sophos (LON:SOPH)** had a decidedly pedestrian start to the year. For the first few months of last year it was capped by the 290p/300p resistance level. Various rallies up to this level since the end of 2015 had seen the sellers come out and it was proving to be a tough level to crack – until April.

**"TREND FOLLOWERS WERE WELL REWARDED BY THIS MARKET OVER THE LAST YEAR."**

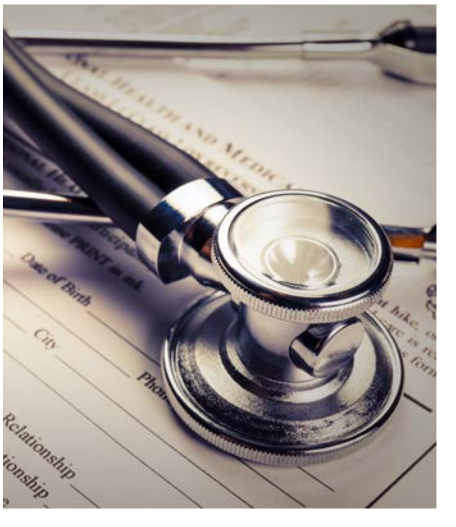
Once again, we have the breakout, shown by the arrow on the chart. A level that has been a real obstacle in the past is finally overcome, suggesting a significant shift in sentiment and the chance of a new leg higher. Adding to the weight of this was the most recent trend going back to the summer of 2016 which was still up and intact. So, what happened next?


Lo and behold – it worked! It did signal the start of a much sharper move higher, eventually seeing the share more than double in price from the breakout point. By the end of 2017 some of this momentum had faded but overall that main trend was still up and the dedicated chartist would still be looking to buy the dips.

## NMC – The trend continues

One of the next big gainers was Healthcare business **NMC (LON:NMC)**. There's a good lesson here – and it is that trends can go on much further than you expect them to. Let's wind the clock back to the beginning of last year and see what the chart looked like.

This one had spent much of 2016 in an uptrend. It started off from around the 750p mark and by January last year was up at 1,550p. Now, this could put some people off buying – *it has doubled in a year so how much higher can it go?* That's the little voice in your head that the disciplined chartist has to ignore. That trend was still most definitely up with good support running from 1,250p through to 1,300p – a sensible




level to place stop losses below. Let's jump forwards.

What a surprise – the trend continued, and the share price doubled again. Now clearly this was a great outperformer over the last year, but it does hopefully help to ram home the importance of trading with the trend and not trying to second guess when it is going to end – which is admittedly easier said than done.

But last year was not just all full of winners of course. Let's have a look at a couple of the worst performers and see if there were any clues in the charts that we should have given them a wide berth.

> **"WHAT A SURPRISE – THE TREND CONTINUED, AND THE SHARE PRICE DOUBLED AGAIN."**

## Provident Financial – An uninspiring chart

If you came into 2017 not owning any shares in this specialist lender, the chart did not give you any reason at all to change that position. It had enjoyed some great moves up in previous years but had lost a lot of ground in 2016 leaving a decidedly sideways trend at best. Major support had been left ahead of 2,100p, but it was really struggling to make any progress through 3,400p.

Bring on the profit warnings.


There's another great investing lesson here – the first loss is often the least painful. That 2,100p support broke in August suggesting the first signs of trouble – and then the price went into freefall, trading below 500p before finally stabilising. There really was no identifiable trend here at the start of the year, and there were definite warning signs as the year went on.


## Dixons Carphone – The trend is your friend again

I have chosen a long-term chart here going back to 2012. This is to highlight that if we were looking at the Dixons Carphone chart in early 2017, the uptrend had ended. Plenty of us spend lots of time thinking about where to get into an investment – but not much thought about when we should be getting out. That trend in Dixons looks well and truly over with no reason yet to think a new trend higher is forming. Let's see what the rest of the year looked like.


It went on to continue its most recent trend, which was down. By mid-December the share price had dropped by more than 40%. No chartist should have been buying this one in early 2017.

## But hindsight is always 20:20

It *is* always easy to look back on the big winners and losers on the year and say "well clearly you should have bought here", or "you would have definitely have been a seller here". But I think picking these extreme angles does reinforce a really important approach to investing and trading – and it is of course sticking with the trend. I have deliberately kept the approach simple, just looking at previous trends. It really is one of the most basic forms of chart analysis – but still one that plenty will struggle with. How many times have we bought that plunging share because "it can't go any lower..." – only to see it do just that? Or put off buying that great performer because "surely the top will be in soon"?

Identifying and following trends really is a powerful tool in an investor's armoury. And, in this day and age of real-time charting and trading packages that can load up ten indicators with a couple of clicks, it is often relegated to a secondary consideration ahead of the next magic forecasting system. But hopefully as these examples from the past 12 months show – it should be one of the first things that the chartist looks at. And, arguably, everything else is just window dressing!

**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 BBC Radio 5 Live'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

# NEW YEAR RESOLUTIONS WORTH THE EFFORT

## (AND LEARNING FROM SNOW SHOVELS)

**According to analytical researchers with nothing better to do at this time of year, most of us making New Year Resolutions will at best survive a week or so before slipping into the same old bad habits. According to a poll of a couple of thousand of us in January last year, at least half of us setting New Year Resolutions admitted to lacking the willpower to last under any new regime until February, if we're lucky. It's the same every year apparently.**

So what are your priorities for 2018? How about resolving not to over-react when rolling "shock horror" headlines trigger unnecessary panic amongst nervous investors? I'm sure you can remember a few false panic alarms from last year. Or why not promise to check that you're maximising the tax reliefs you're entitled to? Let's face it, there aren't many things in life as rewarding as a bigger tax deduction. And it feels so good when you get a heads-up from HMRC that they're kindly sticking a tax-rebate cheque in the post to you. Ya beauty!

Now, you'd think that financial matters would be high on the list of any such Resolutions – simple things such as saving more. And in the right places too instead of leaving hard-earned excess cash in boring deposits, Cash ISAs and the like.

But surprisingly in poll after poll, year after year, financial targets remain buried way down in the top ten of "popular" resolutions. Forty per cent of us say we want to exercise more, a third of us fancy losing weight, while another third are drawn to eating more healthily… no more deep-fried Mars Bars then. One in six of us aspire to drinking less alcohol. Surely not! But our New Year financial resolutions are so insignificant they are hidden deep in tenth place, together with other unclear but unpopular "improvements", and quietly filed away under "Other".

I find that astonishing considering the widespread and growing evidence suggesting far too many of us are still completely unprepared for a decent standard of living in our later years. Consider these facts from the savings statistics released by The Treasury:

As at September 2017 the total value of what financial journalists call "Stocks and Shares" ISAs (containing Unit Trusts, Corporate Bonds, and oddities called OEICS, which were dreamt up by academics presumably in a clever attempt to confuse investors even further) came to a heady £247 billion. Sounds impressive, doesn't it? But…

Look what's in Cash ISAs – a whopping £270 billion! Now, given that the average Cash ISA is paying a mere smidgeon in interest – try 0.1% for size – and you'd think billions would be leaving to find better homes. Especially when you think it's now over eight years since interest rates were dropped by the Bank of England to the lowest rates since the 17th century. But no. Statistics show a fall in fresh inflows from over £50 billion in 2016, to £30 billion or so in 2017. How daft can savers be?

Well it gets worse. Statistics also show that in September a cool £185 billion lay wasting away in non- interest bearing bank accounts, while a further £170 billion in what's laughingly known as "interest bearing accounts" earned smidgeons – 0.1%

**"IN POLL AFTER POLL, YEAR AFTER YEAR, FINANCIAL TARGETS REMAIN BURIED WAY DOWN IN THE TOP TEN OF 'POPULAR' RESOLUTIONS."**

**"YOU WOULDN'T BELIEVE HOW MANY TIMES I'VE COME ACROSS HIGHER-RATE TAXPAYERS THAT HAVEN'T BOTHERED TO CLAIM BACK THEIR EXTRA TAX RELIEF ON THEIR CONTRIBUTIONS TO PENSION PLANS."**

per annum at most. Run that rate through "The Rule of 72" simple calculator, and you'll spot that, even if the return's tax free, it takes 720 years to double your money. Ouch!

Then there's the financial media's favourite "savings plan" of the 1990s, With Profit Bonds. Remember them? Bought by the bucket load they were. Sold as a "safe" alternative to deposits and based on the "tried and trusted" Endowment policy. Billions poured in. Then they ran into trouble as the millennium introduced the dotcom boom and bust. Small print came to the rescue of insurance companies who designed these "safe" alternatives. Penalties popped up called "Market Value Adjustments". Savers faced big losses. So they sat on their hands waiting for better times.

It's funny we don't hear about these With Profit Bonds anymore. And isn't it odd it's so difficult to find out how much is still "invested" in them. The best I could find was a report showing totals in 2015. Would you believe that it was £278 billion? Mind you, with an average return that year of 2.2%, at least they did better than Cash ISAs and Deposits. Though why so much still sits festering in bland funds liable to tax internally (unlike ISAs) is beyond me.

Discounting even more billions eroding away in "Money Market Funds", why is over £900 billion sitting in these dire so-called investments when over the last eight and a half years "Cautious Monthly Income ISAs" have paid out to investors around 5% tax-free income annually, and simultaneously grown the invested sum well above inflation? Doesn't make any sense, does it?

Why is it that too many of us, including otherwise serious investors, leave hard-earned money in such daft places? Why do so many switched-on higher-rate taxpayers pay such little attention to ensuring they aren't paying more tax than necessary? And by the way, my experience is that the more you earn and the wealthier you become, the less likely you are to bother about details like tax efficiency. And the worst offenders are those connected to the financial industry – investment professionals, accountants, lawyers and judges. Up here in Scotland this is known technically as "Cobbler's Bairns Syndrome".


So let's zero in on areas that could do with a Resolution revisit....

## ISAs

Why not give serious thought to swapping deposits and Cash ISAs for Equity Income ISAs? Consider the upside: more tax-free income plus the opportunity to grow your savings simultaneously. Of course, the value of Equity Income type funds can slip from time to time, but your income stream should be unaffected. At least that's my experience since I became an IFA 45 years ago.

## Pensions

You wouldn't believe how many times I've come across higher-rate taxpayers that haven't bothered to claim back their extra tax relief on their contributions to pension plans. Yes, really. So for 45% taxpayers sticking away a mere £10,000 they're turning their backs on an extra £2500. It's a slightly smaller rebate for 40% taxpayers but still enough for a nice tax-free break in Gleneagles.

A quick word for our Scottish readers: Following December's Tartan Budget and the introduction of Scottish Higher Income Tax (I wonder if they noticed it doesn't have an acceptable acronym like CGT or VAT), maybe next year there will be a slightly higher rebate for Scottish higher rate pension contributors – unless, of course, the Scottish Higher Income Tax hits the fan.

## VCTs

With the increasing annual Government tinkering with levels of tax relievable pension contributions for higher-income earners it's no wonder that "riskier" investments like Venture Capital Trusts (VCTs) are becoming more popular. What's not to like? 30% tax rebate on your qualifying investment, tax free income and capital distributions, potentially forever. Say no more.

The problem is too many investors are actually paying tax on income dividends that are supposed to be tax-free. Higher rate tax at that. So isn't it a good idea to resolve to check whether you're one of them?

Let me give you a couple of examples. One of our Law Lord clients decided that on retiring he'd have his tax returns looked after by us instead of the accountants he'd been using for years. On preparing his tax returns we discovered the income from his VCT had been added to his other dividends and taxed. He was delighted to be the recipient of a £6,500 tax rebate. Even worse is the experience of a widowed lady client whose husband had been a top-rate taxpayer for many years and who had owned VCTs that were willed to her. Over dinner in Chutney Mary's excellent curry restaurant in St James' her returns came up in conversation. "Great income" she announced "but sadly not tax-free in my circumstances".

I assured her there was no reason that her income returns should be taxable whatever her tax adviser said. We sent him detailed HMRC notes on VCT taxation. A month later she phoned with the good news – a tax rebate of over £25,000! She bought a fancy beach hut with it. I'm not joking.

Be aware that VCT tax-free income can be passed to your partner when you depart this mortal coil, and on their demise passed down to the kids. What a nice legacy to leave. A tax-free cheque once or twice a year from an ancient VCT is every bit as exciting as an occasional tax rebate. Well worth a fresh yearly spot of resolution.

## 'Til death do us part

I won't bore you again going all the way through the tax benefits of Independent Taxation, or the huge benefits of turning taxable income into zero making use of annual Capital Gains Exemptions. But I do want to talk about death again. I have seen what happens when folks die without a will and/or without proper planning, and I've acted as executor too many times. With this in mind, I'd like to bring something to your attention: charges made winding up estates.


Last month, being one of three executors, including the dearly departed's long-term lawyer, I was asked to agree to the lawyer's charges. On a relatively simple estate of just over £1 million, consisting of a house, a bank account and investments mainly contained in a simple platform (designed to make such a process pretty straightforward), the lawyer's bill came to over £36,000 – and was certified by an Independent Auditor as being acceptable!

A few years ago I was an executor along with the widow. Only the two of us. We asked for estimates from lawyers for winding up a much bigger and more complicated estate. The bill came to only £15,000. So be aware – when you're resolving to lower your exposure to charges don't lumber your family with a bill with an extra wreath pinned to it.

## Beware recency bias

And finally, what can we learn from snow shovels? Where I live in Scotland with a steep "dead-end" road to our drive the snow-and-ice winters of 2009/2010 left my wife and me with no alternative but to abandon the Mercs on flatter ground and struggle home on foot. When the following year's November headlines quoted "well-known climate experts" who predicted more of the same thanks to something called "El Nino", it was obvious we needed to add a 4x4 to our vehicle collection. So we did.

The following weekend I visited my great friend Dougal who runs his wonderful garden centre. "Dougal", I said. "With your deep knowledge of wildlife, trees and plants, what kind of winter do you reckon is in store for us?" "A mild one", said Dougal confidently. "Mmm", I replied. "That's not what the experts are saying. Why do you think it's going to be mild?" "Because", he said, "4x4s are selling like cold cakes and we've run out of snow shovels."

He was right, by the way; it was one of the mildest winters for years.

So remember the snow shovels when you see constant predictions of doom, or indeed when you spot herds of investors rushing to buy (or sell) this and that. Do the opposite. Be contrary. As Johann Wolfgang von Goethe (1749 to 1832) said,

*"I find more and more that it is well to be on the side of the minority, since it is always the more intelligent".*

**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...

# CHARLES ELLIS

## WHEN LESS IS MORE

***"The investment management business (it should be a profession but is not) is built upon a simple and basic belief: Professional money managers can beat the market. That premise appears to be false."***

**— Charles Ellis,**
**at the Graham & Dodd Award 1977**

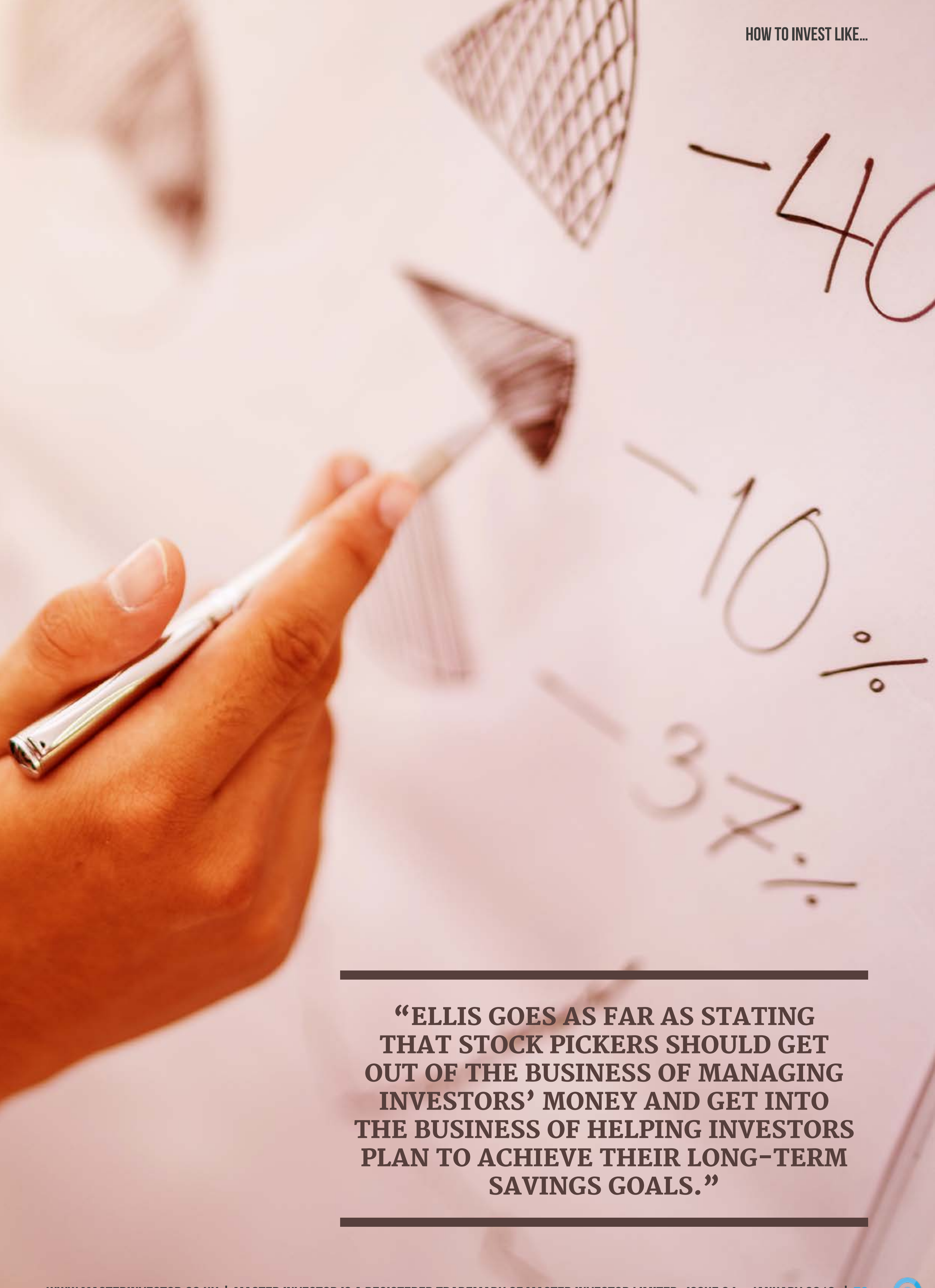
Investment management is based on the belief that investors can beat the market. But if beating the market was relatively easy some 50 years ago at a time when there wasn't much professional trading, that may not be the case today. There are still many professional managers making profits above the market average, but not all of them can make it consistently over prolonged periods of time. Add the fees charged and outperformance sometimes vanishes completely. From the perspective of a non-professional looking to hand his savings to someone, the decision is tough. In most cases, he would end up assuming a lot more risk than intrinsic in the market.

Charles Ellis believes that too much attention has been paid to beating the market and much less to optimising the investment objectives of an individual. In Ellis' view, investors should accept market returns and instead concentrate on the best way to achieve them consistently over time instead of spending time and resources playing a game they can't win.

### Replacing portfolio managers with investment planners

Charles D. Ellis, also known as "Charley", was born in 1937 in Boston, Massachusetts. He studied Art History at Yale College and in 1963 graduated with distinction from the Harvard Business School. He credits the Harvard experience as "the transforming experience", which eventually changed the course of his life. Later he completed a doctoral programme in financial economics at New York University and

**"IN ELLIS' VIEW, INVESTORS SHOULD ACCEPT MARKET RETURNS AND INSTEAD CONCENTRATE ON THE BEST WAY TO ACHIEVE THEM CONSISTENTLY OVER TIME INSTEAD OF SPENDING TIME AND RESOURCES PLAYING A GAME THEY CAN'T WIN."**




**"ELLIS GOES AS FAR AS STATING THAT STOCK PICKERS SHOULD GET OUT OF THE BUSINESS OF MANAGING INVESTORS' MONEY AND GET INTO THE BUSINESS OF HELPING INVESTORS PLAN TO ACHIEVE THEIR LONG-TERM SAVINGS GOALS."**

**"INDIVIDUAL INVESTORS SHOULD PUT MORE EMPHASIS ON THE PRESERVATION OF THEIR CAPITAL, HOLD CONSERVATIVE STOCKS, AND AVOID EMBARKING ON RISKY BEHAVIOUR IN AN ATTEMPT TO BEAT THE MARKET."**

established himself as one of the key figures in passive investing. Due to his performance, as student and as professional, both the Yale School of Management (1970 and 1974) and the Harvard Business School (1986) appointed him to teach advanced courses on investment management.

Ellis began his career at the Rockefeller family investments office. Later, he joined Donaldson, Lufkin & Jenrette where he developed the main ideas that would help him found his own business. In 1972, Ellis established himself under the name Greenwich Associates, a consulting business that would turn into a leading international consulting firm serving institutional investors in over 130 countries. He served as managing partner for 30 years until retiring.

Ellis is mainly known for his philosophy of passive investing through index funds, which he developed in a paper published in 1975, "The Loser's Game"[i], and through several books, in particular *Winning the Loser's Game*[ii], which is currently in its seventh edition. Born in a time when the stock market was a playground for amateurs, but where professionals could make a fortune, Ellis contributed to a rotation towards a professional market where investors compete to gain the smallest of advantages. He believes the market is now mainly a loser's game and advocates investing strategies based on diversified low-cost index funds. Ellis goes as far as to state that stock pickers should get out of the business of managing investors' money and get into the business of helping investors plan to achieve their long-term savings goals.

## From a winner's game to a loser's game

In his paper published in 1975, Ellis puts huge emphasis on the differences between a winner's game and a loser's game, often using examples from tennis and golf. The distinction between the two is key for individual investors, because only after understanding the type of game at play can an investor select the best places to put his money.

In a winner's game, a player actively attempts to win the game, by making points, recording profits, or whatever is the aim of the game. In tennis, as Ellis explains, a professional player hits the ball with strong and precise strokes, trying to find a way past the reach of his opponent to win the point. A professional player is in control of the game and can play for hours. He rarely commits an error. An amateur player wins the game by committing fewer errors than his opponent. He isn't in control of the game, he doesn't play beautifully, and he struggles to keep the ball within bounds. In amateur tennis, play rarely lasts more than a few brief seconds.

Any attempt to win will lead to more mistakes taken and thus increase the odds of losing. The only valuable strategy is to send the ball to the opponent's field with simple strokes, keeping it in play as much as possible, avoiding any mistakes and waiting for one's opponent to commit mistakes by himself. The score of such a game is led by points lost instead of points won.

Ellis believes that the investing world is not all that different from the game of tennis. Until the 1950s, or the 1960s at most, the stock market was mainly comprised of amateurs, who were looking for opportunities to save their money rather than to exploit any opportunities driven by market conditions. At the time, short-term trading was rare and 90% of the market was comprised of individuals taking care of their personal finances. This created rich pickings for professional investors.

But during the 1960s we began to witness globalisation, the commoditisation of information, the rise of the money management business, and more generally a deep change in the make-up of the market. Today, more than 95% of the market is made up of "full-time professionals who are constantly comparison-shopping inside

the market for any competitive advantage. Armed with research and a continuous flood of global market information, economic analyses, industry studies, risk metrics, company reports, and superb analytical models, all investment professionals now have access to more market information than they can possibly use". Any mispricing is quickly discovered and arbitraged away through computer algorithms, particularly if occurring in the most liquid stocks. Markets are a lot more efficient and it is ever more difficult to beat the mean.

"ONLY 35% OF MUTUAL FUNDS OUTPERFORM THE MARKET IN A ONE-YEAR INTERVAL. WHEN THE INTERVAL STRETCHES TO 25 YEARS, ONLY 10% REMAIN ABOVE WATER AND THE NUMBER SHRINKS TO A SHOCKINGLY LOW 5% WHEN A PERIOD OF 50 YEARS IS CONSIDERED."

The market has turned into a loser's game, which makes it difficult for individual investors to play and win. Ellis believes that the situation that best describes the current market, from the perspective of an individual investor, is that of a game of tennis played between amateurs. The only way to win is by avoiding defeat, which means keeping a conservative profile and a simple game plan, and by waiting for one's opponent to commit errors. Individual investors should put more emphasis on the preservation of their capital, hold conservative stocks, and avoid embarking on risky behaviour in an attempt to beat the market.

**TABLE 1 – OUTPERFORMANCE OF MUTUAL FUNDS OVER THE LONG-TERM**

| Period of Time | Percentage of Funds Outperforming the Market |
|---|---|
| 1 Year | 35 |
| 10 Years | 25 |
| 25 Years | 10 |
| 50 Years | 5 |

Source: "Winning the Loser's Game"

## Can professionals beat the market for investors?

During the 1960s the number of professional managers promising alpha to investors increased exponentially. But as this professional market grew, so did market efficiency – to the point where incremental profits from portfolio activity barely covered the extra costs. When Ellis wrote his key paper in 1975, the evidence pointed to 85% of professionally managed funds underperforming the S&P 500 during the previous 10 years. The median fund's rate of return was 5.4%, which was 10% below the market return. More recent evidence, published in *Winning the Loser's Game*, shows that only 35% of mutual funds outperform the market in a one-year interval. When the interval stretches to 25 years, only 10% remain above water and the number shrinks to a shockingly low 5% when a period of 50 years is considered.

The data evidences a cruel reality for active money management and makes it hard for investors to survive in the market by selecting active management. While there are some mutual funds that outperform the overall market, most of them end up reverting to the mean after experiencing such outperformance. If investors base their decisions on past performance, they risk missing the best years from the selected funds and owning them during periods of underperformance. From the perspective of long-term investment, lasting for 25 years or more, an investor has a chance of 10% or less of beating the market by selecting a mutual fund. Such odds are frustratingly low for anyone to risk their retirement funds on.

## An example

In order to illustrate how tough it is for a professional manager to deliver market-beating performance, Ellis presented a simple example in his paper, which he later updated to reflect changing market conditions. But no matter how optimistic one may be regarding the parameters used, the cruel reality is that beating the market with mutual funds is similar to playing the winner's game at amateur tennis.

Let me demonstrate how much outperformance a fund needs to achieve to reach certain goals with a few simple examples. As starting point let's assume the market return is 10% (which coincides with the annual average for the S&P 500 since its inception). While passive investment doesn't involve buying and selling (apart from the initial purchase of the index fund and the final disbursement), mutual funds do trade regularly. When Ellis wrote his paper, he assumed that the annual portfolio turnover was about 30%. But this number has increased substantially over time. Portfolio managers are compelled to trade (churn) their portfolio positions frequently, partly in order to justify their management fees. Turnover of 100% or even 200% is common today. Because trading stocks involves costs, we need to consider a fee for the round-trip transaction costs (buying and selling). Additionally, there are management or custody fees involved, which we assume are 1.25%.

## TABLE 2 – HOW MUCH OUTPERFORMANCE IS NEEDED TO BEAT THE MARKET?

| | Fees Incurred | | | Outperfomance Goal 20.00% | 10.00% | 0.00% |
|---|---|---|---|---|---|---|
| **Setting 1** | Management Fees of 1.25% plus Round-Trip Transaction Costs of 1.0% | *Turnover* | ***30.00%*** | 35.5% | 25.5% | 15.5% |
| | | | ***100.00%*** | 42.5% | 32.5% | 22.5% |
| | | | ***200.00%*** | 52.5% | 42.5% | 32.5% |
| **Setting 2** | Management Fees of 1.25% plus Round-Trip Transaction Costs of 2.0% | *Turnover* | ***30.00%*** | 38.5% | 28.5% | 18.5% |
| | | | ***100.00%*** | 52.5% | 42.5% | 32.5% |
| | | | ***200.00%*** | 72.5% | 62.5% | 52.5% |
| **Setting 3** | 2-20 Hedge Fund with Round-Trip Transaction Costs of 0.5% | *Turnover* | ***30.00%*** | 76.9% | 64.4% | 51.9% |
| | | | ***100.00%*** | 81.3% | 68.8% | 56.3% |
| | | | ***200.00%*** | 87.5% | 75.0% | 62.5% |

Table 2 summarises the results of a sensitivity analysis on the outperformance required of an actively-managed fund to achieve a certain performance goal. Setting 1 considers management fees of 1.25% and round-trip transaction costs of 1%. A fund operating under these conditions with a 100% annual turnover would need to outperform the market by 22.5% in order to deliver the same returns as the market to its investors. If the market delivers 10% per year, this fund would need to deliver 12.25% to keep pace. But no-one is willing to pay for the market performance; the goal of active management is to outperform the market. If the goal was to deliver 20% above the market, the same fund would need to achieve consistent outperformance of 42.5%.

If transaction costs for a round-trip were 2% and the fund turnover 200%, the fund would need to outperform the market by 72.5% to deliver outperformance of 20% to investors. Beating the market by such a high margin seems more a matter of faith than rationality. The evidence points to a near impossible affair.

To complete the exercise, let's consider the typical case of a hedge fund which charges a 2% initial fee and a 20% performance fee. Let's also cut round-trip fees to just 0.5%. In this case, to deliver market performance to its investors, the fund needs to outperform the overall market by 56.3% if turnover is 100%. Basically, if the market delivers 10%, the hedge fund must deliver 15.63%. An investor expecting 20% outperformance from this fund would indirectly be expecting the fund to outperform the market by 81.3%. If this game is worth playing for any party, it's for the hedge fund, not the investor.

As Ellis observes, "[the] costs of active management are so high and the incremental returns so low that, for clients, the money game is no longer a game worth playing." The odds of an individual amateur investor succeeding

**"AS ELLIS OBSERVES, '[THE] COSTS OF ACTIVE MANAGEMENT ARE SO HIGH AND THE INCREMENTAL RETURNS SO LOW THAT, FOR CLIENTS, THE MONEY GAME IS NO LONGER A GAME WORTH PLAYING.'"**

### Box 1 – How to compute the outperformance needed by a mutual fund

Suppose that a mutual fund operates under the following setting:

- Management fees: 1.25% of assets
- Round-trip transaction costs: 2%
- Annual turnover of assets: 100%
- Main goal: deliver returns 20% above the market to investors

Additionally, let's suppose the market rises 10%. We can then determine total operating costs and the performance goal for the fund, as follows:

- Operating Costs per Unit= (0.0125 + 1 x 0.02) = 0.0325 or 3.25% of assets
- Performance Goal: 0.10 x 1.20 = 0.12 (the fund must return 12% to outperform the market by 20%)

To obtain how much outperformance the fund must achieve, we should solve the following equation:

$$0.10\,(1+R) - 0.0325 = 0.12$$

Solving for R obtains 0.525 or 52.5%.

This fund needs to outperform the market by 52.5%. That means achieving a return of 15.25% when the market rises 10%.

through active investment are pretty slim. This is why Ellis advises investors to seek out cheap index funds and expect market returns.

## A few suggested steps for individual investors

In his most recent book, *The Index Revolution*, Ellis suggests a few steps individual investors may follow to improve their performance. The key idea is to develop a plan or guidance to help investors maximise their long-term chances of winning from investing. The plan includes:

- Search for leading firms like Vanguard or BlackRock.

- Buy index funds directly from a broker or investing account.

- Start with a plain-vanilla index that uses the overall market as a proxy.

- Decide whether to add an international component to the portfolio or not. This should help with diversification. The main challenge is deciding on the best proportions. Alternatively, investors may use a global index fund, which covers equities around the globe.

- Commit for the long term. Passive investment is no different than any other kind of investment in terms of its horizon. Only by committing to keep positions for a long period of time can investors maximise the benefits of investing; otherwise they encounter the problems derived from trying to time the market. Discipline is key in order to hold tight when the market is declining and avoid the temptation of buying equities that are already rising too much.

- Decide on the percentage allocation between bonds and stocks. While both should register to some extent, investor should keep in mind that in the longer term bonds may be more risky than stocks. Inflation risk is one of the main reasons why investors should add bonds to their portfolio with parsimony.

- Keep the portfolio low cost. The simplest well-diversified portfolio is composed of one high-grade bond index fund and one equity index fund (either domestic or global) in the desired proportions. This option should keep trading costs at bay.

- Tilt the portfolio towards investment themes. After gaining experience, investors may adapt the portfolio

### Box 2 – The outperformance of a hedge fund

We can compute the outperformance of a hedge fund in a similar manner to the outperformance of a mutual fund. The main difference in this second case is that a hedge fund imposes a performance fee that is a function of returns instead of initial assets. Departing from a similar example as depicted in box 1, let's now consider the following structure:

- Management fees: 2.00% of assets
- Round-trip transaction costs: 0.5%
- Annual turnover of assets: 200%
- Performance fees: 20% of returns
- Main goal: Deliver returns 20% above the market to investors

Let's additionally assume that the market return is 10%. Operating costs and performance goal can be now determined as follows:

- Operating Costs per Unit= (0.02 + 2 x 0.005) + 0.2 x 0.1 ( 1 + R )
- Performance Goal: 0.10 x 1.20 = 0.12 (the fund must return 12% to outperform the market by 20%)

To obtain how much outperformance the fund must achieve, we should solve the following equation:

$$0.10\,(1+R) - (0.02 + 2 \times 0.005) - 0.2 \times 0.1\,(1 + R) = 0.12$$

Solving for R obtains 0.875 or 87.5%. This fund needs to outperform the market by 87.5%, which means achieving a return of 18.75% when the market rises 10%.

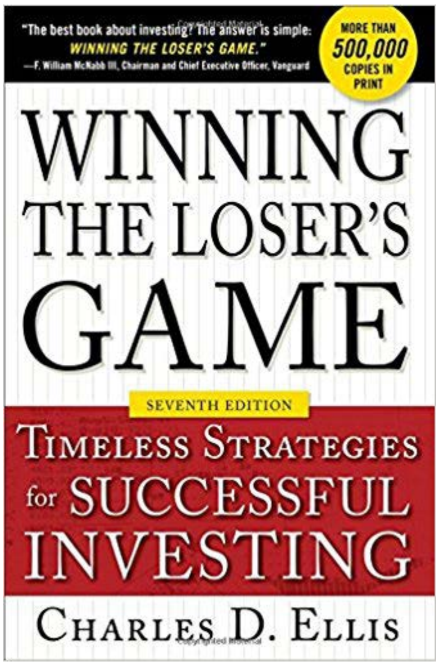



**TABLE 3 – TRADE-OFF BETWEEN MARKET RISK AND INFLATION RISK**

| 1926-2006 Total Returns | Nominal Returns: Average Annual Return | Nominal Returns: Percent of Years With Negative Return | Nominal Returns: Highest Annual Loss | Real Returns: Average Annual Return | Real Returns: Percent of Years With Negative Return | Real Returns: Highest Annual Loss |
|---|---|---|---|---|---|---|
| 100% T-Bills | 3.8 | 0.0 | 0.0 | 0.8 | 35.0 | -15.0 |
| 100% Bonds | 5.2 | 9.0 | -2.3 | 2.1 | 38.0 | -14.5 |
| 100% Stocks | 10.5 | 30.0 | -43.1 | 7.2 | 35.0 | -37.3 |

Source: "Winning the Loser's Game"

# 8 STEPS FOR INDEX INVESTING

1. **SEARCH FOR INDEX FUNDS**
   Consider only the offer from leading firms

2. **BUY INDEX FUNDS**
   Buy directly from a broker or investment account.

3. **START WITH PLAIN-VANILLA**
   Buy some index that covers the overall stock market.

4. **ADD INTERNATIONAL COMPONENT**
   Consider whether to add some international equities or not to help on diversification.

5. **COMMIT TO THE LONG-TERM**
   Investment decisions are for 10 years or more.

6. **ALLOCATE BETWEEN EQUITIES AND BONDS**
   Decide on the exact proportions between the two asset classes.

7. **KEEP LOW-COST**
   Buying one high-grade index fund and one overall equity index is enough for most investors.

8. **TILT THE PORTFOLIO**
   Some investors may wish to tilt the portfolio towards some factor (small cap, emerging markets etc).

*Source: "The Index Revolution"*

holdings towards specific needs. Investors may tilt returns towards small caps, value investing, a region or country, or some other specific factor. Nevertheless, diversification should always be taken care of and holdings should be kept for periods of 10 years or more.

Investors need to avoid being lured by the promise of exceptional returns, because it is really difficult for someone to achieve them and mostly impossible to achieve them consistently over time and after fees. The most important tasks for an investor are to understand his realistic needs, define investment objectives to meet those needs, build a portfolio and develop well-reasoned investment policies to be able to achieve his goals in the long term.

## Winning the loser's game

In a market more than 90% constituted by institutional investors, it is hard to see how these institutions, as a group, can achieve superior profits over time. They constitute the market and they just can't beat themselves consistently.

> **“WHILE IT MAY SEEM PARADOXICAL, AN INDIVIDUAL HAS THE BEST ODDS OF BEATING A PROFESSIONAL WHEN HE DOESN’T TRY TO.”**

Unfortunately, the stock market has turned into a loser's game, where it is ever more difficult to gain a real advantage over all other players and win points like a professional tennis player. Today's game is won by avoiding losing points – principally through being relatively discrete, conservative, self-disciplined, patient, and highly committed towards a long-term objective.

But an individual amateur investor can still improve his outcome with almost no effort. While it may seem paradoxical, an individual has the best odds of beating a professional when he doesn't try to. All he must do is avoid playing against professionals that are better equipped than himself and instead try to profit from their expertise as much


as he can. "To get combined expertise of all top professionals, all [an investor must do] is index – because an index fund replicates the market, and today's professional-dominated stock market reflects all the accumulated expertise of all diligent experts making their best judgements, which means that [the investor] will always have the most up-to-date consensus when [he] indexes".

**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.

**i Ellis, C. D. (1975). The loser's game. Financial Analysts Journal, 31(4), 19-26.**
**ii Ellis, C. D. (2017). Winning the loser's game. McGraw-Hill Education. Seventh Edition.**

BY DAVID JONES

FORENSIC FOREX

# 2018 COULD BE A STERLING YEAR FOR THE POUND

**Regardless of how you voted in the EU Referendum in June 2016, if you are anything like me you are a little weary of how every other news story appears to be about the progress of Brexit.**

*Theresa May gets on a plane to Brussels.*

*Theresa May gets on a plane back from Brussels.*

*There has been a step backwards in negotiations with the EU.*

*There has been a great leap forward in EU negotiations.*

*Rinse and repeat.*

I know this might be a stretch, but have some pity for the poor foreign exchange trader. The fate of the pound day to day often hangs on the latest murmurings, rumours and speculation about the Brexit progress. Forget about inflation, unemployment and interest rates – the main cause of volatility for our home currency is, unsurprisingly, political at the moment and looks set to stay that way.

But this can still present opportunities – and it is possible to filter out at least some of the short-term noise to make sense of where the pound may be headed in the months to come. Let's wind back first of all to that big day in June when the vote was cast to leave the EU.

Frederic Legrand – COMEO / Shutterstock.com

“KEEP AN EYE ON INFLATION.”


## The impact of the Referendum

No prizes for guessing which bit of the chart above shows the results starting to come through. The vote to leave the European Union saw levels of short term volatility that were unprecedented in living memory. For a quick comparison, when the UK was forced to withdraw from the Exchange Rate Mechanism on 16 September 1992 – often referred to as "Black Wednesday" – the range on the day for GBP/USD was 1,000 points. 24 June 2016 – when the results were coming in – saw this currency pair travel through a day's range in excess of 1,600 points. Further wrong-footing markets was the move after the polls closed, with the pound initially moving to a fresh 2016 high versus the US dollar, only to set new multi-decade lows shortly after 3 am.

The eventual low for the GBP/USD exchange rate in 2016 was around 1.20 set in October – there was a mysterious "flash crash" in Asian trading. However, since then, the story has been one of recovery – although admittedly not yet threatening anywhere near the levels hit ahead of the Referendum vote.


## Further recovery ahead?

So leaving aside the various Brexit hopes and fears, the pound has had a good year versus the US dollar, gaining around 10%. As of the end of 2017, this recovery trend was still intact with the 1.3000 mark providing something of a floor to the odd panicky sell-off.

It doesn't seem too over optimistic to expect further gains to come, with a run back up to the 2017 highs in the 1.36/1.37 area the first target. There are a couple of factors that could help bolster the pound from here.

Last November saw the Bank of England raise the base interest rate. This was something of a momentous move – the first time in ten years that the central bank had actually put rates up. (Although all this does is put the lending rate back to where it was in the summer of 2016 before the Bank, according to some, panicked a little and cut rates following the EU referendum vote.) Raising rates is symbolic and usually suggests that there are more to come – although the Bank itself says that we should not get too carried away, and only expects gradual and infrequent rises in the next three years. But traditionally, higher interest rates normally help drag the country's currency upwards.

The state of the UK economy is arguably more important in the short term. Although immediate pressure on the UK's growth did not materialise after the Referendum vote, recent months have shown sluggish performance. It is currently growing at around 1.5% per year, although some slowdown is expected in the quarters to come with Brexit uncertainty a contributing factor. But maybe there is a little *too much* pessimism around the UK's outlook. A surprise to the upside for the economy – or even just avoiding growth tailing off – would usually be seen as good for the pound and bolster the argument for further recovery.


**"THERE ARE A COUPLE OF FACTORS THAT COULD HELP BOLSTER THE POUND FROM HERE."**

## Back to Brexit

Which brings us back to where we started – Brexit. This is going to be the one over-riding factor for the pound's fortunes in the short to medium term. Just the last two months of 2017 saw the effect that the market's view on progress – or lack of it – had on the exchange rate. We often saw quite sharp and sizeable rallies during the day – more than 100 points or 1c (which is a big move in a day) – on hopes that negotiations had moved ahead. And, if disappointment followed, those gains would be quickly given up. In mid-December, with it looking as if serious trade discussions would not be starting until March, the market was disappointed again and the pound fell sharply. This yo-yoing of emotions looks set to be par for the course in 2018.

But it doesn't change that overall recovery story that has been in place for a year. So the canny investor or trader may use the sharp sell-offs in sterling to pick up the currency "on the cheap", assuming that 1.3000 continues to be a floor. Also, keep an eye on inflation. The reading in December saw the cost of living at a six-year high. Admittedly this is coming off a very low base, but 3.1% is above the Bank of England's target of 2%. If inflation remains stubbornly at this level – or creeps higher – then the classic way of combating this would be to put interest rates up. This is something the Bank of England will not want to do in a hurry but its hand may be forced, which would come as a surprise and give the pound another boost.

It looks set to be another interesting year for the pound. And the actions in the foreign exchange markets may be the best sentiment barometer as to how well – or otherwise – the Brexit negotiations are actually going.

**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 BBC Radio 5 Live's Wake up to Money programme and the Chartist for Shares magazine. He is an active trader and private investor.

BY RICHARD GILL, CFA

BOOK REVIEW

# HARRIMAN'S STOCK MARKET ALMANAC 2018

## A HANDBOOK OF SEASONALITY ANALYSIS AND STUDIES OF MARKET ANOMALIES TO GIVE INVESTORS AN EDGE THROUGHOUT THE YEAR

## BY STEPHEN ECKETT

**As we exit 2017, which has been pretty good for stock market investors, it's the time of year when we look ahead to our strategies for making money in the coming 12 months. So where better to look for guidance than the annual classic, *The Stock Market Almanac*? Author Stephen Eckett has once again updated his seminal handbook in order to guide investors and traders through the markets in 2018, and most importantly, to help them beat the market.**

For those not familiar with previous editions of the Almanac, it is part diary, part reference guide and part trading bible. Its unique selling point is its detailed and original analysis of the anomalies which crop up within the stock market year after year (also known as seasonality analysis), despite many of them not having a clear rational explanation. These anomalies go against the popular financial theory, the Efficient Markets Hypothesis (EMH), which claims that it is impossible to "beat the market" because stock markets are so efficient that share prices always reflect all relevant information. Indeed, the author claims that the book is a celebration of the failure of the theory, in revelling in the trends and irregularities which the EMH says should not exist.

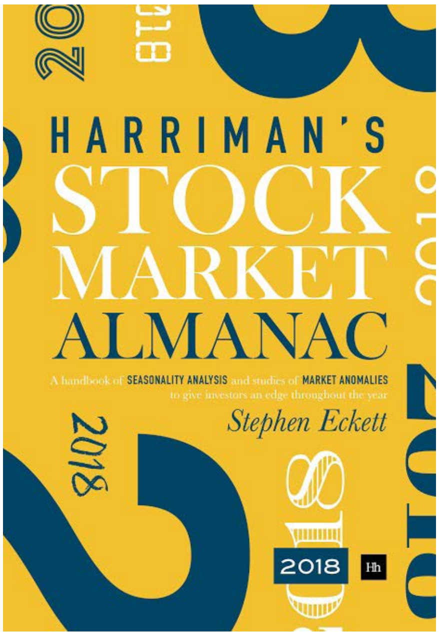
> **"2018 AS A WHOLE LOOKS LIKE BEING ANOTHER GOOD YEAR FOR THE STOCK MARKET."**

There is a slight change to the format this year, with the previous weekly diary section having been discontinued. For those who found this section useful, they will be glad to know that it is available online, with the freeing up of space enabling the core analysis and trading strategies to be explained in more depth.

### 2018: A dog of a year?

The core text of the almanac is divided into four parts. Part One provides a two page analysis of the main features of each month during the year, including details on historic performance, sectors and shares that tend to be notably good or bad performers, significant dates and a discussion of how the markets perform during an average month. For example, in December – which is the best performing month

## "ON A HUNDRED-YEAR BASIS, YEARS ENDING IN 18 SINCE 1718 HAVE DELIVERED AN AVERAGE GAIN OF 5.7%."




historically with a 2% gain – if previous trends are to be repeated then investors should be backing bookies Paddy Power Betfair, dumping Barclays and preparing themselves for the "Santa Rally".

Readers will be pleased to know that, looking at the historic data, 2018 as a whole looks like being another good year for the stock market. For over 200 years the market has been relatively strong in the eighth year of the decade and especially strong since 1958 when an average return of 11% was seen. Excluding the disastrous 2008, when the FTSE 100 plunged by 31%, eighth years since 1958 have delivered a tasty return of 19.3%. On a hundred-year basis, years ending in 18 since 1718 have delivered an average gain of 5.7%.

In the Chinese calendar we move from the year of the rooster to the year of the dog. These marvellous mongrels have been an investor's best friend since 1950, with the S&P 500 having risen by an average of 16.8% in every dog year since then. That's the best record of all 12 zodiac signs, putting pooches well ahead of second placed oxen and tigers at around 14% each.

## Beat the market

Taking advantage of the anomalies identified, Part Two of the book then discusses a number of strategies which investors can use to give themselves an edge in the year ahead. The Bounceback Portfolio, for example, has a strategy of investing in the ten worst performing FTSE 350 stocks of the previous year in January and holding them until the end of March. Between 2003 and 2017 this strategy would have delivered a total 367.5% gain, significantly outperforming a strategy focussed on investing in the wider FTSE 350.

Eckett also develops a strategy to exploit the well known "Sell in May" anomaly. He suggests being fully invested throughout the year in FTSE 350 stocks but rebalancing your portfolio according to which sectors perform the best in the two halves of the year. Such a strategy backdated to 1999 would have delivered wealth gains over 12 times higher compared to a simple FTSE 350 buy and hold approach. If these two strategies don't take your fancy there are 16 others to choose from.

Part Three then provides an in-depth analysis of the UK and international markets to help investors better understand the markets they are investing in. This section is packed with statistics on everything from daily average returns, comparative index performance, sector analysis, interest rates and even how politics influences the financial markets.

Finally, we end with a useful reference section which provides a range of information on the UK and international markets. These are useful for beginners and experts alike, with the author discussing details of the major UK and overseas indices, the basic structure of the UK trading day and company results announcement dates. Perhaps the most interesting section is an analysis of the old FT30 index, the precursor to the FTSE 100, and a discussion of where the original constituent companies are now. Only four, including Imperial Tobacco, Rolls Royce and Tate & Lyle, still exist as listed companies, reflecting the many changes which have occurred to UK Plc over the years.

## Great gift

Just like in previous years the latest edition of the Stock Market Almanac is packed with informative, stimulating and actionable investment analysis. Readers are treated to a raft of ideas which will help them potentially gain an edge in the market in 2018. While too late for Christmas, it would make an ideal gift for any investor in the New Year.



**About Richard**

Richard Gill is an investment analyst with over a decade's experience of analysing small/mid cap equities. He is the Head of Research at Align Research. 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

# THE ONLY 2 WORDS YOU NEED TO KNOW IN 2018

**To Benjamin Braddock (Dustin Hoffman in Mike Nichols' film *The Graduate*), the well-meant one-word piece of advice was "plastics". To the godfather of value investing, Benjamin Graham, the well-meant three word piece of financial advice was "margin of safety" – and that one happens to have lasted the test of time. Faced with the challenge of distilling the wisdom of the investment gods into just two words, I would offer the following coinage: "capital allocation".**

Close and lock the doors. Dim the lights. We are about to discuss one of the under-acknowledged holy grails of investing. Whether you are looking for a superior fund manager or for the more promising CEO of a listed business with real prospects, those two words are the ones you should be looking for: capital allocation. They will also be the key determinant of the relative success, or failure, of your own investment portfolio.

The ability to successfully allocate capital is what differentiates be-

tween the good fund manager and the bad one, between the billion-dollar market-cap company and the micro-cap *also ran*. It may be the single most important characteristic of any investment you ever make.

## Follow the outsiders

In *The Outsiders*, which should be considered, alongside Benjamin Graham's *The Intelligent Investor*, as one of the finest investment books ever written (Warren Buffett certainly thought so), William Thorndike examines the life and habits of eight truly unconventional but highly successful chief executives of US businesses. Their firms' average returns outperformed the S&P 500 stock index by a factor of twenty – that is to say, an investment of $10,000 with each of these CEOs, on average, would have been worth over $1.5 million twenty-five years later. If you weren't fortunate enough to have someone buy you a copy for Christmas, make amends by buying yourself a copy now. You will not regret it. Here follows a straightforward comparison. On the one hand, the headquarters of FIFA. They comprise 11 acres on a wooded hill overlooking Zurich. The compound cost $255 million, and it includes five underground levels, clad in black Brazilian granite. The conference room has a floor of lapis lazuli. FIFA is a not-for-profit organisation, not that you could tell.

On the other hand, consider the headquarters of Capital Cities Broadcasting, under the management of Tom Murphy, a business owner almost clinically averse to spending cash. The business was based in a dilapidated former convent. When he

was appointed as CEO of the firm, his board begged him to spruce the place up and project a more professional image to potential advertisers with the company. He responded by painting the two sides of the building facing the road. The other half of the building he left untouched. But Murphy was not neglectful of his shareholders. Capital Cities shares, under his stewardship, gave an extraordinary annual compound return of more than 22%, over a period of 19 years.

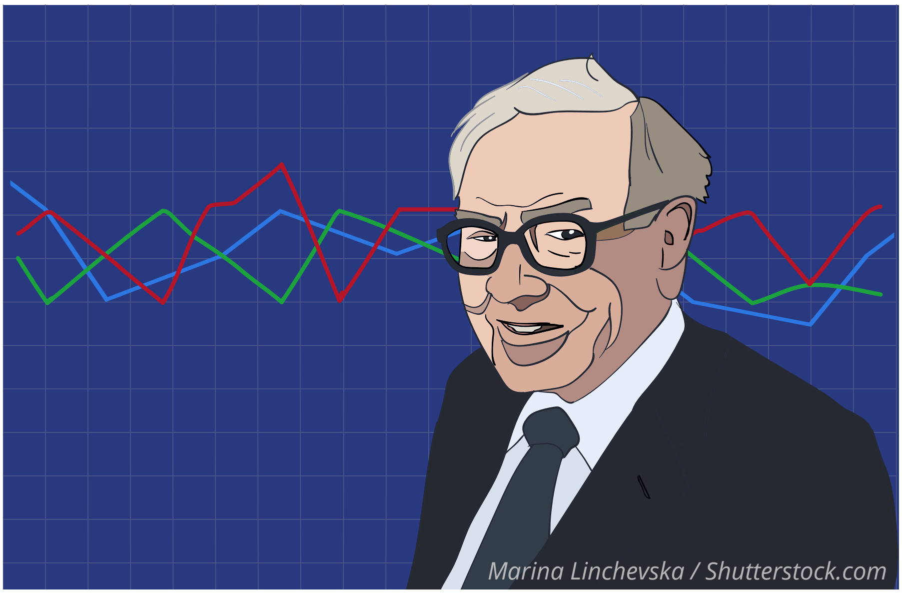
Or consider TCI (which under its CEO John Malone delivered a remarkable 30.3% compound annual return over 26 years). TCI's corporate HQ contained a surprisingly small number of executives, even fewer secretaries, and a handful of peeling metal desks on Formica floors. The company employed just one receptionist and incoming calls were routed to an answerphone. When TCI staff went on the road for marketing purposes, they tended to stay at motels. TCI's chief operating officer JC Sparkman confesses, "Holiday Inns were a rare luxury for us".

You might also wish to consider one of the most celebrated investors of all time – Warren Buffett. His company's investment returns from 1985 to 2005 compounded annually at an astonishing 25%, a track record of corporate outperformance than is almost unrivalled in financial history. But while the Berkshire Hathaway holding company now has more than a quarter of a million staff, the corporate headquarters in Omaha, Nebraska, caters to just 23. And Buffett lives in the same modest dwelling in Omaha that he bought back in 1958 for just $31,500.

As Thorndike makes abundantly clear, the most successful CEOs tend to be ultra-cautious when it comes to spending. As he emphasises, what every successful business manager and owner has in common is a fierce and unyielding respect for shareholders' money. They acknowledge every day that they are a custodian of their shareholders' sacred capital, and it is not to be squandered.

In fact, much of what we tend today to associate with a successful business turns out to be a masquerade – a Potemkin village of presumed wealth. Banks cultivate an image of opulence with the implied permanence of marble halls. This helps disguise the poverty at the heart of many of their balance sheets.

**"IT MAY BE THE SINGLE MOST IMPORTANT CHARACTERISTIC OF ANY INVESTMENT YOU EVER MAKE."**


Marina Linchevska / Shutterstock.com

Many CEOs also devote considerable time and effort to promotional activity. But some of the most successful business owners have shunned investor relations almost completely, preferring to let the share price alone do the talking. Thorndike's business owners are just such people.

So there are a number of corporate characteristics that represent red flags to the discerning investor. Lavish company HQs are among them. Thorndike points out that, over recent years, at least three media companies – The New York Times, IAC and Time Warner – have all constructed Taj Mahal-like edifices in midtown Manhattan, at vast expense to their shareholders.

Over the same period, not one of those companies has engaged in value-creating share repurchases or enjoyed market-beating returns. By contrast, not one of the outsider CEOs he profiles ever overspent on the company HQ.

What Thorndike's outsiders also have in common is a rare ability to delegate. Their organisations are typically highly decentralised – there are very few staff at the corporate HQ to begin with. But there are also limits to delegation. The very best executives are also masters of capital allocation, and they tend to keep this to themselves.

## Overcoming the "institutional imperative"

Charlie Munger, Buffett's right-hand man, describes winning companies as "an odd blend of decentralised operations and highly centralised capital allocation", and the mixture of delegation with hierarchy seems to act as a healthy antidote to what Buffett has otherwise disdainfully described as "the institutional imperative" (to underperform).

Successful capital allocation amounts to two things: spending wisely, and otherwise hoarding capital for its deployment to more productive ends further down the line. It is a message that also comes out loud and clear in Alice Schroeder's biography of Warren Buffett, *The Snowball*. What Buffett learned at a prodigiously young age is that capital compounds, and that the forces of time can be harnessed to maximise capital over time provided that your money isn't frittered away in the meantime. In other words, Buffett had an instinctive understanding of the power of compound returns and a laser-like focus on the time value of money. A dollar wasted today – either by being spent on a frivolity or on overpaying for an acquisition – is not merely a single dollar foregone. Over time it will amount to tens, hundreds, perhaps thousands of future dollars. So be frugal.

**"A DOLLAR WASTED TODAY – EITHER BY BEING SPENT ON A FRIVOLITY OR ON OVERPAYING FOR AN ACQUISITION – IS NOT MERELY A SINGLE DOLLAR FOREGONE. OVER TIME IT WILL AMOUNT TO TENS, HUNDREDS, PERHAPS THOUSANDS OF FUTURE DOLLARS. SO BE FRUGAL."**

There are plenty of instructive lessons and investment tips within William Thorndike's excellent book. Within my own asset management business we barely distinguish between company leaders and fund managers – because to excel, they both need to be skilled in the arts of capital allocation. What is the difference, for example, between a diversified holding company (such as Warren Buffett's Berkshire Hathaway) and a diversified fund? Almost none – except that the holding company comes without management fees!

So if you are looking for pointers to superior investment returns – either from a portfolio of listed stocks or from a portfolio of well-managed funds (or perhaps both) – seek out managers with superior capital allocation skills. Look for executives who are disciplined and shareholder-friendly, with an acute attention to saving and not squandering shareholder capital. Look, too, for executives who don't court the limelight, and who don't fritter away their companies' capital in expensive acquisitions or stock buybacks.

There is nothing wrong with buying back stock provided it's done at the right price. The right price is at or ideally *below* book value. Whenever buybacks are conducted at a significant premium to book value, shareholder capital is simply being destroyed.

One of my favourite companies, for example, is Loews Corporation, managed by the Tisch family. Loews is an interesting assortment of businesses, including commercial property and casualty insurance, offshore oil and gas drilling, pipelines, and a chain of hotels. But one of the company's most successful investments has been its own stock – bought back by the company at the right price. Every decade since 1970, Loews has bought back more than one quarter of its outstanding shares. Since 2010, the company has bought back and retired more than 18% of the stock. But these buybacks are only ever conducted at a discount to what the family consider the shares are actually worth. Since listing in 1965, Loews stock has returned annually, on average, 17% versus 10% for the S&P 500.

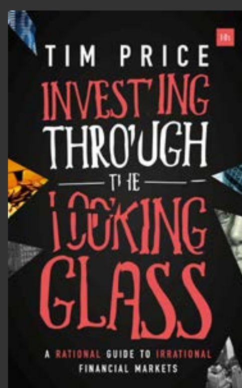
Two words. Capital allocation. Worth a million dollars, easily.

A Happy New Year to you all!

EQRoy / Shutterstock.com

**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

# DECEMBER 2017

## GLOBAL EQUITIES

| Index | Last Month % | 2017% | Proximity to 52w High* |
|---|---|---|---|
| Bovespa | 6.4 | 26.9 | |
| FTSE 100 | 4.9 | 7.6 | |
| Hang Seng | 2.5 | 36.0 | |
| Dow Jones | 1.8 | 25.1 | |
| S&P/ASX 200 | 1.6 | 7.1 | |
| Russian Trading System | 1.6 | 0.2 | |
| S&P 500 | 1.0 | 19.4 | |
| NASDAQ 100 | 0.5 | 31.5 | |
| Nikkei 225 | 0.2 | 19.1 | |
| Euronext 100 | -0.6 | 10.6 | |
| DAX Xetra | -0.8 | 12.5 | |
| CAC 40 | -1.1 | 9.3 | |
| IBEX 35 | -1.6 | 7.4 | |

## COMMODITIES

| Commodity | Last Month % | 2017% | Proximity to 52w High* |
|---|---|---|---|
| Copper | 8.2 | 32.6 | |
| Cotton | 3.5 | 6.9 | |
| Crude oil (Brent) | 3.3 | 13.6 | |
| Silver | 2.7 | 6.0 | |
| Crude oil (Light Sweet) | 1.9 | 8.5 | |
| Gold | 1.5 | 12.6 | |
| Iron Ore | -0.2 | -11.9 | |
| Palladium | -0.3 | 47.5 | |
| Platinum | -5.2 | -1.3 | |
| Coffee | -6.3 | -11.1 | |
| Natural Gas | -9.1 | -25.7 | |
| Sugar (No. 11) | -9.4 | -29.9 | |
| Cocoa | -12.0 | -16.4 | |

## FOREX

| Pair/Cross | Last Month % | 2017% | Proximity to 52w High* |
|---|---|---|---|
| AUD/USD | 3.3 | 8.3 | |
| EUR/GBP | 1.0 | 4.3 | |
| EUR/JPY | 0.9 | 9.9 | |
| EUR/USD | 0.8 | 14.1 | |
| USD/JPY | 0.1 | -3.7 | |
| EUR/CHF | -0.2 | 9.2 | |
| GBP/USD | -0.2 | 9.3 | |
| USD/CHF | -1.0 | -4.3 | |
| USD/CAD | -2.4 | -6.3 | |
| GBP/AUD | -3.4 | 1.0 | |

## CENTRAL BANKS - RATES & MEETINGS

| Central Bank | Key Rate | Next | After |
|---|---|---|---|
| BOE | 0.50% | Feb 08 | Mar 22 |
| ECB | 0.00% | Jan 25 | Mar 08 |
| FED | 1.50% | Jan 31 | Mar 21 |
| BOJ | -0.10% | Jan 23 | Mar 09 |
| SNB | -0.75% | Mar 15 | Jun 21 |
| BOC | 1.00% | Jan 17 | Mar 07 |
| RBA | 1.50% | Feb 06 | Mar 06 |
| RBNZ | 1.75% | Feb 08 | Mar 22 |
| BOS | -0.50% | Feb 13 | Apr 25 |
| BON | 0.50% | Jan 25 | Mar 15 |

## FTSE 350 TOP

| Sector | Last Month % | 2017% | Proximity to 52w High* |
|---|---|---|---|
| Ladbrokes Coral PLC | 36.0 | 56.8 | |
| IWG PLC | 31.0 | 4.6 | |
| Intu Properties PLC | 29.0 | -10.1 | |
| Dixons Carphone PLC | 25.0 | -43.9 | |
| Cap & Counties Prop PLC | 22.0 | 7.6 | |

## FTSE 350 BOTTOM

| Sector | Last Month % | 2017% | Proximity to 52w High* |
|---|---|---|---|
| Saga PLC | -31.0 | -35.4 | |
| Capita PLC | -14.0 | -24.5 | |
| Wood Group (John) PLC | -10.0 | -25.8 | |
| Northgate PLC | -9.1 | -22.7 | |
| Stagecoach Group PLC | -9.0 | -23.8 | |

## FTSE 350 SECTORS TOP

| Sector | Last Month % | 2017% | Proximity to 52w High* |
|---|---|---|---|
| Industrial Metals | 18.0 | 71.3 | |
| Mining | 13.0 | 26.5 | |
| Forestry & Paper | 9.3 | 15.9 | |
| Real Estate Inv Trusts | 8.4 | 8.7 | |
| Real Estate Inv & Services | 8.3 | 18.5 | |

## FTSE 350 SECTORS BOTTOM

| Sector | Last Month % | 2017% | Proximity to 52w High* |
|---|---|---|---|
| Electricity | -3.3 | -16.2 | |
| Oil Equip, Services & Dist | -2.5 | -21.1 | |
| Gas, Water & Multiut | -1.1 | -14.5 | |
| Electronic & Elect Equip | -0.7 | 34.0 | |
| Food Producers | -0.5 | 3.4 | |