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**masterinvestor**

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# AFRICAN DAWN

## HOW TO PLAY THE NEXT EMERGING MARKET

### PLUS...

#### MELLON ON THE MARKETS

JIM REPORTS FROM THE JP MORGAN  
BIOTECH CONFERENCE

#### CARILLION COLLAPSE

WHO WILL BE THE NEXT  
DOMINO TO FALL?

#### RUNNING PROFITS

HOW TO STICK WITH  
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# WELCOME



Dear Reader,

Once again, we are gearing up to host many of you at our annual gathering in London. The next Master Investor Show will take place on Saturday, March 17th. As in previous years, there'll be a few innovations and changes. For example, this year, for the first time in our history, we will have one of the global corporate giants taking to the stage.

TOTAL S.A., the world's 4th largest global oil and gas company, with a €115 billion market cap, will exhibit and present at our event. We can't pre-empt the presentation TOTAL will deliver on the day, but if you wanted to learn about achieving superior investment income through an attractive dividend yield, without having to risk investing into unproven companies or illiquid shares, then this could well be a presentation for you to listen to.

Our event has public company exhibitors from around the world. At this year's show, delegates will be able to meet listed companies from the UK, US, Canada, Germany, and Australia. One of our four stages, the Rising Stars Stage, is dedicated exclusively to companies of which anyone can buy and sell shares on an international stock exchange. This stage is sponsored by [London South East, the leading UK finance portal](#).

The public companies exhibiting at our event currently range in market size from £5 million to £100 billion. With six weeks to go, we expect to announce soon that all exhibitor spaces and speaking slots are sold out. For the last remaining exhibitor spaces, please contact Amanda Taylor, our Head of Business Development, on [amanda@masterinvestor.co.uk](mailto:amanda@masterinvestor.co.uk). Ticket bookings by delegates are also ahead of last year, and we expect to attract an even larger number than last year's record attendance of 3,800 private investors through the door.

Have you booked your ticket already? As reader of our e-magazine, you are entitled to two free tickets. Secure your space now using discount code "M0218" at <https://masterinvestorshow.co.uk/tickets>. As an early ticket holder, you will also be able to purchase tickets for an exclusive session with our very own Jim Mellon before anyone else – see page 10 for details.

I hope to see many of you for what will be an exciting, informative and inspiring day. Expect the likes of Jim Mellon and Merryn Somerset-Webb to take to the stage, and plenty of networking with likeminded individuals.

Best regards

Swen Lorenz  
Editor, Master Investor



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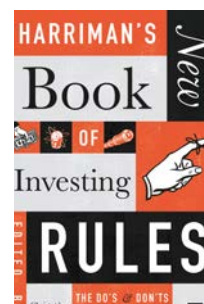
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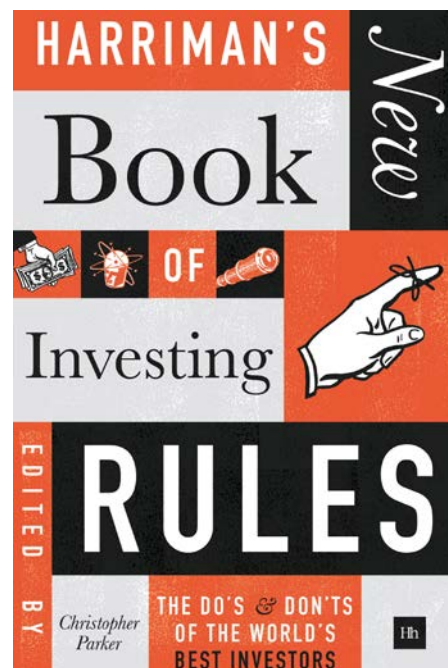
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BY JIM MELLON

# MELLON ON THE MARKETS

**Another year, another pilgrimage to the JP Morgan Biotech conference in San Francisco, now in its 26th year. About 9,000 people scurry around the passageways of the far-too-small-for-purpose St Francis hotel, watching companies present stuff that is now readily available online. The smarter lot, who number about 41,000, hover in the periphery of the conference, doing deals, establishing relationships and promoting their companies and prospects from sometimes dodgy hotel rooms, rented at vast expense – complete with un-made beds!**

The group I was in was there to get the Juvenescence ball rolling, and we also picked up a few titbits for stock market investment in the biotech sector. And boy, is that sector on fire! Kite, Juno, Ablynx and Bioviteriv all taken over in multibillion-dollar deals, and we are only now at the end of January! And Kite and Juno were recommended as core portfolio positions in the book Juvenescence, though there are still plenty left to get your teeth into – so don't forget to get your hands on a copy of the book!

We did some less expensive deals, partly as a result of our association with some of the research institutions in the Bay Area and partly because the redoubtable Aubrey de Grey co-hosted with us a sort of Dragons' Den/Shark Tank event at a pizza restaurant. There, in front of some hand-picked investors, eleven companies – at least one of which will surely be headline news in the future – unfurled their wares.

Although there is plenty of great science in the UK, Japan, Australia, Singapore, Belgium, Switzerland et al, there is no doubt that San Francisco is the new Athens and attracts many of the best in the biotech industry. The fact that at least 5% of its residents are homeless and live on the streets is shameful but is a topic for a different time.




The fusion of venture capital, universities, and entrepreneurship is more evident here than anywhere else I have been, and it shows in the stats. Of course, in the US, Boston, San Diego and other cities are important, but the beating heart (pace Tony Bennett) of the biotech – and longevity – industry is left to San Francisco.

Meantime, back at the ranch, or rather at the Viva Mayr clinic where I am spending a few days detoxing with the calorie intake of a mouse, things are looking very interesting.

The crypto bubble has seemingly burst. Luckily, my friend who was ministering to our holding got us out. I feel it has a long way to go down, especially as there was a particularly shrill time in early January when the least financially savvy of my friends were piling in, and one day will wish to get out. That will be their first experience of investment capitulation and it will be a sobering lesson. I would have thought that



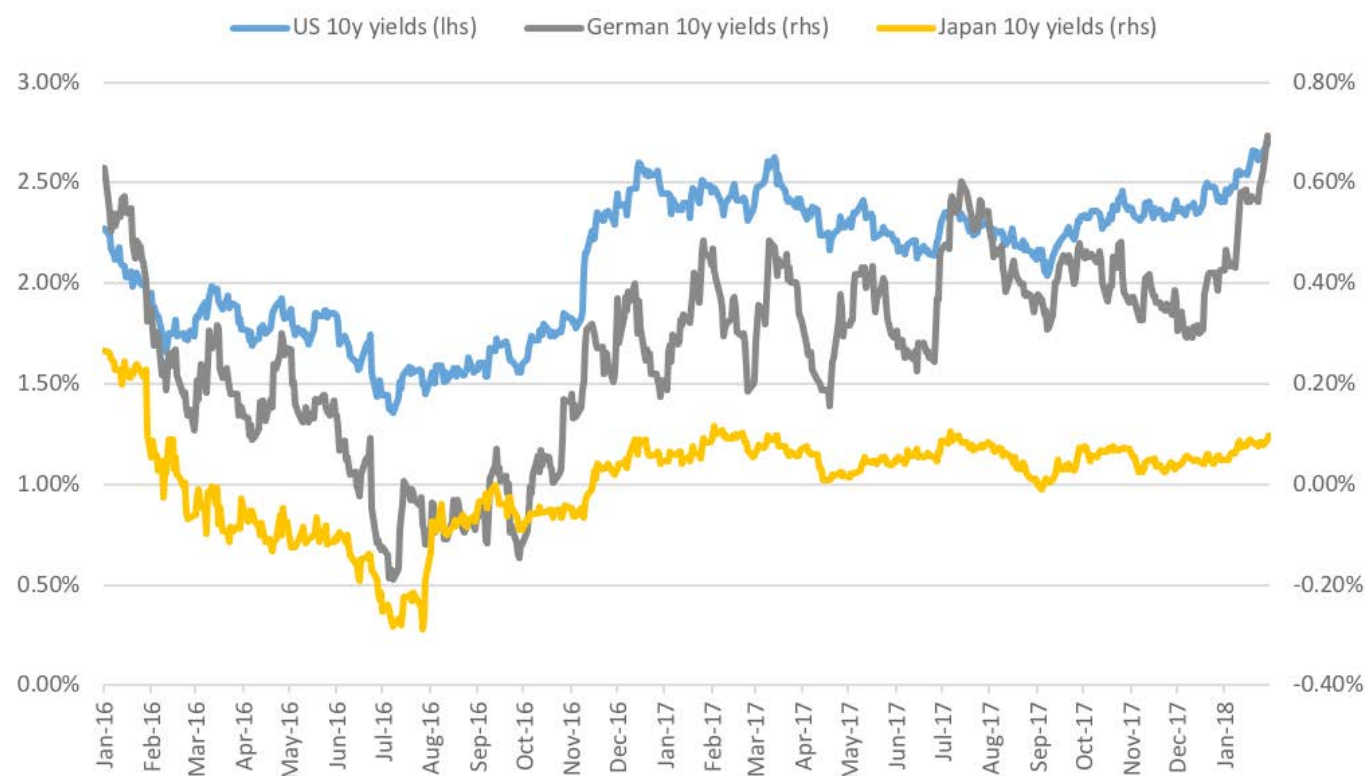


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**“THERE IS NO  
DOUBT THAT SAN  
FRANCISCO IS THE  
NEW ATHENS AND  
ATTRACTS MANY  
OF THE BEST IN  
THE BIOTECH  
INDUSTRY.”**

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bitcoin could easily go back to \$1,000, but I am not going to bet either way.

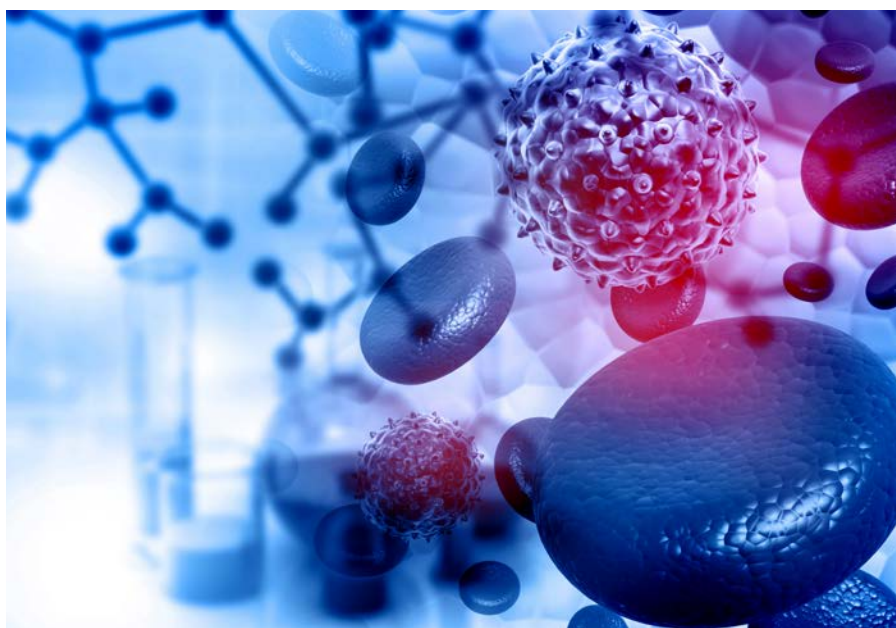
The blockchain, on the other hand... well, it may just about be ready for the big time, and Factum, a holding of **Fast Forward Innovations (LON:FFWD)**, might turn out to be a good investment. Lorne Abony, who runs FFWD, has roundly rebuffed an arch-critic (whom I will not name lest he benefit from the advertising) by investing in Nuveera, which appears to have made FFWD 8x its money. That's damned impressive, and I am proud to have been a co-founder and director.

Likewise, **Portage (PTGEF:OTC)** divested itself of its shares in **Biohaven (NYSE:BHVN)**, which is now a \$1 billion company, established just three short years ago by my partners and me for \$3 million.

Portage has returned about 9x the money of its investors over its short life, and its success – and that of so many others – is a good reason for you to join us at Master Investor on March 17th in London. The quality of the companies selected for inclusion this year is excellent, and I will be speaking away from the main stage to an invited audience on how I see matters for the coming year.

Here is a foretaste. As those who attended last year might remember,

**“IN MOST MAJOR BOND MARKETS, I FORECAST THAT YIELDS WILL AT LEAST DOUBLE AT THE SHORT END AND GO UP BY HALF AT THE LONG END. THAT’S PRETTY AGGRESSIVE STUFF, AND IF I AM RIGHT IT WILL BE A PHENOMENAL TRADE.”**



my theme was the coming return of inflation. This is really happening, and strong growth just about everywhere is a determinant of its likely forward trajectory. Wages are going to rise in most economies, and prices will too. So will

bond yields – and, actually, come to think of it, they already are.

The Phillips curve was asleep but is now reviving. I am not suggesting that inflation is going to be rampant, just



**“ALREADY, THE S&P ONLY YIELDS HALF AS MUCH AS THE US 30-YEAR TREASURY BOND – AND THAT IS A RECIPE FOR SERIOUS TROUBLE.”**

the highly enjoyable ride of the past three decades is about to come to an end.

I keep banging on about gold and silver, and at long last they are on the move, as are most commodities. Funny enough, even though higher interest rates and high levels of debt presage a coming recession (perhaps in 2019), commodity prices would still defy gravity for a while.

And I do think gold will slice through \$1,500 an ounce soon, and silver through \$20.

Meantime, I am working on matters Juvenescence, and on some new investments I hope to talk about at the Master Investor show. If you are interested don't forget to book your ticket, as this year's event will be packed to the rafters. We expect a record crowd, and we promise a thoroughly informative day.

**Happy Hunting!**

**Jim Mellon**



**Click here  
to follow  
Jim's trades  
on Twitter**

sufficient to start normalising the price of money. And this is happening when most central banks are tapering, or about to taper.

So, what we have is a changing environment. A 30-year bull market in bonds has driven equity valuations to sometimes crazy levels, fostered speculation in crypto currencies, and led to ludicrously negative yields in many bond markets.

This is about to change. In the coming year, the bond bear market, which has already started, will accelerate. Highly leveraged companies, which have been enjoying zombie status as a result of artificially depressed interest rates, will start to default. Countries with poor credit risk will no longer be able to enjoy stupid levels of interest. And in most major bond markets, I forecast that yields will at least double at the short end and go up by half at the long end. That's pretty aggressive

stuff, and if I am right it will be a phenomenal trade.

Already, the S&P only yields half as much as the US 30-year Treasury bond – and that is a recipe for serious trouble. I have always found that incipient bear markets start slowly, like a single snowflake descending on the animal spirits below. Then the snow really starts to fall and the spirits retreat. This is what is happening in cryptocurrencies – and is about to happen to equities.

Yes, there is good news on the economic growth side, partly bolstered by Trump's tax reductions, but this is at a cost: the single biggest expansion of debt – to, frankly, unsustainable levels – ever experienced in history.

Everyone knows that governments like inflation – up to a point – because inflation whittles away the value of debt. Those still in bonds should beware –

### 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 MASTER INVESTOR

# MASTER INVESTOR SHOW 2018

# MEET THE UK'S SMARTEST PRIVATE INVESTOR

**Jim Mellon's investments have made him £920 million. Imagine being one of the few people to pick his brain... Get the chance at Master Investor Show 2018!**

Many people dream of "hitting the jackpot" with their investments, yet few ever do. Some, however, get it right time and time again. One of them is Jim Mellon, a private investor with a net worth of £920 million.

## Starting from nothing to calling the next big trends

Jim began his investing career in the 1980s in a windowless studio apartment in Hong Kong. In the decades that followed, he repeatedly invested into emerging global trends, just at the right time:

- **Investing into Russian companies in the early 1990s?** A \$2 million investment turned into \$17 million in just six weeks.
- **German property in the early 2000s?** Jim started to buy at the bottom and has now built himself a portfolio of 3,000 apartments in

Berlin and other choice locations. Prices are up 5-10 times in value compared to what he paid.

- **New trends in battery technology?** In 2016, Jim invested into Canadian lithium producer, Criti-

cal Elements. The share went up tenfold within two years.

- **Cryptocurrencies?** A company that Jim is a large shareholder of bought into bitcoin early and recently cashed out \$43 million.
- **Biotech?** Portage has risen more than seven-fold since it first exhibited at Master Investor Show just three years ago.

When it comes to identifying "money fountains", as he calls them, Jim has a track record like few others. It is no wonder that he is widely known as "Britain's Buffett".

## Get the chance to pick Jim's brain – only at Master Investor Show

With investments in over 300 companies, Jim is a very busy man. Once a year, however, Jim shares his latest thinking at Master Investor Show,







**“JIM MELLON’S INVESTMENTS  
HAVE MADE HIM £920 MILLION.  
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the UK's largest event for private investors.

At this year's show on 17 March in London, visitors will be given not just one, but two unparalleled opportunities to meet one of the UK's most successful private investors:

- A **free-to-attend 30-minute panel discussion** compered by Jim and joined by Charlotte Ransom, founder and CEO of Netwealth Investments, and Merryn Somerset Webb, editor in chief of MoneyWeek and market commentator. Expect Jim to quiz Charlotte and Merryn on what the future holds for private investors in wealth management.
- An **exclusive, ticketed 30-minute session with Jim**, full of his investment predictions and left-field

ideas. Hosted as a "secret backroom gathering" for an audience of 150 visitors only – a fraction of the 4,000 people attending the show – this session is bound to sell out quickly. If you are quick, you can register for the free show ticket and then sign up for this special session for an additional £25. As a participant at this exclusive gathering, you will also be able to buy a copy of Jim's latest book "Juvenescence" for only £10.

## What else is on?

While Jim Mellon usually draws the biggest crowds, Master Investor Show attracts a host of other high-profile investors that provide visitors with exclusive yet easy-to-understand financial insights. Guest speakers will cover retirement planning, crowdfunding opportunities, and the investment

funds with the best returns. With 50 presentations taking place over four stages, and even a finance stand-up routine from a celebrity UK comedian, visitors are spoilt for choice.

In between presentations, delegates can interact with 100 exhibitors from sectors as diverse as fintech, mining and life sciences to renewable energy and specific opportunities for female investors. Master Investor is a simply unique opportunity to network with the CEOs and founders of investible companies, and meet successful entrepreneurs and investors.

With so much going on, it is not surprising that the majority of visitors stay for over five hours. Investing: a dull subject? Not if you attend Master Investor Show. Make some time for your financial health and come along!

### FREE ENTRY TICKETS

Claim up to two free tickets now for the entire day. Entry to the show gives you the opportunity to purchase tickets for the exclusive session with Jim Mellon before anyone else at a price of £25.

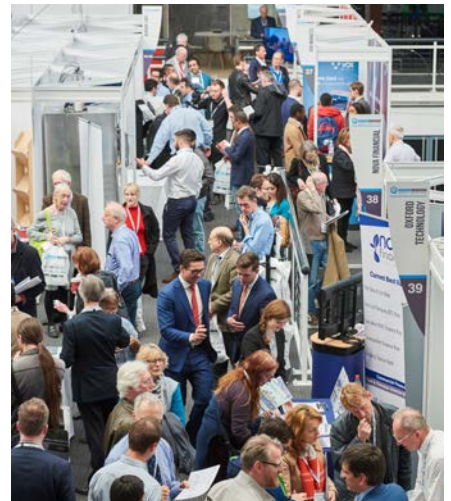
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BY VICTOR HILL

OPPORTUNITIES IN FOCUS

# AFRICAN DAWN: WHY AFRICAN MARKETS WILL RALLY IN 2018

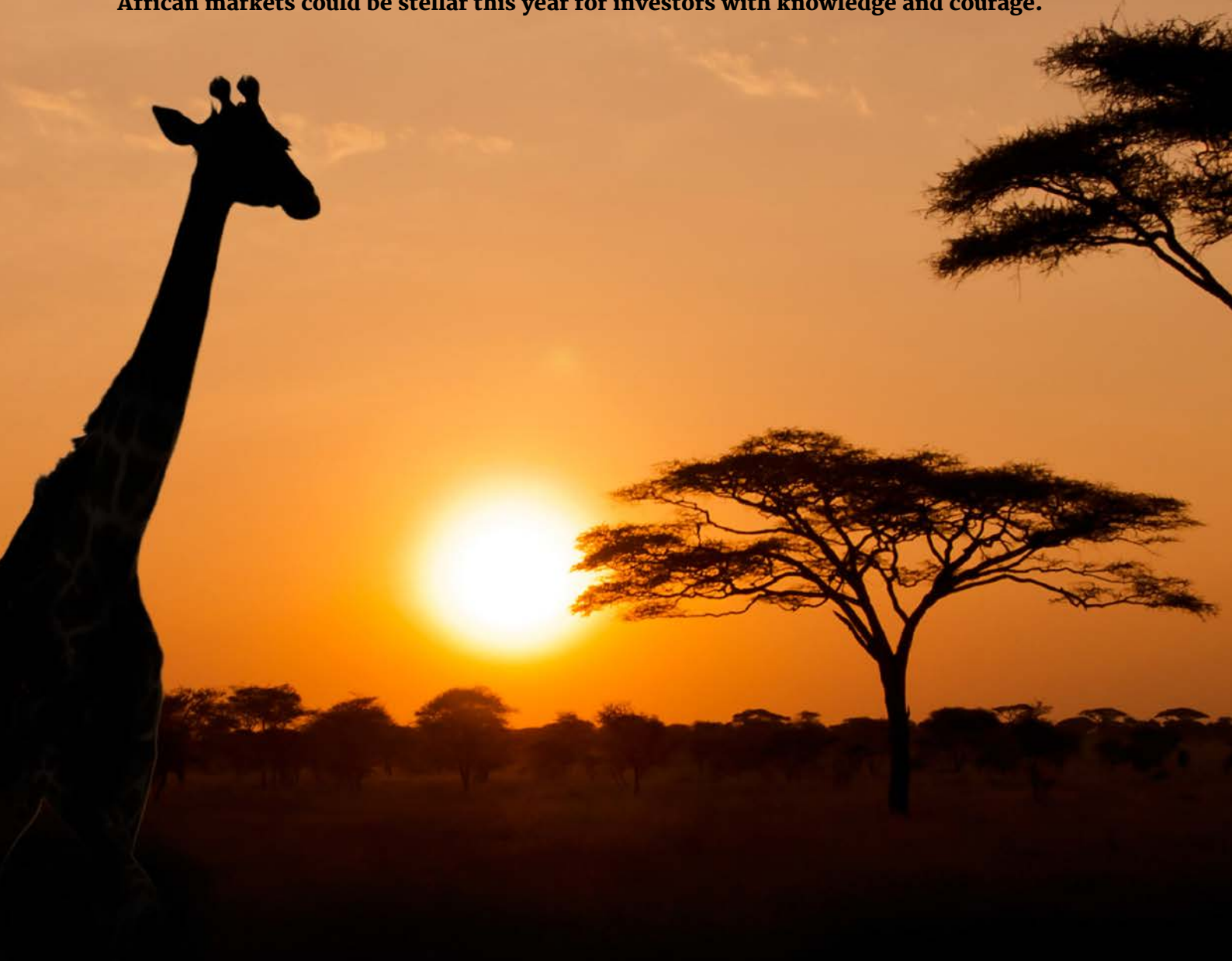


Imagine a continent which leads the world in mobile telephony banking and in fourth generation (satellite) internet access. This is a continent which has achieved remarkable advances in health outcomes as evidenced by levels of infant mortality and life expectancy, and in education over the last two decades. And which is now enjoying supercharged growth.

This continent has been attracting direct investment on a massive scale from both the West and from the new superpower, China, whose construction companies are ubiquitous there. Its natural resources are abundant. Its agriculture has massive potential (which is why the Chinese and others are buying farms there). Its infrastructure is gradually improving by leaps and bounds.

I'm talking about Africa. What a pity, then, that so often when the word *Africa* is uttered, many people think of famine, pestilence, poverty and war. It is true that a few African countries are still benighted – mostly due to civil war, corruption and poor governance. But it's time to shed our prejudices and to acquaint ourselves with a continent of opportunity.

Last year the leading African stock markets surged ahead. I predict that this year momentum is likely to be sustained for reasons that I shall explain. Last month I foresaw that the outlook for the US and UK markets was bright. This month I foresee that returns in selected African markets could be stellar this year for investors with knowledge and courage.





# “IT IS RECKONED THAT ABOUT 30 PERCENT OF OUR PLANET’S MINERAL RESERVES RESIDE IN AFRICA.”

## The lords of misrule are (slowly) dying...

I am not going to pretend that Africa has not had more than its fair share of nightmares, often caused (or at least exacerbated) by poor governance as much by natural disasters such as periodic drought. Under the heinous kakistocracy of Robert Mugabe, the beautiful nation of Zimbabwe was demoted from one of the wealthiest countries on the continent to one of the poorest, with a GDP per capita of just over \$1,000 in 2015. With the displacement of Mugabe by Emmerson Mnangagwa in November last year, there is light at the end of the tunnel for Zimbabwe – but investing there is still only for the very brave...

South Sudan, since gaining official independence, has proved unable to establish political stability in what was always an extremely arid and poor region of the continent (so different from neighbouring Kenya, large swathes of which are lush and fertile). Somalia remains a desperately troubled country – a failed state in fact – where private armies, terrorists and pirates strangle all hope of progress. The Democratic Republic of Congo (DRC) also is controlled largely by local militias. Corruption is still endemic in Africa. For these reasons, sadly, the poorest people on the planet are Africans. But that is not the whole story...

The lords of misrule who validated their grip by owning the history of "colonial liberation" are being replaced by a technocratic class of pragmatists – many educated at British and American universities. (Their predecessors were often educated in Moscow.) President Zuma of South Africa is another old school ideologue who is on his way out. Canny investors should look beyond the horror stories. And the story that emerges for much of Africa is one of steady progress and rising living standards, as well as of new investment opportunities.



Why am I so optimistic about investment prospects in Africa? Basically, I note four key long-term trends in play.

## Four long-term trends which ensure Africa's centrality to the world economy

The first factor is economic growth. In the first phase of the post-colonial period, economic growth in Africa was sluggish, and often negative. That has now changed. In 2017 the fastest-growing economy in the world was Ethiopia (at 8.3 percent as against 2.7 percent for overall global economic growth). Tanzania was sixth at 7.2 percent growth and Djibouti seventh at 7.0 percent.

The second factor, closely related to the first, is the recovery in commodity prices. In a world of seven-and-a-half billion people, all commodities – energy and agricultural – are in huge demand.

Africa produces more than 60 of the most precious strategic metals and minerals required by modern industry. These include gold, platinum



group metals such as palladium, diamonds, uranium, manganese, chromium, nickel, bauxite and cobalt. It is reckoned that about 30 percent of our planet's mineral reserves reside in Africa, including 40 percent of the world's gold, 60 percent of the world's cobalt – demand for which will increase with the rise of electric cars, though much of that cobalt resides beneath the surface of the DRC. An estimated



90 percent of the world's platinum group metal reserves are to be found in Africa.

Moreover, geologists regard the continent as relatively unexplored. New discoveries of mineral reserves are relatively common in Africa. Mozambique, Nigeria and Madagascar are just three countries where intensive mineral exploration is proceeding at a brisk pace. Major new discoveries in recent years include diamond beds in Mauritania and potential marine diamond deposits off the coast of southern Namibia.

South Africa, Ghana, Zimbabwe, Tanzania, Zambia and the DRC dominate the African mining industry, whilst countries such as Angola, Sierra Leone, Namibia, Zambia and Botswana rely heavily on mining as a major source of foreign currency. True, several of the continent's pernicious civil wars have been funded by these commodities, in particular diamonds, for example in the cases of Liberia and the DRC.

Major new mines opening in Africa or under development are distributed between South Africa, Namibia, Botswana, Tanzania, and Gabon. These will produce gold, diamonds, niobium (used mostly in steel alloys), platinum group metals and chrome; plus base metals (iron, nickel, lead, zinc and copper).

All of the big international mining firms are active in Africa. **Rio Tinto (LON:RIO)** mines lead and zinc in South Africa. **Norilsk Nickel (VIE:MNOD)** mines nickel in Botswana. **BHP Billiton (LON:BLT & ASX:BHP)** mines titanium in South Africa and Mozambique. Generally speaking, these multinationals have maintained cordial relations with host governments. Interestingly however, the conduct of the four Chinese-owned copper miners in Zambia (all subsidiaries of **China Non-Ferrous Metals Mining Corporation** – a state-owned entity) has attracted negative publicity in Zambia, and was a major issue in the 2011 presidential election there.

Africa is also a major oil producer, though the petroleum industry is concentrated in just four countries – Nigeria, Angola, Libya and Algeria. (Equatorial Guinea and Gabon are minnows,

but rank high in GDP per capita terms given their tiny populations.) **Nigerian National Petroleum Corporation** (state-owned) is ranked in the top ten in the world in terms of proven reserves. Nigeria was the 13th largest oil producer in the world in 2016. Libya also has massive oil reserves, though currently production is hampered by the country's extreme political fragility.

The third factor is that Africa has transformed itself from a continent riven with hunger into a major *net exporter* of food. African agriculture is flourishing. The area under cultivation is rising rapidly and, at the same time, an increase in agricultural productivity has facilitated a reduction in staple food prices.

According to a study by the International Food Policy Research Institute (IFPRI), for many years agricultural production in Africa failed to keep pace with population growth. That has now been reversed. One shining example

of success is Kenya where horticultural exports have increased five-fold since 1975. Horticultural exports include both food and fresh flowers. If you buy roses in the British winter the chances are that they were grown in one of the huge hot houses that surround Lake Naivasha.

The growth of Kenya's horticultural exports, like South Africa's fruit exports, has been supported by the growth of cheap and frequent air freight cargo to Europe and beyond – the same flights that ferry tourists back and forth – another major source of foreign currency income.

These successes have been largely driven by the systematic application of modern farming techniques. Soil and water conservation initiatives in many countries have mitigated declining fertilizer subsidies. Effective pest control and animal vaccination have also boosted yields. And, yes, African

## “AFRICA HAS TRANSFORMED ITSELF FROM A CONTINENT RIVEN WITH HUNGER INTO A MAJOR NET EXPORTER OF FOOD.”



**“DESPITE MANY  
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farmers have also been much less timid about using genetically modified organisms (GMOs) than their European counterparts.

The IFRPI reckons that Cassava yields have increased by over 40 percent since the late 1970s. The cultivation of hybrid maize has also yielded dramatic improvements, especially in Zimbabwe and Kenya. And West Africa's share of global cotton exports has grown from zero in the 1960s to around 15 percent today, making the region the third largest supplier of cotton after the USA and the former Soviet Union.

The fourth factor is that, despite many political setbacks, Africa is more peaceful today than at any time since the post-colonial period began. The bloody civil war in the DRC is now over. Sudan too is now at peace after the resolution of the bitter Darfur conflict, though, admittedly the new state of South Sudan is wretchedly poor. Ethiopia has advanced rapidly since the secession of Eritrea was resolved. And West Africa looks more stable than ever, with Ghana considered a model of African enterprise and democracy.

The Arab Spring of 2011 of course toppled regimes across the Maghreb. The political landscape is still tense there though it does seem that Egypt and Tunisia have stabilised. Libya, without a strong central government and beset by competing factions, is now vying with Somalia for the status of failed state.

The presidential elections in Nigeria in 2011 were considered to have been fairly conducted, according to international observers, although tensions between the Christian and Muslim communities in the country are still a

major cause for concern. Similarly, the first presidential election in Kenya of 2017 led to ugly tribal clashes; yet the second presidential election (with one candidate – Mr Kenyatta!) was largely peaceful and the country has now stabilised.

Post-apartheid South Africa has been stable, broadly democratic and economically successful. South Africa has been a role-model for other African states. But under President Jacob Zuma, with corruption rampant, the country has lost some of its moral authority across the continent and in the world at large. There are high hopes for the succession of Cyril Ramaphosa who – all things being well – will take over the South African presidency in the autumn of this year.

## Africa matters

From a strategic perspective, Africa is the world's second largest and second most populous continent after Asia. With a land area of 30 million square kilometres, it covers 20 percent of the Earth's total land mass. Africa had an estimated population in 2016 of 1.2 billion people representing about 16 percent of humanity living in 54 different countries. No African nation has yet joined the ranks of the developed nations (as evidenced by membership of the OECD) but South Africa is now ranked alongside the BRIC countries and attends their inter-governmental conferences.

The temperate northern and southern tips of the continent are wealthier than tropical sub-Saharan Africa. Within the tropics, East Africa (except Somalia), with its long pre-colonial history of trade with the Arab world, has tended

to be wealthier and more stable than elsewhere. Ethiopia is an ancient Christian country with a rich culture, as are the Maghreb Arab Muslim countries of North Africa. Egypt is the most populous Arab nation and is the most cosmopolitan. Egypt, like Kenya, also has worldwide tourist appeal, though political instability since the Arab spring has hugely reduced tourist numbers.

The three largest economies in Africa are Nigeria (about 19 percent of the continent's nominal GDP), Egypt (15.5 percent) and South Africa (13.75 percent). Nigeria is also the most populous nation in Africa with 190 million people (the seventh most populous nation on Earth) – and growing fast. The United Nations has estimated that Nigeria's population, on current trends, will overtake that of the United States by mid-century.

## African stock market performance in 2017

There is a compelling story to be told about Africa, but how can investors get exposure to this extraordinary continent? Apart from Johannesburg, all of the major bourses (Cairo, Nairobi, Abidjan and Lagos) are small by Western standards with a matter of some 50-100 corporations listed on each. They can be illiquid.

The BRVM (*Bourse Régionale des Valeurs Mobilières SA*) is the unique stock exchange for eight Francophone West African countries: Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo. The BRVM, located in Abidjan, Côte d'Ivoire started operations on 16 September 1998. The BRVM was one of the laggards amongst African markets during 2017.





**Table 1: African stock market performance in 2017**

Country	Index name	Index level at 31/12/2017	2017 returns local currency %	2017 returns US\$ %	2017 returns EUR %
Botswana	BSE-DCI	8,860.13	-5.75	2.54	-10.23
BRVM	BRVM-CI	243.06	-16.81	-5.16	-16.89
Egypt	EGX-30	15,019.14	21.66	26.77	11.63
Ghana	GSE-CI	2,579.72	52.73	43.96	26.14
Kenya	NSE ASI	171.20	28.39	28.20	12.23
Mauritius	SEMDEX	2,202.14	21.77	30.75	14.55
Morocco	MASI	12,388.82	6.39	15.29	1.01
Malawi	MSE ASI	21,598.07	62.14	61.18	41.26
Namibia	NSX OI	1,299.67	31.62	34.35	17.83
Nigeria	NGSE ASI	38,243.19	42.30	24.51	9.17
Rwanda	RSE ASI	135.38	6.38	3.75	-8.61
South Africa	JSE ASI	59,504.67	17.47	30.37	14.29
Tanzania	DSE ASI	2,396.23	9.00	6.60	-6.87
Tunisia	TUNINDEX	6,281.83	14.45	7.28	-5.96
Uganda	USE ASI	1,962.39	32.83	32.26	16.07
Zambia	LuSE ASI	5,327.57	26.97	26.63	10.89
Zimbabwe	ZSE Ind	333.02	130.42	130.42	102.01

Source: *African Markets*<sup>ii</sup>

2017 was a year of revival on African stock markets in the wake of good economic data across the continent. Inflation, current account, demand and other economic metrics showed positive trends in all the leading countries. This translated into excellent gains for the major stock markets (see Table 1).

Malawi, Ghana, Nigeria, Uganda and Kenya's stock exchanges were the top five performers in 2017, excluding the exceptional and counter-intuitive performance of Zimbabwe. (This was probably the triumph of hope over experience; but, just conceivably, an intimation of things to come.) The Malawi MSE gained 62.1 percent. This benchmark benefited from positive sentiment following improved agricultural production as weather conditions improved, the inflation rate sub-

sided precipitously and judicious fiscal reforms were enacted. *African Markets* expects that MSE's performance will be mixed in 2018 as the 2019 presidential elections start to loom and fiscal pressures could reduce government spending.

2016's worst performers – Ghana and Nigeria – outperformed strongly in 2017 gaining 52.7 percent and 42.3 percent respectively. Ghana's GDP growth rate rebounded to 9.3 percent in Q3 2017 from 3.5 percent in Q3 2016 driven by fiscal and monetary reforms put in place by President Nano Akufo-Addo, who took office in January 2017. Nigeria has seen its performance accelerate following the floatation of its currency for foreign investors, which has precipitated cash inflows in the country. Uganda's index gained 32.8 percent as the country saw a strong economic performance.

The Nairobi (Kenya) exchange gained 28.39 percent. GDP growth slowed in 2017 following drought, political tension around the two presidential elections and caps on commercial banks' lending rates which affected private sector investment sentiment.

One key event in 2017 was the well anticipated downgrade of South Africa's long-term local and foreign currency credit ratings. And yet the Johannesburg index still added 17.4 percent.

## Outlook

If we take the South African stock market as a proxy for the continent as a whole, 2018 has started well for African markets. The **MSCI South Africa Index** was up by roughly ten percent in January alone. But then Emerging Market (EM) equities were up overall by 8.7 percent in the first month of this year in US dollar terms. EM bonds, the yields of which are up on average by 4.4 percent, are also outpacing European and US bills and bonds<sup>iii</sup>.

Political risk in Africa remains high. In the Maghreb the dust has still not settled from the Arab Spring. Somalia is still a failed state. But for the first time

**“2017 WAS A YEAR OF REVIVAL ON AFRICAN STOCK MARKETS IN THE WAKE OF GOOD ECONOMIC DATA ACROSS THE CONTINENT.”**



## Two British companies which are old Africa hands

**DekelOil Public Ltd. (LON:DKL)** is one of the leading commodity groups trading in palm oil. Britain's involvement in African palm oil goes back to 1907 when one William Lever from Bolton was one of the first to import palm oil to make soap at his Lancashire plant. He then set off for the Congo with his brother James and established **Lever Brothers**. Lever Brothers merged with the Dutch company **Margarine Unie** in 1931 to form **Unilever (LON:ULVR)**. Palm oil can now be found in half of all consumer goods in Western grocery stores from chocolate, ice cream, baked goods, soaps, lotions, and detergents. **DekelOil** has come a long way since its IPO in 2013. It runs a profitable seed to palm oil operation in the Ivory Coast which produced 39,000 tonnes last year. Its shares climbed steadily in January after it posted record production levels for Q4 2017 and was rewarded with a BUY recommendation by brokers Cantor Fitzgerald. Be aware that in mid-2017 the compa-

ny's shares fell from 14 pence to 9 pence after it revealed mechanical problems at its mill. 70 percent of production takes place between January and June and the outlook for 2018 is promising. **DekelOil** has palm supply agreements with many local farmers and does not operate company-owned estates as other commodity producers do. In 2015 London-listed **New Britain Palm Oil** was acquired by Malaysian palm oil giant **Sime Darby (KLSE:SIME)**. Could **DekelOil** be another acquisition target?

The South African platinum miner **Lonmin PLC (LON:LMI)** came under the control of rival **Sibanye Gold Ltd. (JSE:SGL)** in December after a protracted period of low platinum prices. The company has been plagued by poor labour relations – you may recall a notorious incident in 2012 when 34 striking miners were shot dead by police. **Lonmin** was founded in 1909 and became one of the most famous conglomerates under the buccaneering leadership of Roland ("Tiny") Rowland who used it as an acquisition vehicle in the asset-stripping eighties.

## “THE AFRICAN DEVELOPMENT BANK EXPECTS AFRICAN GDP TO GROW AT 4.1 PERCENT IN 2018, UP FROM 3.6 PERCENT IN 2017.”

in many years there are no major civil wars on-going.

South Africa and, to a lesser extent, Zambia could surprise on the upside. Three things need to happen to improve the outlook for South Africa. Firstly, fiscal reforms are required to stimulate tax revenues; structural economic reforms are much needed; and thirdly, state-owned companies need to be better managed. Zambia's fundamentals could see improvement driven by increased demand for copper, energy reforms and fiscal discipline.

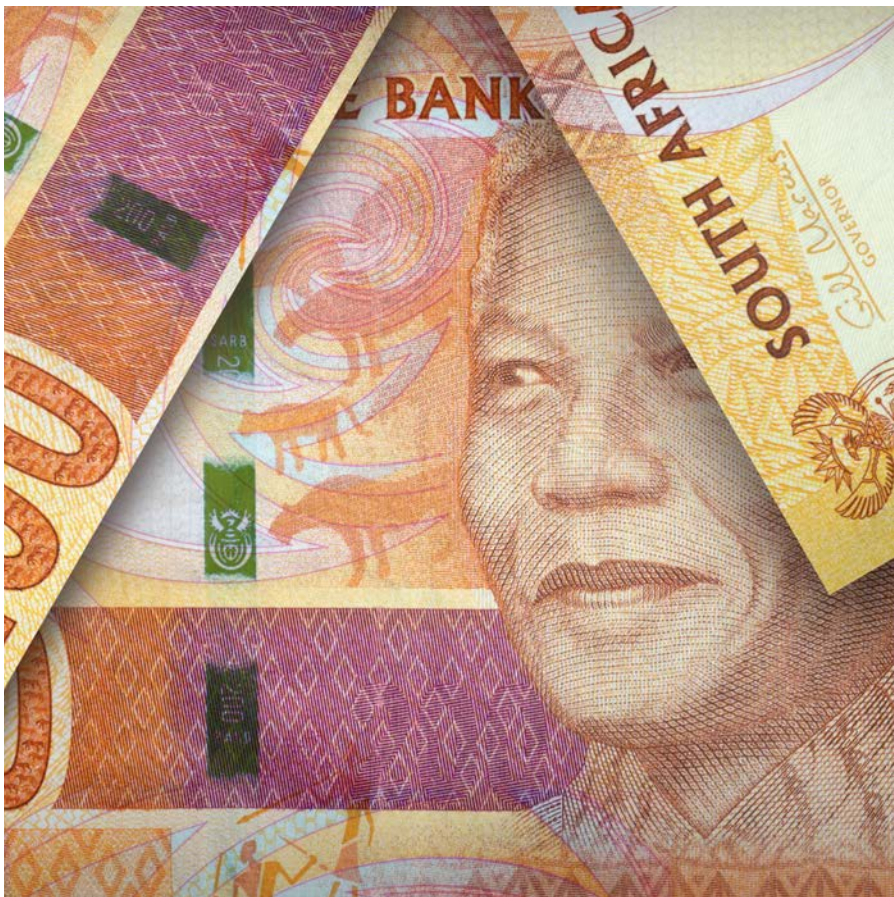
The **African Development Bank** expects African GDP to grow at 4.1 percent in 2018, up from 3.6 percent in 2017. Be aware that not all African countries will benefit equally from the improving fundamentals.

Many siren voices are warning that developed markets are looking overpriced – not least the USA. Bank of America Merrill Lynch warned in late January that many companies were trading at 3.5 times book value. In comparison stocks on the M1 EM Index are trading at about 1.95 times book value.

Africa has long been the Cinderella of the so-called Emerging Markets. But there are now three short-term trends in play across the EM universe which will redound to the benefit of the leading African markets in 2018.

**Short-term Trend One: African nations – together with other EMs – are benefiting from the Synchronised Global Recovery**

The World Bank report on the state of the world economy issued on the eve





**Table 2: GDP, Population and Credit Ratings of leading African Countries**

Country	Nominal GDP (US\$ 2016)/ Rank in Africa/54	Nominal GDP/ capita US\$	Population (millions) 01/2017	Credit Rating (S&P) (since)
Botswana	12.70(23)	5,896.556	2.29	A- Stable (04/2016)
Egypt	332.30 (2)	3,740.249	97.55	B- Stable (11/2016)
Ghana	43.30 (14)	1,384.354	28.21	A- Stable (10/2014)
Kenya	68.90 (9)	1,422.411	49.69	B+ Stable (10/2016)
Mauritius	11.86 (26)	9,421.541	1.26	N/A
Morocco	100.60 (5)	3,195.564	35.73	BBB- Stable (05/2014)
Malawi	5.347 (38)	286.981	18.62	N/A
Namibia	11.210 (27)	5,005.166	2.53	N/A
Nigeria	406.0 (1)	2,929.525	190.88	B Stable (09/2016)
Rwanda	8.490 (31)	732.463	11.92	B Stable (09/2016)
South Africa	294.1 (3)	4,768.235	56.70	BB+ Negative (04/2017)
Tanzania	47.2 (10)	943.797	57.30	N/A
Tunisia	43.2 (11)	3,919.332	11.53	N/A
Uganda	26.2 (17)	608.353	42.86	N/A
Zambia	19.117 (18)	1,143.550	17.09	B Negative (03/2016)
Zimbabwe	14.659 (19)	1,081.531	16.52	N/A

of the annual gathering of plutocrats in Davos could not have been more bullish. Global growth is predicted to rise this year by 2.7 percent on the back of a recovery in manufacturing and trade, improved market confidence and resurgence in commodity prices. Trade increased by around four percent in 2017, up from a post-crisis low of 2.4 percent in 2016, although it is still growing at below pre-financial crisis levels.

#### **Short-term Trend Two: Commodity prices are trending upwards as the dollar falls**

On 25 January the Bloomberg Commodity Index edged up to a two-year high. It was up by ten percent since mid-December 2017. What is driving this is a weaker dollar which makes commodities cheaper in US dollar terms, combined with expansionary global economic conditions. Oil prices are also on the up. In late January Brent crude hit \$71 a barrel for the first time since 2014. This represents a jump of nearly 50 percent since mid-2017.

Admittedly, there are exceptions in the commodity universe. The palm oil price was down by about 20 percent

in 2017 mainly on account of the huge expansion in global capacity – from one million hectares under cultivation in 1990, by 2015 there were 22 million hectares in production. Agricultural commodities overall, however, are on the rise.

#### **Short-term Trend Three: Default rates on Emerging Market debt are down to record lows – and African borrowers are sound**

Last November Venezuela defaulted on two dollar-denominated bond issues by failing to pay interest. That was unusual: the number of governments in default to private creditors fell to the lowest level since 1977. Of the 131 sovereign debtors tracked by **S&P Global**, Mozambique is the only other country currently in default, having failed to make interest payments on its Eurobond and having failed to honour guarantees on loans to two state-owned enterprises.

There is a school of thought that some sovereign defaults may in fact be hidden – by China. China is said to have rescheduled numerous sizeable bilateral loans to African countries without declaring so. But the real reason why the sovereign default rate has fallen

#### **Kenyan government bonds**

For (mostly institutional) specialist investors who follow domestic government bond markets in Africa, there are real opportunities. Two-year Kenyan government papers are yielding 13-14 percent at present. Of course, the exchange risk for foreign investors is considerable but it is of note that the US dollar to Kenyan shilling exchange rate as I write (at KES102 = US\$1) is roughly the same as it was exactly two years ago. You will need nerves of steel but the yield differentials between European and African government papers invite speculation.

is that emerging economies increasingly borrow in their own currencies. This is in line with the overall EM trend that there are fewer vulnerable countries and currencies in the EM universe than before. Even the *Fragile Five* (India, South Africa, Turkey, Brazil and Indonesia) have reduced their dependence on external financing by bearing down upon their current account deficits.



Fewer emerging market economies are pegged to the US dollar these days (though Zimbabwe is still using the dollar as a surrogate currency). Of 54 economies followed by the consultancy Oxford Economics, only 11 have foreign currency bonds outstanding amounting to more than 20 percent of their GDP – and none of them are African<sup>iv</sup>. Economists normally assert that countries never default on local currency debt because they can always print more of it. This obviously does not apply to eurozone members; moreover, Russia defaulted on its Rouble obligations in 1998. In some cases, sovereign default on domestic debt may be less catastrophic than a currency collapse.

### Four African markets that have got my attention

Regular readers of the MI website will know that I am very keen on **Kenya**, which is not only a beautiful country with a vibrant extant tourist industry but one with massive potential in agriculture, manufacturing and services. I predict that it will become a very favoured partner of the UK post-Brexit – especially for agricultural products. Most of the French beans that you buy in the supermarket come not from France but from Kenya. Similarly, Kenya is one of the largest exporters of pineapples. The American food giant, **Del Monte Foods** (a subsidiary of the Singapore-listed holding company **Del Monte Pacific Ltd (SGX:D03)**) sources most of its pineapple from Kenya.

## “FOR INVESTORS WHO WANT TO GET SOME AFRICAN ACTION THERE ARE A NUMBER OF WELL-MANAGED AND DIVERSIFIED INVESTMENT FUNDS ALLOCATING ACROSS THE CONTINENT.”

The Kenya stock market, the Nairobi Securities Exchange, has about 69 listed entities of which **Air Kenya (NSE:KQ)**, **Standard Chartered Bank Kenya (NSE:SCBK)** and **Safaricom (NSE:SCOM)** will probably be most familiar to Western investors. The Nairobi Securities Exchange (NSE) is developing rapidly. On 18 January Treasury Secretary Henry Rotich announced that Kenyan investors will be able to lend and borrow shares from each other from November this year, with the NSE set to roll out a system upgrade within the next five months. The regulations will allow investors to short-sell listed entities<sup>v</sup>. Clearly, the *hedgies* are welcome in Kenya – and they shall enjoy the six-star hospitality in Nairobi and other centres.

I am also bullish on **Ghana**. The country should perform strongly on the back of continued reforms, less dependence on the oil sector, lower inflation and fiscal discipline. **Nigeria** also should enjoy positive sentiment following higher oil prices, higher agriculture production and higher foreign currency liquidity thanks to recent measures taken by the central bank.

I am also enthusiastic about **South Africa** this year. To explain fully why will require a separate article but, suffice to say that South Africa has far and away the most sophisticated financial system in Africa and, come a change of government, and a much-needed burst of optimism, I am predicting excellent gains on the Johannesburg markets this year.

If I have favoured four Anglophone African countries that is not entirely a coincidence. You may have observed that the **BRVA Index**, which is a platform shared by eight Francophone West African nations, performed very poorly in 2018. This is at least partly because those nations, under French influence, are trying to shadow the euro (just as they previously shadowed the French Franc). This is much to their disadvantage for reasons that I shall explain soon in an upcoming article.

### Action

For investors who want to get some African action there are a number of well-managed and diversified investment funds allocating across the con-





**“MAYBE WE SHOULD NOW CALL AFRICA THE BRIGHT CONTINENT – FOR THAT WOULD BETTER DESCRIBE ITS FUTURE.”**



continent. One such is the [Africa Opportunity Fund \(LON:AOF\)](#), a closed-end investment fund which is managed by Francis Daniels (based in Johannesburg) and Robert Knapp (based in Boston) and trades on the AIM in London. Both Daniels and Knapp are experienced Africa hands.

AOF's strategy is to focus on investing at historically low valuations in companies with minimal debt that sell goods and services in short supply in Africa. It also invests in commodity-related companies, selectively, if it can purchase the underlying resources at a material discount to spot market values. The fund was launched in July 2007.

Possibly the easiest way to invest in Africa is via exchange-traded funds (ETFs). They are inherently diversified and cost less than building a portfolio with ADRs. Some of the most popular ETFs which provide exposure to Africa include:

- **Market Vectors Africa Index ETF (NYSE:AFK)**
- **SPDR S&P Middle East & Africa ETF (NYSE:GAF)**
- **MENA Frontier Countries Portfolio (NYSE:PMNA)**
- **Middle East Dividend ETF (NYSE:GULF)**
- **Frontier Markets ETF (NYSE:FRN)**

The most popular South African ETF is the **MSCI South Africa Index Fund (NYSE: EZA)**, which represents the only pure play to invest in the country.

The **SPDR S&P Middle East & Africa ETF (NYSE: GAF)** also has more than 80 percent exposure to South Africa, which makes it a diversified play on the country and region.

There are alternative routes. [Trine](#) permits private investors to invest in renewable energy projects in Africa. A private equity fund which specialises in Africa is [Helios Investment Partners](#). Founded in 2004, Helios is one of the largest Africa-focused private investment firms, managing funds totalling around \$3 billion. Helios offers both private equity and direct lending opportunities in Africa.

Africa has always been a continent where white men should tread carefully, and that is still the case. For the first time in the post-colonial era, however, hope is out-pacing fear – and a refreshing post-colonial mentality is emerging. Europeans used to call Africa the *Dark Continent* – not because its inhabitants had dark skins but because much of the continent remained unmapped until the early 20th century and large parts of it were impenetrable.

Maybe we should now call Africa the *Bright Continent* – for that would better describe its future.

#### About Victor

Victor is a financial economist, consultant, trainer and writer, with extensive experience in commercial and investment banking and fund management. His career includes stints at JP Morgan, Argyll Investment Management and World Bank IFC.

- i See: <https://www.weforum.org/agenda/2017/06/these-are-the-world-s-fastest-growing-economies-in-2017-2>
- ii Available at: <https://www.african-markets.com/en/stock-markets/commentary/2017-a-revival-year-for-african-markets>
- iii See: <https://www.ft.com/content/cac11928-011f-11e8-9650-9c0ad2d7c5b5>
- iv See The Economist, 23 December 2017, The rarity of busts, page 93.
- v See: <https://www.african-markets.com/en/stock-markets/nse/nairobi-securities-exchange-upgrade-to-enable-kenyans-borrow-and-lend-each-other-shares>





BY NICK SUDBURY

## FUNDS IN FOCUS

# VALUE FUNDS FOR WHEN THE GROWTH BUBBLE BURSTS

**Views differ as to whether it is better to invest in growth stocks or value stocks with a number of well-respected fund managers operating in each camp. Both of these contrasting strategies goes through periods of outperformance, but it is very rare that the side you come down on could have such a profound impact on your future returns as it does now.**

According to Neil Woodford, one the UK's best known fund managers, the outperformance of growth over value in the US is greater than at any stage in history and he sees this both as a risk and an opportunity.

A similar albeit weaker trend can also be seen in other markets. Over the five years to 9th January 2018, the MSCI UK Growth Total Return index outperformed its value equivalent by 18%, while on a global basis, the FTSE World Growth GTR produced a 13% higher return than the FTSE World Value GTR.

These differences in performance may not sound much, but Woodford likens the current market conditions to the nifty-fifty bubble that ran from the late 1960s into the early 1970s. During that time a small group of stocks with reliable growth characteristics experienced a strong run that resulted in their valuations moving to unsustainably high levels.

This was followed by a severe market crash in 1973-74.

### **An outstanding opportunity for value stocks**

Woodford believes that the loose monetary policy employed by the world's central banks since the financial crisis is driving a global stock market bubble. This fervour for a narrow group of growth stocks has created an opportunity to pick up out-of-favour areas – such as domestically-focused UK stocks – at the sort of "incredibly depressed" valuations that he has only seen two or three times during his long career.


Hugh Sergeant, who manages the **R&M UK Equity Long Term Recovery fund**, agrees that there is a massive chance for investors to profit from the mispricing. He has said that 'Today continues to represent the best opportunity to buy value

type shares since the end of the TMT [Tech, Media and Telecoms] bubble in 2000.'

A value stock is one that is out of fashion with investors and that has been unjustly written down by the market so that it trades at a lower price relative to its fundamentals. It will typically have a low price-earnings ratio (PE) and often a high dividend yield. Growth stocks are more highly valued based on the same metrics because investors believe that their earnings will grow faster.

If Woodford and Sergeant are right this would be an excellent time to switch into value-orientated funds, which have less potential downside and more potential upside than their growth counterparts. The problem is that there are not that many to choose from as it has been suggested that value is such an unloved strategy that only 11% of all global equity funds are now managed that way.





**“ACCORDING TO NEIL WOODFORD, ONE THE UK’S BEST KNOWN FUND MANAGERS, THE OUTPERFORMANCE OF GROWTH OVER VALUE IN THE US IS GREATER THAN AT ANY STAGE IN HISTORY AND HE SEES THIS BOTH AS A RISK AND AN OPPORTUNITY.”**

## US Value versus Growth – the difference could hardly be greater

Over the last ten years the S&P 500 Growth index has outperformed its value equivalent by an average of more than 3% per annum on an annualised basis. It is currently dominated by a 40% weighting in the Information Technology sector, with most of this made up of the likes of Apple, Microsoft, Amazon, Facebook and Alphabet, whereas value is strongly tilted towards Financials and Energy.

At the end of December the growth stocks were trading on a PE ratio of 23 times projected earnings and on a price-to-book ratio of 5.3, whereas their value counterparts were priced at 18 times projected earnings and a price-to-book of 2. Both look expensive, but the difference between the two seems pretty extreme.

## Global value opportunities

The £151 million **EP Global Opportunities Trust (LON:EPG)** is one of the few investment trusts that provides exposure to an international portfolio of value stocks. It has been managed by Sandy Nairn of Edinburgh Partners since its launch in December 2003.

Nairn has a well-established approach that aims to take advantage of the market's short termism by looking for companies that offer value based on their predicted earnings in five years' time. This has led him to put together a concentrated portfolio of 39 holdings with the largest positions including Royal Dutch Shell, Panasonic, Novartis, AstraZeneca and Bank Mandiri.

About half of the portfolio is invested in Japan and Europe, where he is finding the best value opportunities, with only 8% in the world's largest stock market, the US. A further 12% is held in UK stocks. EPG shares have returned 92% in the last five years and they are trading on a discount to NAV of 5.6%.

Edinburgh Partners also manages the **European Investment Trust (LON:EUT)**, which has a similar value approach.

## Small-cap value

**Aberforth Smaller Companies (LON:ASL)** has a strong value investment methodology that it applies to the UK small cap sector. It is a large fund with total assets approaching £1.5 billion and this has enabled the managers to put together a relatively diversified portfolio of 85 different holdings.

Aberforth are value investors who buy shares that they calculate are selling below their intrinsic worth. This is determined through detailed financial and industrial analysis, combined with a valuation approach that looks at both the stock market and corporate value.

**“OVER THE FIVE YEARS TO 9<sup>TH</sup> JANUARY 2018, THE MSCI UK GROWTH TOTAL RETURN INDEX OUTPERFORMED ITS VALUE EQUIVALENT BY 18%, WHILE ON A GLOBAL BASIS, THE FTSE WORLD GROWTH GTR PRODUCED A 13% HIGHER RETURN THAN THE FTSE WORLD VALUE GTR.”**

The fund is currently tilted towards the smaller end of the small cap spectrum and has a diverse group of businesses in its top 10 holdings. These include the metal flow engineering company, Vesuvius; housebuilder Bovis; Brewin Dolphin, the private client fund manager; and the ground engineering services company Keller.

ASL's portfolio has a price-to-earnings ratio of 11.8, which is much cheaper than the 20.8 for the FTSE All-Share, and the level of dividend cover is twice that of the wider market. Its shares

have returned 114% in the last five years and are currently trading on a 12% discount to NAV. They are yielding 2%.

## Mappa Mundy

One of the best-known value managers operating in this country is Alastair Mundy, who runs the **Investec UK Special Situations fund**. Mundy uses a deep-value, bottom-up approach to stock selection and looks for unloved large-caps with strong balance sheets. He will not include a stock in the portfolio unless it has fallen by at least 50% over the last five years relative to the market and will then normally hold it for 4-5 years to give it time to recover.

The £1.1 billion fund has a concentrated portfolio of 55 holdings with the ten largest making up just over half of the assets. These include the likes of HSBC, RBS, Glaxo and Barclays, as well as Royal Dutch Shell, BP and Tesco. Over the last ten years it has generated an annualised return of 8.3% per annum.

Mundy also manages the similarly sized **Temple Bar Investment Trust (LON:TMPL)** that the analysts at Winterflood have recently included in their model portfolio for 2018. It is very similar to the open-ended fund and is built around the same out-of-favour stocks in the FTSE 350, but where it differs is that the investment trust has a larger 19% cash weighting – his open-ended fund has a net market exposure of 86.1% – because of Mundy's concerns about the high valuation of the UK stock market.

Winterflood acknowledge that Mundy's contrarian approach will often lead him to invest in stocks too early and this will result in periods of under-performance, although they believe that Temple Bar offers an attractive long-term investment opportunity.

## Experienced value managers

Another experienced value manager is Ben Whitmore, who has run the £1.9 billion **Jupiter UK Special Situations fund** for more than 10 years. He has put together a concentrated 39-stock portfolio with two-thirds of the assets invested in out-of-favour UK large-cap



stocks and the remainder in the mid-caps.

Whitmore's top ten stocks include the likes of BP, Pearson, Anglo American, Standard Chartered, Tesco and Aviva. Over the 10 years to the end of December the fund has generated a cumulative return of over 140%, which is about 60% ahead of its FTSE All-Share benchmark.

Hugh Sergeant of the **R&M UK Equity Long Term Recovery fund** has more than thirty years' experience in the industry and he uses this to identify businesses where the management have the ability to turn things around. About a fifth of the portfolio is currently invested in FTSE Small Cap and AIM stocks with a further 17% held overseas.

It is a smaller fund than the others with assets of £205 million and is much more diversified with 228 separate holdings. The biggest positions are HSBC, Royal Dutch Shell, BP, Lloyds and BHP Billiton. It has returned 122% over the last five years.

**Schroder Income** is a deep value-driven fund where the managers, Nick Kirrage and Kevin Murphy, invest in companies that are valued at less than their true worth and then wait for them to be positively re-rated.

The £2 billion fund has a concentrated 35-stock portfolio and a healthy historic dividend yield of 3.2%. Its largest holdings are: HSBC, BP, Pearson, Aviva and South32. Over the last ten years it has generated a cumulative return of 134.4%.

#### 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

The highest profile value-orientated investment trust is the £810 million **Fidelity Special Values (LON:FSV)**. It has been managed by Alex Wright since September 2012 and he has done remarkably well since he took over the reins.

Wright has a contrarian, value approach and looks for unloved stocks with the potential for positive change and the scope to deliver asymmetric returns with much more upside than downside. He currently has a high 40% weighting in the Financials sector where he is finding these sorts of opportunities, but is underweight in the defensive, higher yielding staples that he considers to be expensive.

It is a diversified portfolio with around 110 holdings with the 10 largest positions including the likes of Citigroup, CRH, Ladbrokes Coral Group, Shire, Esure and Pearson. The fund is unusual as Wright also has the scope to use CFDs to short sell stocks that he thinks will fall in value, although this is a relatively minor aspect of the mandate and has contributed very little to the performance.

In the last five years the fund has generated a return of 133% due in part to the mid and small cap exposure. The shares are currently trading on a tight 2% discount to NAV and are yielding a modest 1.7%.

Wright also manages a similar open-ended fund, **Fidelity Special Situations**. This is much larger with assets of over £3 billion, but has less exposure to smaller companies and fewer holdings.

#### Fund Facts

Name:	Fidelity Special Values (LON:FSV)
Type:	Investment Trust
Sector:	UK
Total Assets:	£810 million
Launch Date:	Nov 1994
Current Yield:	1.7%
Gearing:	10%
Ongoing Charges:	1.06%
Website:	<a href="http://www.Fidelity.co.uk">www.Fidelity.co.uk</a>





BY JAMES FAULKNER

# NEX EXCHANGE: A REAL ALTERNATIVE TO AIM

**James Faulkner interviews Patrick Birley, CEO of NEX Exchange, a junior market that is offering public companies a real alternative to AIM. Interest in NEX Exchange is at an all-time high, so we thought it would be a perfect time to catch up ahead of NEX Exchange's presence at the Master Investor show in March.**

**James Faulkner:** Hi Patrick. Thanks for taking the time to speak with Master Investor. For those among our readers who aren't familiar with NEX Exchange, can you give us a brief summary of what it's all about?

**Patrick Birley:** We are a stock exchange offering companies and investors the opportunity to meet each other in a simple and well-regulated environment. We are the equivalent of AIM and

have the same regulatory, tax, trading, legal and accounting mechanisms but offer a service that is superior with greater flexibility and hopefully at a more reasonable cost.

**JF:** NEX Exchange has gone through its fair share of name changes in the past – Ofex, PLUS Markets, ISDX and now NEX Exchange. What prompted the latest makeover – and can you promise us this will be the last?

**PB:** Since 2012 we were a 100% subsidiary of ICAP Group (the 'I' in ISDX). In December 2016, ICAP sold their voice broking business to Tullett Prebon and the remaining, largely tech focussed, businesses were renamed NEX and hence the change from ISDX to NEX Exchange. NEX Group is a substantial player in the financial markets with annual revenues of over £500 million, and the company continues to be led by Michael Spencer.


## About NEX Exchange

We are a stock exchange offering companies and investors the opportunity to meet each other in a simple and well-regulated environment. We give companies of all sizes, from micro to mid-caps, access to a public quote or a fully regulated listing. And for investors, we offer simple access to a range of dynamic, small and medium-sized companies.

At NEX Exchange our goal is straightforward: we want to put investors in touch with investment opportunities and help businesses attract new capital. Investors can trade through UK stockbrokers. Advisory, discretionary and online services are available. NEX Exchange securities are eligible for inclusion in SIPPs and ISAs and exempt from stamp duty while Growth Market securities may also be eligible for EIS, SEIS, IHT & CGT reliefs.

To find out more visit [www.nexexchange.com](http://www.nexexchange.com)



A middle-aged man with grey hair and a beard is sitting on a black leather armchair. He is wearing a dark blue suit jacket over a white button-down shirt. He is smiling and looking towards the camera. His hands are resting on the armrests of the chair. The background is a large window with a view of a city skyline. The lighting is bright and natural.

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**“WE ARE THE EQUIVALENT  
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**JF:** You pitch yourself as an "alternative to AIM" (AIM being the junior market of the London Stock Exchange). But is there really the demand out there for another junior exchange? What are you going to do differently to all the previous incarnations of NEX Exchange that will make this one a success?

**PB:** We firmly believe that competition is a good thing, as do many of our members and other supporters. Having a single marketplace in any area tends to result in monopolistic behaviour and that drives high costs and low levels of service.

We have been working to ensure a more appropriate rule book, better relationships with the advisers, greater broker coverage and tighter prices from market makers. Added to the high levels of service that we offer, this makes us a compelling venue for smaller companies.

**JF:** NEX Exchange saw some pretty significant secondary fund-raisings in 2017. Can you give us an overview of the activity and how that compares to previous years?

**PB:** We saw a number of significant secondary fund raises during the year, culminating with the £18.53 million raised by Chapel Down in December and their oversubscribed fundraising for a further £2.35 million in January. In total, over 2017, companies on NEX Exchange raised in excess of £50 million last year. Capital for Colleagues raised £2.42 million while National Milk Records raised £7.33 million. Property developer Black Sea Properties raised £7.5 million as well as successfully securing debt funding. And in the fintech and blockchain space, Coinsilium Group raised £1.2 mil-

#### About Patrick

Patrick Birley is Chief Executive of NEX Exchange, a UK stock exchange focussed on giving companies simple and economic access to a public market and investors looking for long-term rewards and access to interesting growth stories. Patrick has been involved with exchanges and clearing houses since the late 1980s. He has led a number of successful exchanges, most notably SAFEX in South Africa and the European Climate Exchange in London.

lion which was accompanied by a share price increase of over 1,700% over the period.

**JF:** Liquidity is key – both for investors and the listed companies themselves. You state that liquidity has improved of late. How do you measure liquidity and how does it compare with your main rival, AIM?

**PB:** I do not necessarily agree that liquidity is key. It is an important factor but has different relevance to different companies and, for many, they are not concerned about trading volumes in the shares. Having said that, we have seen volumes in our stocks grow by over 300% over the last few years, and the recent interest in blockchain and crypto-currency has seen significant retail interest in our two blockchain focussed investment firms, Coinsilium and Kryptonite.

**JF:** You currently have four drinks companies listed on the exchange – Adnams, Chapel Down, Shepherd Neame and Daniel Thwaites. What's the attraction for companies like these? I hear you have previous experience in the brewing industry. Is that pure coincidence?

**PB:** I ran a micro-brewery for a short period before joining NEX Exchange and

continue to have a keen interest in the sector, but this is purely coincidental. Many of these companies are long-established and have a strong family element to their shareholding and therefore they have wanted a trading facility for their shares but aren't driven by high volumes. All of these companies also have strong executive management teams who are very conscious of costs and therefore we are the natural choice as a platform partner.

**JF:** What is the current level of institutional support for NEX Exchange and what are you doing to improve this?

**PB:** Institutional support in the small-cap area is increasingly difficult to secure. It is absolutely true that it is often easier to raise £200 million than it is to raise £10 million or £20 million, as most institutions want large ticket investments. However, there are specialists with impressive track records, like Miton, Dowgate and Octopus who will and do invest in NEX Exchange stocks.

**JF:** AIM has attracted a fair share of criticism of late for the spurious nature of some of its listings. What are you doing at NEX Exchange to ensure that investors are protected from situations like these?

**“WE HAVE SEEN VOLUMES IN OUR STOCKS GROW BY OVER 300% OVER THE LAST FEW YEARS, AND THE RECENT INTEREST IN BLOCKCHAIN AND CRYPTO-CURRENCY HAS SEEN SIGNIFICANT RETAIL INTEREST IN OUR TWO BLOCKCHAIN FOCUSED INVESTMENT FIRMS, COINSILIUM AND KRYPTONITE.”**





**PB:** We have a strong regulatory team and we work hard to weed out companies where there are structural problems or insufficient governance. We also do everything possible to ensure that investors are informed of any changes in a fair and timely manner. However, it is inevitable that some companies will fail, and we will also be criticised. We encourage all investors to do their own research on our companies and to only invest if they feel comfortable with the proposition and the people involved.

**JF:** A listing on NEX Exchange costs roughly a quarter of one on AIM. If cost was the main factor, then you'd have companies flocking to NEX Exchange. Isn't the real issue that investors simply aren't familiar with NEX Exchange and therefore lack the confidence to get involved? What are you doing to educate investors about NEX Exchange?

**PB:** There is no doubt about it that we need to do more to raise awareness, but we seek to do so in a responsible and sustainable way. Since our re-branding to NEX Exchange there has been an increasing level of engagement across our entire community and the level of enquiries is significantly higher. We hold regular events for investors, we work closely with other partners to raise our profile and we are growing our social media approach. We are told by our community that they are increasingly being asked about NEX Exchange and our pipeline for 2018 is strong.

**JF:** You claim to offer a "much more engaged" service than AIM. What do you mean by that?

**PB:** We are a small team (14 people) and really care about our business and the success of our customers. We answer our own phones and respond quickly and di-

rectly to enquiries. We attend events and spend lots of time amongst our community, both in London and in other parts of the UK. We believe that this level of personal service is much appreciated and resonates particularly well with the entrepreneurs who often lead successful, growing businesses.

#### 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 GONÇALO DE VASCONCELOS

# WHY HIGHER-RATE TAXPAYERS CAN NO LONGER IGNORE EIS TAX RELIEF

The [Enterprise Investment Scheme \(EIS\)](#) is a tax relief for UK taxpayers launched in 1994 and designed to incentivise private investors to invest into small unquoted companies. According to the [Enterprise Investment Scheme Association](#), by the end of the 2014/15 tax year £14.2 billion had been invested under the scheme into approximately 25,000 companies.

The rules governing the scheme have been updated several times since its creation, with the most recent update disclosed at the Autumn 2017 budget announcement. This latest update increased EIS limits for knowledge-intensive businesses and removed the tax break from asset-backed and low-risk EIS funds since these go against the principle of the tax break – to incentivise investment into early-stage, higher-risk small unquoted companies. Overall, the latest changes were good news for both investors and companies.

The EIS tax relief can reduce the capital at risk for UK taxpayers to less than 40% of the capital invested (using income tax relief and loss relief), whilst any profits are exempt from capital gains tax as long as the shares are held for a minimum of three years. Further to this, there is an exemption of inheritance tax if the investor holds the shares for a minimum of two years.

## Are the tax benefits really that good?

Yes. An investor investing £10,000 into an EIS company or fund can get a 30% income tax relief, and therefore the initial capital at risk becomes just £7,000.

Then should the investment go well and the investment doubles in value from £10,000 to £20,000, the investor needs to consider several things:

**“TOO OFTEN FINANCIAL ADVISERS FOCUS IN REDUCING THE RISK OF LOSS RATHER THAN INCREASING THE LIKELIHOOD OF HIGHER RETURNS.”**

1. The increase in value is capital gains tax exempt;
2. The initial capital at risk was just £7,000 and the worst case scenario is a loss of just £4,200 (see below), therefore, the real return becomes considerably larger than double the original value; compared to the initial capital at risk of £7,000, the investment has almost trebled in value;
3. Should the worst happen and the business fails, an investor can claim loss relief, which is based on the

investors' income tax bracket. For an investor in the 40% tax bracket, a further £2,800 tax relief would be due, making the capital loss just £4,200 of the initial investment of £10,000.

## The catch

The level of risk for this type of investment is high, which is why there are such generous tax breaks and why most wealth managers recommend a diversified portfolio of EIS companies and/or EIS funds as a path to manage risk.

## What are the risks?

Investing into early-stage small unquoted companies is a risky business. According to the industry-leading '[Siding with the Angels](#)' report by NESTA, investors in early-stage companies had an internal rate of return (IRR) of 22% on their overall portfolio of small unquoted companies. Such potential for long-term returns coupled with a very generous tax relief scheme are the key reasons why well-informed wealth managers and financial advisors regularly include EIS funds as part of a well-balanced investment portfolio for their clients.



Further to the risks involved, investments into early-stage businesses are typically highly illiquid, meaning there isn't an easy way to access the capital invested until an exit event (a trade sale or IPO), which can take three to seven years, if not more. As a comparison, Facebook took just over eight years to go from being founded to IPO. Whilst early investors had their capital locked away for a considerable period, their return was phenomenal, with \$500,000 investment increasing in value to \$1bn at IPO and about \$10bn at today's Facebook share price (\$180).

## Why isn't everybody doing it?

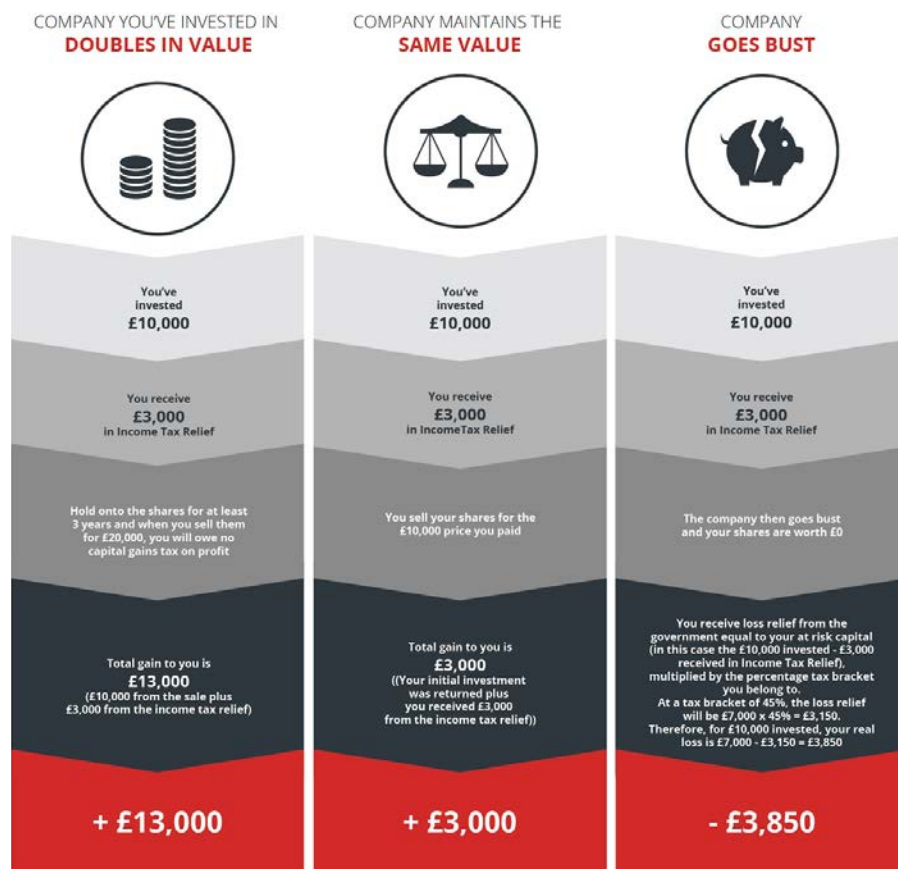
Unfortunately, there are three main barriers for high-net-worth investors to gain greater exposure to EIS investments, be it directly into companies of their choosing or via EIS funds:

1. There is an acute aversion to risk within the financial advice industry, which tends to prioritise risk avoidance over clients' interests of increasing overall returns. Too often financial advisers focus in reducing the risk of loss rather than increasing the likelihood of higher returns;
2. The lack of knowledge of how EIS tax relief works among less informed financial advisers is truly astonishing. Any advised client should ask their financial adviser detailed questions about EIS tax relief to ascertain whether they are getting the best financial advice they can;
3. Accessing EIS investment opportunities used to be the privilege of very well-connected individuals. Fortunately, this has changed in recent years, with the surge of platforms such as [EIS online investment platform SyndicateRoom](#) (full disclosure: I'm a Co-founder and CEO of SyndicateRoom).

## How to invest into EIS opportunities

EIS investments used to be the privilege of well-connected business angels and venture capitalists. However, in the past five years there has been an increase in the number of EIS online

# Examples of EIS RELIEF



## SYNDICATE ROOM

Invest with the professionals

investments platforms. Some give investors access to an array of EIS funds, whilst others provide access to specific companies that qualify for EIS. Very few give access to specific EIS companies and EIS funds.

Choosing between investing into specific EIS companies or EIS funds is a matter of personal preference. Some investors really enjoy reading about the potential 'next big thing' and hand-pick their own EIS investments, building a carefully selected portfolio. Other investors prefer the ease of investing into an EIS fund that offers access to

a large portfolio – such as [EIS Fund Twenty8](#), the UK's only passive EIS fund.

*Although the EIS tax relief is fairly simple and straightforward, any tax relief depends on an individual's circumstances. In addition, the availability of tax relief depends on the investee company maintaining its qualifying status. Any investor considering EIS investments should seek the advice of a professional tax adviser. No part of this article is tax or financial advice, nor should it be taken as such, since neither SyndicateRoom nor I can provide tax advice.*





BY FILIPE R. COSTA

THE MACRO INVESTOR

# CAN OIL HIT \$100 AGAIN?

*"Whenever you find yourself on the side of the majority, it is time to reform (or pause and reflect)."*

— Mark Twain, Notebook, 1904





## After the storm comes the calm

Inside the commodities complex, the oil market has been one of the most tumultuous rides an investor could embark upon. From a price below \$20 in 2002, which hardly covered production costs, it rose to a whopping \$145 just a few months before the financial crisis. In just a couple of months, between 2008 and 2009, prices were violently hammered down to \$35 on concerns about global demand and the supply glut that was forming. But easy money depressed the dollar and enticed a recovery, pushing oil higher again to regain its triple-digit value in 2011. The oil price then spent almost three years hovering around. But a second dip pushed prices down again, this time hitting \$28 on February 2016, as the shale oil industry boomed while demand was lagging.

It took some difficult coordination between OPEC and non-OPEC members to cut production and boost prices higher again. Meanwhile, countries like Venezuela and Russia couldn't escape currency crises and recession. Of late, oil prices have recovered to their current \$70 level, but the long and tortuous path towards that level has uncovered the loss of pricing power at OPEC. On the one hand, the shale-oil sector's boost to total supply is limiting OPEC's scope of action; and on the other, the rise of alternative sources of energy is making demand

ever more sensitive to oil prices. It is under such a scenario that *The Macro Investor* attempts to answer some key questions, while discussing some of the new challenges faced by oil suppliers.

*Can oil prices continue to rise steadily, as they did during the 2002-2008 period? Are we ever going to see the \$140 level again? Is Saudi Arabia really able to bust everyone else by pumping oil in excessive quantities? What is the real strength of OPEC and how much price power do they have?*

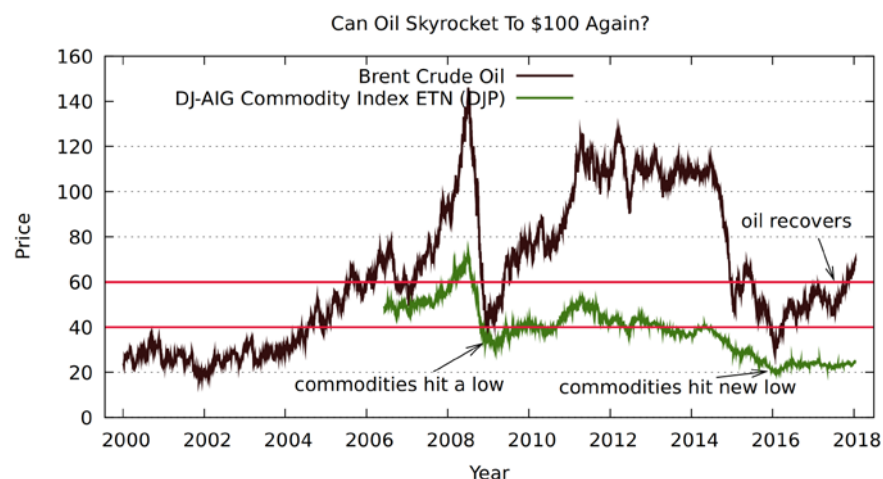
## A bullish trend

In January 2016 oil dropped to \$28, a price not seen since 2003. It was the result of a mix of lagging global demand and a supply glut. Unlike other bear markets for oil, this time Saudi Arabia was not willing to coordinate efforts with other oil producers to cut production. After all, such cuts would support prices but lead to a loss of market share for the cartel, as shale oil companies would take the opportunity to continue pumping oil to the market and keep themselves above water.

Taking into consideration that the cost of producing and distributing a barrel is around \$9 in Saudi Arabia, allowing oil prices to drop seemed like a smart strategy to force inefficient producers out of business. But the financial crisis was so deep and the increase in oil inventories so large that oil prices were battered down to levels not even seen in the aftermath of the Lehman Brothers collapse. The number of oil rigs in the U.S. declined at a fast pace, as many shale oil producers were losing money from their activities. Debt in the energy sector rose quite rapidly and shareholders were ripped off.

To some extent, Saudi Arabia was successful in leading some shale companies out of business. Additionally, it led to currency collapse in countries like Angola, Venezuela and Russia along with severe economic contraction. But the strategy also came with collateral damage and





Saudi Arabia didn't escape the negative impact of lower prices. Oil exploration at a price of \$28 certainly makes economic sense in a kingdom where the breakeven point comes in at \$9. But it pays for half the government spending that a price of \$56 would. For the first time, we saw the kingdom issuing government bonds to avoid other forms of financing or having to cut spending.

The lesson to learn is that regardless of the supply dynamic and the resulting breakeven price for oil exploration, a non-cooperative equilibrium leads to substantial costs to everyone and can't prevent competition forever. This is the main reason why in 2016 OPEC reached a deal to cut production, one that was signed by many non-OPEC producers, such as their depressed state.

OPEC's deal eased the pressure and allowed oil prices to first stabilise and then recover to the \$40-\$60 range. But despite the best efforts of the car-

tel, oil prices remained range-bound between mid-2016 and mid-2017. It was only in November 2017 that the \$60 barrier was broken on the upside, in a bullish trend that seems to have started in June of that same year. Since then, oil prices have risen from \$45 to \$70, a 55% rise in just seven months. Over the last twelve months, the price of Brent crude has climbed 28%, while the price of light sweet crude has risen by 23%. During the same period, the commodities complex, here proxied by the **iPath Commodity Index (NYSE:DJP)**<sup>1</sup>, rose only 0.8%.

After so many years in the doldrums, 'black gold' is regaining its mojo. The excitement is now huge. Open interest in futures and options markets is at record highs, with money managers getting what they can while producers take the opportunity to hedge. Traders' sentiment is at multi-year highs, as the crowd is ignoring key fundamentals. But, as data pointing to a new glut is released, sentiment will surely revert,

and the market will be exposed to a correction.

## A crowded trade

If we take a look at the Commitment of Traders reports, we can observe that the open interest in Nymex crude oil futures and options contracts is at all-time highs, with a total of 2.6 million contracts opened. The number of open contracts rose rather quickly, from 2.1 million one year ago to the current 2.6 million. While the mix of a sustained price increase and a rise in open interest is a bullish signal, it also raises a few early warning signs.

## “THE LONG OIL TRADE IS NOW A CROWDED TRADE.”

Money managers are an increasingly significant contributing factor to the rise in open interest. Historical records show that when this happens, sell-offs are usually exacerbated. Investors should keep an eye on a potential levelling off of the current steadily increasing levels of open interest in the market; it could be an early signal of exhaustion of upside potential. The involvement of managed money is a good enough reason to fear the worst. Staying out of the crowd may lead to some lost upside at times, but it is a good recipe for avoiding crashes. The long oil trade is now a crowded trade, just like bitcoin.

**TABLE 1 – OIL AND OIL-RELATED EQUITIES PRICE CHANGES (%)**

Name	Ticker	3-Month	6-Month	1-Year	3-Year	5-Year	2017
Crude oil (Brent)	BZ	19.5	42.9	28.2	39.2	-37.8	17.0
Crude oil (Light Sweet)	CL	22.3	37.8	22.5	30.8	-33.2	12.0
iPath ETNs DJ-AIG Commodity Index	DJP	4.6	8.0	0.8	-16.0	-41.3	0.9
iPath ETNs GSCI Crude Oil	OIL	30.8	46.8	18.2	-35.9	-68.8	3.3
iShares GSCI Commodity-index	GSG	11.4	19.3	8.8	-15.4	-49.9	4.0
iShares U.S. Oil & Gas Expl. & Prod.	IEO	18.6	26.3	5.6	2.4	2.9	-0.5
SPDR S&P Oil & Gas Expl. & Prod.	XOP	17.2	24.2	-4.7	-12.0	-31.6	-10.0
United States Oil Fund	USO	22.1	34.1	14.7	-30.2	-63.2	2.6
VanEck Vectors ETF Trust Oil Refiners	CRAK	14.2	31.7	50.9	N/A	N/A	48.0

Source: Sharescope



## Global demand is favourable...

One of the key factors behind the rally in oil prices is rising global demand. After many years facing deep financial trouble, Europe is now emerging from its malaise with renewed vigour. In the US, the economy is growing at 3%, which is technically considered to be near full capacity. China is no longer growing at double-digit rates, but it is still a heavy commodity user. India is growing at 6.3% and Japan above 1.0%, which should also be interpreted as a good signal for the oil market, as these are two of the largest oil consumers. But with growth comes monetary contraction, which has already begun in the US, and may soon be discussed at the ECB. Others may follow. With the FED still expected to hike its key rate a few times over 2018 – and faster than other key central banks – the dollar may well reverse its downtrend, which would act as a negative force for the whole commodities complex, including oil. Any gains in global demand from now on will probably occur at diminishing rates and have limited positive impact on oil prices.

## But supply is (and will always be) a concern

A good way of describing my concerns regarding the supply side of the oil market is by citing a comment I made a year ago in a blog for Master Investor:

*"Oil prices are no longer the result of OPEC's actions but rather a complex determination that is partially floored by OPEC's desires but, at the same time, capped by an entire army of shale oil companies anxiously waiting for their opportunity to shine".*

Saudi Arabia and Iran certainly possess the most efficient means of producing oil. Both can do it at around \$9 per barrel. Meanwhile, Canada and the UK, for example, are much less competitive because it is costly to extract oil from sands (in the first case) and the deep sea (in the second). The shale industry is also less competitive, as it carries some significant operational costs. But while Canada and the UK can't do much to gain operational efficiency, the shale industry has been improving at all levels. OPEC's policy of keeping oil prices high led to the creation of revo-

**TABLE 2 – Cost of Producing a Barrel of Oil (USD)**

	Total Cost	Gross Taxes	Cost Without Taxes
UK	44.3	0.0	44.3
Venezuela	27.6	10.5	17.1
Canada	26.6	2.5	24.2
US Shale	23.4	6.4	16.9
US Non-Shale	21.0	5.0	16.0
Russia	19.2	8.4	10.8
Iran	9.1	0.0	9.1
Saudi Arabia	9.0	0.0	9.0

*Source: Rystad Energy (2016)*

lutionary ways of extracting oil, which would be unprofitable under lower prices. More recently, the decline in prices helped this industry become more competitive. The US shale sector now needs a price of \$23.4 per barrel to break even. But if the industry continues to improve its efficiency, and the legal framework under which it operates becomes more favourable, it is feasible that US shale could reach a breakeven price below Russia's. Given the huge increase in oil reserves over the last few years due to shale oil, this certainly puts a cap on OPEC's pricing power.

A good indicator of the effect oil prices have on the US oil industry is the oil rig count data supplied by Baker Hughes.

Rig counts in the U.S. were hovering around 1,600 in 2014. As the price of oil fell from \$100 to \$60 that year, the number of rigs started to decline at a fast pace. In May 2016, the count was showing just 316 rigs. But, the trend is reversing, as the last count showed 752 rigs, which corresponds to an increase of 230 in one year. The rig count data is a good proxy for activity in the industry. At this point, we can say that such activity is gathering pace, which should be interpreted as negative for oil prices.

The rise in oil prices has coincided with a substantial decline in US oil inventories. These inventories now stand at 1,883 million barrels, down from a peak of 2,055 million barrels in February

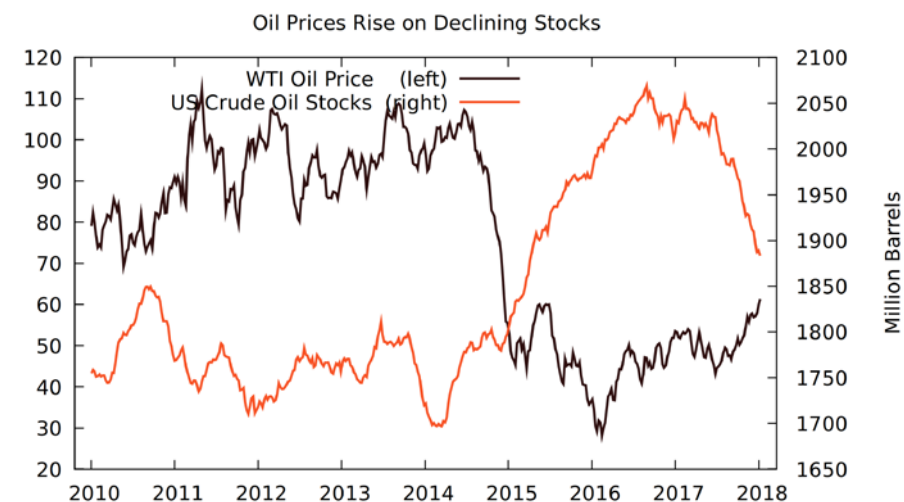


## “THE RIG COUNT DATA IS A GOOD PROXY FOR ACTIVITY IN THE INDUSTRY. AT THIS POINT, WE CAN SAY THAT SUCH ACTIVITY IS GATHERING PACE, WHICH SHOULD BE INTERPRETED AS NEGATIVE FOR OIL PRICES.”

2017. But to sustain higher oil prices, these inventories need to decline a lot further. With rig count data rising, it is hard to foresee that happening, particularly given that global demand is not expected to rise substantially to cope with any supply increase.

### Where to put the money

With so much optimism for the oil recovery, in particular from money managers, one should become wary. The oil trade is pushing prices higher regardless of market fundamentals, particularly regarding supply. Many producers will take the opportunity to sell puts and/or futures above \$70 as a way of locking in profits. The increasing sell side will put a dent on the oil rally. At the same time, if prices continue to rise, so will the oil rig count and the number of shale oil producers in the US willing to resume operations. These producers are not part of any OPEC agreement and will be happy to pump ever more oil at ever greater prices. But, as this happens, inventories will start rising and the fundamentals will point towards lower prices again. Sentiment, for now, is positive and may well push prices a bit higher, but I don't believe we're going to see \$100 oil this time. For each price level, there are more



sellers and less buyers today than one decade ago. The shale oil industry and renewable energy sector have limited the pricing power OPEC once had.

To play a reversal in sentiment, I prefer three alternatives. The first is through short selling a long ETF, like the **United States Oil Fund (NYSEARCA:USO)**. The second option is to go long on an inverse ETF like the **United States Short Oil Fund (NYSEARCA:DNO)**. Both are highly correlated with spot oil prices, but the short fund carries a higher beta<sup>i</sup>, meaning it is expected to change more for each percentage point change in spot prices than a short

in the long oil fund would. But with this fund an investor must contend with the monthly rolling costs of futures, which are significant over time. A third alternative is to purchase a put option on the future price of oil. An out-of-the-money option with maturity towards the end of the year is a good bet on a significant decline for oil over the year.

To summarise, the United States Short Oil Fund is better suited for a shorter holding period; the United States Oil Fund is a good alternative for a slightly longer holding period; and the put option is better for an even longer holding period.

- i Many other proxies for commodities exist. The choice of DJP comes from the fact this exchange-traded product is broad and limits exposure to energy commodities. Most other broad ETFs, have a substantial exposure to commodities, which limits the comparability value. Still, even if using the iShares S&P GSCI Commodity Index ETF (GSG), the rise in price is 8.8%, still much below the rise in oil prices.
- ii In regressions conducted for the last 10 years of data, beta for the USO fund in relation to oil spot prices is 0.47 while it is -0.60 for DNO. The negative sign of DNO is because of it being a short fund.

### 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.





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BY SWEN LORENZ

10 QUESTIONS FOR...

# CHARLOTTE RANSOM

## NETWEALTH AND THE FUTURE OF WEALTH MANAGEMENT

For anyone wondering about how to best use their savings and plan their own financial future, Charlotte Ransom is someone worth following. After 20 years at Goldman Sachs, she took a career break and investigated how to invest her own personal savings. Not finding a single convincing proposition among the plethora of conventional wealth managers and private banks, she decided it was time to set up a new kind of wealth management firm – Netwealth!

Master Investor interviewed Charlotte about the challenges private investors face in securing their own financial future, and how she turned herself from City employee to successful founder and CEO of a company that attracted £16.5 million in early-stage equity funding from backers that included many high-profile City veterans.

**Swen Lorenz:** Lots of people complain about the quality of the financial services on offer in this country but not many people have actually done something about it. You are one of the select few that belong to the latter category. Presumably you now have your own savings managed by Netwealth?

**Charlotte Ransom:** *Not only do I have my money managed by Netwealth, which has transformed my own financial*

*set-up, but also my extended family and many friends have also moved their investments across. We have all suffered from the same inadequacies that dog the incumbent managers and Netwealth finally provides the solution.*

**SL:** Your company claims it is neither a robo-advisor nor a traditional wealth manager. How does someone who has never previously heard of your firm need to visualise the USP it offers its customers?

**CR:** *At Netwealth, we have deliberately retained specific areas of a more traditional service that really matter to clients – a seasoned and expert team, institutional-grade security levels for both client assets and data, and access to financial planning and advice. We have taken these important aspects and embedded them into our modern technological framework. This means our clients have an unprecedented level of transparency when it comes to understanding how their portfolios are performing and how*

### About Netwealth

Netwealth is an investment management service that brings together a highly qualified team, a powerful online service and a robust investment framework. Clients have access, for a fraction of the industry cost, to fully managed portfolios and experienced advice while benefiting from cutting edge financial technology. Netwealth was founded in 2015 by former Goldman Sachs and JP Morgan executives and is backed by high-profile City investors.



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## “OUR APPROACH IS THAT INVESTORS KEEP MORE OF WHATEVER RETURN IS GENERATED, REGARDLESS OF THE LEVEL OF RATES AND YIELDS.”

much they are being charged, as well as tools which allow them to plan for bespoke cashflows according to their personal needs. In addition, our technology allows us to run the firm in a highly efficient way, keeping overall costs to a minimum and resulting in our clients paying a third to a half of the traditional industry cost, which can have a hugely positive impact on their financial outcomes.

**SL:** I am old enough to remember the glory days of getting 8%-9% annual returns, which made it easier to pay 2% annual fees to wealth managers. In today's world of near-zero interest rates, everything has changed. Your fee structure is very much geared towards helping private clients to increase their returns by minimising fees. This is all the more relevant if rates remain this low. Do you expect them to?

**CR:** We don't know how long rates will stay this low; however, we don't anticipate inflation or interest rates moving higher quickly. The key for investors is what their net total return is. Even if rates rise, there is no excuse for managers to be charging the levels they do. Instead our approach is that investors keep more of whatever return is generated, regardless of the level of rates and yields.

**SL:** What else do prospective clients need to know about your firm's investment framework? Aren't wealth managers all offering pretty much the same standardised products nowadays?

**CR:** Our investment framework is based on a multi asset, globally diversified approach. As a headline, this is not dissimilar to many other discretionary managers where the onus is on medium to

long term investing that targets modest excess returns rather than pursuing a more alpha-based strategy with the additional associated risks and volatility. Where our framework differs quite a bit from traditional discretionary managers is that we don't include hedge funds, private equity or structured products in our asset allocation. This allows our clients to retain very high levels of transparency, liquidity and flexibility, as well as ensuring that costs are kept to a minimum.

**SL:** Your company manages its clients' funds, but in order to hire the team and build the infrastructure for this, you first had to raise equity to fund your company's operation. The investors who are backing you as a shareholder of Netwealth include names like Edward Bonham-Carter, the Vice-Chairman of Jupiter Fund Management; Harvey McGrath, the former CEO and Chairman of Man Group and former Chairman of Prudential; and Bruce Carnegie-Brown, the Vice-Chairman of Banco Santander. It seems remarkable that such City grandees are backing an entrepreneur who has set out to disrupt conventional wealth managers. How did you manage to get their backing?

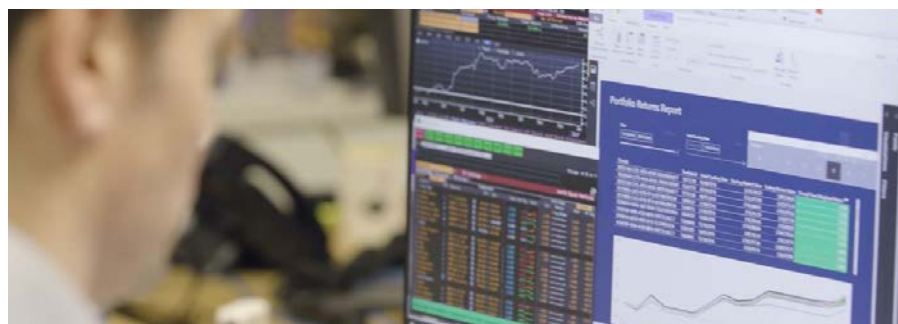
**CR:** We have a terrific set of backers, all of whom have personal experience of and strong opinions on the UK wealth management market. Netwealth is unique in its approach and in the client demographic that we address, and our shareholders wanted to back a business that they could accurately compare to more traditional providers. Almost all our shareholders are also clients of the firm, so they know exactly how our service contrasts with previous or current groups they work with.

**SL:** You are building your firm on the back of widespread dissatisfaction with traditional wealth managers. One of your innovative services is the "Netwealth Network", which allows clients to invite family mem-

### About Charlotte

Charlotte is the founder and CEO of Netwealth, a leading UK online wealth manager. Having started her career at JPMorgan, she spent 20 years at Goldman Sachs, serving as a partner for 10 years. Her leadership roles spanned relationship management, marketing and product development in the Securities Division. From 2006 to 2011, Charlotte was head of Institutional Wealth Management and the Market Solutions Groups for Europe, Middle East and Asia in the Investment Management Division. From 2012, she explored the impact of digital technologies on a variety of industries before founding Netwealth in 2015.

On Saturday 17 March 2018, the Business Design Centre in London will host the 16th annual Master Investor Show. In a panel discussion compered by renowned UK financier and entrepreneur Jim Mellon and joined by market commentator Merryn Somerset Webb, attendees will hear first-hand about Charlotte's role in changing the face of private wealth management and how Netwealth is leading the way in fintech.





bers or friends to co-invest and realise yet further savings on fees. I was excited to learn about it because it immediately made sense to me. Can you explain the details to our readers?

**CR:** The Netwealth Network has been part of our offering from the start. It is unique in the UK and it is a critical part of our offering and philosophy. Once a client of Netwealth, an individual can invite up to seven family members or friends into their Network and it is the aggregate funds in the Network which drives the fee rate. As an example, if a client has, say, £200k with us, the annual fee is 0.65%. If they add a Network member with another £200k, between them they have £400k at Netwealth and both drop to the second fee tier of 0.50%. Should they add a third member, with an example amount of £100k, the total Network now has £500k and all members drop to the bottom fee tier of 0.35%. In addition, Network members have a reduced minimum amount that allows them to start investing with £5k rather than our minimum of £50k.

The principal thinking behind the Network is that families, or groups of friends, should be able to benefit from economies of scale, yet typically wealth managers charge all individuals separately and aggregate amounts are not taken into account. Over 70% of our clients are in Networks and often span multiple generations.

**SL:** Amidst all the exciting milestones you have already achieved, there is also the reality that any new wealth management firm needs to get at least £1-2 billion in client funds under management before it can operate profitably. I have yet to spot Netwealth advertisements on the Tube. How are you intending to reach out to potential clients?

**CR:** Don't look out for us on the tube – we won't be advertising there! We have a very targeted approach to advertising given what we know about our clients.

*The Master Investor show is a great example of the type of event that Netwealth likes to support, since we expect there will be many of our target audience there and we will have the opportunity to go into further detail about what makes us uniquely appealing.*

**SL:** You'll be bringing your team along to the show, for our delegates to meet them. It must take a special kind of employee to leave the City behind and instead work from the West End to advance the next generation of financial services innovation. Now that you are a founder-CEO rather than a team leader at an established bank, what traits are you looking for in your employees?

**CR:** Firstly, our employees have all displayed excellence in their given area of expertise. They are at Netwealth because they can see the direction that wealth management is taking, and they want to be part of that movement. The typical characteristics we look out for beyond demonstrated excellence are those who are hard-working, versatile and curious team players who are excited about how they can contribute to changing the status quo.

**SL:** I couldn't help but notice that you are a registered speaker for "Speakers at Schools", a charity that

gets interesting speakers into state schools to inspire their students and broaden their horizons. Tell us about the best experience you had at that programme.

**CR:** Speaking at "Speakers for Schools" events has been a delightful experience. The best part of it is to be able to help inspire these pupils and potentially take them down a path they may not have realised was available to them. From my own past experience, it is amazing how one or two things that you hear from speakers stick with you and help direct your own approach and choices. Small things can determine momentous outcomes.

**SL:** Your involvement with youth education extends to Bhutan, Rwanda and Uganda. Did you have a chance yet to actually visit these countries?

**CR:** I have spent time in Rwanda and Bhutan in particular and, where possible, we have also taken our children to see the work being done with Save the Children. Nothing is more inspirational than seeing the change you can bring to the lives of young people who have very limited resources and yet extraordinary resilience and optimism. I am a firm believer that ultimately education is the key to a fairer and safer world and the earlier you can help to educate, the better the opportunity to bring about lasting change.

## 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 JOHN KINGHAM

## DIVIDEND HUNTER

# WHO WILL BE THE NEXT CARILLION?

**For many dividend investors, the demise of Carillion was a disaster. Not only did their portfolios lose an important source of income, they also saw a permanent loss of capital. It's easy to see what went wrong with hindsight, and in the August 2017 issue of Master Investor I wrote about some of the key lessons from Carillion's collapse. Hindsight is a wonderful thing, but the problems with Carillion were not exactly hard to spot, even several years before its eventual demise. So rather than do yet another Carillion post-mortem, I thought it would be more useful to apply a little foresight and look for companies with similar "red flags" which investors might want to avoid or get out of.**

There were four key lessons from Carillion, so I'll be looking for four red flags: 1) Large contracts; 2) Weak profitability; 3) Big acquisitions; 4) High debts.

### Interserve PLC

- **Share price:** 123p
- **Index:** FTSE 250
- **Market cap:** £170 million

Interserve is perhaps the most obvious "next Carillion", having been in the media spotlight shortly after Carillion's liquidation.

Like Carillion, Interserve operates in the cyclical Support Services sector. It mostly provides facilities management and construction services to both public and private clients,

so the similarities with Carillion are clear. The company has also had its problems, resulting in a recently suspended dividend and a share price which has gone from over 700p a few years ago to around 100p today.

With results like that, many dividend investors will have already sold out. However, I still think it's worth looking at Interserve because it's a good example of how these four risk factors can bring previously successful companies to their knees.

#### Large contracts? YES

As a provider of cleaning, security, construction and other services, Interserve needs to win large long-term contracts to generate profits.

One problem with this business model is that these contracts are typically for a fixed period of several years, and when the contract ends, the associated revenues and profits disappear as well. This can make large contract-based businesses riskier than other businesses with smaller and more frequent sales "wins" (such as companies selling soap or toothpaste).

Another problem is that these contracts can be very costly if they go wrong. A good example of this is Interserve's Glasgow "energy from waste" contract. In May 2016 the company announced that problems with the design, procurement and installation of a gasification plant, plus challenges with the supply chain, would lead to overruns and

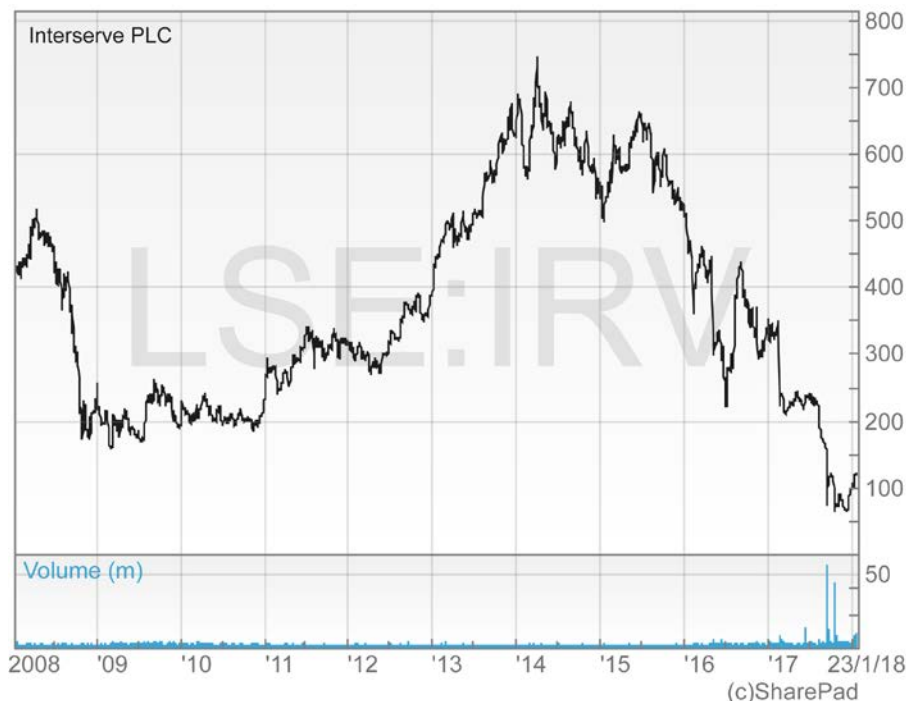


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**“INDUSTRY-WIDE SUICIDE  
BIDDING LEAVES MANY  
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## “THE SIMILARITIES WITH CARILLION ARE CLEAR.”

delays with an expected cost of £70 million. In February 2017 that expected cost was increased to £160 million and today it stands closer to £200 million. To put that in context, Interserve's average net profit over the past decade has been £40 million to £50 million per year.

### Weak profitability? YES

Yet another problem with large contracts is that they tend to attract "suicide bidders" – i.e. companies who will bid for a contract at a price which is almost certain to produce a loss, just so that their staff have something to do. This may seem daft, but it's usually better than having skilled staff sitting around doing nothing. It's also better than laying them off only to have to re-hire them at a later date (assuming they haven't found a better job with a competitor).

Industry-wide suicide bidding leaves many support services companies with barely acceptable levels of profitability. Interserve fits that description, with post-tax return on capital employed

averaging just 7.7% over the last decade. With the FTSE All-Share returning about 7% per year over the long-term, Interserve's rate of return is not exactly impressive, although it did just about meet my profitability rule:

**PROFITABILITY RULE: Only invest in a company if its ten-year average return on capital employed is above 7%**

In terms of Interserve being the next Carillion, weak profitability is a sign of weak or non-existent competitive advantages. Companies with weak competitive advantages are vulnerable to industry downturns because they have little or no pricing power. They must undercut the suicide bidders and hope that somehow they can still eke out a profit. That is not a good position to be in.

### Big acquisitions? YES

When a company wants to grow but cannot grow its core business, one easy way to boost short-term growth is to acquire other companies, and that's exactly what Interserve set out to do in 2010.

In that year's annual results, the company announced its intention to double earnings per share, from 40p to 80p, by 2015. The results also stated that the company's then-reasonable borrowings of £121 million gave it "the financial strength to supplement

organic growth with acquisitions". So with the goal of doubling earnings in mind, management went on a massive debt-fuelled acquisition spree.

Between 2010 and 2014, the company spent about £430 million in cash acquiring other businesses, including £250 million (in cash and shares) for Initial Facilities, the facilities management business of Rentokil Initial PLC. Over the same period the company generated post-tax profits of about £210 million, or less than half the amount it spent on acquisitions. That was a serious red flag according to my acquisition rule:

**ACQUISITION RULE: Only invest in a company if it spent less on acquisitions over the last ten years than it made in adjusted post-tax profits**

Why might this make Interserve the next Carillion? Because a) companies being acquired don't exactly shout about their problems from the rooftop; b) acquisitions add complexity and can distract the acquirer from their own (often weak) core business; and c) acquirers often overpay because of over-optimistic beliefs about synergies, cost savings and other potential benefits.



### High debts? YES

With £430 million spent on acquisitions between 2010 and 2014 and total profits in that time of £210 million, it was always going to be hard for Interserve to pay for that lot using spare cash thrown off from its existing business. The answer, of course, was to borrow the money instead.

The bulk of those borrowings came in 2013 and 2014, when the company's total borrowings went from £50 million to £370 million. That debt expansion



took the company's borrowings from just over one-times its then-average profits of about £40 million to almost ten-times. That was another red flag according to my debt rule:

**DEBT RULE: Only invest in a cyclical company if its total borrowings are less than four-times its five-year average adjusted post-tax profits**

By that standard, Interserve had gone from prudent to reckless in just a couple of years. In fact, things have become considerably worse since 2014, with the company's debts ballooning to more than £460 million (and potentially much more in the soon to be released 2017 results), which is more than ten-times its latest average profits. Exactly why institutional investors signed off on all this is beyond me (I guess they get paid either way).

And it gets worse. On top of that £460 million (or more) debt-pile, Interserve has a pension obligation of more than £1,000 million. That is a literally unbelievable financial obligation for a company that makes barely £50 million or so each year. It's also yet another red flag according to my pension rule:

**PENSION RULE: Only invest in a company if its total pension obligation is less than ten-times its five-year average adjusted post-tax profit**

Of course, the pension fund has assets, but the fund still has a deficit of more than £50 million, and given the £1,000 million size of the fund it's possible the deficit could get a lot worse. This deficit is nowhere near as bad as Carillion's astonishing near-£600 million pension deficit, but it does take Interserve's combined debt plus pension deficit "borrowings" to more than £500 million, which is way too high in my opinion for a £50 million per year company.

**Is Interserve the next Carillion?**

Obviously, I have no idea whether Interserve will go into liquidation like Carillion. Its situation is bad, but not as bad as the jaw-droppingly bad state of affairs at that other company. However, I think the situation *is* bad and a rights issue of several hundred million pounds could be the best option, assuming shareholders are willing, which they may not be.

## G4S PLC

- **Share price: 291p**
- **Index: FTSE 250**
- **Market cap: £170 million**

G4S is another company operating in the Support Services sector. It's the world's leading security services company, born from the merger of Securicor and Group 4 in 2004. It's a company that only seems to make the headlines when things go wrong, such as Group 4's problems with escaping prisoners in the 1990s or G4S's failure to provide enough security personnel during the 2012 Olympics.

**Large contracts? YES**

G4S earns its profits by providing security services (such as security personnel or security systems and technology) to clients through sometimes large and long-term contracts. I've already outlined the potential problems with this business model, so rather than go over them again let's have a look at what happens when things go wrong.

Remember the London Olympics in 2012? As official security services provider for the games, G4S was in a good position to use this high-profile contract to increase its profits and its reputation around the world. Sadly, it didn't quite work out that way. Rather than increasing its profits or reputation, G4S lost money and reputation at the 2012 Olympics. It failed to provide

enough security personnel and, at the last minute, thousands of troops had to be brought in to make up the numbers. As a result, the CEO and other senior management lost their jobs and the company lost around £90 million on the contract.

This is precisely why large contract-based businesses are risky and why they should be treated with care. G4S makes around £200 million per year in post-tax profits and it lost around £90 million from a single contract. And of course, the long-term damage to its reputation may be far more serious than the short-term damage to its bottom line.

**Weak profitability? YES**

The average post-tax return on capital employed across all 220 companies on my stock screen is 11% and, as I've already mentioned, the long-term expected return of the FTSE All-Share is about 7% per year.

How does G4S compare to those benchmarks? Not too well. Over the last decade its return on capital employed has averaged just 5%, which is very unimpressive. Its return on shareholder equity is better, with an average of about 18%. However, that higher return on equity is only possible because returns have been boosted with large amounts of borrowed money (which I'll cover in a moment), and that increases risk as well as returns.





## Big acquisitions? NO

In recent years, and especially following the 2012 Olympic disaster, G4S has shied away from large acquisitions. The last really big acquisition was in 2008, when it purchased Global Solutions Limited for £355 million. That acquisition cost more than an entire year's profit (of about £200 million at the time) so it was big, but 2008 is ancient history now so this acquisition doesn't bother me.

## High debts? YES

G4S's return on capital employed is very weak, so it uses large amounts of debt to boost shareholder returns. This is a legitimate strategy, but also a risky one if the debt burden becomes too large.

As I've already mentioned, I prefer cyclical sector companies to keep their total borrowings below four-times their recent average profits. For G4S, which has average post-tax profits of about £185 million (there has been little or no profit growth over the last decade) that would mean a debt-ceiling of about £740 million. In fact, the company announced total borrowings of more than £2,500 million in its latest annual report.

But is this enough to make G4S the next Carillion? It's possible, especially given that G4S has almost three times as much debt as Carillion on a debt-to-profit basis. And the fact that its debt interest payments are equal to about 50% of its post-tax profits is not exactly a good sign either.

This massive debt burden is more than enough to make G4S a very risky proposition in my opinion, but it gets worse.

## "G4S'S DEBT AND PENSION OBLIGATIONS RELATIVE TO ITS PROFITS ARE IN THE SAME BALLPARK AS CARILLION'S WERE JUST BEFORE IT COLLAPSED."

The company also has a massive pension obligation totalling some £2,700 million. That gives the company a pension obligation to profit ratio of 15, well above my preferred maximum of ten.



This huge pension also comes with a huge deficit of £341 million, taking G4S's combined debt plus pension deficit liabilities to almost £3,000 million, which is a vast amount for a company generating less than £200 million in profits. And don't think this is just an accounting anomaly with no impact on cash flows, because it isn't. G4S is currently obliged to pay around £40 million per year into the scheme to close the funding gap, with that amount increasing by 3% per year.

## Is G4S the next Carillion?

G4S's debt and pension obligations relative to its profits are in the same ballpark as Carillion's were just before

it collapsed, so the company certainly seems to have the right characteristics to be the next Carillion. However, G4S has put out positive trading statements recently and has so far maintained its dividend, unlike Interserve which has already suspended its dividend.

A maintained dividend might reassure investors, but it's exactly what I would expect to see. Long experience has taught me that CEOs will almost always paint a positive picture and, more importantly, maintain the dividend. They'll do this even when it seems obvious that the sensible thing to do is to suspend the dividend and use the cash to reduce debt and pension obligations (and perhaps even raise a little extra cash through a rights issue).

But what is sensible and what keeps a CEO in their job is not always the same thing, as Carillion's shareholders know all too well.

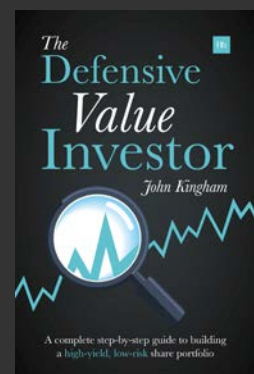
Of course, I'm not saying that G4S or Interserve are going to go bust or that their management are incompetent, but both companies have a lot of characteristics which make them look very similar to Carillion. That's why I won't be buying either company, no matter how low their share prices go. And just as importantly, I'll be looking to avoid any other companies with a similarly risky combination of large contracts, weak profitability, big acquisitions and high debt and pension obligations.

## About John

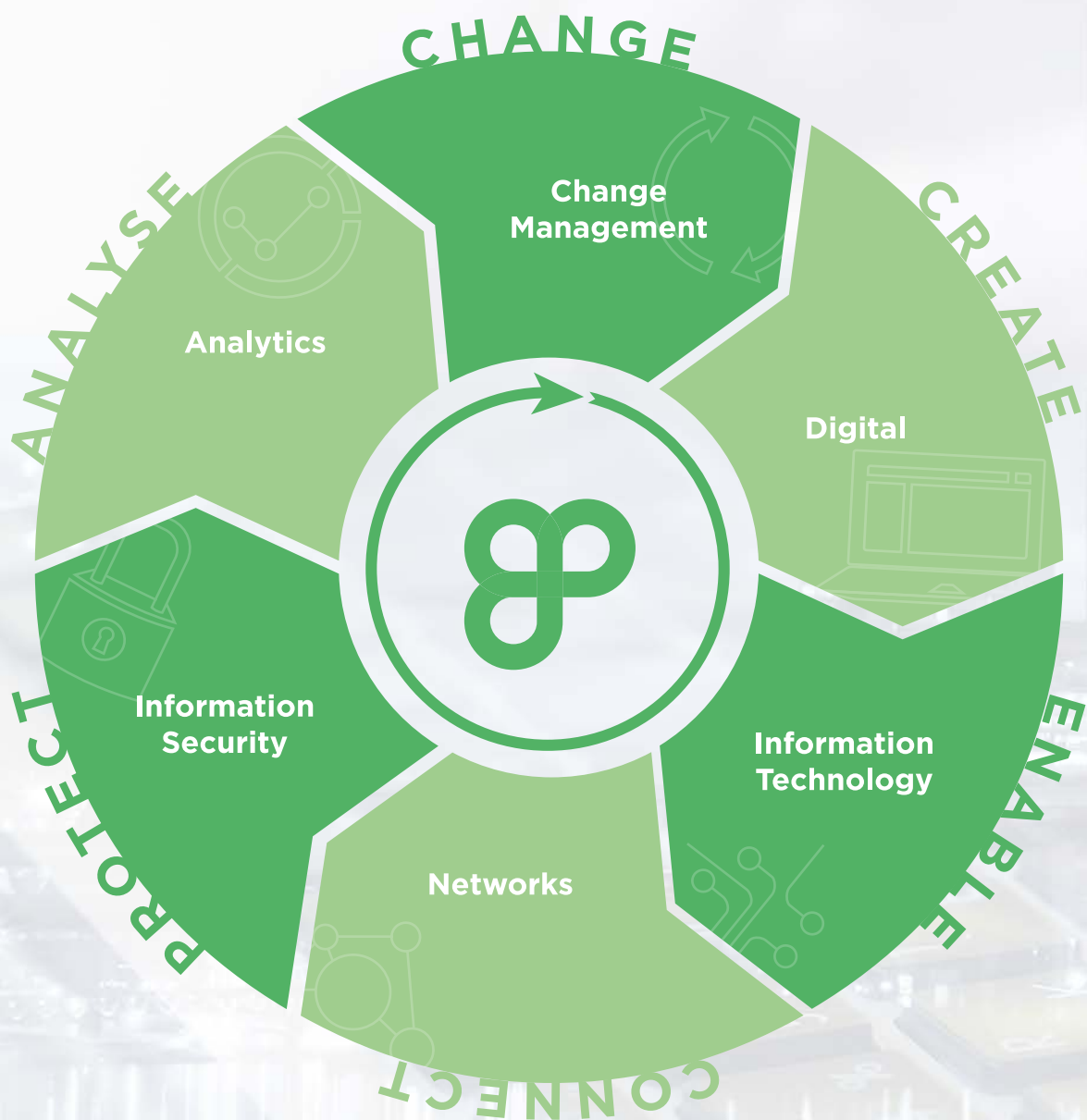
John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John's approach to high yield, low risk investing is based on the Benjamin Graham tradition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

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

His website can be found at: [www.ukvalueinvestor.com](http://www.ukvalueinvestor.com).



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BY RICHARD GILL, CFA

## FROM ACORNS TO OAK TREES

# SEARCHING FOR SMALL CAP VALUE AND INCOME

**As I discussed in last month's edition of Master Investor magazine, small cap shares had a pretty good year in 2017. The AIM All Share index hit its highest level for almost a decade during the year, rising by 24.3%, with the FTSE Small Cap Index up by 14.9% and reaching an all-time high. Both indices have gone on to make modest gains so far in 2018.**

While investors are reaping the rewards of the bull market, the problem with high prices is that it is becoming increasingly difficult to find new investment opportunities at reasonable valuations. So what better approach to take in the current markets than value investing? Made famous by the likes of legendary investors Benjamin Graham and Warren Buffett, value investing involves seeking out stocks which are trading below their so called "intrinsic value". They may be trading below this theoretical level due to a number of reasons, such as a lack of liquidity, a poor profile amongst investors or the markets over-reacting to some recent bad news.

The following three stocks, between them, exhibit a mixture of the above characteristics but I believe they are

currently trading at low valuations and should be good investments for the long-term. As a bonus, they all offer a decent dividend yield too.

### SHOE ZONE

A report released last year by fashion retailer Simply Be suggested that

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INCREASINGLY  
DIFFICULT  
TO FIND NEW  
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AT REASONABLE  
VALUATIONS."**

women, on average, own 24 pairs of shoes. Perhaps that's one reason why market research firm Mintel sees the UK footwear sector rising to a value of almost £10.5 billion this year, up from £8.7 billion in 2013. One company taking advantage of the growth being seen is AIM listed **Shoe Zone (LON:SHOE)**.

Shoe Zone has its origins going back to 1980, when the father and uncle of current Chairman, Anthony Smith and Chief Operating Officer, Charles Smith, bought a business named Bensonshoe. Since then the company has grown by organic means, as well as via several acquisitions, to currently operate almost 500 discount footwear stores around the UK. These are supported by a number of fast growing online activities.

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**“SMALL CAP  
INVESTORS  
HAD AN  
EXCELLENT  
YEAR IN  
2017.”**

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## “THIS IS A BUSINESS WHICH RELIES ON VOLUME AND ECONOMIES OF SCALE.”

ments. But with the balance sheet remaining strong, with net cash of £11.8 million at the period end, the dividend was hiked by 0.1p to 10.2p per share. I should note that there is a modest pension liability of £7.1 million but the annual contribution of £0.65 million was easily covered by cash flow.

The company's focus is on the lower end of the footwear market, with target customers being in the C, D and E demographic groups. Additionally, complementary non-footwear ranges include handbags, school bags, lunch boxes, purses and accessories, although these only made up around 5% of revenues in the last financial year. Overall, the average transaction value was just £9.60 in 2017.

With such low prices, and gross margins of just 19%, this is a business which relies on volume and economies of scale to bring in the profits. In the Autumn/Winter 2014 season for example, an average of approximately 25,000 pairs of shoes per product style were ordered, with the company also keeping costs low by direct sourcing from factories and by maintaining a low product line count. The vast majority of its products are sourced from China.

### Flip Flop

Shoe Zone listed on AIM in May 2014, the company raising £36 million at a price of 160p per share with all proceeds going to a company controlled by the Smith family. However, following the sale, Anthony and Charles Smith retain a combined 50.01% holding in the business.

It hasn't all been plain sailing since the IPO. The shares plunged by almost 30% in one day in April 2015 after the company announced a profit

warning due to the dubious excuse of warm weather conditions resulting in more lower margin products, such as cheaper ankle boots, being sold. Then in early 2017 the weakening pound hit half year profits after making goods imported into the UK more expensive. However, results for the full 2017 financial year showed a good recovery.

For the 52 weeks to September 2017 revenues slipped slightly, by £2.1 million to £157.8 million, reflecting a strategy of closing loss making stores. While gross profits increased due to margins growing from 62% to 63.2%, pre-tax profits fell by 7.3%, largely as a result of the negative foreign exchange move-

Following the results CEO Nick Davis' wife spent £18,370 buying 11,000 shares in the company at a price of 167p each, with CFO Jonathan Fearn buying 350 at the same price, hardly breaking the bank with a £585 purchase.

### Sneaker investment?

At the current price of 166p shares in Shoe Zone are currently trading just 4% above the May 2014 IPO price, with the company capitalised at £83 million. Both revenue and profit trends have been modestly negative over the past few years, so the company can hardly be described as a growth stock. But





what is attractive about Shoe Zone is that earnings now look to be stabilising and that net operational cashflow delivered by the business has been consistently strong.

Consensus market forecasts for the current year to September 2018 see earnings rising from 15.8p in 2017 to 16.55p and then to 17p in 2019. That puts the shares on respective earnings multiples of 10 times and 9.8 times. While that looks relatively cheap, I believe that an income-based method is a more relevant way to value the business as the company's consistent dividend payment gives the shares an annuity like characteristic. The recent strategy has been to pay out c.60-65% of post-tax earnings as a normal dividend, an approach which should continue given the large director stake.

With a 10.55p dividend being pencilled in for 2018 the shares currently yield a decent 6.36%. However, I believe that a 5% yield would be more appropriate given the cash generative nature of the business, implying a share price of 211p. That's 27% upside from the current price. I also point out that in 2017 the company's free cashflow yield (surplus net operating cash after capex, divided by the market cap) was an impressive 7%. This provides ample opportunity to make special dividend payments, as the company did for 2016. Any surplus cash above £11 million, a figure the board believes is

required for the business to operate effectively, will potentially be considered for a special distribution.

## HARVEY NASH

Recruitment stocks are well known for being exposed to cyclical changes in the wider economy, with their earnings being driven by fees earned on placing new employees with employers. So the best time to buy them is surely at the bottom of the economic cycle. However, despite the UK economy doing fairly well right now, growing by a better than expected 0.5% in the final quarter of 2017, AIM listed recruiter **Harvey Nash (LON:HVN)** continues to command a low valuation, with it having the added bonus of a sector leading dividend yield.

Founded in 1988 and originally listing on the LSE in 1997, Harvey Nash is a global recruitment business with a focus on technology and digital talent recruitment. It has expanded around the world over its existence and currently operates from 39 offices across Europe,

the US and Asia Pacific where it helps clients to find candidates to fill technology related roles. The company's vision is to be Europe's market-leading technology and digital talent provider, supported by "challenger" businesses in the US and Asia.

The current strategy is focussed on taking advantage of the growing demand for executive and technology recruitment, with 80% of clients now being in the fast-growing technology sector. According to specialist recruitment website Recruitment Buzz, IT and Technology is its number one recruitment sector for growth in 2018, with the market being driven by a shortage of appropriately qualified professionals and the acceleration of investment in technology by businesses.

Complementary acquisitions are being considered for further growth and to help speed things up in this respect the company moved from the Main Market of the LSE to AIM in July 2017 – regulations covering acquisitions are less onerous on the junior market. Harvey

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**“THE COMPANY’S VISION IS TO BE EUROPE’S MARKET-LEADING TECHNOLOGY AND DIGITAL TALENT PROVIDER.”**

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Nash is also currently undergoing a programme to streamline the business and reduce costs.

### Hire revenues

Back in September Harvey Nash delivered a decent set of numbers to the markets reporting that revenues had grown by 12.6% to £425.3 million in the six months to July 2017. Pre-tax profits grew by 16.8% to £4.4 million, with earnings up by a more pronounced 25% at 4.47p per share as the effective tax charge fell from 31.3% to 26.5%.

Across the operations, a "challenging" UK market saw gross profits (also known as net fee income) in the UK &

Ireland business slip by 1.2% to £18.2 million after a slowdown in permanent hiring in the UK during the election period affected margins. Offsetting this, net fee income grew by 9.2% to £19.4 million in Mainland Europe after record results in Benelux offset a 23% fall in the larger Swiss operations. Finally, in the Rest of the World segment net fee income fell by 4.4% to £10.6 million but operating profits rose by 21% (albeit from a low base) to £81,000.

The company was optimistic about the second half stating that it was, *"well positioned to capitalise further on market opportunities as they arise and confident about the outlook for the remainder of the year."*



**“THE SHARES YIELD A HEALTHY 5.25%.”**



### Recruit the shares?

Shares in Harvey Nash have done quite well over the past 18 months or so, rising from a low of 52.5p in June 2016 to the current 86.7p. For the current financial year to January 2019 market consensus forecasts are for earnings of around 13.25p, putting the shares on a multiple of just 6.5 times. That makes Harvey Nash one of the lowest valued recruitment companies listed in London. Additionally, with a 4.55p dividend being pencilled in for the year, the shares yield a healthy 5.25% – that's at the top end of the wider peer group.

It looks as though the dividend is reasonably secure, with the forecast payment for 2019 being covered almost 3 times by forecast earnings. This is supported by a reasonably strong balance sheet which, at £10 million, has only a modest amount of net debt. In any case, net finance costs were covered 17 times by underlying operating profits in the first half of the last financial year, a position which is more than comfortable. Net assets amounted to £63.6 million as at 31st July 2017, almost identical to the current market cap of £63.7 million. However, if intangible assets are stripped out this falls to just £5.8 million.

There are some minor concerns, with an £11.6 million net cash outflow from operations in the first half being a worry. This was caused by trade and other receivables rising by £23.7 million, reflecting growth in contract services over the period. However, given that trading in the second half is expected to be stronger and that management have historically been good at keeping working capital tight, this position should reverse for the full year. Margins are also low, with gross margins being just 11% in the first half of FY2018 and net margins just 0.76%. The company's cost cutting ventures, which are expected to deliver savings of £2.2 million this year, should help in this respect, as should the broad geographical range of the operations.

With the markets being cautious over forecast growth rates here I believe that a positive trading update for the full 2018 financial year (usually released in late Feb/early March) should act as a catalyst to the share price.



## PALACE CAPITAL

Finally, value opportunities can frequently present themselves within the property sector, with the shares of quoted companies often trading at a discount to the value of their tangible, income producing assets. One such company currently trading at a discount to net asset value is AIM listed **Palace Capital (LON:PCA)**.

The company is a typical active property investor, with a focus on the secondary market outside London. Its strategy is to buy up attractive assets across a range of sectors in key regional UK towns and cities, enhancing recurring income through active asset management and generating capital growth through refurbishment and development opportunities.

Palace Capital was created in July 2010 when AIM listed Leo Insurance Services disposed of its assets and became a property focussed investing company. It made its first property purchase in 2011 but significantly expanded its operations in 2013 when it bought the "Sequel" portfolio, which consisted of 24 properties valued at a total of £44.2 million.

Reflecting the company's successful track record, the remaining Sequel

portfolio was valued at £66.9 million as at 31st March 2017, with seven properties having also been sold since acquisition at prices equal to or above book value. A number of further acquisitions and disposals have been made since then, with the current portfolio consisting of a mixture of retail, industrial, office, leisure and warehouse assets.

**“VALUE  
OPPORTUNITIES  
CAN FREQUENTLY  
PRESENT  
THEMSELVES  
WITHIN THE  
PROPERTY  
SECTOR.”**

In October last year Palace Capital completed a major acquisition, buying R.T. Warren (Investments) for a total cash consideration of £53.3 million. The deal brought with it a portfolio of 21 commercial properties, including office buildings, retail properties and industrial holdings, over 90% of which are located in the Home Counties. R.T.

Warren also owns 65 residential properties predominately located around the London Borough of Hillingdon, with Palace Capital intending to sell these assets by the end of summer 2018 subject to price and reinvest the proceeds in higher yielding assets.

As at 31st March 2017, R.T. Warren had net assets of £58.9 million, with the properties in the portfolio independently valued at £71.8 million. Rental income for the year ended 31st March 2017 was £3.6 million and profit after tax was £5.3 million. To finance the deal, described as being, *"the most exciting portfolio offered to Palace Capital for over 2 years"* the company raised £70 million before expenses in a controversial equity raise priced at 340p per share, a 12% discount to the previous day's closing price.

### Building value

Results for the six months to 30th September 2017 were good overall, showing pre-tax profits up by 26% at £4.9 million. The portfolio was independently valued at £202.8 million at the period end, with a contracted rent roll of £14.1 million per annum and a net income after property costs of £12.4 million per annum. The EPRA NAV per share increased by 1.8% to 451p per share although this figure is



now out of date due to the R.T. Warren acquisition and associated equity placing (see more below).

Early in 2018 the company arranged a new five-year £40 million facility with Barclays, allowing it to pay back some existing debt and provide further facilities for expansion. The loan carries a margin of 1.95% over LIBOR, further reducing the average cost of debt to below 3% and extending the average debt maturity to 4.7 years. As at 24th January the company had net debt of £84.2 million, representing a loan to value (LTV) net of cash of just 31%, a highly conservative figure within the overall property industry. In addition, Palace now has combined facilities of £115.4 million, providing significant capacity for further acquisitions.

### Safe as houses?

The recent equity raise was highly dilutive to Palace Capital shareholders, increasing the number of shares in issue by 81%. Arguably, this has destroyed quite a lot of value for shareholders given an associated reduction of NAV per share. However, I believe there is an opportunity here for new investors.

Accounting for the recent deal, analysts at Edison forecast an EPRVA NAV of 392p for end March 2018. At the current price of 334p the shares therefore trade at a 15% discount. It should also be noted that this valuation does not include any upside potential from the acquired assets.

Palace Capital also has a highly attractive dividend policy. While it is not a Real Estate Investment Trust (REIT) it has consistently made generous distributions to shareholders, paying out over 80% of net earnings over the past few years. With a total payment of 19p expected for 2018 the current yield is 5.69%, with the company moving this year from making two annual payments to one every quarter.

I expect that the full year report, due around June, will reveal progress on the R.T. Warren portfolio and could act as a driver of the shares assuming progress has been made. What's more, a planned move from AIM to the premium listing segment of the Official List is expected this year and should help to attract a wider investor base.

## “PALACE CAPITAL ALSO HAS A HIGHLY ATTRACTIVE DIVIDEND POLICY.”



### 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

# HOW TO STICK WITH WINNING INVESTMENTS

**It's market cliché time again. The key to success in the stock market, whether as a trader or investor, is to let your winners run and cut your losses quickly. This always sounds so easy of course, but both sides of that coin can be difficult to achieve in the real world when actual money is involved. I've written a little about how charts can be used to get out of a loser before too much damage is done but this time around let's look at just how we can use charts to squeeze as much profit as possible out of a position that continues to go in our favour.**

### The importance of not snatching at profits

Many new investors have something of a love/hate relationship with their shares. It's not uncommon to feel that your investments have a personality – one that is continually trying to confound you! And profitable positions can be a problem too. Let's say our investor has £1,000 invested in ABC shares. It has moved higher by 10% since she purchased them. She is feeling pretty good – until the next day when it drops back 5%. Now she is worried that the evil market is going to take her hard-earned profits away. The temptation may be to sell out and bank the money before the share price slips back to where she purchased it – or even lower, leaving her with a loss. This knee-jerk reactive way of deciding when to get out really doesn't have a place in a sensible and disciplined approach to investing.

There was a study done a few years ago by a foreign exchange broker, looking at millions of trades done

by its clients. The unequivocal result from this (apart from of course that most people lose) was that we are very bad at managing both winning and losing positions. The average losing trade was twice the size of the average winner. So, every time the trader made £100, the losing trade would lose almost £200. This is not a recipe for success when it comes to investing or trading. Let's look at some ways to try to install a more regimented process.

### Don't be in a hurry to move the stop loss

If you are a sensible investor or trader, you probably have some sort of stop loss (mental or otherwise) in mind when you buy into a share. You buy into XYZ and decide if it drops by, for example, 15%, then you will take the manageable loss and sell out. So far so good. But the temptation can be, if XYZ starts moving in your favour, to move the stop loss too quickly. Let's say the share rises by 5% – some might decide to move the stop to a breakeven position –

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**“WE CAN USE CHARTS TO SQUEEZE AS MUCH PROFIT AS POSSIBLE OUT OF A POSITION THAT CONTINUES TO GO IN OUR FAVOUR.”**

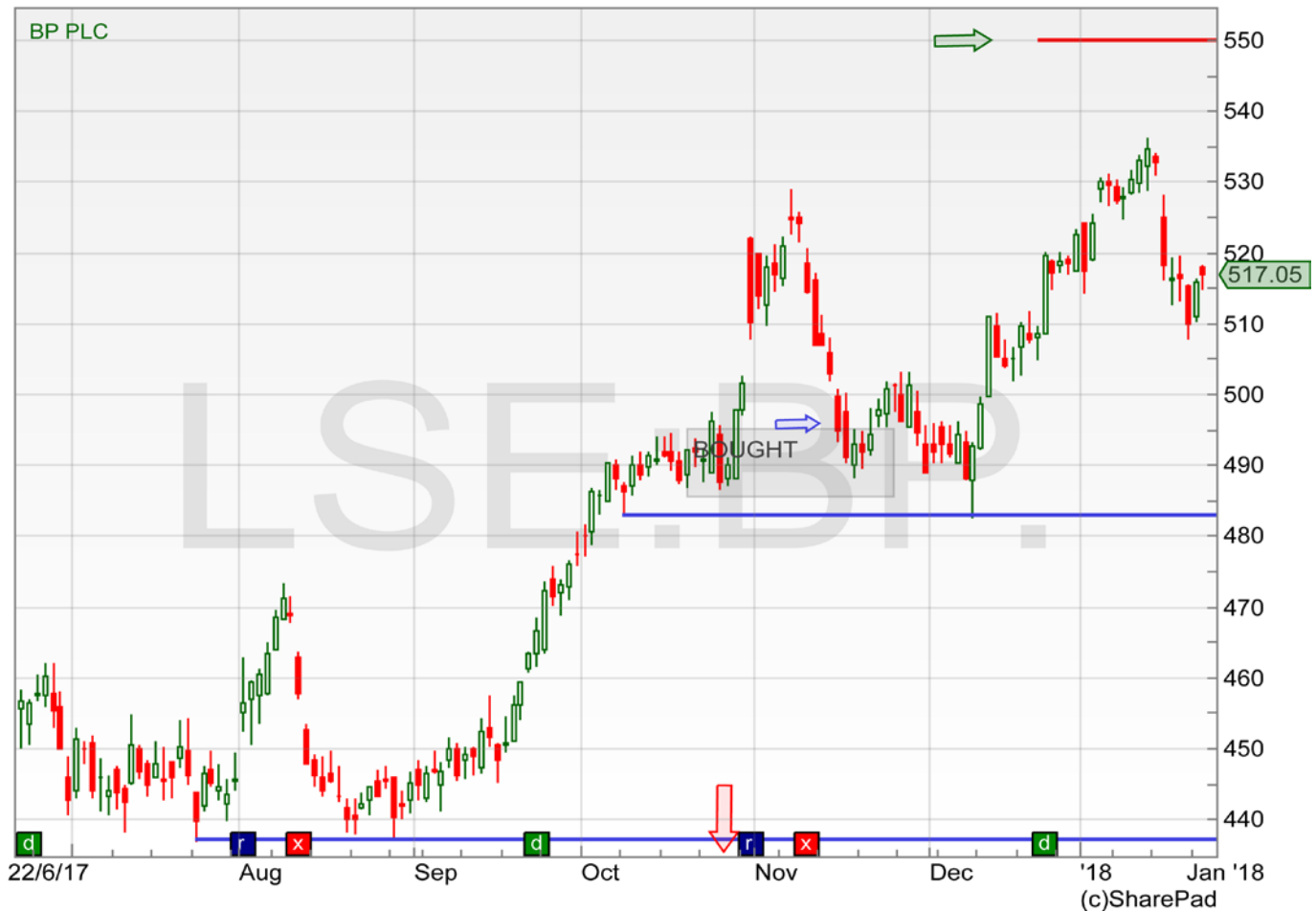
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where they bought in. This is plain illogical. In the beginning you were willing to risk losing 15% – but now you are looking to lock into the position just because it has made 5%. An easy rule of thumb is the share (or whatever other market it is) must move at least the amount of your initial stop loss before you consider moving the stop. So, in this example, you can't move it to breakeven until XYZ has risen by at least 15%.

Here's an example below from one of my own investments.







## “SNATCHING AT PROFITS THAT ARE LESS THAN THE AMOUNT OF RISK TAKEN ON IN THE FIRST PLACE IS SELDOM A RECIPE FOR SUCCESS.”

I bought into **BP (LON:BP.)** last year around 490p. Based on the chart, I decided on a stop loss at 430p. There had been a lot of support ahead of here, so I reasoned if the BP price dipped below, then I was probably wrong in the view that the uptrend was going to continue, and it was time to take a manageable loss. So, my stop loss was 60p away from where I got in. Using the approach outlined above, the BP price needs to move at least 60p in my favour for me to consider moving the stop loss to where I bought it. BP needs to reach 550p to allow me to move the stop loss to my entry point of 490p. At the moment, at the time of writing, it's only got as high as 535p, so nothing has been done with the stop loss.

Of course, the drawback with this approach is that if the share price reverses from here then I am going to

give up all that profit and more. But to that I would say "so what?" I am trying to identify major trends. They are not all going to work out. And snatching at profits that are less than the amount of risk taken on in the first place is seldom a recipe for success.

This has covered the first stage of trying to run with winning investments or trades – giving them room to breathe and start moving. Let's take a look at the next step, if the share does start to move further in our favour.

### Don't get out on a whim

I think the 2016 US Presidential election is a good example of why we shouldn't just bail out of an investment on gut feel alone. The forecasts ahead of the vote were almost unanimous – if Donald Trump got in it would be bad for stock markets. There was a wobble on

results day but since then the broader US indices have risen – and continue to do so at the time of writing. Selling out on the wobble and having no strategy for getting back in again would have left a lot of money on the table.

We need to be more mechanical, again giving the investment enough room to go higher, with us still on board. The approach here is not vastly different to the first step above – now we employ a "trailing stop". Plenty of brokers will now do this automatically, but it is not hard to do it the old-fashioned way. Let's take the BP example above. Assuming it hits 550p, the stop loss will now be at 490p. If it moves another 10p, to 560p then the stop loss gets moved to 500p. Every time the market moves up, the stop loss gets moved too. If the market falls, then the stop loss stays where it is. It's only when new highs are made since you have been in the investment (assuming you had bought) that the stop gets moved. I will show another real example of this, a US share – one of my best performers over the past 15 months, although there was no way of knowing that's how it was going to turn out at the beginning.





I bought into **Verisign (NASDAQ: VRSN)** at \$76, with a stop just below \$66, meaning the share price needed to move to at least \$86 for me to move the stop to break-even. This

took a while to happen but eventually did. And then the share price started moving. All I have done is every time it has made a new high I have moved my stop – so it is just over \$10 below

the recent high. The trend has been so strong that it hasn't dropped back –\$10 from the highs. The most recent high is at \$118 so my stop – to take profits – is currently at \$108.



Of course, there is no way of knowing how high an investment will go but trailing a stop is a sure-fire way of letting your winners run with minimal maintenance – and eliminating the emotional aspect of when to take profits on an investment.

**“TRAILING A STOP IS A SURE-FIRE WAY OF LETTING YOUR WINNERS RUN WITH MINIMAL MAINTENANCE – AND ELIMINATING THE EMOTIONAL ASPECT OF WHEN TO TAKE PROFITS ON AN INVESTMENT.”**

## Chart of the Month

As I have mentioned the performance of the US stock market, I thought our chart of the month should be the broader US stock market, the S&P500. Now, as a UK investor you may ask why this is important. A couple of reasons: The rest of the world follows the US, so I would suggest it is the *most* important stock market out there. And secondly, it is easy to get exposure to this markets via UK listed products such as ETFs which just track the index. Here's the chart.



This is a really simplistic chart. It goes back a couple of years to early 2016 and shows the trend since then and a couple of moving averages – the blue is the 200 day and the red is the 50 day.

This is market that continues to defy gravity – and bearish calls for a top, or a crash, or even any sort of meaningful correction. The trend is your friend in this market – and it is undeniably up. Any weakness brings the buyers back in very quickly. Admittedly, it is an old bull market now – the lows were put in during the financial crisis in March 2009. But, with the trendline coming in around the 2550 mark, even a 10% drop in US stock markets would just be viewed as a buying opportunity.

### 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.



# Youth may be wasted on the young, but it's an investible commodity in the hands of the wise.

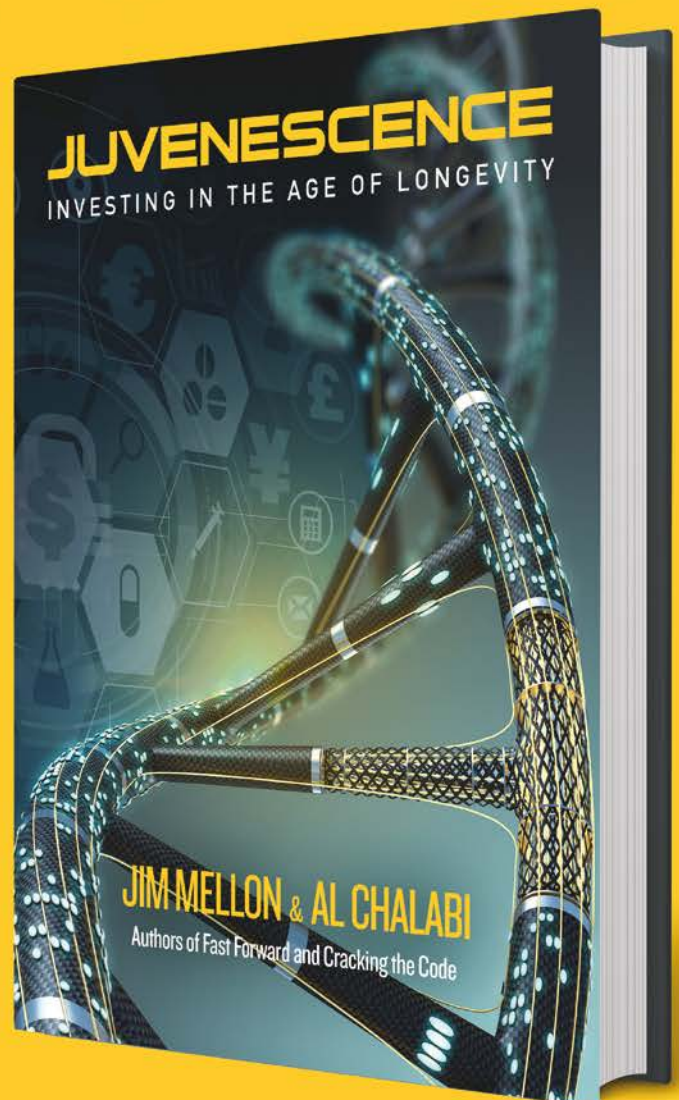
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BY ALAN STEEL

## DEATH & TAXES

# HOW TO CREATE ORDER FROM CHAOS THROUGH FINANCIAL PLANNING

**Have you noticed that survey after survey shows that most people in the UK are desperately unprepared financially for retirement? That the gap between those who are prepared and those who aren't is widening? That increasing numbers are losing their savings, especially their pension pots, to scammers and conmen? That recent evidence highlights the majority of investors still chase performance, following what's popular, not learning the lessons of the past? And despite the chaos that follows those who die intestate (without a will) it's still the case that around half of UK adults don't bother having one? Why, oh why?**

All this chaos has transpired in spite of 30 years of financial regulation designed to protect savers, but which has failed miserably. Chaos, despite a myriad of increasing "advice" columns in the national press and social media, written by a revolving crew of young journalists with no money or experience, and who compete with one another for "shock horror" stories and media awards. Chaos, assisted by successive governments tinkering year after year with never-ending tax changes and broken promises. There is another way – which I shall deal with later – but first, let's review how we got into this mess.

### Early signs of madness?

Forty-five years ago last month I left the job security of a "big" life assurance company to become an

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**“THOSE TRYING TO INVEST OR SAVE FOR THEIR LATER YEARS HAVE TO CONTEND WITH AN INCREASINGLY BEWILDERING ARRAY OF INVESTMENT CHOICES AND PRODUCTS.”**

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Independent Financial Advisor in a small firm in the Scottish Borders. My mother thought I was daft. Not to worry though, for I was all of 25, had spent three and a half years as a Trainee Actuary, and dabbled in

Training, Job Evaluation and O&M (Observations & Measurement) so I knew practically everything. Two years later I started my own business, Alan Steel Asset Management (ASAM). Blind faith? Or early signs of madness?

Incidentally the "big" life assurance company (or to give it its proper description a "life assurance society", for it was a mutual established in Victorian times and owned (theoretically) by its policyholders) went bust many years ago, whereas the small firm in the back of beyond is still going strong. As is ASAM. (Touch wood!)

Anybody remember the advice from generations of personal finance "expert" journos to save only with mutuals, especially their favourite one, that "nice n cheap" Equitable

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**“THANKS TO CONSTANT  
INTERFERENCE AND BROKEN  
PROMISES, PENSIONS ARE A  
DOG’S DINNER.”**

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Life? It went belly up 18 years ago and most mutuals followed suit one way or other. As did another one of their favourites, the "safe as a Volvo" Split-Cap Investment Trusts. Oops.

Forty-five years ago in March, UK Pensions legislation was turned on its head when in the 1973 Finance Act shareholding (controlling) directors of SMEs, or family companies as they were known then, were for the first time given the same pension rights as PLC employees. I'll spare you the complicated details but it was a game changer for those affected. And it turned effective financial and tax planning on its head.

Since then the bloody taxman, or HMRC as they're known these days, has introduced hundreds of tax changes, affecting taxes on earned income, investment income, capital gains, gifting, trusts, pension laws, and death, with perhaps the most confusing changes directed at private pensions. As for the latter, there were 300 major changes alone between 1997 and 2005, and that's before they dreamt up the utter disasters of Lifetime Allowance and Pensions Freedom. Today, thanks to constant interference and broken promises, pensions are a dog's dinner as my grannie would have opined. No wonder so many people fall for sweet-talking scammers.

If all that wasn't bad enough, those trying to invest or save for their later years have to contend with an increasingly bewildering array of investment choices and products, and are subject to a barrage of 24/7 opinion and noise from all sides by "experts" in a social media explosion, where fear trumps balance, quantity trumps quality, and "reporters" are chosen for their looks and shiny teeth rather than knowledge or experience.

### A dog's dinner

Consider why so much in the UK sits wasting away in cash earning nada, as I reported last month. Apart from the £270 billion fermenting away in Cash ISAs, and £355 billion in bank accounts (as at Sept 2017) being quietly eroded by inflation, there's another £150 billion in National Savings, the vast bulk of which sits in Premium Bonds. Premium Bonds? What does that say



**“THERE ARE FEWER THAN 300 WORDS IN THE TEN COMMANDMENTS. GOOD JOB THERE WERE NO REGULATORS IN THOSE DAYS!”**

about the way savers think? You stick away hard earned after-tax income into a plan that gives you no return, unless of course Ernie picks out your number at random from a few billion others.

Mind you, that didn't stop a Daily Telegraph Personal Finance "expert" in a main Money piece exactly three years ago advising readers to put the maximum they could into Premium Bonds rather than invest in "stocks and shares" ISAs, because in his opinion the stock market was "overvalued". Guess how many FTSE 100 all-time highs there have been since. 36! But as experienced investment managers like Terry Smith would ask, "why stick to the UK market when so many opportunities lie elsewhere in the world?" Any idea how many times the Dow Jones index has closed on a new all-time high in the last five years? 197! Yes, really.

Consider also the annual US Dalbar Survey findings over the last 30-odd years. The investment returns of private investors over varying time periods show that their returns in equities *and* bonds drag substantially behind

index returns. And I mean substantially. 4% per annum net as opposed to 9% per annum from the S&P 500 index is one hell of a difference, believe me. The former doubles your investment every 18 years; the latter does it in every eight!

As for those talking heads on telly who see Armageddon around every corner, a recent spat between economist Dr Ed Yardeni and CNBC didn't go down well with their "anchors" when Ed reminded them that despite their 58 panic attacks since March 2009 the secular bull market was still intact and continuing to deliver positive returns.

Meanwhile the savings industry here in the UK has been regulated by an FCA increasingly obsessed with ever more regulation. Only four years ago their RDR (Retail Distribution Review), which was supposed to help investors, has actually led to increased charges. To increase transparency, we now have "MiFID II" (don't ask!) with only 1.7 million paragraphs. No kidding. There are fewer than 300 words in the Ten Commandments. Good job there were no regulators in those days!



It gets worse. There are now more than 70 times as many stock market indices as there are quoted stocks in the world. According to the World Bank there are around 43,000 public companies but 3.28 million Indices. Eh? Madness or what?

So is it any surprise that so many savers these days are confused? New clients are coming to us looking for someone to trust. Someone that can create order out of their chaos. Someone to explain in simple words what they actually have and how to make it simpler and better.

Usually they turn up with an unstructured pile of disparate investments, savings plans and a mess of pension plans collected over years of employment. Hieroglyphics from old Final Salary Schemes, the odd Section 32 Buy-Out, private plans from periods of self-employment etc. Old single-premium investment bonds stuffed with charges, far too much in deposits, bits and bobs of shares or funds they bought on tips ages ago. Can't remember why. And when you ask what they're trying to achieve with all this, they look at you in quiet despair.

## Time to change

But even if your finances are a dog's dinner you can only fix things if you are open to change. As I learned thirty years ago in a workshop with a chap

called Dr David Cormack, a former Head of Training at Shell, who was an expert on Change, there are only two ways to change someone. Either give them a frontal lobotomy or help them to want to change. And the only way you can do that is to create disquiet. No disquiet, no desire for change. Simple.

Presumably as readers of Master Investor you are pretty clued up on money. So you've maximised your pension pots, and your investment ISAs, carefully selected good value shares using a tried and tested process, and made sure you aren't paying more taxes than you need. Let's check.

Now what's the worst thing that could happen to you today? You could die. And if that happened, how organised are your financial affairs? If you have a partner or family, what are you leaving them with? Everything well organised and simple? Or a bit of a shambles? Do you have a will? If you haven't, have you any idea of the mess and extra pain (and costs) you are leaving behind? If you have a will, when was it last looked at? Is it still effective?

What will happen to your pension pots? Who gets what? Are you sure? Are they protected by Trust? When was the last time you reconsidered the wordings? Did you have them rewritten since Pensions Freedom changes? Do you understand the question?

Is there any debt? Mortgages? What happens to them? Are they paid off with life cover? Are you certain about that? So the policies are written in trust? If you're married and have a wife, is her credit card an extension of yours? If so she could be struggling for cash or credit. And how is your partner going to survive financially if you were the breadwinner and the assets are in

limbo for at least six months and often much longer?

On the assumption you're not going to snuff it today, let's check your goals for the future. Are you aiming for financial independence? What age would you be then? If you were that age today what would that look like in terms of net disposable income in today's money? Are you on target? What do you mean you've no idea?

How have your pension plans and investments done over the last year? How about over the last five years? How do you choose the shares or funds? Any laggards? Why do you have so much sitting earning nothing in Cash ISAs and deposits? Doesn't it make sense to ensure all your finances are firing on all cylinders? And doesn't it make sense to have at least an annual financial MOT?

David Cormack introduced me to the change formula. It changed my thinking (if you forgive the pun). And as a result it changed the financial effectiveness of hundreds of my clients. It's quite a simple wee formula:

**C=D+V+F+E** – Where C stands for CHANGE, D for DISQUIET, V for VISION, F for FIRST STEPS, and E for ENERGY

So, if you fancy a fresh look at how you're doing, go see an experienced financial advisor, who will ask the questions to check for disquiet, explain how easy it is to fix the problem by taking responsibility, and then provide the ongoing energy, year after year, to keep you on target. Otherwise as you're probably aware, you'll simply slip into the old bad habits all over again. Good luck.

## About Alan

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

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





BY FILIPE R. COSTA

HOW TO INVEST LIKE...

# RICHARD DRIEHAUS

## BUY HIGH AND SELL EVEN HIGHER

***"I would much rather invest in a stock that's increasing in price and take the risk that it may begin to decline than invest in a stock that's already in a decline and try to guess when it will turn around."***

— Richard Driehaus

Most investors reviewed by this column seek out cheap, undervalued equities, which have the highest odds of recovering and generate substantial profits. The aim is often to uncover value before others do, to then invest and wait for others to follow. Under such a scenario, value investing often becomes contrarian investing, in the sense that it opposes the herd. But opposing the herd is a risky business, as we never know when sentiment is going to mean-revert. When bad news spreads, equities are battered down and sometimes become fundamentally cheap due to humans' propensity for overreaction. Sentiment regarding such equities is low and may remain at low levels for prolonged periods of time. Value investing is a lonely play against the herd. It takes time, patience and money.

But if stocks remain undervalued for long periods of time, they can also remain highly valued for equally long periods. Given that there is a positive bias in stock prices, as the market tends to rise over time, stocks generally remain highly valued for longer periods than they remain undervalued. There are periods when sentiment remains so elevated for so long that investors are better off following the trend instead of opposing it. The dotcom bubble lasted for at least five years between 1995 and 2000 before investors, as a group, realised how foolish prices were. The US housing bubble was even more prolonged, with sentiment pushing prices higher between 1997 and 2006. Market irrationality will always lead to a crash or price deflation at some point, but in the meantime, it pays to follow the trend rather than oppose it. At least,

that is the reasoning behind Richard Driehaus, the man referred to as the "father of momentum investing". The common Wall Street adage urging investors to "buy low and sell high" is replaced by the observation that "far more money is made buying high and selling at even higher prices".

### From coins to stocks

Richard Driehaus was born in 1942 in Chicago. Having graduated in 1965 and completing his master's degree in 1970 at DePaul University, Driehaus started working as a research assistant at a local broker. His interest in the stock market started years earlier, during a failed attempt at making money out of two stocks he purchased. While still young, he turned into a coin collector. When he had enough money, he



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“DRIEHAUS WAS  
NOT INTERESTED  
IN BUYING CHEAP.  
RATHER, HE  
WANTED TO RIDE  
POSITIVE TRENDS  
IN COMPANIES  
WITH HUGE SALES  
AND EARNINGS  
POTENTIAL.”

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**TABLE 1 – DRIEHAUS CAPITAL – PORTFOLIO HOLDINGS AT 30/SEP/2017**

No.	Security	Ticker	Shares	Value (x\$1000)	% Port
1	Alibaba Group Holding	BABA	887,688	\$153,313	5.97
2	H D F C Bank	HDB	1,012,691	\$97,593	3.80
3	Taiwan Semiconductor Mfg	TSM	2,150,931	\$80,767	3.14
4	N X P Semiconductors	NXPI	613,481	\$69,379	2.70
5	Tivo Corp		2,334,220	\$46,334	1.80
6	Loxo Oncology Inc.	LOXO	409,536	\$37,726	1.47
7	Gaming & Leisure Properties Inc.	GLPI	1,003,700	\$37,026	1.44
8	Microchip Technology IncBOND	MCHP	20,700,000	\$36,122	1.40
9	Petroleo Brasileiro Sa Petrobras	PBR	3,224,962	\$32,379	1.26
10	Credicorp Ltd	BAP	156,199	\$32,024	1.24

Source: SEC, 13F filings

**“WHILE CONTRARIAN INVESTORS OPPOSE THE HERD BY ENTERING THE MARKET BEFORE ALL OTHERS DO AND WAIT FOR SENTIMENT TO IMPROVE, MOMENTUM INVESTORS FAVOUR THE TREND, LEAVING THE MARKET BEFORE EVERYONE ELSE AS SOON AS SENTIMENT DETERIORATES.”**

decided to jump into the stock market. He then bought two equities: one more conservative (Union Tank Car Company) and another more aggressive (Sperry Rand). In the end, neither performed well, and he realised that there was more than plain randomness in the market. He then spent time reading books, newspapers and whatever he could find at the local library about investment. He even subscribed to a few investment newsletters. One of those, "America's Fastest Growing Companies", written by John Herrold, changed his mind about investing. Some of Herrold's recommendations had gone up several thousand percent, in particular companies with high sales and earnings growth. This observation focused his attention on growth companies. He was going to develop a way of capturing this growth, while minimising the risks of entering too soon.

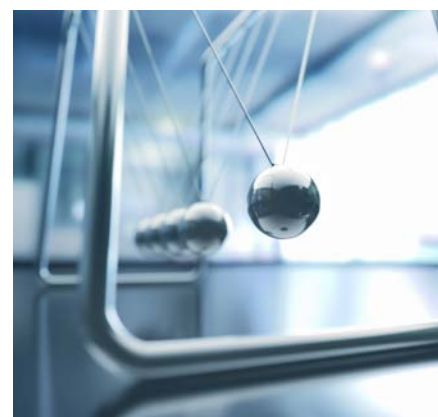
Driehaus was not interested in buying cheap. Rather, he wanted to ride positive trends in companies with huge sales and earnings potential. Not willing to wait for reversion in sentiment, he instead wanted to ride momentum until the first warning signal arrived. Then he would sell. Driehaus' strategy

was based on riding trends and capturing momentum. While the strategy has been traced back to Richard Donchian<sup>1</sup>, it was Driehaus who adopted and implemented it systematically.

Before setting up his own shop, Driehaus spent some time developing his skills. After his stint at a local broker, he worked in research and money management at A.G. Becker & Co. between 1968 and 1973. In 1973 he became director of research at Mullaney, Wells & Co. Later, in 1976, he jumped ship to Jesup & Lamont to become director of research and money manager. In 1979 he set up his own business – Driehaus Securities – a research broker providing ideas to a select group of accounts. In 1980, he founded Driehaus Securities LLC and in 1982 he founded Driehaus Capital Management LLC, a company for which he still serves as chief investment officer and chairman.

### The momentum strategy

Equity prices depend on many factors, which include not only fundamentals but also the emotions of stock market participants. Economic performance is cyclical. There are periods when



the economy is growing and others when it isn't. Fundamental factors alone are enough to create waves in the stock market. But these waves are exacerbated by the influence of psychological and emotional factors. When economic performance is good, businessmen become more confident about the future and hire more workers. With a better job, or the prospects of finding one, workers become more confident, and are willing to increase their expenditure. Consumption, credit and optimism all rise. Consumer and business sentiment both amplify current economic conditions. The equity market is just one part of that reality and is highly exposed to sentiment.

Both value/contrarian investing and momentum investing aim to exploit the herd – they just differ in the perspective taken. While contrarian investors oppose the herd by entering the market before all others do and wait for sentiment to improve, momentum investors favour the trend, leaving the market before everyone else as soon as sentiment deteriorates. Momentum investors like Driehaus are much more "nervous" regarding market action than value investors are. They like to ride the positive sentiment while it lasts, selling the losers early and reinvesting the money in other places that enjoy better momentum. Unlike value investing, which thrives on sentiment reversion, momentum dies at the first signs of reversion. Value investors incur the risk of entering a market too soon, at a time when sentiment and price are still deteriorating. Conversely, momentum investors incur the risk of entering too late, at a time when sentiment is already reverting. Momentum investors often explore behavioural bias like herd behaviour, conservatism bias and the disposition effect (see box 1).

## Momentum as an investment factor

Narasimhan Jegadeesh and Sheridan Titman<sup>ii</sup> are among the first to document scientifically that there is a persistent momentum factor in the stock market. In a paper written in 1993, they conclude that stocks that perform the best (worst) over a three to twelve-month period tend to continue to perform well (poorly) over the subsequent three to twelve months. Strategies exploiting the phenomenon have been consistently profitable over time. In more recent studies, the momentum effect has been confirmed. Jegadeesh and Titman report that momentum profits out of the simplest of strategies, which consists of ranking past winners (losers), picking the best (worst) and keeping them for a period of time. But Driehaus goes the extra mile, as he only

picks past winners with a confirmed record of earnings increases and which show potential for further growth. His strategy, reviewed in the next section, requires a little more than looking at a list of 52-week highs and lows.

## Momentum investment strategy

In order to build a momentum portfolio, the first thing to keep in mind is that we are willing to capture price movement that has already initiated. As explained above, Jegadeesh and Titman just picked up the best price performers for a time window. But in order to replicate Driehaus' ideas, we need to do more than simply filter stocks by past performance. Driehaus focuses on earnings growth and improvements over time. This last part is key, because for these strategies to work, investors must get rid of any assets showing the slightest weakness.

While there are many ways we could define a momentum strategy, here is Driehaus' approach defined in a very simple plan, divided into four steps:

### 1. Market capitalisation between £150 million and £600 million

We begin by filtering an initial list of stocks by market capitalisation. The lower bound is needed to avoid illiquid stocks. There is no definitive cut-off and investors should adapt it according to the market under consideration and portfolio restrictions. Regarding the upper limit, it is not really needed, but results have been shown to be better for smaller capitalisations.

### 2. Earnings must have grown in each of the last three years

Here we impose three conditions. Earnings growth must be positive between t-3 and t-2, t-2 and t-1, and t-1 and t. Using a longer period

## Box 1 – More about behavioural bias

One of the main reasons why stock prices deviate from fundamental values is the existence of behavioural bias. While the full list includes dozens of different biases<sup>iii</sup>, some of the most frequent biases that have been mentioned to explain momentum profits are:

### Conservatism bias

Investors tend to underweight new information. When presented with new developments regarding a stock, investors only partly revise their expectations. When this happens, prices will only slowly adjust to information. This bias is connected with under-reaction.

### Disposition effect

Tendency of investors to hold on to their past losers and sell the winners. This means that investors cut gains fast and allow losses to grow. The weighting given to losses is significantly higher than the weighting given to winnings.

### Herd behaviour

Tendency of investors to follow the actions of others, joining the crowd in a rush to get in or out of the market. When herding is significant, optimism rises too much, leading stock prices to deviate substantially from fundamentals.

would exclude nascent companies. At the same time, a period of three years seems enough to discern a pattern of sustained increases in earnings.

### 3. Earnings must be growing above industry median

Sometimes, more important than having positive earnings is to evaluate how positive they are in relative terms. If the whole economy is growing fast, more companies are expected to be doing well. By requiring earnings to be growing above the industry median during the last twelve months, we put earnings

**“DRIEHAUS GOES THE EXTRA MILE, AS HE ONLY PICKS PAST WINNERS WITH A CONFIRMED RECORD OF EARNINGS INCREASES AND WHICH SHOW POTENTIAL FOR FURTHER GROWTH.”**





TABLE 2 – MOMENTUM STRATEGY EXAMPLE – LONDON STOCK EXCHANGE SHARES

Ticker	Asset	Industry	Market Cap. (£m)	Rel. Strength to index (3m)	Rel. Strength to index (6m)	Current EPS %chg	1y ago EPS %chg	2y ago EPS %chg
BOOT	Boot (Henry)	Industrials	£455.7	1.5	9.9	20.5	9.9	90.5
CLG	Clipper Logistics	Industrials	£466.8	4.0	2.6	21.5	27.3	54.1
CRW	Craneware	Technology	£475.8	7.9	33.5	40.1	22.1	15.6
DOTD	Dotdigital Group	Technology	£292.9	13.8	34.2	30.6	13.7	35.3
TUNE	Focusrite	Consumer Goods	£211.2	37.2	10.4	27.3	10.7	10.8
GAMA	Gamma Communications	Telecommunications	£643.7	14.0	2.5	38.8	17.7	16.2
BOWL	Hollywood Bowl Group	Consumer Services	£309.0	10.0	25.5	128.5	112.7	439.6
IPX	IMPAX Asset Man. Group	Financials	£220.4	10.2	65.1	94.6	16.8	13.4
NUM	Numis Corporation	Financials	£358.0	9.1	34.5	15.5	21.9	6.9
CAKE	Patisserie Holdings	Consumer Services	£388.0	9.3	6.7	19.1	20.1	2.0
RWA	Robert Walters	Industrials	£501.5	10.0	45.0	34.1	36.6	75.4
TRI	Trifast	Industrials	£298.9	12.6	8.5	17.3	13.4	33.2
XLM	XLMedia	Consumer Services	£442.9	22.8	42.2	38.5	107.3	6.0

Source: Sharescope

into relative terms. Note that we are using the median instead of the average for a reason. If there is some extreme result in earnings, the average is distorted while the median stays the same.

#### 4. Relative strength for the last three and six months is positive

Unlike value investing, momentum looks at a trend that is already underway. A stock may present an excellent investment opportunity because it is cheap by some metric, whether that be a price ratio or a growth expectation, but if price action isn't already trending higher, there is no investment case. Here we require that the price change relative to a broad index or an industry index is positive for the last three months and for the last six months.

After applying the above selection process to shares from the London Stock Exchange, a list of 15 stocks is obtained. After filtering out two investment trusts, the final list is provided in table 2.

While momentum is a valuable strategy that can be easily implemented, it should be noted that it comes with a few issues to consider. Momentum strategies have a high turnover when compared with contrarian strategies. Investors need to rebalance their portfolios regularly and monitor their holdings for any news announcements. Driehaus often mentioned in interviews that at the first sign of declining future growth he would sell. The sign



## MOMENTUM STRATEGY

- 1

### MARKET CAPITALISATION

Market capitalisation should be between £150m and £600m.
- 2

### EARNINGS PERSISTENCE

Earnings growth for current year, last year and previous year should be positive.
- 3

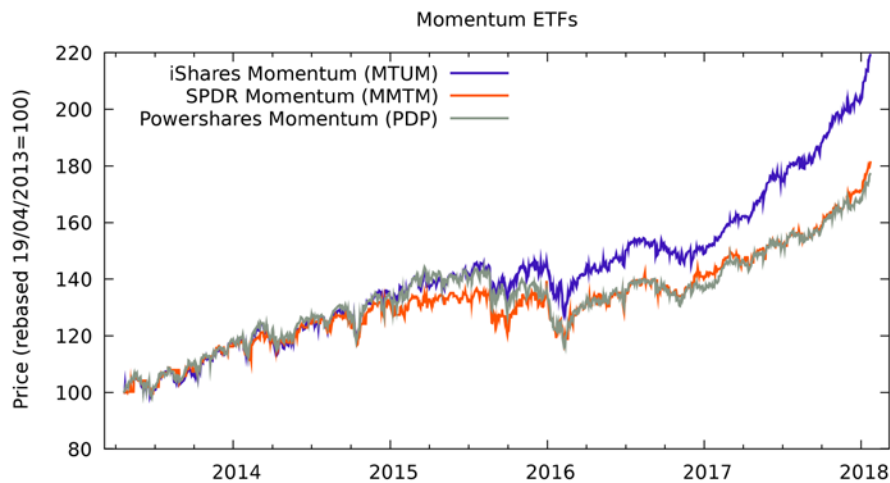
### EARNINGS ABOVE MEDIAN

Earnings growth should be above industry's median.
- 4

### RELATIVE STRENGTH

Price should be rising more than a broad or industry specific index for the last 3 and 6 months.

BASED IN RICHARD DRIEHAUS STRATEGY



#### Portfolio ETF (NASDAQ:PDP)

- SPDR S&P 1500 Momentum Tilt ETF (NYSEARCA:MMTM)
- MomentumShares U.S. Quantitative Momentum ETF (BATS:QMOM)

While these ETFs offer exposure to the momentum factor, they don't mirror Driehaus' strategy. Firstly, momentum is more significant for micro and small capitalisations. With large amounts of capital under management, these ETFs just can't get exposure to some of these companies without being exposed to severe liquidity risk. Secondly, momentum is not just about relative strength; it's also about earnings growth translated into upward price movement.

### The "father of momentum investing"

Driehaus was the first to apply a momentum strategy in a systematic way to stock selection, at a time when academics had no clue about it. But more than 20 years after being reported as a profitable strategy, it continues to deliver high profits, particularly when combined with a growth outlook. But the strategy is not suitable for all investors. The time horizons are much shorter than for value investing, requiring a lot more dedication. Turnover is also larger, which increases transaction costs. Additionally, it only works when there is some degree of herding in the market, which means the strategy may undergo periods of significant underperformance. That said, if investors recognise all the drawbacks, the strategy can lead to excellent returns over time.

## “FOR THESE STRATEGIES TO WORK, INVESTORS MUST GET RID OF ANY ASSETS SHOWING THE SLIGHTEST WEAKNESS.”

could come in the form of a profit warning, an earnings report or any other source. That means Driehaus complements a quantitative approach with a close monitoring of portfolio holdings. Not all investors are willing to spend the required time for the strategy to work. The high turnover also comes with larger transaction costs. Investors need to carefully evaluate how significant they may be.

Another important point to consider (perhaps the most important of all), is that momentum doesn't always work as an investment strategy. The main reason is that, as a trend following strategy, it needs a trend or a herd. Herds do occur when the market is rising, but they tend to dissipate when markets decline. When optimism dissipates and there is a return to rational/fundamental values, herd behaviour declines, volatility increases, and momentum disappears. Under the current

market conditions, where volatility is at historic lows and the market has been rising for a long time, the momentum strategy works very well. But if volatility increases and there is a sudden correction, a momentum strategy is likely to underperform.

### Momentum as an investable asset

Recently, the funds industry decided to turn momentum into an investable asset. An investor willing to profit from momentum may just buy an ETF instead of picking individual stocks. These ETFs own a diverse mix of mid and large capitalisation stocks that are currently showing a high degree of relative strength. These funds, in general, follow quantitative selection criteria and change assets often. Examples of ETFs following momentum are:

- iShares Edge MSCI USA Momentum Factor ETF (BATS:MTUM)
- PowerShares DWA Momentum

#### 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 Richard Donchian was a commodities and futures trader living between 1905-1993. From the observation that commodities prices moved in long, sustained waves, he developed a trading system that followed trends in prices. He is often credited as the father of trend following and he is the predecessor of Driehaus' momentum strategy.
- ii Jegadeesh, Narasimhan, and Sheridan Titman; "Returns to buying winners and selling losers: Implications for stock market efficiency;" *The Journal of finance* 48.1 (1993): 65-91.
- iii See for example Kahneman, Daniel; *Thinking, fast and slow*; Macmillan, 2011.





BY DAVID JONES

## FORENSIC FOREX

# WILL 2018 BE THE YEAR OF THE DOLLAR TURNAROUND?

2017 was not a good year for the US dollar. In fact, it ended up being the worst in terms of performance for the US currency since 2003. There's a dollar index that measures its performance against a basket of other world currencies and last year this fell by around 10%. The euro has a significant weighting in this basket and a solid performance here added to the US dollar woes.

Even three interest rate rises by the US central bank, the Federal Reserve, had little effect in stopping the decline. Plus, there were so many other places attracting cash throughout last year – for example, the ongoing bull run in various stock markets sucked money in from global investors. The dollar is seen as something of a safe haven during times of trouble and market turbulence, and we just didn't really have any. All this has led

to something of a downbeat outlook for the US dollar again this year – but maybe that is being a little over-pessimistic. The likes of the pound and the euro have enjoyed a great run of strength in recent months against the greenback – the euro for example has rallied by around 5% just since the beginning of November. But there are other factors driving these markets, and it may be time for the rise to take a breather.







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**“IT SEEMS A LITTLE  
OVEROPTIMISTIC  
FOR THE DOLLAR’S  
SALVATION TO COME  
FROM THE FED.”**

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## Euro/US dollar EUR/USD

The EUR/USD has spent a long time going nowhere. After the major decline in 2014, the next couple of years saw the market just chop around in a wide sideways range. But as the eurozone economy has improved, the currency has had something of a tailwind, pushing out to its best levels versus the US dollar in three years.

There are plenty of potential hazards though. In last month's issue we were looking at the pound – which has staged a very strong comeback versus the dollar to trade at levels not seen since immediately after the Brexit vote. But the risk of Brexit does also extend to the euro of course. If negotiations end up being protracted or result in something of a "messy" deal for both sides of the English Channel, it does inject a tone of uncertainty for the eurozone, and this would normally be played out in the currency markets.

So, whilst the euro has started this year on the front foot surrounded by optimism, the risk for EUR/USD is probably for more negative surprises, which could lead to a cautious performance.

If we take Brexit out of the equation, it might give a different slant on the US dollar's fortunes.

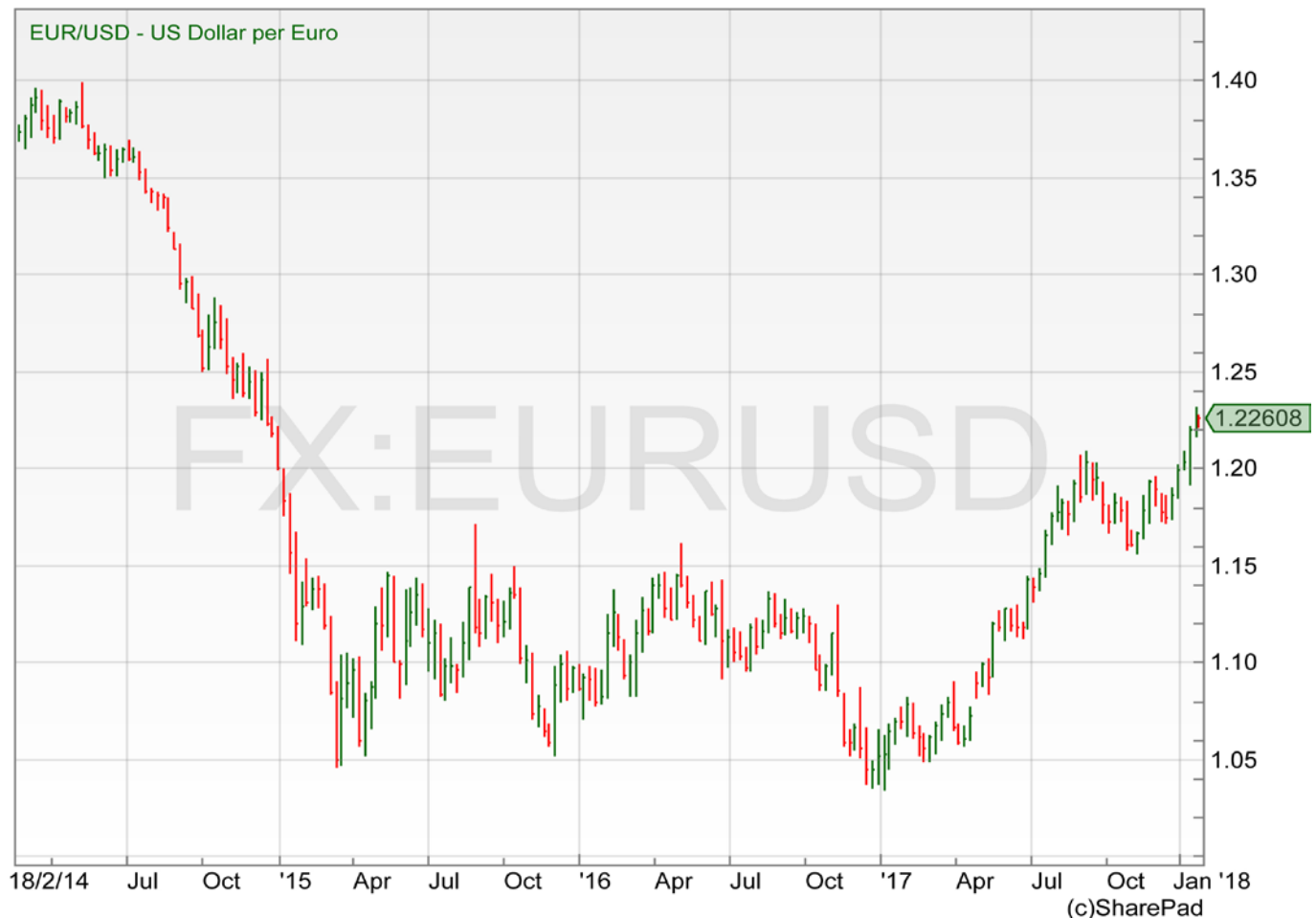
## US dollar/Japanese yen (USD/JPY)

The dollar did lose ground against the Japanese yen last year – although to be fair, most of this was done in the first few months and it spent the rest of 2017 trading in a wide range. There are plenty of forecasters expecting more dollar weakness to come this year – and investment bank Morgan Stanley goes as far as saying that that the

yen will be the stand-out performer in 2018. Of course, if the yen goes up, then the US dollar would weaken.

For most currencies against the US dollar, a major catalyst for further US dollar weakness would be continued strength in the world economy. For now, this shows no signs of changing, but it is still early days for the new year. If other assets continue to outperform then the US dollar will remain an unattractive destination. Japan of course is something of a special case. It has suffered deflation for years so a return to inflation here – this would

**“THERE ARE PLENTY OF FORECASTERS EXPECTING MORE DOLLAR WEAKNESS TO COME THIS YEAR – AND INVESTMENT BANK MORGAN STANLEY GOES AS FAR AS SAYING THAT THAT THE YEN WILL BE THE STAND-OUT PERFORMER IN 2018. OF COURSE, IF THE YEN GOES UP, THEN THE US DOLLAR WOULD WEAKEN.”**





be where the cost of living starts to rise – could change things. If inflation returned, then the central bank would be expected to alter its policy of negative interest rates – and rising interest rates traditionally mean that the currency gains ground as well. Although, as previously mentioned, that didn't quite play out for the US dollar last year!

So, what are the catalysts to look out for, to signal that the pessimistic view to the US dollar is overdone? First of all, it is the state of the world economy. If cracks *do* start to appear here, then investors will be looking for a safe place to park their cash, at least until things become clearer. At the moment we just don't have these cracks appearing. But, US stock markets for example, are way overdue some sort of correction.

But so far these have been incredibly short-lived, emboldening investors to just keep piling in and buying the dips. A more prolonged sell-off here could be enough to spook some that it is time to take some money off the table and lift the US dollar.

There is a new chairman of the Federal Reserve – the US central bank – starting this year. Jerome Powell replaces the outgoing Janet Yellen. Perhaps Mr Powell will come in with an aggressive approach to rate rises – but that seems unlikely. All signs for now are pointing to continued minuscule rises in the rate of borrowing in the US, so it seems a little overoptimistic for the dollar's salvation to come from the Fed.

And then finally there is the prospect of geo-political uncertainty that could

lift the US dollar. The sabre-rattling between President Trump and North Korea has gone quiet in recent months. But a notching up of the rhetoric here is also something to watch and has the potential to prod investors back to the safe old greenback.

Admittedly all three of those factors seem something of a long-shot for now. However, currency markets are often illogical. We have seen strong moves versus the dollar all the way through last year and whilst these markets do exhibit strong trends, they don't go on forever. Given the looming unknown of Brexit, global investors may well decide that they have sold the dollar low enough for now, and it is time to sit it out for a few months to see what ends up being agreed between the UK and EU.

### 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 NEW BOOK OF INVESTING RULES

## THE DO'S AND DON'TS OF THE WORLD'S BEST INVESTORS

EDITED BY CHRISTOPHER PARKER

**Although fund managers as a profession aren't known for being particularly adept at outperforming the market – quite the opposite in fact, as many academic studies have shown – there are of course some incredibly talented individuals working in financial services. So where better to look for guidance and inspiration than those who have been at the top of their game for most of their careers?**

Edited by Christopher Parker, *Harriman's New Book of Investing Rules* is an updated collection of over 60 articles from a range of some of the most interesting minds in modern investing. It carries on the tradition of the "old" *Harriman Book of Investing Rules*, started in 2001 by Stephen Eckett and Philip Jenks, and brings together a fresh selection of ideas and investment approaches – all but two of the contributors to the book are new.

Contained within the book are the *do* and *don't* rules that have created prof-

its in the many billions of pounds over the years for the investors themselves and their clients. From value investing, dividend investing, emerging markets, property, passive investment, active investment, technical analysis and so on, this is a diverse and comprehensive compendium which has something to offer anyone who is involved in the business of making money.

### From pilots to politicians

The authors of the book are as diverse as the topics covered, with the opening article coming from US investment adviser Frank Armstrong, a former US Air Force pilot with 250 combat mis-

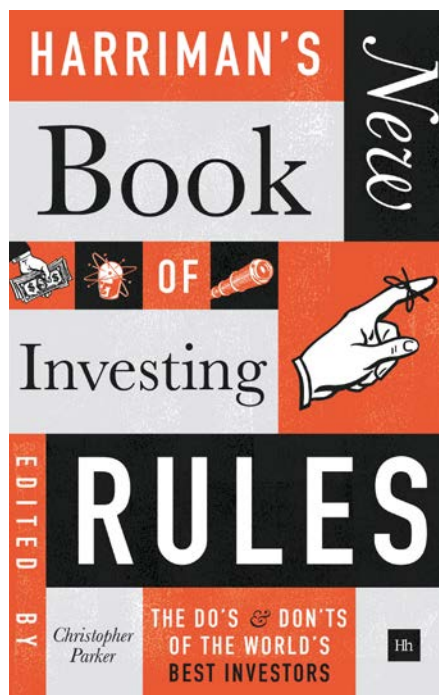
sions in Vietnam to his name. His contribution, *Investing from the Cockpit*, is themed along the lines of his flying career, with rules he learned when he was a pilot being directly applicable to being an investment adviser. Any pilot, just like an investment adviser, has to plan ahead for success, with a focus on high-probability "shots" increasing the likelihood of success. Of course, both professions need commitment, can expect turbulence along the way and need continuous maintenance so passengers can have a good trip.

Many famous fund managers make a contribution to the book including Anthony Bolton, Jeroen Bos, Gervais Williams and Nick Train. Train's views on the world are particularly interesting, with the manager of the top performing Lindsell Train funds offering up his seven pillars of investing wisdom. These are pointers which Train himself tries to remember before considering what to do with his own cash. He starts off by telling readers that the purpose of investment is to preserve the real,

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**"TIME, NOT  
TIMING IS THE KEY  
TO INVESTMENT  
SUCCESS."**

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post-tax purchasing value of capital in the least risky way, fighting both inflation and the tax man in order to reach your objectives. He ends with the wise words that time, not timing is the key to investment success. Therefore, the best time to invest is now.

One of my favourite articles is from all round top chap Robbie Burns, otherwise known as Twix eater and tea drinker, The Naked Trader. In his own unique jaunty style he explains how he went from making money from a Buffy the Vampire Slayer information hotline to having traded his way to having more than £2 million in his ISA and spreadbetting accounts. As a rule he doesn't like rules but nevertheless provides 14 pearls of wisdom for private investors, being one himself. These include to be careful of taking advice from others, pay attention to liquidity when buying stocks and always remember the words of the great 20th-century English philosopher, Corporal Jones: "Don't panic!"

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## "THERE ARE NO SHORTAGE OF TIPS, HINTS AND ADVICE FOR BOTH THE AMATEUR AND PROFESSIONAL INVESTOR ALIKE."

Also making a contribution is Jacob Rees-Mogg, better known as MP for North East Somerset (or to his Right Honourable friends, the MP for the 18th century). Touted as a future Conservative Party leader, he is less well known for his background in financial services where he started his career working for J. Rothschild Investment Management and co-founded Somerset Capital Management in 2007. The specialist emerging markets investment firm has now grown its assets under management to almost \$9 billion. Rees-Mogg provides ten tips on how to make money from emerging markets, arguing that as countries move towards capitalism and commerce growth can be staggeringly high.

### Opposite opinions

Of course, with so many authors and so many different investment topics being covered in the book, there is always going to be some conflicting opinions of how things should be done. For example, Ken Fisher, the US money manager, argues that investing must be approached in a scientific manner, with hypotheses being tested and methods evaluated for best results. In contrast, CEO of Old Mutual Global Investors Richard Buxton writes that investing is not a science, it is an art, with detailed financial models not to be relied upon too heavily.

There are many other examples of contrasting opinions throughout the

book. But that doesn't mean one conflicting approach will always work over the other. Parker argues that the many contradictions represent the open minded world of investing, with such a marketplace of ideas being an illuminating proposition. As Gandhi one said, *"Where there is honest effort, it will be realised that what appeared to be different truths are like the countless and apparently different leaves of the same tree."*

### Make it a rule to buy this book

Coming in at over 500 pages *Harriman's New Book of Investing Rules* is a hefty tome, packed full of expert insights and super value for money. While it is a lengthy volume overall, it can easily be used to dip into from time to time as each article is typically between five to ten pages long. From fund managers to property experts, the collective experience of the authors runs into many hundreds, if not thousands of years. So there are no shortage of tips, hints and advice for both the amateur and professional investor alike to get stuck into. As such, it makes a valuable addition to the library of anyone serious about managing and growing their wealth.

### 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

# ICE AGE FOR THE PERMA-BEARS



**For many fund managers, the arrival of January means primarily one thing: the latest investor conference from the Société Générale team of perma-bear analysts, led by Albert 'Ice Age' Edwards. In fact, this description is somewhat unfair, given that Albert's two bearish partners in crime, James Montier and Dylan Grice, have both gone on to work in pastures new over the past few years. Nevertheless, Dylan rejoined Albert on stage for 2018, which offered at least a partial opportunity to get the band of bears back together.**



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## “THE DAY WHEN THE LAST BEAR CAPITULATES IS WHEN IT’S REALLY TIME TO START BATTENING DOWN THE HATCHES.”

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The SocGen team (or now, Albert and his colleague Andrew Laphorne) regularly win awards for the quality of their research. Attendance at their annual London conference is often treated as a contrary indicator with regard to the health of the markets. A conference packed to the rafters equates to huge interest in their bear thesis, which invariably means that markets outperform in the subsequent year – the so-called 'climbing the wall of worry' argument that has made this latest rally by Anglo-Saxon and especially US stocks to be regarded as one of the most unpopular rallies in history. A conference thinly attended, on the other hand, equates to huge levels of com-

placency, which invariably means that market returns in the subsequent year tend to be disappointing. This year, the conference was well attended but there were still gaps in the crowd, which means... well, I'm not sure we can deduce anything sensible from that.

But Albert and team are nothing if not thought-provoking. And Albert's a realist, who's well aware that his continued warnings of a day of reckoning for stocks sound like a broken record, or the proverbial stopped

clock that might yet be right twice a day. And in his defence, the rally for risk assets, but notably stocks, that began in March 2009, at the height of the Global Financial Crisis, has defied just about everybody in its length and intensity. He even has a sense of humour about it, pointing out that one financial journalist described his advice as "how to correctly predict ten of the last one market crashes".





# “THIS IS A DAMNING INDICTMENT OF EUROPEAN CORPORATE HEALTH, AND PRECISELY THE REASON WHY MANY OF US VOTED FOR BREXIT IN 2016.”

## Defying gravity?

So, for many investors and market-watchers, the rally of 2009-? just keeps on chugging, in the face of historical precedent, high levels of corporate leverage, significant stock buyback activity, valuations, and plain reality. Will 2018 be the year that the market finally responds to gravity?

Central bankers could be the first to discover this year that the forces of gravitation have yet to be rescinded. It is surely their grotesque dollops of Quantitative Easing over the past decade that have propelled so many otherwise relatively fragile equity markets to fresh highs. And Albert is careful to quote Sir Mervyn King, the then Bank of England Governor, in February 2012, when he said,

I have absolutely no doubt that when the time comes to reduce the size of the [Bank of England's] balance sheet that we'll find that a whole lot easier than we did when expanding it.

As a marker of insane hubris, that has to be on a level with outgoing Federal Reserve Chair Janet Yellen when, at an event in London last June, she was asked about the likelihood of another financial systemic shock:

Would I say there will never, ever be another financial crisis? You know probably that would be going too far, but I do think we're much safer and I hope that it will not be in our lifetimes, and I don't believe it will be.

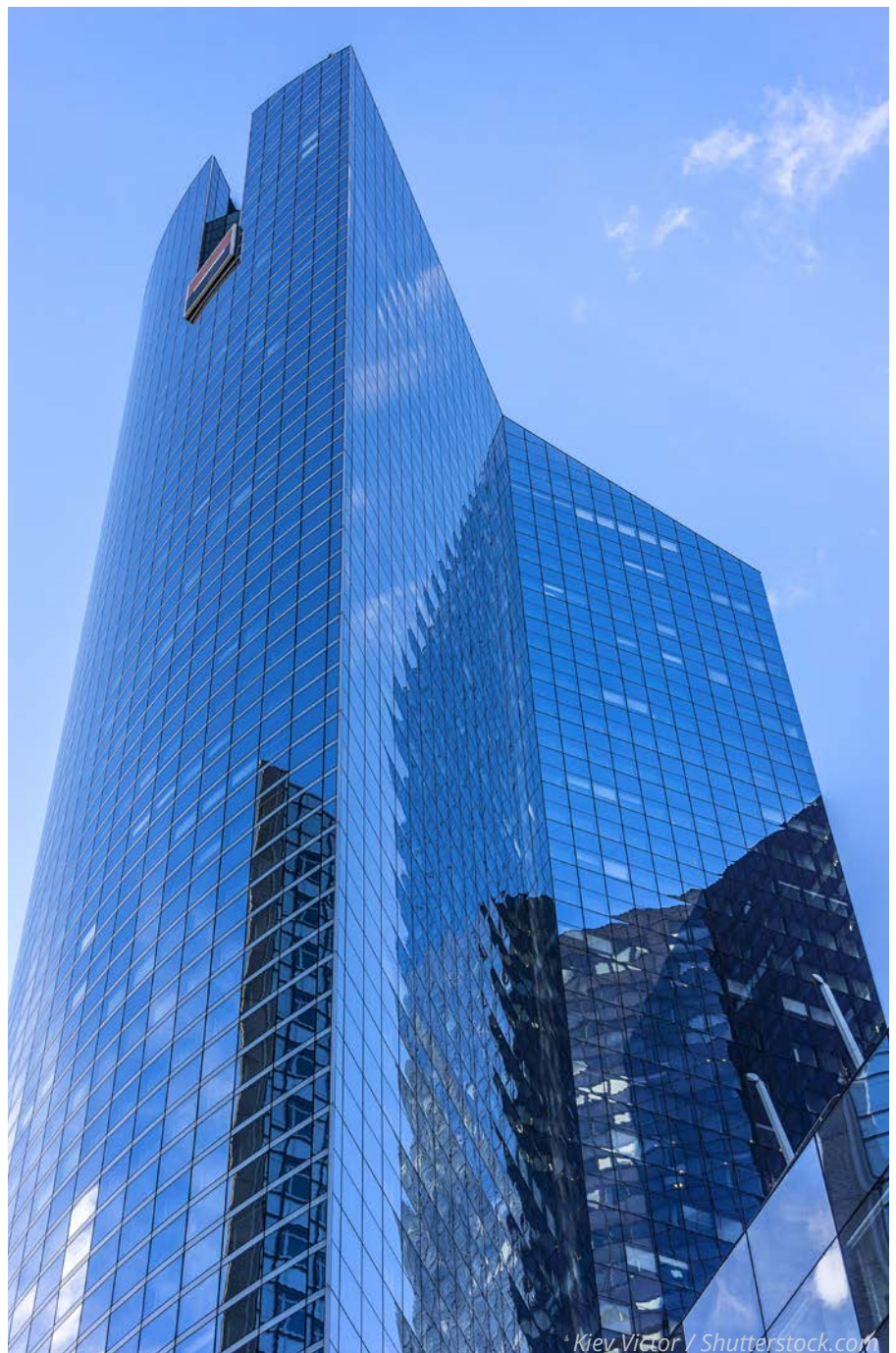
Hmm. We'll get back to you on that one, Janet.

Much of the SocGen conference material this year went over already well-trodden ground: markets seem to have abandoned any conception of respecting valuations; the Shiller cyclically adjusted price/earnings ratio (the so-called CAPE) for US markets now puts them at their second most expen-

sive level in history; 2017 saw bumper central bank money printing; the stock exposure of individuals is also at its second most expensive level in history; professional advisers remain extremely bullish; equities are, for the time being, ignoring rising bond yields (this could be the biggest red flag of all for 2018); inflationary pressure is seemingly quiescent just about every-

where; companies, especially in the US, are still aggressively buying back their own stock, even if they have to borrow to do so.

But there were two slides that really stood out, at least for me. One of them showed that as a percentage of global profits, those made by US and Japanese companies had largely held their



own over the last 15 years or so. The percentage of global profits made in emerging markets grew quite sharply over the same period. But the percentage of global profits made by European companies roughly halved – from 40% of the MSCI World Index in 2002 to just 20% in the last couple of years. This is a damning indictment of European corporate health, and precisely the reason why many of us voted for Brexit in 2016 – because the European economy is fast becoming irrelevant on the global scene.

The second SocGen chart that caught my eye was on a related theme. It showed that Japan (population: 127 million) was now generating the equivalent of 50% of European profits (population: 743 million), as shown by reported earnings for MSCI Japan versus MSCI Europe in US dollars. That is a *real* eye-opener, especially when you consider how out-of-favour the Japanese stock market remains. Albert's colleague, Andrew Laphorne, went on to say that Japan's problem was never a fundamental economic one; rather, its stock market simply got too expensive during the 1980s, and so it spent the next quarter century in the doldrums. There is a lesson for the other developed markets here, and it is not an encouraging one.

## Everybody hates bears

The problem with bearishness is that just about everybody hates bears, especially when they're right. The distinction between being ultimately right and being right in respect of timeliness, however, is a subtle one, and most bears have been caught out by – with hindsight – being fantastically premature.

A case in point is US money manager John Hussman – whose latest commentary you can read [here](#). I don't know Mr Hussman, but he writes well, and with intelligence. But US financial advisor Lawrence Hamtil has written a [damning piece](#) about Hussman's prolonged bearishness that makes for awkward reading for any bear, and not least Hussman in particular. Among the highlights, for example:

Since the publication of [his] November 2010 article, the S&P 500, which Mr. Hussman has repeatedly warned

us has been in a bubble, has returned over 100% on a total return basis. It must be exhausting – not to mention humbling – to be so dedicated to an idea that, despite all your evidence to support it, is repeatedly rejected by investors who have continued to bid shares higher and higher.

In fact, since the current bull market began in March of 2009, Mr. Hussman has repeatedly called for a titanic decline in the S&P 500, but, in a twist of irony, it has been his own fund, Hussman Strategic Growth (HSGFX), that has suffered a disastrous bear market all its own with a peak-to-trough decline of almost 50%.

## “THERE IS A LESSON FOR THE OTHER DEVELOPED MARKETS HERE, AND IT IS NOT AN ENCOURAGING ONE.”

Mr. Hussman's mania over perceived bubbles has almost a sinister aspect to it. This obsession with prophesying doom no matter what makes Mr. Hussman resemble the naysayer of which Pascal Bruckner [has written](#), "[H]e becomes intoxicated with his own words and claims a legitimacy with no basis... Catastrophe is not [his] fear, but his joy. It is a short distance from lucidity to bitterness, from prediction to anathema."

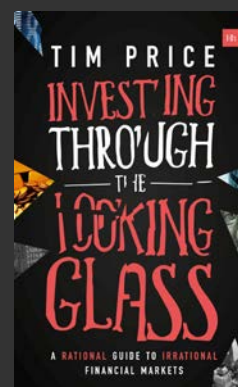
Investing is an extremely difficult endeavour, and most will fail at it. All the charts in the world that show stocks have averaged X return over Y period of time are useful only to the extent that investors realize that there were countless periods when stocks lost 10, 20, and even 50% along the way to averaging those returns. While we should heed the counsel of wise men, we should be on guard against the Cassandra-like Mr. Hussman, who have wedded themselves to an idea, and who point an accusatory finger at those of us who, having seen the weight of evidence, choose to ignore their warnings. It is to the great misfortune of Mr. Hussman's shareholders that he has been more preoccupied with being right about the inevitable doom of our investments, at the expense of ignoring the catastrophe suffered by his own.

Ouch. Let he who is without sin cast the first stone.

I'm minded to believe that most investors now suffer from some form of crisis fatigue. The effects of the Global Financial Crisis – huge market instability followed by the mother of all reflationary attempts by the world's central banks – have distorted so many markets and been with us for so long that it is tempting just to go with the flow; to capitulate and, to paraphrase the infamous Hugh Hendry, simply buy just about everything. But that would be a dereliction of duty for those of us whose primary responsibility is to preserve our clients' capital. The day when the last bear capitulates is when it's really time to start batten down the hatches. Are we that much closer to a sea change in markets in 2018? Both logically and statistically, we must be.

### About Tim

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





## MARKETS IN FOCUS

# JANUARY 2018

### GLOBAL EQUITIES

Index	Last Month %	YTD%	Proximity to 52w High*
Russian TSI	11.0	11.0	
Bovespa	11.0	11.0	
Hang Seng	9.9	9.9	
NASDAQ 100	8.7	8.7	
Dow Jones	5.8	5.8	
S&P 500	5.6	5.6	
IBEX 35	4.1	4.1	
CAC 40	3.2	3.2	
Euronext 100	2.9	2.9	
DAX Xetra	2.1	2.1	
Nikkei 225	1.5	1.5	
S&P/ASX 200	-0.5	-0.5	
FTSE 100	-2.0	-2.0	

### COMMODITIES

Commodity	Last Month %	YTD%	Proximity to 52w High*
Cocoa	8.9	8.9	
Platinum	8.1	8.1	
Iron Ore	6.5	6.5	
Crude oil (Light Sweet)	6.0	6.0	
Gold	2.8	2.8	
Cotton	2.3	2.3	
Crude oil (Brent)	2.1	2.1	
Coffee	1.6	1.6	
Silver	0.5	0.5	
Sugar (No. 11)	0.4	0.4	
Palladium	-2.5	-2.5	
Natural Gas	-2.8	-2.8	
Copper	-3.3	-3.3	

### FOREX

Pair/Cross	Last Month %	YTD%	Proximity to 52w High*
GBP/USD	5.2	5.2	
EUR/USD	3.5	3.5	
AUD/USD	3.2	3.2	
GBP/AUD	2.0	2.0	
EUR/JPY	0.3	0.3	
EUR/CHF	-1.1	-1.1	
EUR/GBP	-1.6	-1.6	
USD/CAD	-2.2	-2.2	
USD/JPY	-3.1	-3.1	
USD/CHF	-4.4	-4.4	

### CENTRAL BANKS - RATES & MEETINGS

Central Bank	Key Rate	Next	After
BOE	0.50%	Feb 08	Mar 22
ECB	0.00%	Mar 08	Apr 26
FED	1.50%	Mar 21	May 02
BOJ	-0.10%	Mar 09	Apr 27
SNB	-0.75%	Mar 15	Jun 21
BOC	1.25%	Mar 07	Apr 18
RBA	1.50%	Feb 06	Mar 06
RBNZ	1.75%	Feb 08	Mar 22
BOS	-0.50%	Feb 13	Apr 25
BON	0.50%	Mar 15	May 03



## FTSE 350 TOP

Sector	Last Month %	YTD%	Proximity to 52w High*
GKN PLC	32.0	33.7	
Ocado Group PLC	27.0	31.1	
UBM PLC	22.0	21.2	
PageGroup PLC	16.0	16.5	
NMC Health PLC	16.0	14.4	

## FTSE 350 BOTTOM

Sector	Last Month %	YTD%	Proximity to 52w High*
Dignity PLC	-55.0	-57.6	
Capita PLC	-54.0	-56.0	
Card Factory PLC	-35.0	-34.4	
Brown (N) Group PLC	-26.0	-23.7	
AA Ltd	-26.0	-27.2	

## FTSE 350 SECTORS TOP

Sector	Last Month %	YTD%	Proximity to 52w High*
Automobiles & Parts	30.0	30.0	
Industrial Metals	6.0	6.0	
Chemicals	4.1	4.1	
Industrial Engineering	3.2	3.2	
Aerospace & Defense	2.6	2.6	

## FTSE 350 SECTORS BOTTOM

Sector	Last Month %	YTD%	Proximity to 52w High*
Gas, Water & Mult.	-7.8	-7.8	
Software & Comp. Serv.	-6.9	-6.9	
Beverages	-6.8	-6.8	
Fixed Line Telecom.	-6.4	-6.4	
Food Producers	-6.0	-6.0	







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