ISSUE 36 – MARCH 2018
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MAGAZINE

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THE UK'S **NO.1** FREE INVESTMENT PUBLICATION

AROUND THE WORLD IN EIGHT INVESTMENTS

FIDELITY'S TOM STEVENSON GOES GLOBE-TREKKING FOR THE BEST RETURNS

PLUS...

MELLON ON THE MARKETS

WHY THIS BULL MARKET IS APPROACHING ITS CONCLUSION

ALTERNATIVE ASSETS

HOW TO DIVERSIFY YOUR PORTFOLIO WITH INVESTMENT TRUSTS

INFLATION ON THE MARCH

WHAT IT MEANS FOR MARKETS AND INVESTORS

BSE: THE GATEWAY TO EMERGING EUROPE

WE INTERVIEW BUDAPEST STOCK EXCHANGE CEO RICHÁRD VÉGH

WELCOME

Dear Reader,

Once again, we are proud to have assembled a high-calibre line-up of speakers for the Main Stage of the Master Investor Show on March 17th.

Last year, we brought you a selection of the UK's best-known investment experts. To keep the event fresh and interesting, this year we decided to provide a very different emphasis. We will show you the extraordinarily broad selection of investments from around the world that are now open to investors operating with UK brokerage accounts.

- Is sustainable, attractive investment income your objective? The French oil and gas giant **Total** pays a hefty dividend yield and already counts 400,000 retail investors among its shareholders. They'll kick off the day with a late-morning presentation.
- How will markets fare in 2018? What are the best ways for private investors to build a nest-egg? Tom Stevenson, Investment Director for Personal Investing at **Fidelity International**, and renowned market commentator, will give you the low-down. For the second year running, Fidelity International is headline sponsor of our event and we are delighted to have Tom's 'Around the World in Eight Investments' as this month's cover story.
- When equities at home are anything but cheap, where else can you find value? The team of the **Budapest Stock Exchange** will open your eyes to investment opportunities that are nearby in Europe, yet much cheaper in terms of valuation. You'll also be surprised to learn how easy these shares are to trade through many UK brokers.
- **QuotedData**, the award-winning sponsored research house that provides free, reliable information to all investors, is hosting a panel focusing on the largest – yet curiously least-known – sectors of the London Stock Exchange, Investment Companies. Led by QuotedData CEO Edward Marten, the panel will examine why Investment Companies are one of the fastest growing sectors in the stock market. Informative, lively discussion is guaranteed, rounding off the day with a bang.

The Master Investor Show is the no. 1 event for any private investor eager to protect and grow their money. Don't forget – you can still register for up to two free tickets by using discount code "M0318".

As for the Main Stage presentations, grab your seat with plenty of time to spare – it's going to be busy!

Best regards
Swen Lorenz
Editor, Master Investor

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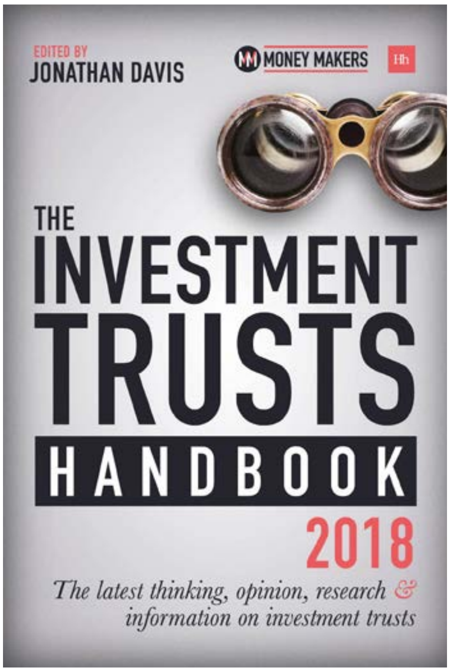

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BY JIM MELLON

MELLON ON THE MARKETS

The mini collapse in shares earlier in February must surely presage something more serious. In my excessively long experience of markets, the first shudder is rarely the last. Emollient words from inexperienced market commentators should be roundly ignored. This bull market is approaching the shadows of its duration and investors should make use of the current phony war to reallocate and reshuffle their portfolios. From now on, it's pass the parcel.

When I was a very young fund manager with an optimism bordering on the fanatical, I came back to the house I had just bought in London (at the time, I lived in Hong Kong), switched on the TV and saw on Teletext (ancient history) that the US market had fallen by a quarter or so. Luckily, I had been fortified by Chianti in a nearby hostelry, or the shock to the system might have been too much!

Since then, there have been many ups and downs, but mostly ups, and I have become used to them. But I have to say, the situation today strikes me as precarious. Bond yields are, to use the favourite parlance, "normalising", inflation – which has been my bugbear since last year's Master Investor show – is returning, and there has been too much damn complacence.

To my mind, the upsurge in the VIX fear index (nicely played as a trade by my colleague Anthony Chow) was an omen; the collapse of the whole ludicrous crypto-complex was another; and the tweeting of stock market bullishness as a personal validation by President Trump, a further negative augury. Since then, normal service has been resumed. But, mark my words, the real blitz has not yet started in earnest – but it will.

Unlike in 1987, when the first frisson of bear market blues hit me, valuations have expanded to ludicrous levels, the likes of which were last seen in 1929. Stock prices have been manipulated by ultra-low interest rates (which are going to soon be a thing of the past), by share buybacks and by an accumulation of "stories", which when retold in the cold light of day, two or three years out, will look considerably less alluring. This makes me feel that the next lurch down is coming – and coming soon.

This doesn't mean that I am not a raging bull on all the good things happening in the world (longevity, medicine, tech, etc) but it does make me wary of the immediate outlook for the major stock markets of the world. I think that the broad indices could fall by 25% or so peak to trough, and while some will do better than others (e.g. Japan vs the US), normally even the good girls go down with the bad.

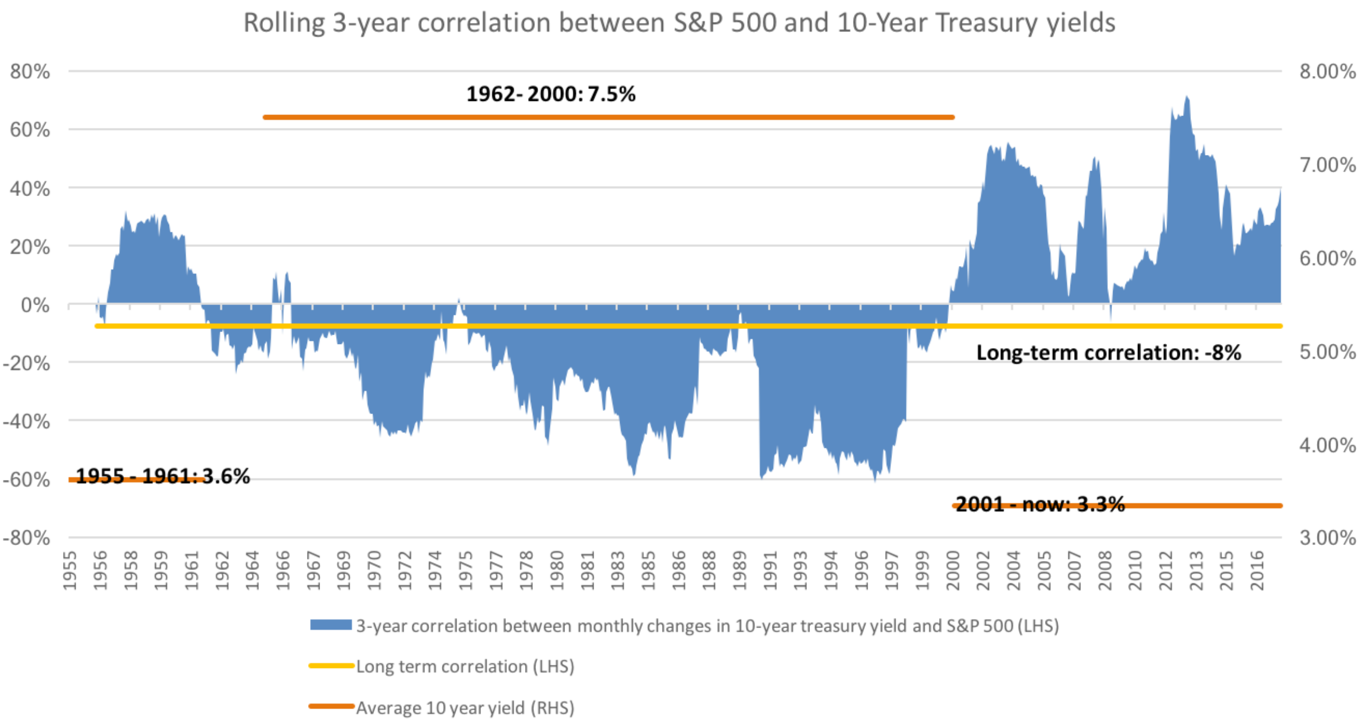
In my talk at Master Investor this year on March 17th (and by the way, it's a ticketed session so best

"I THINK THAT THE BROAD INDICES COULD FALL BY 25% OR SO PEAK TO TROUGH."

to apply soon, if of interest), I will be outlining a portfolio which I think can weather the storm that is coming. It will include some banks that will benefit from higher interest rates and the reduction in so-called "misconduct" charges, some dividend-yielding companies that look secure in their earnings, and some blue-sky tech and biotech companies that have the potential to change the world.

"THIS BULL MARKET IS APPROACHING THE SHADOWS OF ITS DURATION AND INVESTORS SHOULD MAKE USE OF THE CURRENT PHONY WAR TO REALLOCATE AND RESHUFFLE THEIR PORTFOLIOS."

My call – until very recently an appalling one – that the big internet platforms of **Google (Alphabet) (NASDAQ:GOOGL)** and **Facebook (NASDAQ:FB)** would soon be getting some comeuppance seems to be coming modestly right. These companies are way over-owned in institutional portfolios, and although their PEs have come down, they are still stratospheric compared to the inherent risks the companies face – rising costs of compliance, less advertiser engagement, mounting competition and, most importantly, regulatory risk – as well as, in the case of Facebook, boredom. A short Facebook position will be my number one short idea for the year ahead, along with a massive short in German Bunds, which having fallen a bit, are destined for a much bigger fall.



My overall negative sentiment is based on the following. The economic situation appears to be benign, but in fact is based on ever-increasing amounts of debt in most major economies. This debt accumulation is also facing diminishing returns in terms of its ability to drive further growth. Countries with rising and particularly worrying levels of debt include the US, China, Italy, France and Japan.

Take the US as an example. Just before the mini-crash at the end of January, the Trump tax cuts were being hailed as miraculous. On further examination, they are anything but, and will add hugely to the budget deficit of the US, which is already substantial. To put this into perspective, under the Trump plan, receipts will be only 75% of expenditures at a Federal level, and this matters.

It matters because the US economy is already running hot – wages are rising, commodity prices are generally rising, and interest rates are on the way up. With the government "priming the pump" at exactly the wrong point in the cycle, inflation will become a problem, necessitating more rate hikes this year (five in 2018?) – and hey presto, we already have the first sprouts of recession emerging.

Yes, I am aware of the disinflationary power of digitisation and automation, but I am sure that wage inflation and commodity inflation will outweigh all of those big time in the next two to three years. With corporates pretty indebted (remember those buybacks?) as well as the consumer (although less so than in 2008), things could get ugly.

And it's the same in many other major countries. The UK isn't as bad, and actually is performing better than most might have thought. Germany's balance sheet is pristine. But if the US and (God help us) China slow down – and I think they will – prospects for global growth and trade diminish.

Our world is awash in a sea of debt – and that is not a good place to be. Yes, there is synchronised economic growth going on; and yes there is a productivity gain that is coming due to automation; and yes there are wonderful things happening in longevity. But central banks (so far, with the exception of China) are putting on the brakes (rather belatedly so), inflation is rising fast, yields are going up, and that is *never* a good place for equity investors.

So please come on down to Master Investor on March 17th. As always, I will have some recommendations for you on the day (those attending my ticketed event will get them 10 days ahead of everyone else), and there is a sold-out list of company stands to visit. In particular, I want to direct you to aircraft leasing specialist **Avation (LON:AVAP), Fast Forward (LON:FFWD), Manx Financial Group (LON:MFX), Condor Gold (LON:CNR)**, Insilico Medicine, and Bradda Head.

Evil is speaking, Dominic Holland is doing his hilarious thing, Merryn Somerset Webb of Money Week is speaking with me, and Tom Stevenson of Fidelity, along with many others, will be giving his views on markets. Registrations are already up 20% on last year, and it's going to be a cracking show. See you there!

Happy Hunting!

Jim Mellon

Meet Jim at Master Investor Show 2018

Get the chance to pick the brain of one of the UK's most successful private investors. Join Jim for his investment predictions and leftfield ideas at an exclusive, ticketed 30-minute session at Master Investor Show (17 March 2018, London). Hosted as a "secret backroom gathering" for an audience of 150 visitors only, this session is bound to sell out quickly.

Register now for a free show ticket at masterinvestor.co.uk/tickets (discount code: M0318) and purchase a ticket for the exclusive session with Jim (£25 per ticket) while available.

Click here to follow Jim's trades on Twitter

About Jim

Jim is an 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 is often described as the British Warren Buffett and 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 subsequently *Cracking the Code* (2012), *Fast Forward* (2014) and, most recently, *Juvenescence* (2017). His monthly "Mellon on the Markets" column in Master Investor Magazine has gained him cult status among investors. He holds a master's degree in Politics, Philosophy and Economics from Oxford University. He is on the Board of Trustees of the Buck Institute in California, a trustee of the Biogerontology Institute, and a Fellow of Oriel College, Oxford.

BY TOM STEVENSON, INVESTMENT DIRECTOR, FIDELITY PERSONAL INVESTING

AROUND THE WORLD IN EIGHT INVESTMENTS

Phileas Fogg went around the world in 80 days to win a £20,000 bet (about £2 million in today's money). He didn't set out in search of investments but the route he took would make good sense to a modern-day investor in search of a globally-diversified portfolio.

London to Suez took him across Europe to the oil-rich Middle East. From there he explored the world's biggest emerging markets in India and China, re-entering the developed world in Japan before crossing the Pacific to the US and back to the UK.

Of course, the world was a very different place in 1873 when *Around the World in 80 Days* was published. Pretty much everything east of Suez and all the way back home again was an emerging market then, including the US and Japan which today account for 60% of the world's market capitalisation between them.

Analysis of financial markets by Credit Suisse and the London Business School doesn't go back quite that far, but their breakdown of world stock markets for 1899 shows a much more Euro-centric picture. The UK represented a quarter of the value of global stocks at the end of the Victorian age, America 15%, Germany 13% and France 12%. South Africa and Australia contributed nearly 7% between them and Russia 6%.

Today the US alone represents more than half of the value of global stocks and France and Germany are now relative also-rans. The UK still punches above its economic weight while Japan, even after a lost generation in stock market terms, is still number two in terms of capitalisation.

Following in Fogg's footsteps

Thinking about my current investment outlook, I thought it might be fun to set off in pursuit of Phileas Fogg and his assistant Passepartout. Like the travellers in Jules Verne's classic, I'm heading across the Channel to Europe to begin my tour.

Europe is one of my preferred equity market regions this year for a long list of reasons. The first of these is the strength and sustainability of the economic recovery. The region has a lot of catching up to do, having lost ground during the sovereign debt crisis. Europe's economy is only just bigger than it was before the financial crisis while the US and UK are 15% and 10% bigger respectively.

Markets have also lagged, so valuations add a second string to the catch-up story. This is particularly the case in light of company profit margins being much more exposed to a pick-up in activity as the fixed costs of Europe's less flexible labour

"TOWARDS THE BACK END OF THE ECONOMIC AND MARKET CYCLE, COMMODITIES TEND TO PERFORM WELL AS DEMAND RISES AND SUPPLIES BECOME TIGHTER."

“EUROPE IS ONE OF MY PREFERRED EQUITY MARKET REGIONS THIS YEAR FOR A LONG LIST OF REASONS.”

market mean profits rise more as sales improve.

A big exposure to the financial sector is another positive for the region as slowly rising interest rates and higher bond yields improve bank profits. The central bank remains supportive, too, and politics is less of a concern than it felt this time last year.

The only fly in the ointment as far as Europe is concerned is the strength of the currency. Not only does a rising Euro make our trip across the continent feel like a pricey start to the journey, it makes European exports less competitive.

Playing the European growth theme: In a still-low interest rate environment in Europe, I like the Invesco Perpetual European Equity Income Fund, managed by Stephanie Butcher. Her value approach lagged quality/growth last year and should have its moment in 2018.

Commodities back in focus

Fogg and Passepartout headed to Suez because it was the quickest sea route to the Far East. My reason for stopping

in the Middle East, with a quick detour down the East African coast to South Africa, is all about commodities, and particularly oil and gold.

Towards the back end of the economic and market cycle, commodities tend to perform well as demand rises and supplies become tighter. Over the past two years, we have seen the oil price

more than double from a low of under $30 a barrel. Continuing discipline from OPEC and Russia has seen output curbs extended until the end of 2018, albeit with a review at the half-year stage. This confirms Saudi Arabia's desire to put a floor under the oil price while it pushes through far-reaching reforms of its economy and faces off against its regional rival Iran. The days when it thought it could price US Shale out of the market are long gone and it is learning to live with the new energy kid on the block. Strong end-user demand, as the world enjoys a synchronised economic upturn, should offset any further uptick in US fracking and keep oil above $60 this year.

Gold should also remain in favour this year as the precious metal performs its traditional function as a hedge against growing inflationary pressures. The recent volatility in global markets was largely triggered by fears that rising prices would trigger a faster acceleration of the Federal Reserve's monetary normalisation. Although rising interest rates increase the opportunity cost of holding gold (which pays no income), more volatility and inflation concerns should support the yellow metal.

Our preferred way of playing the overheat phase of the commodity cycle is via natural resources producers which benefit from a lag between the uptick in product prices and the consequent rise in their costs. The Investec Global Gold Fund is a decent way of tapping into this theme.

Investing in the Year of the Dog

Emerging markets had a great 2017. Returns were spectacular and it would be too much to expect them to continue at that level in 2018 as well. The combination of strong global growth and a weaker dollar was a happy one for emerging market investors that may not be repeated. That said, though, there are lots of positives in this asset class with still undemanding valuations and a good long-term growth story.

India is our first stop on the journey east and it remains one of the most popular destinations for emerging market investors. Rightly so. Demographics continue to look compelling and the country has a way to go to catch up with China in terms of urbanisation and the growth of its manufacturing base.

In China, the Year of the Dog brings with it a range of canine investment themes – from emerging opportunities (pups) to areas of concern (strays) and best buys (top dogs). In the first category, we would include the health care sector, which is benefiting from strong growth and consolidation, particularly in pharmaceutical distribution. An area we're cautious about is property development, where prices have soared and the policy risks are to the downside. Top dogs continue to include many consumer sectors, including the auto market.

Investing in emerging markets is best conducted via a generalist fund which can move around the world in search of the best opportunities. We like Nick Price's Fidelity Emerging Markets Fund. For more of an Asian focus, we also favour Ian Heslop's Old Mutual Asia Pacific Fund.

Rising Sums in the Land of the Rising Sun

A combination of reasonable valuations and strong earnings growth continues to argue for an exposure to Japan. After a lost generation of deflationary stagnation, we are beginning to see real evidence of wage growth feeding through into more sustainable inflation. Despite this, the Bank of Japan remains the most accommodative of all the major central banks so the next year could be a sweet spot of growth and stimulus.

Other positives for Japan include fund flows, with Japanese pension schemes starting to shift their heavy cash and bond weightings towards the equity market. As the stock market moves back towards levels it had not reached for years if not decades, the attraction of equities will only increase. Overseas investors will follow suit as the market rises.

There are still negatives for investors in Japan. The country is no longer the great hidden secret of the investment world and an overweight in Tokyo is more mainstream than it was. Japan's demographics also remain unfavourable and the geo-political risks in the region should not be dismissed. That said, there is enough going for Japan to keep it on our buy list as we board our

"A COMBINATION OF REASONABLE VALUATIONS AND STRONG EARNINGS GROWTH CONTINUES TO ARGUE FOR AN EXPOSURE TO JAPAN."

ship in Yokohama to set sail for San Francisco.

There are plenty of good Japan-focused funds but for an investor searching the world for opportunities, my preference is for a global fund with a significant weighting to Japan: Jeremy Podger's Fidelity Global Special Situations Fund.

Headwinds and tailwinds on Wall Street

There are good reasons to be positive on the US stock market and we get the chance to see the first of these as we disembark on the West Coast. America continues to dominate technology and this sector looks like it will remain a market leader in 2018. The high quality of US companies, their high margins and the flexibility of the country's labour market make it something of a safe haven too if you fear that growth might falter later this year. The final reason to like the US stock market is the likely positive impact of tax reforms, the benefits of which should flow through to investors in the form of dividends and share buybacks.

The fuel of tax cuts being poured on the already smouldering fire of the US economic recovery, however, is also the main reason to worry about American stocks. The recent market wobbles were triggered by fears that the US economy might be firing on too many cylinders right now. With inflation more of a threat than for many years, the risk is that interest rates rise faster than expected. Bull markets do not die of old age; they are killed by the Fed. And there is no reason to think that new Fed chair Jerome Powell is going to be any less hawkish than his predecessor Janet Yellen. She set the US on a tightening path and he will most likely build on it.

The US is the world's most expensive market as we move deeper into 2018. Whether you look at valuations as a multiple of earnings or assets or relative to the dividend income paid by US companies, alarm bells are starting to ring. This does not mean that the US won't have another good year but the odds of it doing so are reducing.

If you think I'm too cautious on Wall Street, the best way to play US market leadership is via James Thomson's Rathbone Global Opportunities Fund. With more than half its assets in US shares, it is a good way to gain exposure to the world's biggest market.

Back in Brexit Britain

Which brings us back home – thanks to the wonders of modern travel – in a lot less than 80 days. As we head back into London to pick up our winnings at the Reform Club, just one more question remains: Should we invest that cash in our home market?

A few months ago, I would have said no. I have been negative on the UK stock market for some time now as the post-referendum honeymoon came to an end and anxiety about Brexit deepened. While neither of these factors has really abated, the underperformance of the London market over the past year or so means the bad news is much more in the price.

Plenty of negatives remain, of course. Consumer confidence is weak as the sterling-fuelled inflation rate leaves average earnings growth behind. Business investment is weak. Productivity is still poor. And let's not forget the political backdrop either. The next year will be tough as the divisions within and between the political parties are highlighted by the ongoing Brexit talks. But all this is reflected in valuations which are more attractive than in most developed markets. When it comes to income, too, the yield on the UK stock market is about twice that available in the US and Japan.

There is a vigorous debate in the UK market at the moment between those investors who believe a contrarian, value-based approach is poised to have its day and those who are sticking with the quality/growth focus that has outperformed since the financial crisis. I prefer to stand back from the argument and back both approaches, via Alex Wright's value-focused Fidelity Special Situations Fund and Nick Train's quality fund, Lindsell Train UK Equity. I interviewed both manager's in our latest MoneyTalk video, which you can watch at www.fidelity.co.uk/moneytalk.

IMPORTANT INFORMATION

This information and Select 50 are not personal recommendations to buy or sell a fund. If you are unsure about the suitability of an investment you should speak to an authorised financial adviser. The value of investments can go down as well as up so you may get back less than you invest. The views expressed may no longer be current and may have already been acted upon. Overseas investments may be affected by changes in currency exchange rates. Investments in small and emerging markets may be more volatile than those in more developed markets. Funds that use financial derivative instruments for investment purposes may increase the level of risk and cause larger than average price fluctuations.

BY VICTOR HILL

OPPORTUNITIES IN FOCUS

TURNING AROUND THE TANKER

WHERE NOW FOR OIL AND THE FRACKING REVOLUTION?

One year ago I reported for this magazine that the global oil and gas industry was experiencing one of the severest downturns in 30 years. A perfect storm of overproduction, geopolitical tensions and the long-term move towards alternative energy sources (renewables) had caused oil prices to fall to levels that were often below the long-term break-even cost of production. As I explained, this had impelled the oil majors to diversify into renewables.

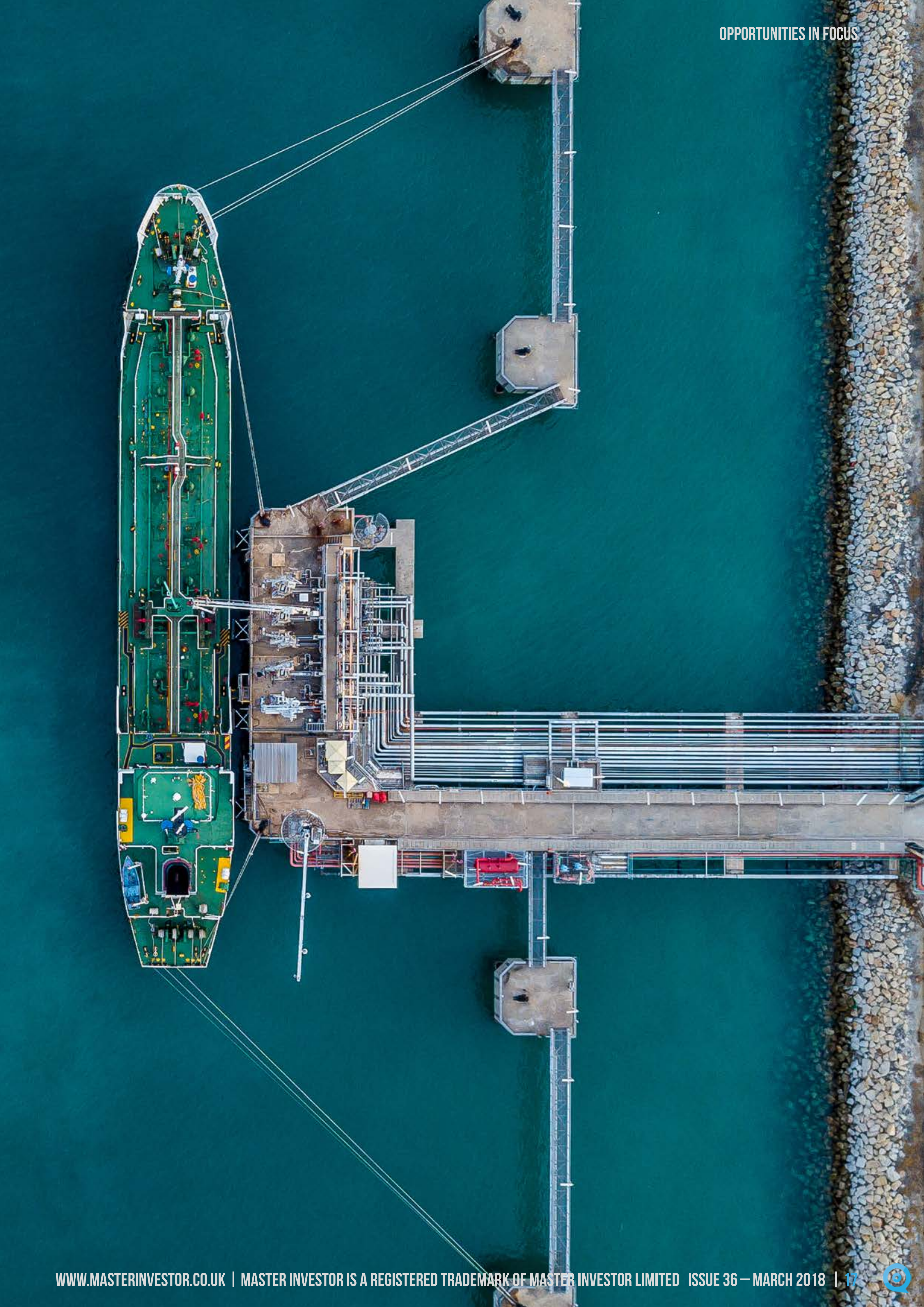
The long-awaited rebound in the oil price has now materialised along with *synchronised* global economic growth. From the low point of below $30 per barrel seen in January 2016, oil reached $70 in mid-January 2018 and is trading as I write at around the $65 mark. Some analysts foresee an oil price of above $70 by the end of the year. As a result, many exploration projects that were on hold are now back on track.

This month I want to look at key new developments in the oil sector, including oil exploration and the service providers that they contract. New technologies in the oil exploration sector could reduce drilling costs exponentially. Meanwhile, the efficacy of hydraulic fracturing – fracking – which last year looked like the future of the oil and gas sector is increasingly coming into question – with potentially dramatic results.

Oil output and demand are set to rise during 2018

According to the Paris-based International Energy Agency (IEA) the US is poised to become the world's largest oil producer in 2019, with rising output from shale fields offsetting robust demand growth and supply cuts by conventional oil producers. US crude output, which is up 1.3 million barrels a day compared to last year, will soon pass Saudi Arabia's output and could even overtake Russia's by the end of this year[i].

The oil price crash forced US oil producers to cut costs dramatically and to become more efficient. As oil prices have rebounded, they are



"OIL COMPANIES HAVE FINALLY GRASPED THE IMPLICATIONS OF THE RISE OF ELECTRIC CARS."

drilling more wells and production is rising again. The IEA reckons that the growth in US output this year could equal the growth in global demand. It has raised its forecast for 2018 global oil demand growth to 1.4 million barrels per day, given a stronger global economy. It expects total consumption to reach 99.2 million barrels per day this year. Production from outside the OPEC cartel is likely to rise to 59.9 million barrels per day.

The first wave of the US shale boom was propelled by higher prices which spurred global producers from OPEC and Russia to battle for market share through over-production. The shift in policy came in 2017 as lower oil prices impacted the economies of producer nations. They joined forces collectively to reduce output by 1.8 million barrels per day, forcing consumer countries to draw down on global stockpiles. In fact OECD oil stockpiles fell by 55.6 million barrels in December 2017 – the steepest drop since February 2011.

OPEC's crude oil production in January this year held up at around 32 million barrels per day, though disruption of production in one of OPEC's largest producers, Venezuela, remains a cause for concern.

The cuts in production initially propelled international Brent crude to above $70 a barrel, although the oil price has retreated further due to the stock market turmoil during the week of 05 February and higher estimates for US crude production. For OPEC and its main collaborator, Russia, revenue maximisation is now the name of the game rather than output maximisation.

The impact of automotive electrification

Oil companies have finally grasped the implications of the rise of electric cars. They are planning for a day when there will be few, if any, petrol stations in city centres – even if they are converted into charging stations. Motorists with off-street parking will generally charge their electric vehicles at home while others will use communal charge points provided by their employers at their place of work.

The number of petrol stations is already declining as cars become more fuel efficient. In the UK, the number of stations has fallen by 80 per cent since 1970, even though consumption of petrol and diesel has risen massively.

Privately owned **Chargepoint** has raised investments from Mercedes-Benz owner **Daimler AG (ETR:DAI)** and German industrial group **Siemens AG (ETR:SIE)** and is in the process of building a network of electric vehicle charging points across Europe. Oil majors that own petrol stations, such

hans engbers / Shutterstock.com

as **Royal Dutch Shell (LON:RDS)** and **BP (LON:BP)**, have committed to installing electric vehicle charging points at their existing petrol stations. Shell will launch high-speed charging points at retail sites across 10 European countries this year. Last year the oil giant bought electric charging group **NewMotion**. In February this year BP invested $5 million in **FreeWire Technologies** with the objective of offering charging points at strategic locations.

Many players in this space see more potential for retail sites which sell food and drink to consumers while they wait for their vehicles to charge, since charging an electric car takes considerably longer than filling an internal combustion engine car with petrol. Elon Musk, CEO of **Tesla Inc. (NASDAQ:TSLA)**, has proposed the company may open restaurants at its network of *superchargers*.

Doubts about fracking

The recent surge in US oil output has been largely driven by the impact of hydraulic fracturing – *fracking* – which has been rolled out on a huge scale in many US states, notably Texas, since about 2012 onwards. Fracking has always been controversial and even demonised by certain environmentalists, though the oil majors have maintained that the risks of poisoning the water table are well understood. Recently, doubts about the efficacy and safety of fracking have been voiced even within the oil industry.

Hydraulic fracturing was first used to release shale gas in Kansas by Standard Oil and Gas Corporation in 1947. But the modern hydraulic fracturing technique, called *horizontal slick-water fracturing*, was first used only in 1998 on the Barnett shale bed in Texas.

“DOUBTS ABOUT THE EFFICACY AND SAFETY OF FRACKING HAVE BEEN VOICED EVEN WITHIN THE OIL INDUSTRY.”

Risks of fracking

The main risk is that the water table contained in underground aquifers can be contaminated by the fracking chemicals. If these chemicals interact with a subterranean water source then such water can become highly toxic. The contamination, if it occurs, is so severe that it cannot even be treated. Although this risk has been recognised from the outset, in the USA numerous water sources have been contaminated due to negligence. Moreover, nobody seems to know how long it takes for fracking fluids to contaminate the water table since this is still a relatively new technology.

Some of the chemicals used in fracking are known to be carcinogenic such as benzole, formic acid, methanol and

How fracking works

Fracking is a means of recovering natural gas from porous rock deep beneath the Earth's surface. The porous rock is fractured by means of water, sand and chemicals until such point as the rock releases the natural gas contained within it which is then piped to the surface. The fracking boom in the USA over the last ten years has occurred because most conventional natural gas fields have been exhausted. As natural gas prices have risen so fracking, which is complex and relatively expensive, has become economically viable. Fracking has now been used over one million times in the USA alone. Sixty percent of all new oil and gas wells in the USA are drilled using fracking.

First, a vertical shaft is drilled several hundred metres into the Earth. A horizontal hole is then bored into the gas-bearing rock. Next, fracking fluid is pumped into the ground using immensely powerful pumps. Typically, the fluid consists of eight million litres of water – enough to satisfy the consumption of a typical American town of 65,000 inhabitants for a day – plus several thousand tonnes of sand and about 2,000 litres of chemicals. This mixture penetrates the layer of porous rock and creates innumerable tiny cracks. The sand prevents the cracks from closing again. The chemicals act to compress the water and to dissolve minerals.

Then, most of the fracking fluid is pumped back out of the shaft to the surface whereupon the natural gas can be recovered. When the gas released is exhausted the drill hole can be sealed. Generally, the fracking fluid is pumped back into deep underground layers beneath the water table and sealed there, supposedly for evermore.

Another worry: where does the sand come from?

In the week of 12 February, analyst Lucy Acton at **HSBC Global Research** released a research note warning that the extraction rate of sand – the second most-used raw material in the world – is running at unsustainable levels. She writes: "Sand mining presents devastating environmental and social issues such as damage to ecosystems, water scarcity and illegal trade. Additionally, transportation of sand and gravel is a significant part of the supply process, both in terms of costs and environmental impact."[ii]

hydrochloric acid. Some environmentalists are concerned that the oil companies that use fracking have not been transparent about the exact composition of these fracking fluids.

A second risk is the release of greenhouse gases into the atmosphere. Most of the natural gas recovered from fracking is methane, which is twenty-five times more potent as a greenhouse gas than carbon dioxide (CO_2). The fracking process requires a very large consumption of energy. Sites are quickly exhausted and therefore a much larger number of drill holes are required than for conventional gas recovery. About three percent of the recovered gas is lost in the extraction process which escapes into the atmosphere.

A third risk is that of *seismicity* – that is causing earthquakes. Environmental campaigners blamed seismic activity in Lancashire on fracking. In 2011, two earth tremors were detected following **Cuadrilla Resources'** hydraulic fracturing operations at Preese Hall Farm. The first took place on 01 April 2011 and measured 2.3 on the Richter scale. To determine whether this was due to hydraulic fracturing, Cuadrilla worked with Keele University and the British Geological Survey (BGS) to monitor ground movements around the active well sites.

A second tremor was recorded during the fourth fracture operation at Preese Hall measuring Richter 1.5 on 27 May 2011. Following this and after discussions with the Department of Energy and Climate Change (DECC), Cuadrilla "voluntarily" halted hydraulic fracturing operations while a report was commissioned to discover if there was a link between seismicity and fracturing. The UK Government then imposed a moratorium on fracking.

But a report published in April 2012 by DECC concluded that it was safe to resume hydraulic fracturing, subject to appropriate safeguards and stringent monitoring. Cuadrilla subsequently issued a statement citing "an unusual combination of geological factors" which would be unlikely to recur.

To put this into perspective, in geological terms, such events are classed as *micro-earthquakes* and are happening all the time, even in the UK. Most do not cause any material damage. By comparison a "naturally occurring" earthquake in Lincolnshire in 2008 was more than 22,000 times more powerful than the tremor which hit Blackpool on 01 April 2011.

Conventional oil and gas drilling has also been blamed for induced seismicity. According to the United States Geological Survey (USGS) only a very small fraction of roughly 40,000 waste fluid disposal wells for oil and gas operations have induced earthquakes large enough to be of concern.

Fracking has proven, over the short-term at least, an effective way to meet our insatiable demand for low-cost energy. But the long-term consequences of fracking are worrying given the risk to drinking water.

Fear of aquifer contamination in America

Imaging technology currently under development can accurately trace the source of aquifer contamination along migration pathways to fresh water aquifers. Both environmentalists and some oil companies engaged in conventional oil and gas production would like to see a permanent ban on fracking. They argue that the public perception in the USA of the advantages of fracking shale is far from reality. Moreover, shale drilling may be more expensive than thought – especially if exponents of fracking have to indemnify victims of aquifer contamination.

From late 2014, when oil and gas prices began to fall, the industry responded by drilling longer laterals with much bigger fracks. Laterals are now commonly more than 3,000 metres long and fracks have expanded from 1 million pounds of sand to as much as 14 million pounds. Shale is naturally prone to aquifer contamination because of numerous undetected near vertical faults that can become conduits when fracked. Some analysts believe that contamination in the Eagle Ford shale field (Texas) is already occurring on a large scale.

If widespread aquifer contamination could be definitively demonstrated by research agencies and by the academic community, that could put the share prices of oil companies which are heavily reliant on fracking under downward pressure.

The UK: the fracking boom that didn't happen?

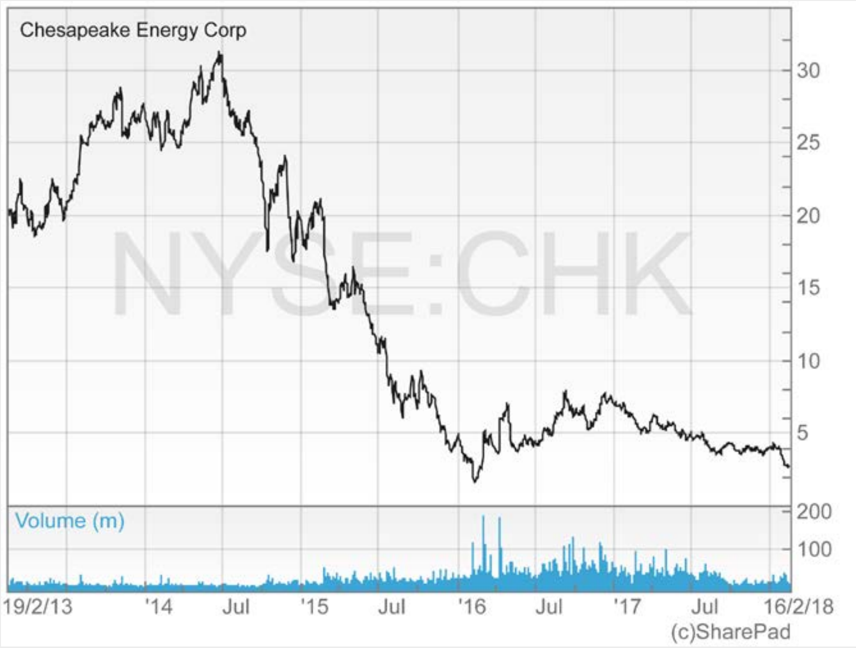
Here in the UK we are sitting on a huge subterranean belt of shale. This is rock which was laid down in the Palaeozoic

"IF WIDESPREAD AQUIFER CONTAMINATION COULD BE DEFINITIVELY DEMONSTRATED BY RESEARCH AGENCIES AND BY THE ACADEMIC COMMUNITY, THAT COULD PUT THE SHARE PRICES OF OIL COMPANIES WHICH ARE HEAVILY RELIANT ON FRACKING UNDER DOWNWARD PRESSURE."

Three US shale oil producers under pressure

In last year's article I identified three US shale oil and gas producers which were then riding high. These were considered bellwethers for the sector. How did they do? Let's just say the US shale revolution has not created shareholder value for some of its leading advocates...

Chesapeake Energy (NYSE:CHK) operates in Louisiana, Ohio, Oklahoma, Pennsylvania, Texas and Wyoming. In February last year Chesapeake announced that average 2016 production amounted to 635,400 barrels per day – in line with 2015 levels. Total oil and natural gas proven reserves stood at 1.7 billion barrels of oil equivalent, a 14 percent increase compared to 2015. The company had succeeded in reducing production expenses by about 28 percent as compared with 2015. What happened to their share price? Between February 21 2017 and February 16 2018 the share price declined fairly steadily from $6.08 to $2.73! So the share price more than halved essentially because it has still not fulfilled its objective of breaking even this year.



2016 was a "transformational year" for Oklahoma based **Devon Energy (NYSE:DVN)** according to its CEO. The company decided to focus on its top two franchise assets, the STACK field (located in the Anadarko Basin of Oklahoma) and Delaware Basin field. The company's drilling programmes generated the best well productivity in its 45-year history. At the time of writing one year ago DVN's share price was trading at $45 – as I write in the third week of February 2018 it is at around $34.

Whiting Petroleum (NYSE:WLL) is a crude oil producer in North Dakota where output is 130,000 barrels of oil per day. It also operates substantial assets in northern Colorado. Headquartered in Denver, Colorado, Whiting's share price rose by over 160 percent from February 2016 to February 2017 when it reached $46. In late February 2018 it is trading at about $23. Once again – a share which has halved in value.

Era some 250-500 million years ago. In September 2011, a leading player in UK shale gas, Cuadrilla Resources, announced that it estimated that there could be 200 trillion cubic feet of gas under the Bowland shale bed in Lancashire alone.

During the week of 05 February a hitherto secret government report was revealed to the UK media after Greenpeace uncovered it via a Freedom of Information request. The 2016 report suggested that the promise of a shale gas fracking bonanza in the UK has been greatly exaggerated. The Sunday Telegraph reported[iii] that "the Government has known for almost two years that the number of wells likely to flow [sic] shale gas from fractures deep beneath the Earth will be just a fraction of the 4,000 wells quoted publicly by ministers..."

In fact the *total* number of viable shale wells in the UK is likely to be in the order of 155 as compared with the 400 per year envisaged in a previous report from Ernst & Young (EY). This report fuelled claims that a shale revolution could drive £33 billion of new investment and create over 64,000 jobs.

This will be music to the ears of environmentalists but represents a blow to tacit government policy. In Chancellor George Osborne's Autumn Statement on 05 December 2012, almost unnoticed by the media, he set up a new body called the *Office for Unconventional Gas and Oil*. And in the small print to the Statement, the Chancellor outlined tax breaks for fracking companies – even though at that time fracking was technically still outlawed in the UK. A week later, on 13 December 2012, the moratorium on fracking in England (though not in Scotland) was removed by statutory order.

The UK was a significant offshore gas producer for many years but production peaked in 2000 and has since been in rapid decline. The country has gone from being a net gas exporter in 2003 to being dependent on imports of gas today. By 2020 the UK may only be able to meet about one quarter of its natural gas demand from domestic production.

The shortfall has been made up by imports of piped gas mainly from Norway, the Netherlands and Russia, supplemented by imports of Liquid Natural Gas (LNG) by ship from Qatar, the

"EVEN ENERGY EXECUTIVES CONSIDER THAT IT WOULD BE DIFFICULT TO REPLICATE THE US SHALE GAS BOOM IN THE UK GIVEN THE DIFFICULTIES OF DRILLING IN A MUCH MORE DENSELY POPULATED COUNTRY."

Halliburton (NYSE:HAL) – the canary in the coal mine?

Halliburton's shares wobbled on 15 February after the giant American oilfield services group revealed that it expects to take a hit on its next quarterly earnings because of delays in sand deliveries to oil firms active in fracking. These delivery backlogs are expected to cost 10 cents to its EPS in Q1 2018. Halliburton is a major provider of inputs and services to the US shale industry including the pumps and fluids used in fracking. At time of writing the shares are trading at $47.50 yielding a top-heavy P/E ratio of 127.

Four fracking companies active in the UK

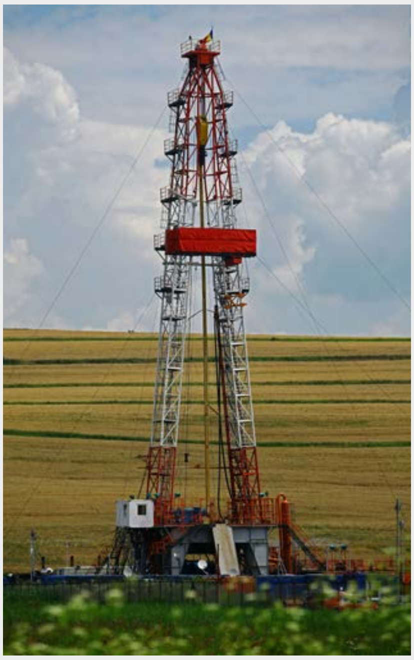
There are just a small posse of unconventional oil and gas producers which are already generating gas and oil here in the UK.

Cuadrilla Resources is owned by the quoted Australian mining services company **AJ Lucas (ASX:AJL)** (45%), Riverstone Holdings (45%) and company management (10%). Cuadrilla announced on 12 January that it was "very encouraged" by the results obtained from a pilot well stretching 2.7 kilometres into the ground at its site near Blackpool. Completion of the well signals a resumption of hydraulic fracturing for the first time since fracking was halted in 2011 after supposedly causing earth tremors. Cuadrilla's latest drill site at Preston New Road was allowed to proceed in 2016 after Sajid Javid, Communities Secretary, overturned a decision by Lancashire county council to block the plans. However, Cuadrilla will require final approval from the new Secretary of State for Business, Energy and Industrial Strategy, Greg Clark, before it can resume fracking.

Third Energy, another shale gas company, is awaiting consent from Mr Clark to start fracking a vertical well at Kirby Misperton in North Yorkshire.

IGas Energy PLC (LON:IGAS) bought out the UK operations of **Dart Energy Ltd.** (headquartered in Singapore but managed from Brisbane, Australia) in May 2014. Dart Energy emerged from the demerger of Arrow International's unconventional oil and gas assets in 2010. It was said to command specialist expertise in the field of unconventional gas exploration and with a portfolio of 52 licensed sites across eight countries. IGas's share price has fallen from over 200 pence in February last year to 77 pence at time of writing.

In March 2017 Swiss-based **Ineos** increased its exposure to UK shale gas by acquiring a portfolio of onshore exploration and production licences from **Engie SA (EPA:ENGI)**, the French energy group, in an effort to bring US-style fracking to Britain. For **Engie** the withdrawal was part of its strategic re-positioning away from production to consumer-facing businesses. **Ineos Group**, privately controlled by its founder and chairman Jim Ratcliffe, is already the biggest owner of shale licences in the UK and last year's deal increased its land holdings by 10 percent to more than 1.2 million acres.



latter amounting to about 40 percent of total consumption. The appeal of domestically produced shale gas is that it would reduce Britain's dependence on potentially vulnerable overseas suppliers – and thus improve our *energy security*. Opponents of fracking argue that the debate has moved on as the price of renewable energy continues to fall. Even energy executives consider that it would be difficult to replicate the US shale gas boom in the UK given the difficulties of drilling in a much more densely populated country.

Advances in oil exploration technology

Conventionally, oil exploration companies start with detailed geological surveys, satellite photography, airborne reconnaissance and seismic samples and begin to drill in promising locations. Unfortunately, most wells drilled are *wildcat wells* which disappoint. Often the confirmation of the existence of an economically viable oil field requires numerous drilling operations. This is an expensive and time-consuming process – even more so when conducted offshore. Any technology that would permit oil explorers to strike oil first time would reduce costs dramatically.

On a recent trip to the USA I was privately briefed about an embryonic Texas-based start-up which has developed a proprietary technology which could revolutionise oil exploration. The technology in question uses sensitive instruments to monitor natural radiation being emitted from the Earth's core.

It detects changes in the frequency of naturally occurring gamma radiation to pin-point the location of hydrocarbon deposits deep below the surface. As the Earth's natural gamma radiation passes through hydrocarbon bearing rock structures it minutely but detectably changes frequency. The changes of frequency can also indicate the extent of the oil and gas reserves.

In principle such technology would permit operators not only to find high concentrations of commercial oil deposits, but also potentially to find precious metals (silver, rare earth minerals) and accurately map these deposits within their fracture systems. Reliable mapping of such deposits would allow for efficient extraction methods which would be more environmentally responsible.

It could also be used to find faults that can become conduits for oil and gas migration. Visualizing the movement of oil and gas from source rock to reservoir rock would give oil explorers an extraordinary level of detail previously unavailable. One oil major that is rumoured to be investigating the use of this revolutionary new technology is **Saudi Aramco** – which is likely to be listed on either the New York or London markets later this year.

Outlook

The medium to long-term outlook has not changed over the last year. World GDP will nearly double between now and 2035 driven by fast-growing emerging economies where more than two billion people will be lifted out of poverty. Yet efficiency gains and electrification will greatly reduce oil consumption per person. *While global GDP will increase by over 90 percent between now and 2035, energy demand will increase by only around 30 percent.*

The share of hydrocarbons in the fuel mix will continue to decline, although oil and gas, together with coal, will remain the dominant sources of energy. Renewables, along with nuclear and hydroelectric power, will provide half of the additional energy required out to 2035.

Action

My recommendation last year that investors' exposure to the oil sector should be biased towards those oil majors which are diversifying into renewables still stands. I cited **Total SA (EPA:FP)** as a benchmark. I am no longer so bullish, however, on those oil majors which have very large investments in the shale oil and gas sector such as **Statoil (SWX:STL)** and the second-tier US oil majors such as the three discussed above. If an incoming Democratic President were to arrive in the White House in January 2021 with a mandate to ban fracking – which is quite conceivable – the cat really would be set amongst the pigeons...

I'll be having much more to say about investment in renewables this year. Meanwhile, check out the **Power Shares Wilder Hill Clean Energy ETF (NYSEARCA:PBW)**. It's going places.

"RENEWABLES, ALONG WITH NUCLEAR AND HYDROELECTRIC POWER, WILL PROVIDE HALF OF THE ADDITIONAL ENERGY REQUIRED OUT TO 2035."

About Victor

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

i See The Financial Times 13 February 2018, available at: https://www.ft.com/content/1904fd3c-109a-11e8-8cb6-b9ccc4c4dbbb

ii Reported in the Financial Times, 15 February 2018. Available at: https://www.ft.com/content/372fe44e-1265-11e8-940e-08320fc2a277

iii Ministers exaggerated fracking boom, Sunday, 11 February 2018, page B1.

BEST PROFITABILITY AMONG THE MAJORS
DIVIDEND GROWTH FORECAST

Total demonstrated its ability to capture the benefit of higher oil prices by reporting adjusted net income of $10.6 billion, a 28% increase from 2016, and a return on equity above 10%, the highest among the majors. The Upstream, in particular, increased its results by more than 80% and its operating cash flow by close to 40%, compared to a 24% increase in Brent, especially thanks to production growth.
Financial discipline was successfully maintained. Production costs fell to $5.4/boe in 2017 down from $9.9/boe in 2014.
The Downstream confirmed again this year its ability to generate around $7 billion of operating cash flow and reported a return on capital employed of more than 30%.
In E&P, the Group is preparing for future growth with the announced acquisition of Maersk Oil and finalized its entry into the Lapa and Iara fields in Brazil in early 2018. In the framework of reinforcing its integrated gas strategy, it announced the acquisition of the LNG(1) business of Engie to take full advantage of the fast-growing LNG market. Total also partnered with EREN Renewable Energy to accelerate its growth in solar energy and move into the wind power market.
The strategy implemented since 2015 has enabled the Group to reduce its pre-dividend organic breakeven to $27/b in 2017 and generate $22 billion of debt-adjusted cash flow. The Group also continued to strengthen its balance sheet, ending the year with 14% gearing.
In this context, the Board of Directors has decided to propose a shareholder return policy for the coming three years by increasing the dividend by 10%, maintaining the scrip dividend option with no discount and buying back newly issued shared to avoid dilution, and buying back up to 5 B$ of shares over the period 2018-20 to share with investors the benefits of the oil price upside.

Adjusted net income
10.6
billion dollars

Hydrocarbon production
+5%
compared to 2016(2)

2017 dividend
€2.48
per share(3)

Dividend growth forecast
+10%
over the next 3 years(4)

2017 HIGHLIGHTS

Investments that strengthen our positions
- Launched 5 Upstream projects including Libra in Brazil
- Petrochemical platforms expansions in the United States and South Korea

Acquisitions that shape the future
- Maersk Oil, strengthening our position in the North Sea
- Engie's upstream LNG(1) business to rank second in global LNG
- EREN Renewable Energy, renamed Total Eren, to expand into wind and solar energy

New offers designed for our customers
- Launched Total Spring in France to target residential market with gas and green power
- Entered petroleum product retail sector in Mexico

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Total Investors Application

(1) Liquefied Natural Gas.
(2) Hydrocarbon production was 2,566 thousand barrels of oil equivalent per day in 2017 vs 2,452 in 2016.
(3) Pending approval by the Annual Shareholders' Meeting on June 1, 2018. Corresponding to an increase of 1.2% compared to the full-year 2016 dividend.
(4) The 2018 interim dividends will be increased by 3.2% to 0.64 €/share, with the intention of proposing to the Combined Shareholders' Meeting a full-year 2018 dividend of 2.56 €/share. The target for the full-year 2020 dividend would be 2.72 €/share.

MASTER INVESTOR SHOW 2018

A YEAR'S WORTH OF INVESTMENT INSIGHTS

SPEND ONE DAY AT MASTER INVESTOR SHOW AND BENEFIT YOUR INVESTMENT STRATEGY FOR THE NEXT 364 DAYS

Countering the notion that investing is a dull affair, Master Investor Show gets thousands of ordinary private investors to head to Islington, London on a Saturday morning. Now in its 16th year, the event initially began with a focus on AIM-listed companies and has since grown into a much broader affair. Visitors now benefit from multiple investment sectors being covered, including equity funds and retirement saving, crowdfunding, life sciences and fintech, and alternative finance such as film funding and peer-to-peer lending. Below we offer an exclusive preview of what visitors can expect to see on 17 March.

Beat the market with listed shares

As always, the CEOs of a range of successful public companies will attend the event. Master Investor Show has a reputation for working with winners:

AIM-listed growth company: The Singapore-based airplane leasing firm, Avation plc, has steadily risen from 60p in 2013 to 240p today, a 300% gain in 4 years. The company is a regular at our show, giving delegates the opportunity to track its progress every year. It's set for more growth, and one of the show's regular star speakers, Jim Mellon, holds Avation shares in his retirement portfolio.

Listed cryptocurrency play: Our 2017 show featured SatoshiPay, a German crypto-payment start-up. Delegates learned that they could invest into the privately-held company through a secret backdoor, AIM-listed Blue Star Capital, which holds a large stake in SatoshiPay. After last year's show, shares in Blue Star Capital rose from 14p to up to 64p.

Blue chip investing: There is money to be made in the most liquid, widely-held European companies if you know which ones to pick. Deutsche Börse, the giant operator of stock exchanges across Europe, is among our regular exhibitors. Since our 2017 event, the share is up from €80 to €110 at time of writing.

A 6,733% return from a European share: This year's show will feature the Budapest Stock Exchange. Exotic? It's the second largest stock exchange in the EU's fastest growing region, Central and Eastern Europe. One widely-known Hungarian company, KONZUM, rose in value 67-fold! What other potential star performers are there in Hungary and how can UK investors trade them? Learn it directly from the Budapest Stock Exchange team and some of the Hungarian companies they are bringing along.

Have you had such winners in your portfolio? Our delegates can learn directly from the companies' representatives which ones have the best prospects. We even offer a yearly


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www.z

£10,000 stock picking competition to our delegates - more about this at the bottom of this article.

Discover the tools for achieving investment success

Master Investor doesn't issue buy and sell recommendations. Instead, the show gives private investors the tools they need to make their own decisions and access to leading platforms, such as:

London South East: Event sponsor and the leading portal website for private investors will co-host all presentations on the Rising Stars Stage.

Vox Markets: This company aggregates investor relations information from a broad range of sources into a single platform. Its members can communicate with one another via messaging and keep up to date with financial markets via social media and stock market news feeds. This is a powerful tool used by asset managers, stock brokers, hedge fund managers and independent financial advisors. Private investors can use it, too. The Vox Markets team will be on stand-by to show you how to use their platform.

Edison: Offers private investors free access to over 400 equity research reports. Pick up some of their reports and speak to their team about using their free web-based tools for researching public company investments.

Investment insights from a powehouse line-up of speakers

Master Investor Show is proud to host not just one, but four stages where delegates can listen to speakers throughout the day.

Our speaker programme is the best in the industry:

- Each stage has its own main theme.
- We work hard to minimise overlap between stages, allowing you to take in as much as possible.
- Our Show App allows you to plan which presentations to attend; or simply pick up the printed Show Guide on the day.

The **Rising Stars Stage** features companies that are traded on a stock market – i.e. anyone with a brokerage account can easily buy or sell these shares. The line-up of companies presenting in 10-minute slots on the ever-popular Rising Stars Stage includes Auxico Resources, Condor Gold plc and Cadence Minerals plc.

The **Auditorium** is heavily geared towards educational presentations. These presentations are usually 30 minutes long and last year led to queues forming outside for some of the presentations. Come early to secure yourself a seat for the presentations that interest you! Companies presenting in the Auditorium include Fidelity International, VectorVest and Atlantis Wealth.

We use the **Gallery Suite** to give presentation slots to companies that are active in alternative asset classes. This year, it will feature Avation plc, Netwealth Investments and Nova Financial.

The **Main Stage** once again forms the epicentre of the event. Watch out for presentations by Fidelity International's Tom Stevenson, a widely recognised market strategist who also writes a column for the Daily Telegraph. Further speakers include QuotedData, TOTAL S.A., and the Budapest Stock Exchange.

Master Investor Show features around 100 exhibitors and 40 speaking slots. This year's event will once again be packed out entirely, spoiling you with choice!

Learn about alternative asset classes

Publicly listed equities remain the main feature of Master Investor Show; however, the choice of investments that private investors can choose from is bigger than ever before. We introduce our delegates to investments that can complement their portfolio and open up entirely new horizons for their investing.

LendInvest: This company is revolutionising property lending in the UK, and offers investors the opportunity to earn 5.25% p.a. from their publicly traded bond.

EVR Bullion: If you'd like insurance against crash scenarios, gold is still the world's most highly rated safe haven. This company offers you the ability to purchase physical precious metals on the spot markets. Learn from them why this is the best deal for purchasing gold and other precious metals.

SyndicateRoom: The UK's highest quality online equity platform, with a strong angle towards educating and informing their investor base. SyndicateRoom is a Master Investor Show regular and we urge attendees to speak to them about their current opportunities, including their new investment fund. According to recent research, a selection of 519 start-ups in the UK grew by 30% p.a. between 2011 and 2017. Had you invested £10,000 into this group of start-ups in 2011, your investment would now be worth £63,848.

Win £10,000 in our Stock Picking Competition

Starting a portfolio can appear like a daunting task. Yet, many successful investors started with a small amount of capital. Take Jim Mellon, the well-known entrepreneur now worth £920 million. When he started out in the investment business, he was so short on cash that he had to rent a windowless apartment. Fast-forward 30 years and Jim is one of the world's most sought-after investment experts and features in the top 10% of the Sunday Times Rich List.

The charismatic Scotsman gives one participant of the annual event a fantastic financial boost: Jim personally writes the cheque to the delegate who correctly predicts which share price out of 30 publicly listed companies exhibiting at the show will have the strongest share price performance over the coming 12 months. The winner gets a £10,000 prize at next year's event.

With 4,000 delegates attending and 30 companies to choose from, anyone participating has excellent odds.

Entrants must be 18 years old, comply with the terms and conditions and, of course, attend the show on 17 March!

A must-attend event for all investors

Investing can be a daunting subject. Master Investor Show aims to break down the barriers between the finance industry and private investors. Some of our visitors have millions to invest, while others are still at the beginning of their investment career. All investments carry risks, and attending an event for a single day is not a one-way street to riches. However, Master Investor Show does provide access to opportunities and information that private investors can research further to make their own informed decisions. With two weeks to go, the show – the largest event of its kind in the UK – has already attracted over 3,000 registrations. Don't miss out – book your place now.

MASTER INVESTOR SHOW 2018 - FREE ENTRY TICKETS

Exclusive ticket offer for Master Investor Magazine readers: Claim up to two free tickets for the entire day.

Enter discount code: M0318 at masterinvestor.co.uk/tickets

WHEN
Saturday, 17 March 2018 (9.30am - 5pm)

WHERE
Business Design Centre, Islington, London (nearest Tube: Angel)

In association with Fidelity International

BY NICK SUDBURY

FUNDS IN FOCUS

HOW TO DIVERSIFY THROUGH ALTERNATIVE ASSETS

One of the most remarkable trends in the financial markets over the last few years has been the rise in popularity of alternative asset classes. This diverse sector includes everything from property and infrastructure, to specialist bond and hedge funds, with the lack of liquidity in these areas making investment trusts the obvious way to gain exposure.

The growth in demand for alternatives has largely been driven by the desire for an attractive and sustainable yield that has the potential to rise in line with inflation. It also reflects a growing concern with the high valuation of more mainstream asset classes, with investors looking for ways to increase their diversification and protect their portfolios.

Research by Canaccord Genuity shows that alternative investment trusts have generated net inflows – new money raised net of cash returned to shareholders – of £22 billion in the last five years, with £5 billion of that coming in 2017. This compares to net outflows of £1.7 billion from equity investment trusts.

Back in 2002, alternatives accounted for just 9% of the market value of the investment trust sector, but that figure has now risen to an astounding 42%. The question for investors is whether these products can continue to deliver against the backdrop of rising interest rates, reduced bond buying by the central banks (Quantitative Easing) and higher market volatility that we are likely to encounter this year.

Infrastructure

Infrastructure funds have attracted a lot of investor interest in recent years due to a high level of income, which tends to rise with inflation. The excess demand had pushed many of these investment trusts on to a substantial premium to their net asset value (NAV), but those with the highest exposure to Private Finance Initiative (PFI) contracts have now been de-rated following the threat by the Labour Party to bring them back in-house, and the collapse of the outsourcer Carillion.

HICL Infrastructure (LON:HICL) has the largest investment in PFI assets in the sector, but the slide from a 9% premium to a small discount has encouraged the analysts at Winterflood, Numis and Canaccord Genuity to stick with their BUY recommendations. HICL has a diversified portfolio of high quality assets and is yielding around 5.4%. It also has the tightest linkage to inflation with each 1% increase resulting in a 0.8% uplift in the fund's income.

Another favoured option in this area is **International Public Partnerships (LON:INPP)**, which is recommended by both Numis and Canaccord Genuity. INPP has built up a strong performance record that is underpinned by its ability to source

"THE GROWTH IN DEMAND FOR ALTERNATIVES HAS LARGELY BEEN DRIVEN BY THE DESIRE FOR AN ATTRACTIVE AND SUSTAINABLE YIELD THAT HAS THE POTENTIAL TO RISE IN LINE WITH INFLATION."

"LAST YEAR WAS A PARTICULARLY ACTIVE ONE FOR THE PROPERTY INVESTMENT TRUST SECTOR, WITH NINE SEPARATE IPOS AND VARIOUS SECONDARY ISSUES RAISING AROUND £3.7 BILLION OF NEW CAPITAL."

attractive new assets. It is currently yielding 4.6% and trading on a small premium to NAV.

Renewable Energy

Renewable Energy funds achieved net inflows of £822 million in the last five years with the demand buoyed by the improvement in sentiment towards power prices. These projects typically derive about half of their revenues from long-dated government subsidies that rise in line with inflation, with the rest coming from the sale of the electricity generated.

The country's first renewable energy fund was **Greencoat UK Wind (LON:UKW)**, which raised £260 million in March 2013 and has since had a number of successful placings that have enabled it to increase its market value to £1.2 billion. It is the only UK focused wind fund in the sector and operates 29 different wind farms. UKW has delivered steady returns and is yielding 5.4% with both Numis and Canaccord Genuity including it on their recommended list.

A more diversified option is the **Renewables Infrastructure Group (LON:TRIG)**, which provides exposure to a mixture of onshore and offshore wind, solar PV and battery storage. It owns a total of 57 renewable energy generation projects and has a market value of around £1 billion. Capital returns have been modest, but it is yielding 6.2% and the analysts at Canaccord Genuity believe that it offers a low cost, low risk exposure to the asset class.

Property

Last year was a particularly active one for the property investment trust sector, with nine separate IPOs and various secondary issues raising around £3.7 billion of new capital. Most of this money was invested in specialist mandates such as social housing, warehouses and healthcare properties, although a number of listings had to be cancelled towards the end of the period because of a lack of demand.

The £1.1 billion **F&C Commercial Property Trust (LON:FCPT)** owns the highest quality portfolio of properties in the sector with around 55% of the value concentrated in London and the South East. It has a strong long-term performance record and is yielding 4.3% with monthly dividends that it has maintained since launch in March 2005.

A more specialist selection by Winterflood is the £205 million **Impact Healthcare REIT (LON:IHR)**, which was launched in March 2017. The fund owns a portfolio of 57 residential care homes that have been let on 20-year inflation-linked leases. It has a targeted yield of 6% based on the issue price and offers an uncorrelated exposure that should be relatively immune to the economic cycle.

The core buy recommendations from Numis in this area include the £203 million **LXI REIT (LON:LXI)**, which was launched in February 2017 and invests in a portfolio of long-lease assets. These have an average net initial yield of over 6% and an average unexpired lease term to the first break in the contract of 24 years. The fund benefits from a diversified tenant base with almost all of the income being linked to inflation or having fixed periodic uplifts.

FUND OF THE MONTH

The last few years have been extremely difficult for listed hedge funds as they have struggled to make any sort of headway against the backdrop of low volatility and stable interest rates. One such is **BH Global (LON:BHGG)**, which raised $1 billion when it was launched in May 2008, but has since contracted to $442 million after a series of tender offers and share buybacks. It is possible that the worst could be behind it as the fund would benefit from a less stable macro environment.

At the end of December BHGG had invested 21.8% of its assets in the Brevan Howard Master Fund, which aims to deliver consistent risk-adjusted returns in different market conditions through exposure to a range of trading strategies. A further 8% was allocated to the BH-DG Systematic Trading Master Fund with another 7.2% in the Brevan Howard Asia Master Fund.

The rest of the fund's assets – over 60% − were allocated to individual traders affiliated to Brevan Howard and it is this Direct Investment Portfolio that has generated the majority of the recent returns. These people employ a variety of different strategies in areas such as credit trading, interest rate trading, foreign exchange, and equity indices.

BHGG's largest underlying allocation is to Macro Strategies and there is every chance that as central banks take steps to normalise monetary policy it will create an improved trading environment with larger market moves and higher volatility. The strong share price performance during the recent market sell-off could be an indication of what is to come.

The fund's shares are trading on a 5% discount to NAV and the Board is actively looking to improve the situation through share buybacks. It has also reduced the management fee from 2% to 1% of net assets. If the higher market volatility continues the fund would be well placed to benefit.

Fund Facts

Name:	BH Global (LON: BHGG)
Type:	Investment Trust
Sector:	Hedge Funds
Total Assets:	$442 million
Launch Date:	May 2008
Current Yield:	0%
Gearing:	0%
Ongoing Charges:	2.37%
Website:	www.bhglobal.com

They also like the £257 million **PRS REIT (LON:PRSR)**, which launched in May 2017 to invest in newly constructed private rental properties that are to be let on 12-month Assured Shorthold Tenancies to qualifying tenants in the largest English towns and cities outside of London. It is targeting a yield of at least 6% per annum and a total annual return of 10% or more once fully invested and geared.

Specialist bond funds

Many bonds have become extremely expensive with valuations pushed up by the historically low interest rates and the aggressive purchasing by central banks. These areas look vulnerable to rate increases and reductions in the level of Quantitative Easing, with the fixed rate, long-duration notes having the most to lose.

Some of the investment trusts operating in this area should be relatively immune to rising rates, as they hold shorter duration floating rate notes that pay more when interest rates rise. A good example is the £470 million **TwentyFour Income (LON:TFIF)**, which invests in European Asset Backed Securities. It is yielding almost 6% and is recommended by the analysts at Winterflood and Numis.

Numis also like **Funding Circle SME Income (LON:FCIF)**, which invests in small and medium enterprise loans through the Funding Circle marketplaces. Its typical loan is £67,000 with a gross interest rate of around 10%. This gives the fund an attractive projected net return after bad debts and costs of 7.1% per annum. FCIF is yielding 6.3% and stress tests suggest that the annual return in the event of a 2008 financial crisis-type event would be 5.1%.

BioPharma Credit (LON:BPCR) raised $762 million at its IPO in March 2017 and has invested the proceeds in a portfolio of loans backed by royalties and other cash-flows from sales of approved life-science products. The fund aims to deliver a NAV total return of 8% to 9% per annum over the medium term, with a target dividend yield of 7%. It has recently raised an additional $154 million and is subject to a BUY recommendation by Canaccord Genuity.

"SOME OF THESE AREAS COULD BE SEVERELY TESTED BY CHANGES TO THE MACRO ENVIRONMENT AND THOSE FUNDS THAT FAIL TO DELIVER ARE LIKELY TO BE HIT HARD."

Outlook

The growth in popularity of alternative funds has come at a time of low interest rates and low volatility so it remains to be seen how they will perform when challenged on both fronts. Some of these areas could be severely tested by changes to the macro environment and those funds that fail to deliver are likely to be hit hard.

Investors in **Empiric Student Property (LON:ESP)** know how expensive this can be. The fund invests in high quality student accommodation, but a set of poor results in September and a subsequent reduction in the dividend have resulted in a near 20% fall in the share price over the last year and the departure of its CEO and CFO. Peer-to-peer lender **Ranger Direct Lending (LON:RDL)** has also suffered due to its poor due diligence and risk controls.

Market conditions have been a lot more challenging this year and could provide a foretaste of what is to come, but so far most of the alternatives have held up pretty well. The main exceptions have been the infrastructure funds, which have been dragged down by the collapse of Carillion, and some of the specialist property mandates.

Higher interest rates and a reduction in Quantitative Easing by the world's central banks will inevitably put pressure on the mainstream asset classes. Alternatives will not be immune from these macro challenges, but by carefully selecting individual funds it may be possible to protect and enhance your portfolio returns.

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.

BY FILIPE R. COSTA

THE MACRO INVESTOR

INFLATION MAKES A COMEBACK

"This is not yet a major earthquake... Whether it's an early tremor or a random fluctuation remains to be seen. I'm nervous and will stay nervous. [It is] far from clear that good growth and stable finance are compatible."

— Lawrence Summers, 2018

"NO MATTER HOW GOOD THE PROSPECTS FOR RISING CORPORATE PROFITS AND ECONOMIC GROWTH MAY SEEM, THE REAL TRUTH IS THAT THE CURRENT BULL MARKET HAS BEEN TOO STRONG FOR TOO LONG."

At a time when the world economy is ticking along at a healthy pace, unemployment is low, and equities are flying high, the unthinkable strikes: major equity indices suddenly collapse 4% in a single day and then another 4% three days after. Is this the end of the bull market?

Probably not. It is too soon to call a serious inversion in market direction. Still, the bulls have been sent a shot across the bow. Some blame the rising inflation numbers; others point the finger at computer algorithms; even opaque volatility products have come under scrutiny. Ultimately, each of those should probably bear a portion of the blame but the key reason behind the market jitters remains unknown. Still, what time doesn't kill it cures, and investors took the sudden collapse as an entry opportunity rather than as a warning signal. Nevertheless, we shouldn't ignore the sudden spike in volatility, as it was not the consequence of a trading glitch or any kind of error but rather the result of an amplified reaction to investor concern that the long-lasting bull market was coming to an end. No matter how good the prospects for rising corporate profits and economic growth may seem, the real truth is that the current bull market has been too strong for too long.

The strong uptrend can hardly be attributed to the fundamentals. A more likely culprit is the central bank and its ultra-low interest rate policy framework. The Federal Reserve of Ben Bernanke and Janet Yellen has been astoundingly effective in managing downside risks for years. As a result, equity prices moved higher, bond yields remained low, credit spreads tightened, credit standards eased, and the dollar fell. All this has contributed to the long-running bull market in stocks.

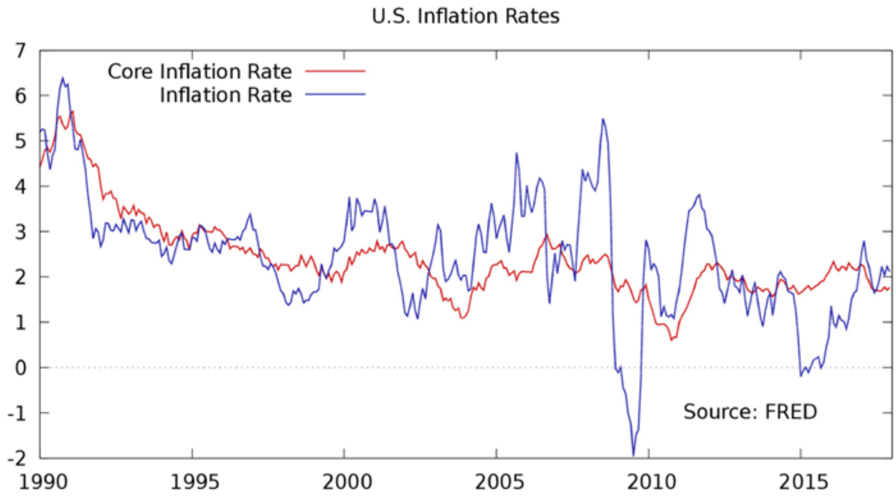
But the Federal Reserve *is* changing direction, albeit gradually. Interest rates are now up 1.25% from their record low of 0.25%, and expectations point to another 75 basis points to be added this year. This seems plainly justified by real data. If we look at the overall economy we see that real growth has accelerated, the unemployment rate has dropped to levels typically associated with full employment, and the government is implementing fiscal stimulus through tax cuts and fresh spending. The inversion in policy direction is more than justified.

However, there is a risk that the Fed is behind the curve (for more about equilibrium policy rates see box 1). With the discount rate being so low, any sudden increase may derail equity valuations. Is the central bank willing to risk a crash? Or will it tolerate accelerating inflation for some time?

Whether they are manifested in the form of rising inflation or rising interest rates, the risks are mounting fast for equity and bond investors. The volatility experienced at the beginning of February is hardly a one-off event and should serve as a warning that risk profiles really do matter. Protecting against inflation and downside risks is a nascent investment theme for the year.

The economy is heating up

Most investors and economists believe that inflation is far below the point where it would constitute a material problem, even though the latest January figures point to a sudden monthly increase of 0.5% in



consumer prices. While such a number translates into a somewhat worrisome 6% annual rate, seasonal and one-off effects have been cited as an explanation. The core inflation rate (which doesn't take into account food and energy prices) has been moving very slowly over the years and has always read below 2%. But the numbers for the headline rate are accelerating and are currently above 2%. They are still under control, but the trend is clear (see chart). While the numbers are not of immediate concern to the central bank, they fit very well in terms of what we would expect during the later stages of the economic cycle.

Meanwhile, since peaking at 10% during the worst of the financial crisis, the unemployment rate has been steadily decreasing and it currently hovers near 4.1%, a figure not seen since 2000 (and before that, since 1970). It is very unlikely that unemployment can be brought down from the current level, which means we are already operating near full capacity. Any attempts to boost the economy through tax cuts, interest rate cuts, and asset purchases are likely to be futile at this point. At best they would lead to corporations bidding wages higher – a situation that can sometimes culminate in uncontrollable inflation. Only through structural reforms aimed at targeting productivity can the economy expand from here.

The quantity theory of money

Until the 1980s, the mainstream monetary view postulated that an increase in the rate at which the money supply grows leads to an equiproportional increase in the inflation rate. In practice, if the money supply increases by 5%, the inflation rate should also accelerate by 5%. This simple relationship stems from one of the simplest theories ever formulated about money growth, developed by Irving Fisher at the beginning of the last century, which claims that MV = PT. Fisher's equation, which became known as the equation of exchange, uses the money supply (M), the velocity of money (V), the price level (P) and the total transactions of the economy (T). To be precise, it is not even a theory but rather a tautology. It claims that the total amount of money spent must be equal to the total amount of transactions. The total amount you spend at a supermarket should be equal to the total cost of the items you are purchasing. (If not, one party is stealing from the other!)

For the sake of measurability, the second term was later replaced by PY and often read as nominal GDP (price level times real GDP). The total value of goods and services we produce should be equal to the money available to pay for those goods times the frequency each unit of money is used. A single note of $50 may be used 10 times to purchase a total of $500 in goods and services. Alternatively, there may be 10 notes of $50 in circulation, each used a single time. In the end the amount spent would be the same, with the only difference being the velocity at which the $50 notes circulate.

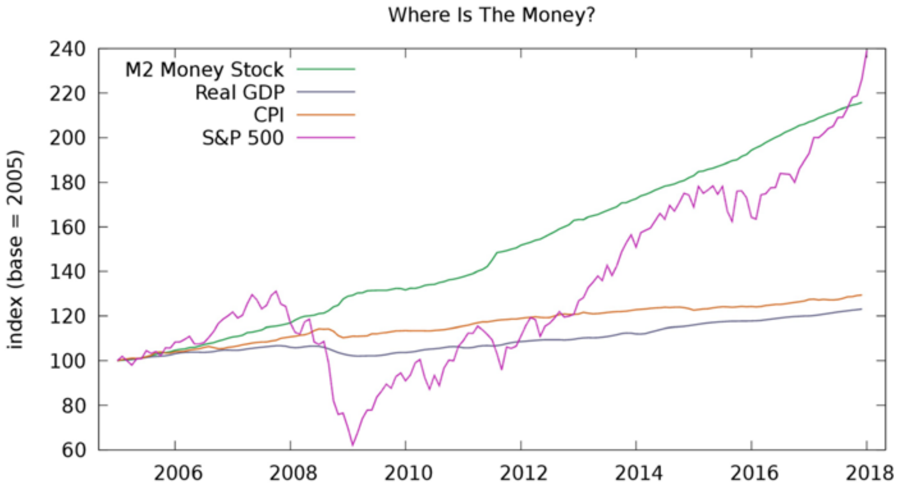
The quantity theory of money developed from Fisher's equation of exchange additionally claimed that the velocity of money is more or less constant over time. This led him to discern a direct proportionality between money and prices. The problem is that during the 1980s, central banks were unable to keep track of inflation by means of controlling the money supply. Only the Bundesbank could do that effectively. All the others started targeting interest rates instead. Many explanations were advanced, in particular a claim that the velocity of money was declining. If that were true, there may be a case for a central bank to expand its balance sheet without creating much inflation.

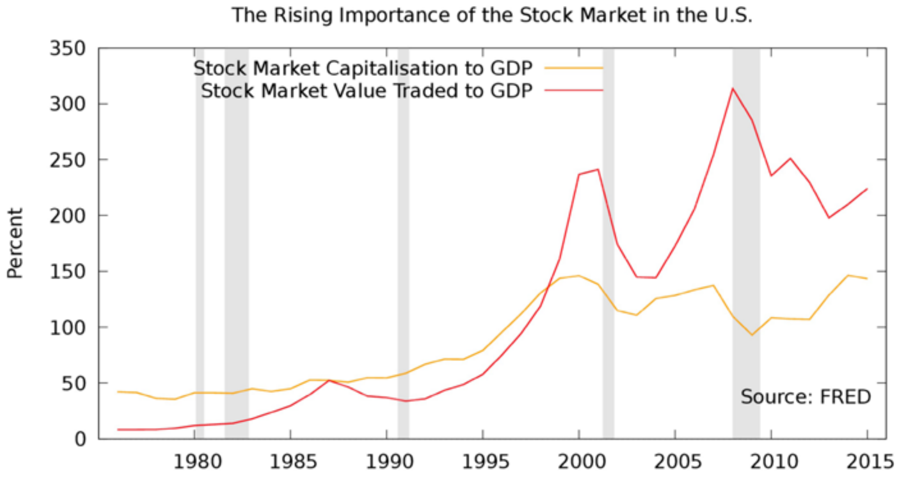
Where is the money?

The recent track record of central bank intervention through asset purchases seems to validate the idea of a declin-

"IT IS VERY UNLIKELY THAT UNEMPLOYMENT CAN BE BROUGHT DOWN FROM THE CURRENT LEVEL, WHICH MEANS WE ARE ALREADY OPERATING NEAR FULL CAPACITY."

ing velocity of money. The lack of inflation allowed the Federal Reserve to adopt unconventional policy measures and to continue expanding its balance sheet for years until reaching a staggering $4 trillion in assets. Just before the Lehman Brothers collapse in September 2008, the monetary base was at the $870 billion level. In August 2015 it reached $4 trillion. If Irving Fisher were alive today, he would predict a period of double-digit inflation. Luckily, the equation of exchange doesn't seem to apply in today's economy. Despite the exuberant management of their balance sheets, central banks were able to keep inflation under control whilst also boosting GDP and improving the labour market.





At this point, it is worth taking a closer look at what has happened during the last few years. Let's consider a 13-year interval starting in 2005 and ending in 2017, which covers the whole financial crisis and its pre and post-phases. During this period, the money supply (here measured by the M2 money stock) expanded from $6.410 trillion to $13.833 trillion, a rise of 115.8%, or 6.1% per year. During the same period, consumer prices rose 2.0% per year and real GDP 1.6% per year. If the equation of exchange was right, one would expect prices to rise 4.5% per year and not just 2.0% . It seems that Fisher's equations have broken down and we shouldn't worry too much about the link between money and inflation...

But we shouldn't discard Fisher and the quantity theory of money so quickly. One possibility is that the velocity of money actually changed – at least that's the mainstream view. To fight the lazy use of money (i.e. saving), central banks adopted negative interest rates which turn money into a hot potato. Such a policy should see the velocity of transactions accelerate, leading to an increase in nominal GDP and an economic recovery.

But while such an explanation may seem appealing, it also seems aberrant. The lack of consumer spending in the present is a consequence of the past excesses. The setting of negative interest rates prevents adjustments from occurring, forcing money into the same past excesses and leading us into a circular flow that culminates in a boom-bust economy. But despite the efforts of the central bank, GDP only grew 1.6% per year over the 13-year period under consideration. The money they created is not flowing towards GDP items. One question thus remaining is: *Where is all the money?*

If we take a look at the chart *Where is the Money?* we get a clue about what has been happening. During the period 2005-2013 the S&P 500 rose at a pace of 6.5%. After hitting the ground in February 2009, the index recovered at a rate of 15.7% per year. Other financial markets experienced the same uptrend. The money created by central banks is flowing through the financial economy. From this, we have one alternative explanation for the missing link in Fisher's equation of exchange. We should remember that Fisher said that the total amount spent should be equal to the total amount of transactions. He said nothing about those transactions referring to GDP items. In this case, they aren't.

"CENTRAL BANKS WANTED US TO SPEND. AND WE DID SPEND, BUT NOT ON THE GDP ITEMS THEY WERE EXPECTING. WE PURCHASED SHARES OF GOOGLE, AMAZON AND FACEBOOK INSTEAD."

Between 1976 and 2015, the market capitalisation of the US stock market as a proportion of GDP rose from 42.2% to 143.3%, while the stock market value traded to GDP rose from 8.3% to 224.1%. These numbers represent stunning increases in the importance of the stock market relative to the real economy, and real proof of the *financialisation* of the economy.

Central banks wanted us to spend. And we did spend, but not on the GDP items they were expecting. We purchased shares of Google, Amazon and Facebook instead. We also purchased houses and property. In the end, there is inflation; it just isn't the consumer inflation central banks were looking for, but rather a non-GDP inflation that comes in the form of financial inflation and asset inflation. The worrying part about it is that there is a name usually given to financial inflation: it's called *a bubble*.

The winds of change are blowing

We are approaching a dangerous junction for financial markets and for the real economy in the US. On the one hand, we find that the money spent by central banks to boost the real economy has been directed almost entirely towards financial assets. This creates a serious problem for central banks regarding the normalisation of interest rates; the likelihood of creating a crash is high. While sentiment is still elevated, we've already had a glimpse of how fast that can change, when out of the blue the market crashed 4% in a day. When interest rates are at such low levels, the slightest move higher creates large changes in equity valuations. So far, the Federal Reserve has been predictable, announcing moves well in advance and delivering more dovish than hawkish surprises. But if that changes, we may experience a significant and prolonged increase in volatility.

On the other hand, we have the real economy operating near full capacity. After so many years of cheap money, one would expect businesses to take the opportunity to expand. If that was the case, the growth bar would have been raised. Unfortunately, current

BOX 1 – THE EQUILIBRIUM POLICY RATE

In general, central banks follow a quantitative target for the inflation rate. To achieve such a goal, they usually have some discretion in setting interest rates. But the margin for action is limited as economic theory outlines a few relationships that don't allow the central bank to do whatever it wants. Inflation tends to accelerate when the economy overheats and when interest rates are low. With this in mind, John Taylor (one of the economists previously mooted as a potential successor to Janet Yellen) developed a rule that often serves as guidance in setting interest rates. Not that policy makers explicitly follow it, but implicitly they use it as guidance.

According to Taylor, the nominal interest rate, set by a central bank should follow this rule:

$$i = r^* + \pi + 0.5 (\pi - \pi^*) + 0.5 (y - y^*)$$

Where:

i = nominal policy rate (Fed funds rate, for example)
r^* = real long-term interest rate (unobservable, estimated)
π = observed rate of inflation (may be core or headline, based on CPI or PCE)
π^* = target inflation rate (often set at 2%)
y = real GDP growth
y^* = real potential GDP growth (unobservable, estimated)

Taylor believes that the long-term interest rate is 2%. Taking into consideration that the Federal Reserve follows a 2% inflation target and that the latest observations for the PCE core number was 1.7% for 2017, we can work out the policy rate. Additionally, we know that the economy is more or less operating near full employment.

Under the above setting, the policy rate would be equal to:

$$i = 2.0 + 1.7 + 0.5 \times (1.7 - 2.0) + 0 = 3.55$$

While this figure only serves as guidance, it gives an idea of to what extent the Fed may be behind the curve. If there's a surprise in the pipeline, it would likely come in the form of higher than anticipated interest rates, as the current Fed funds rate is set at 1.50%. Some economists believe that the real interest rate is lower than 2%. Still, for the rule to point to 1.50%, the real interest rate needs to be zero to negative, which is very unlikely.

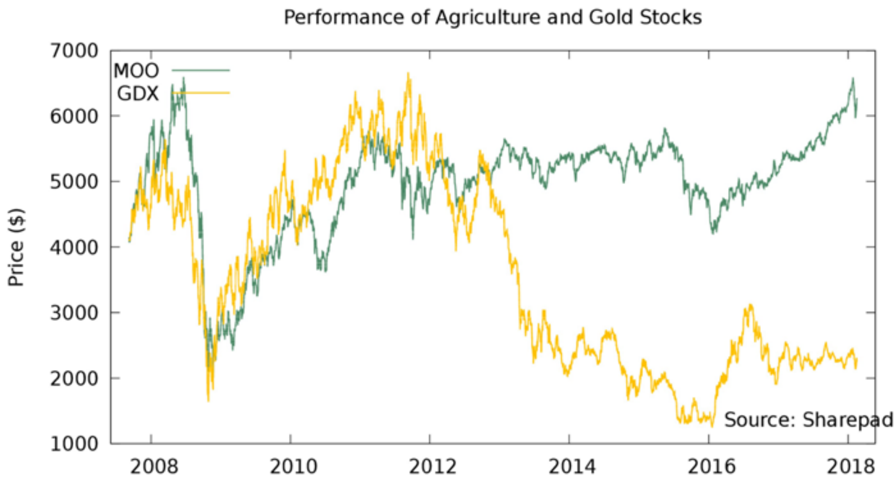
estimates put potential GDP growth at a frustratingly low 2.0%. Under such conditions, the recently announced tax cuts and government spending are likely to lead to an acceleration of inflation and an overheating of the economy, which will ultimately press the Federal Reserve to deliver a few negative surprises.

Diversify and protect

In my view, US inflation is set to rise, which will press the central bank to act faster than expected. This action may come in the form of four rate hikes in the year or in the form of a larger hike than anticipated at some point towards the end of the year. With so much money headed towards financial markets, the risk of collapse is now significant. Positions need to be adjusted accordingly.

"THE KEYWORDS FOR THE MONTHS TO COME ARE *DIVERSIFICATION* AND *QUALITY*."

During the last few years, quality was a feature often overlooked by portfolio managers. Performance has been strong across the board, as downside risks have been managed by central banks. Picking a riskier stock or a junk bond has been a winning strategy, leading investors to ignore risk profiles. A good example of this comes from the sovereign bond market in Europe, where yield spreads don't reflect the full difference in risk across sovereigns. The ultra-low interest rates combined with central bank demand for assets has contributed to a generalised state of complacency.



But with interest rates now on the rise in the US and in the UK, the situation is changing. I expect not only the yields on the 'riskless' countries to rise but also the credit spreads to widen substantially. The same will likely happen in the equity market, where companies carrying more debt will be exposed to large price swings. Those hedge funds with concentrated risky bets will underperform in the future and many of them will go out of business. Investors looking for long-term returns will now have to look for funds providing decent diversification and avoid companies with high debt loads.

With all the above in mind, the keywords for the months to come are *diversification* and *quality*. Looking for well-diversified, actively managed investment funds, where the fund manager has a proven track record may be a good start, as divergence in asset returns is expected to grow over time. Those wishing to explore the themes of rising inflation and interest rates have a few more options available. In terms of interest rates, I like the **PIMCO Enhanced Short Maturity Active ETF (NYSEARCA:MINT)** as a way of keeping money in bonds without suffering from the high risks incurred in longer maturities. Investing in very long maturities to get a juicy yield is absolutely forbidden at this point, due to the high risks incurred. As credit spreads are likely to rise, I also like the prospects of selling junk bonds, in particular from emerging markets. For that purpose, I would consider a short position on **VanEck Vectors Emerging Markets High Yield Bond ETF (NYSEARCA:HYEM)**.

During times of inflation, gold and agricultural commodities are good hedges. They also offer good diversification to a portfolio of equities. To avoid long-term rollover losses, I prefer ETF positions on commodity stocks instead of the commodities themselves. For gold, I like the **VanEck Vectors Gold Miners ETF (NYSEARCA:GDX)**. For the agricultural sector, the **VanEck Vectors Agribusiness ETF (NYSEARCA:MOO)** is a great option. This ETF purchases the stock of almost 60 companies in the industry and is very well diversified covering farm equipment, seed and fertilizer, animal health, food transport and processing.

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 The equation of exchange postulates that MV = PY. If we assume that V doesn't change, it becomes M = PY where M is the rate of change in M and PY is the rate of change in nominal GDP. Alternatively, we could roughly say that P = M – Y, which means that the rate of change in prices is equal to the rate of change in the money supply minus the rate of change in real GDP. Because the quantity theory assumes that Y doesn't change in the long-run, they claim that P = M.

BY SWEN LORENZ

10 QUESTIONS FOR...

RICHÁRD VÉGH

BSE: THE GATEWAY TO EMERGING EUROPE

The Budapest Stock Exchange (BSE) is the main trading venue for Hungarian stocks and provides investment opportunities to the fastest growing part of the EU, the Central and Eastern European region (CEE). Therefore, though it is one of the smaller European bourses, it is now – more than ever before – worth a closer look.

Following its deep economic crisis in 2008/09, Hungary embarked on a path that many considered unorthodox, but which by now has delivered an impressive turnaround. There are many surprising facts to be learned about Hungary as a European investment destination, and the Budapest Stock Exchange as a market in which to hunt for investment value. What's more, access to this market is much easier for British investors than most would expect.

Master Investor spoke to Richárd Végh, the CEO/Chairman of the Budapest Stock Exchange, about the past, present and future of this market and what it means for private investors from Britain.

Swen Lorenz: **During the late 1980s and early 1990s, Hungary was a pioneer of economic reform and the privatisation of formerly state-owned companies. I am old enough to remember the international headlines Hungary enjoyed when listing IBUSZ as the first public company on the newly reopened Hungarian stock market. Talk us through the evolution of the BSE during the subsequent three decades.**

Richárd Végh: *It is a pretty long story to tell in such a short interview. As you alluded to, the early '90s was a very intense period for the Hungarian capital markets. In those years many large companies joined the stock exchange and some of them are still the flagships of the BSE. During that time, we launched one of the first futures markets in Eastern Europe, made the change from floor trading to electronic systems and launched our options market. What followed was a period of consolidation and internal growth, with the market becoming more open and international. Perhaps, as a consequence of this internationalisation, Budapest Stock Exchange became part of the Vienna based CEE Stock Exchange group in 2010.*

The next years were definitely not easy. The economic crisis hit Hungary hard and it can be said that the Stock Exchange fully felt the consequences, with the interest from both investors and companies dropping off significantly. A new chapter began in late 2015 when the Hungarian Central Bank became the majority shareholder of Budapest Stock Exchange. Back in local hands, we benefit now from a new and coherent strategy, an ambitious development plan and the full support of the most important local stakeholders. We are hopeful that the future is bright and that we will be in the international headlines again soon, just as in early '90s.

SL: **Interactive Brokers, one of the UK's largest brokers with 430,000 clients, offers direct access to the Budapest Stock Exchange. You've got a real champion in Thomas Peterffy, the founder of Interactive Brokers, since he is of Hungarian heritage. What I was surprised to hear about was the significant number of other**

"THE TURNAROUND STORY OF THE HUNGARIAN ECONOMY IS IMPRESSIVE."

"HUNGARY AND BUDAPEST RANK HIGHLY IN MANY RESPECTS, FROM COMPETITIVENESS TO QUALITY OF LIFE AND EVEN OLYMPIC MEDALS."

British brokers that can execute trades directly on the BSE, including de Giro, Novum, JM Finn, Cave & Sons, Killik & Co, and others. Presumably the BSE has actively been taking steps to make it easier for international investors to gain access?

RV: *The feedback we hear from our existing base of foreign brokers and investors is that Hungary is an easily accessible market. Our infrastructure is modern and reliable, our trading system runs on the Xetra platform – same as the German exchanges – and getting connected and ready to trade on our infrastructure is straightforward.*

Other than that, we put a lot of emphasis on our strategy of directly approaching foreign partners and we have been very active in recent years in attending various events abroad, introducing our services. Our participation at the Master Investor Show is part of our efforts to open our market further and attract new players.

SL: Talk us through the size of your market. How many companies are listed there, and what other key stats do we need to know about?

RV: *Currently, 37 companies are listed with a market capitalisation of roughly £23 billion. The average daily turnover in cash equities has risen constantly in recent years, reaching about £36 million daily in 2017. Besides the cash equity market, we also manage a derivatives markets in which the currency, index and single stock futures are the most liquid products.*

BUDAPESTI BÉT ÉRTÉKTŐZSDE
BUDAPEST STOCK EXCHANGE

SL: Are there any particularly well-known or otherwise noteworthy companies you'd like to point out?

RV: *For many years the backbone of the Hungarian capital markets was our 'big four': OTP, the largest bank and a major regional player; MOL, the national oil & gas company, which has been an active player internationally for quite some time now; Gedeon Richter, a globally active pharmaceutical company; and Magyar Telekom (former Matav), the leader of the local telecommunications sector.*

Recently, after a long draught, three new players – Duna House, Alteo, and Waberer's – joined the stock exchange, raising funds through our platform, and all three of them are present at your event. They are all very well run and promising companies in our view, and we encourage the investors attending your show to visit their booths.

Finally, it is worth pointing out that 2017 marked the resurgence of the small-to-mid cap sector with a significant batch of issuers enjoying stellar 3-4-digit returns in 2017. For example, Konzum was one of the best performing stocks globally with a 6,733% gain in 2017, and OPUS GLOBAL became the 5th largest company after its fantastic 1,794% performance last year. We hope that investors will continue to be rewarded in the long term and that the dynamism and the spirit of innovation among the local small and mid-caps will take them to new heights in the coming years.

Again, I want to encourage your readers to visit our booth, where our colleagues are happy to provide more details and information about all our issuers.

SL: Hungary did make negative headlines during the time of the 2008/09 financial crisis, when it became the first EU country forced to ask for financial aid. However, I realised during my research that your stock market has doubled in value since 2015, and is up a staggering 40 times since the early 1990s. Has Hungary left its fiscal and economic challenges behind?

RV: *I would say that the resurgence of the market is a clear sign that the skies have cleared over the Hungarian macroeconomic environment. In fact, the turnaround story of the Hungarian economy is impressive. The unemployment rate recently reached a multi-decade low of 3.8%, significantly below the pre-crisis years. The debt-to-GDP ratio, a major worry for European economies in recent years, is on the decline as well, from almost 81% in 2011 to 74% today. Also, the state finances are in excellent shape, with the budget deficit for 2019 falling to 1.9% of GDP – the first time in recent decades that this indicator was lower than 2%,*

About Richárd

Richárd Végh was appointed to the Board of Directors of the Budapest Stock Exchange (BSE) in December 2015 and became Chief Executive Officer on 1 January 2016. He was also elected as the Chairman of the Board on 16 March 2017. He worked at the Central Bank of Hungary (MNB) from October 2013 to December 2015 as Director of the Capital Market Supervision Directorate and was responsible for prudential supervision of capital market institutions in Hungary and market surveillance operations concerning market manipulation, insider trading, and unauthorised financial services. He represented MNB in several national and international organisations including the Board of Supervisors of ESMA. He has been a member of the Board of Directors of the Hungarian Investor Protection Fund (BEVA) since 2013 and a member of the Board of Directors of the Central Depository and Clearing House (KELER Ltd.) from 2016. From 2004 till 2013 he worked at Budapest Stock Exchange in various positions.

and a major improvement from the 5.4% deficit in 2011.

We see the economy growing steadily and in a balanced manner, with the deficits and imbalances which plagued the economy in 2008-2009 being proactively addressed by the decision-makers.

SL: The Daily Telegraph mentioned Hungary in a headline about the global tourism industry the other day, simply describing the country as being "out". When I started to dig around, I came across a global competitiveness ranking from EIU, where Budapest was ranked above much-hyped cities like Lisbon and Tel Aviv. You must feel like the BSE itself is an undervalued and under-appreciated gem right now?

RV: *Hungary and Budapest rank highly in many respects, from competitiveness to quality of life and even Olympic medals. Also, the performance of the market shows that confidence and expectations are at a high level among the investors following us. What we probably lack is the more sophisticated marketing and PR machine of the better-known bourses. This is the main reason we are here.*

"WE ARE OPTIMISTIC THAT THE GAP WILL CONTINUE TO CLOSE BETWEEN WESTERN AND EASTERN EUROPE, AND THIS CAN ONLY TRANSLATE INTO A HIGHER GROWTH POTENTIAL FOR OUR REGION."

SL: For foreign investors, there is always the currency issue. Hungary hasn't joined the euro yet. What do our readers need to know about the risks and opportunities posed by investing into equities that are valued in Hungarian forint?

RV: *The forint has been very stable for the last five years trading in a tight 11% range against the euro during this period. For comparison, the volatility of the pound sterling or the US dollar versus the euro has been a lot higher during the same period (31% and 20% range respectively). In addition, the feedback we get from our existing foreign investor base is positive as far as the currency is concerned.*

SL: Leaving politics aside and looking purely at the bigger economic picture, do you see not just Hungary, but potentially the entire Central/Eastern European region taking a different course to Western Europe over the next ten years? Forgive me for implying a certain bias by asking the question in this way – it's just something I have been wondering about of late. Am I off the mark by assuming that will be the case?

RV: *For the Central and Eastern European region the convergence story has been the major investment theme for more than a decade now. Investors expect that our region will eventually reach the wealth and living standard levels enjoyed*

About the BSE

The Budapest Stock Exchange Ltd. (BSE) creates a platform for Hungarian companies to grow and prosper. Our mission includes providing small and medium sized firms with expertise and financial support needed to join the stock exchange, as well as improving the financial culture in our society. BSE has a considerable history: it was originally established in 1864 and re-established after the fall of communism in 1990. Today we are following our 2016-2020 strategy to become more attractive for investors and companies alike. Our blue-chip companies represent the Hungarian economy, with the total market capitalisation of listed firms standing at approximately $33.8 billion. We are set to further develop the capital market ecosystem where issuers are creating exciting opportunities for domestic and international investors, both retail and institutional. We recently introduced Xtend as a special market for medium sized companies to join the exchange. Furthermore, BSE has a joint programme together with ELITE, a company of the London Stock Exchange Group, which gives mentorship to up-and-coming Hungarian companies to learn about the ways they can grow using diverse financing opportunities. BSE is powered by Xetra, one of the fastest and most reliable trading systems in the world.

by Western Europeans. Despite the 2008-2009 setback which weakened the narrative, we do see this topic gaining more and more strength again. This is clearly shown in the major improvements in the last few years, with, for example, wages growing at double-digit levels, along with infrastructure and the quality and diversity of services improving by the day.

There is still a lot to do, especially in terms of SME productivity, raising the GDP per capita at purchasing power parity and increasing the competitiveness of our workforce and product split, but we are optimistic that the gap will continue to close between Western and Eastern Europe, and this can only translate into a higher growth potential for our region.

SL: Your team will attend the upcoming Master Investor Show on March 17th as sponsor and exhibitor. Tell us what our delegates can learn about from your team and from the other companies and organisations that you are bringing along.

RV: *Our delegates will be happy to share our major projects and development plans, the macro story of Hungary (and to some extent of the CEE region, the fastest growing region in the EU) and, of course, the investment opportunities in our market. In a nutshell, we will argue why Hungary should be on the investment map of British investors. Our companies are there to share their success stories and to put a name tag on the growth promise our market represents.*

SL: Last but not least, to counter the Daily Telegraph's headline, what sites and regions of your home country should our readers visit, if and when they make it to Hungary?

RV: *Without overly analysing the sources and information from the Daily Telegraph article, I can say that tourism has been a major growth driver for the last decade. Budapest is widely seen as a pearl of Central and Eastern Europe and has made it into the holiday plans of millions of visitors every year. The beautiful architecture, the spas, the famous local gastronomy and the lively cultural scene are just some of the attractions bringing tourists to Budapest.*

Nature destinations are also very popular, starting with the Balaton lake, the Danube and its attractive natural hotspots, and ending in the wilderness of the Hortobagy plains, which is one of the oldest natural parks in Europe and a paradise for bird lovers.

Finally, and probably less well-known in the UK, Hungary is a wine-loving country, dotted with countless vineyards belonging to small traditional producers. We are really proud of our wines and I can recommend the rural area around Villany or the surroundings of Eger (also a historical place thanks to its castle) for beautiful wine trips.

"KONZUM WAS ONE OF THE BEST PERFORMING STOCKS GLOBALLY WITH A 6,733% GAIN IN 2017."

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.

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BY JOHN KINGHAM

DIVIDEND HUNTER

CAN A 15% DIVIDEND YIELD EVER BE SUSTAINABLE?

Very few stocks ever have a dividend yield of 15% or more, and if they do then the dividend has probably already been cut or suspended. For example, if I sort my watch list of dividend-paying stocks by yield, I get Provident Financial and Capita at the top, with yields of 20% and 17% respectively. In both cases the dividend has already been suspended, so the true yield (at least for now) is zero, rather than the historic yield quoted above. However, there is a third company on my list which has a yield exceeding 15%. That company is Connect Group (LON:CNCT) and, so far at least, there has been no mention of a dividend cut or suspension.

So just how sustainable is Connect's dividend, and can investors seriously expect to get a dividend yield of around 15%? *(You'll have to be quick though. When I started writing this article, Connect's share price was 63p, giving a yield of 15.6%. By the time I'd finished writing the price had gone up 10% to 70p, taking the yield down to 14.1%!)*

A no-growth company desperately seeking diversification

To understand Connect Group, we need to go back to 2006, when it was called Smiths News and was the newspaper and magazine distribution arm of WH Smiths. Following its demerger from WH Smiths, Smiths News became the UK's leading distributor of newspapers and magazines by some margin.

A dominant market leadership position is usually a good thing, often leading to better brand awareness and economies of scale which in turn can drive attractive returns on capital as well as growth. And that was true in this case, but by 2009 it was clear that the attractiveness of the company's leadership position was more than offset by the unattractiveness of its core business of distributing magazines and newspapers.

The reason, as you're probably aware, was the invention of the iPad and other tablet computers, which enabled people to read magazines, newspapers and a million and one websites from a single convenient and highly mobile device.

From that point onwards, the slow decline of the newspaper and magazine delivery business was both inevitable and obvious, so the company began looking for new ways to generate revenue beyond its traditional core business. Eventually this

"BY 2009 IT WAS CLEAR THAT THE ATTRACTIVENESS OF THE COMPANY'S LEADERSHIP POSITION WAS MORE THAN OFFSET BY THE UNATTRACTIVENESS OF ITS CORE BUSINESS OF DISTRIBUTING MAGAZINES AND NEWSPAPERS."

search evolved into a concrete strategy to diversify the group into other specialist distribution markets, primarily through acquisition but also through organic opportunities where possible.

The first significant move away from newspapers and magazines came in 2009 with the acquisition of Bertrams, at the time the leading UK book wholesaler with a market share of 45%. This acquisition added around £4 million of operating profit to the existing business's operating profits, which were around £30 million at the time. It also added around £6 million of debt to the company's balance sheet, taking total borrowings close to £54 million (a not excessive figure in my opinion).

In 2011, management stated that their new goal was to increase operating profits from outside the core newspaper and magazine business (which was still called Smiths News) to at least 30% of the total by 2014. That was an ambitious target and there was no time to waste, so the Bertrams acquisition was followed by the acquisition of Dawson Books, a leading supplier of books to universities and other educational institutions. This increased the size of Connect's book distribution business, but also increased the company's debts by £15 million to £67 million.

As a side note, can I just say that moving from the dying magazine and newspaper delivery business into the physical book delivery business does not strike me as a sign of towering genius (have management never heard of Amazon?)

After that, management began to push the acquisition accelerator even harder, paying £40 million in 2012 to acquire The Consortium, the UK's leading distributor of exercise books, stationery and other consumables to the educational market. This larger acquisition added about £8 million of operating profit, taking Connect's non-core operating profits to around £16 million, about 28% of the group total. Of course, this acquisition also had to be paid for, so the company's debts took a £40 million hike to £105 million. By this stage the balance sheet was becoming stretched, with debts now almost four-times average post-tax profits.

Quite sensibly, management decided to take a couple of years off from making new acquisitions and instead spent time understanding, integrating and developing the companies they had already acquired. They also decided to launch two new businesses: Pass my Parcel and Jack's Beans.

Pass my Parcel was (and is) one of a growing number of "click and collect" businesses. It enables customers to order goods online and have them delivered to a local store for collection, or to return goods via those same stores. The key to this business's prospects is that from day one it's had Amazon onboard as a major customer. Jack's Beans is something completely different, although if management were after diversification then this certainly looks like diversification to me. This start-up provides coffee vending machines (and the coffee of course) to small retailers using Connect's existing distribution capabilities. While these start-ups are interesting, they're both tiny and neither has yet had any meaningful impact on the group's top or bottom line.

After that brief lull, management were back on the acquisition trail in 2014. Their new goal was to generate at least 50% of profits from outside the core newspaper and magazine business before the end of 2016. A giant leap towards that goal was taken at the end of 2014 when the company acquired Tuffnells, a leading B2B parcel delivery company specialising in items of irregular dimension and weight.

The Tuffnells acquisition was the biggest to date by a long shot, costing some £113 million and requiring additional borrowing of £50 million and a £55 million rights issue. This took the company's total debt pile to £165 million, which took its debt to average profit ratio above four, and in my opinion that's somewhat excessive. As well as debt, acquiring Tuffnells also added £15 million of operating profits, taking total operating profits from non-core operations to around £27 million, or about 40% of the group's £68 million total.

The 2014 Tuffnells deal marked the end of Connect's acquisitive phase which I think was the sensible thing to do. In my experience, it's very hard to make lots of large acquisitions in a short space of time and not make a mess of it. What often happens is that many companies are acquired, overall profits and revenues grow and everything looks great. But the complexity of the business grows, debt interest grows and focus declines. Eventually, what looks like a well-oiled and well-integrated machine turns out to be a house of cards which collapses at the first sign of difficulty.

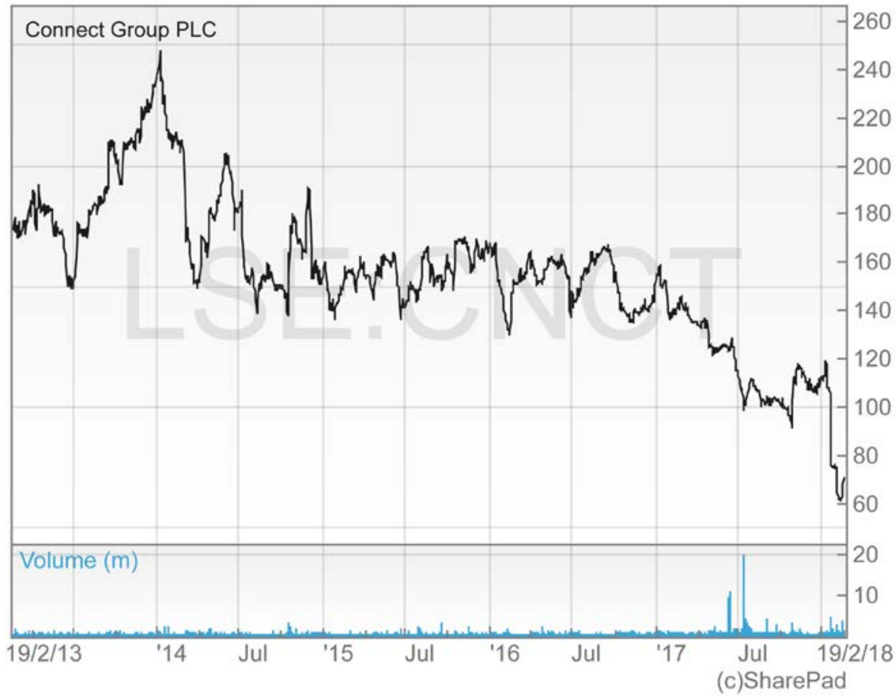
All of that applies to Connect Group and its debt-fuelled acquisitions, to varying degrees. For a while, the acquisitions drove revenue and profit growth, or at least maintained them as the magazine and newspaper business stagnated. But it soon became clear that the acquired book and education businesses were going nowhere. From the outside at least, it seems as if meaningful synergies between the core business and those two businesses were few and far between. Growing debts were also a problem and, following the Tuffnells acquisition, the company repeatedly stated a new goal of debt reduction in the medium term.

So, what was Connect to do, having built up excessive amounts of debt acquiring a bunch of non-core companies which were not producing the hoped-for returns? The answer, of course, was to offload those companies as fast as possible, and that's precisely what Connect did as part of its new strategy to re-focus on its core competencies.

Focus almost always beats diversity

First to go was the company's Education & Care business, made up mostly of The Consortium. This business was sold for £57 million, producing a 10% annualised return over the ownership period. The proceeds from this sale were very sensibly used to help reduce the group's debts to £89 million, a much more sensible amount. More recently, the book business has been sold for £6 million, leaving Tuffnells as the only significant acquisition to survive this cull.

With Tuffnells, the plan is to achieve full integration with the magazine and newspaper delivery business, rather than running them as two separate companies. The idea is that Smiths News and Tuffnells can work better together, sharing their infrastructure of trucks, drivers and depos, as well as systems and processes, to the benefit



"IN MY EXPERIENCE, IT'S VERY HARD TO MAKE LOTS OF LARGE ACQUISITIONS IN A SHORT SPACE OF TIME AND NOT MAKE A MESS OF IT."

of both. This integration programme is expected to take a couple of years in total, focusing on cost reductions from greater scale, better utilisation of existing infrastructure and a greater range of delivery options for customers (in terms of both timeslot and location). This will hopefully lead to organic growth and, thankfully, further acquisitions are off the table for now.

Where does this leave Connect? As far as I can see, what we have is a very stable but slowly declining core business (newspaper and magazine delivery) which generates lots of cash. With sensible cost-cutting measures, it should be able to provide the company with a stable (if slightly declining) base of revenues, profits and cash for a long time. In addition, we have a specialist parcels business, which is perhaps a quarter of the size of the core business. The B2B parcels business should have a brighter future than the newspaper delivery business, although how much impact this might have on the overall group is up for debate. The final pillar is the integration of these two businesses, which may or may not provide the kind of synergies which management are hoping for.

So that's a long and perhaps slightly meandering look at Connect's past, which hopefully provides some useful context for any discussion of its present and future. I also think it shows how hard it can be for a company to expand beyond its core business, which is why corporate diversification is frequently a bad strategy. But enough of the past; let's have a look at Connect's current situation and its future prospects, especially as they relate to its dividend.

Is Connect's 15% dividend yield safe?

There are many factors which can affect the safety of a company's dividend, so I'll just address the main ones here:

Cyclicality: Perhaps the biggest threat to a company's dividend is the cyclicality of its core business. In this case, Connect has a defensive core business based around a dominant leadership position in the magazine and newspaper delivery market. This business is defensive because people will typically keep buying magazines and newspapers even in a recession. The Tuffnells parcel business is less defensive, but at around 25% of the Group I don't see this as significant to the cyclicality of the company as a whole. Overall then, I don't see cyclicality as a major threat to the dividend.

"WHAT WE HAVE IS A VERY STABLE BUT SLOWLY DECLINING CORE BUSINESS (NEWSPAPER AND MAGAZINE DELIVERY) WHICH GENERATES LOTS OF CASH."

Debt levels: Even the most defensive companies can become very risky if they carry too much debt. In this case, Connect was getting ahead of itself a few years ago when acquisition-based borrowings reached £165 million. However, cash from the sale of the book and education businesses has been used to reduce debts to £89 million, less than three-times the company's average post-tax profits. I think this is a reasonable amount of debt and does not represent a significant threat to the dividend.

Pension liabilities: As well as borrowings, another important liability is a company's defined benefit pension scheme. If a scheme is large then there is the potential for a large pension deficit, which companies are legally obliged to reduce. In this case, the last actuarial review stated Connect's pension scheme liabilities as £641 million, its pension assets as £619 million and therefore its pension deficit as £22 million (you'll find different figures in the back of the annual report, but these "actuarial" figures are the ones used to calculate the company's deficit reduction payments). To give you some context, the company currently generates post-tax profits of around £30 million on average each year. Cash is already being funnelled into the pension fund in order to reduce the deficit at the rate of about £5 million per year, which is a significant but not life-threatening diversion of cash.

The bigger threat is simply the size of the pension fund and the potential size of the deficit. At £641 million, those liabilities are almost 20-times the company's average post-tax profits. In my opinion that makes the pension a serious threat to the dividend. For example, a 10% deficit (a fairly typical amount) would give a £64m deficit, which by law the company would be obliged to reduce, typically by cash payments. Personally, this large pension fund is the biggest problem I have with the idea of investing in Connect. Having said that, if the deficit goes away at the next actuarial review (which it might easily do given changes to asset valuations and interest rates) then the risk to the dividend in the short-term would be minimal.

Dividend cover: The obvious metric for dividend safety is dividend cover, in terms of either profit or free cash flow. In terms of reported post-tax profits, the dividend is still covered, although only just. Using adjusted profits (which

"I THINK IT WOULD BE REASONABLE TO EXPECT MANAGEMENT TO TRIM THE DIVIDEND GIVEN THE LACK OF STRONG COVER, BUT THESE RATIOS DON'T SUGGEST THAT THE DIVIDEND SHOULD BE SUSPENDED OR CUT DRASTICALLY."

strips out one-off items such as the cost of integrating the Smiths News and Tuffnells businesses) gives a dividend cover of 1.6, which is not terrible, but it isn't brilliant either; a dividend cover of two or more is where most companies like to be. Turning to free cash flows, these also cover the dividend, although only just. Neither of these dividend cover ratios is particularly healthy, so I would say this is a sign that the dividend is currently under threat and that there is little margin for error.

What does this mean for the dividend? I think it would be reasonable to expect management to trim the dividend given the lack of strong cover, but these ratios don't suggest that the dividend should be suspended or cut drastically, by say 50% or more. On the other hand, if the dividend was not covered by free cash in future years then management might decide to borrow in order to maintain the dividend. Given the company's current low debt levels that might be a reasonable course of action, but only as a temporary measure until growth could be restored.

Future business prospects: A company can be ticking along nicely, with low debts and good dividend cover, but if it's operating in a market where technological progress has made existing products obsolete (such as those sold by Kodak, HMV or Blockbuster) then the company and its dividend will be under serious threat. To some extent, this is the situation faced by Connect and it is perhaps the most serious risk of all.

Connect's core newspaper and magazine business is declining by a few percent each year, although so far that has been largely offset by increased efficiency and reduced costs; but that cannot go on forever. Most of the last decade was spent trying to diversify away from the core business into other niche distribution markets, but that strategy has largely failed. I think its book and education distribution acquisitions failed to add anything because those businesses were competing against Amazon, the one company no sane person would ever want to compete against.

However, the remaining businesses either don't compete with Amazon or are able to deliver parcels for Amazon, thereby benefiting from Amazon's success. For example, Amazon does not do newspaper delivery to newsagents or parcel distribution along the B2B supply chain and Pass My Parcel (Connect's click and collect business) and Smiths News both have agreements to help deliver Amazon's parcels.

Of course, it isn't all about Amazon, but at least the company is no longer diversifying into businesses which are likely just as doomed as its newspaper and magazine distribution business.

A safe 15% yield? In your dreams, but that doesn't make Connect a bad investment

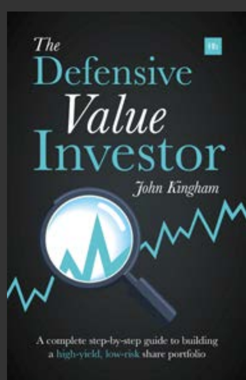
Overall, I would say there's a good chance that Connect's dividend will be cut at some point in the next few years. However, I don't see any obvious reason why the dividend should be suspended or cut drastically. If the dividend *was* cut by 50%, here's what would happen: 1) It would free up about £10 million per year which could be used to reduce debt, pay down the pension deficit or fund the integration of Smiths News and Tuffnells; 2) the dividend would be covered twice over by both profits and free cash flows; and 3) at the current price the yield would still be around 7%. To me that looks like a very attractive proposition, and if I can get over my dislike of large pension schemes then I would be willing to invest in Connect Group, probably at anything under 100p.

About John

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

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

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



BY RICHARD GILL, CFA

FROM ACORNS TO OAK TREES

SEARCHING FOR GROWTH AMONGST AIM'S NEW ISSUES

Last year saw a steady stream of new companies join the AIM market, with investors welcoming a diverse range of businesses focussing on areas including antibodies, mattresses, copper in Africa and even fishing tackle.

According to my research, 51 new companies listed on AIM in 2017 (excluding those which re-listed or moved from other markets). Investors who managed to buy shares in each of these at the IPO price would have seen an average gain per share of 15.4% by the end of the year. This compares to a 24.3% gain for the wider AIM All Share index in 2017, although the two sets of performance statistics aren't directly comparable due to timing differences associated with the newly listed companies.

The typical retail punter, who most likely wouldn't have had access to the IPO fundraisings, could also have made reasonable gains, with the average rise of the 51 companies between close on the first day of dealings and the end of the year being 6.1%.

Winners

The best performing IPO of 2017 was **Fusion Antibodies (LON:FAB)**. Shares in the contract research organisation only began trading on the market on 18th December but by the end of the year were trading up by 160% before slipping back in 2018. Close behind was foreign exchange services provider **Alpha FX (LON:AFX)**, shares in which rose by 149% after the company posted revenues up by 90% for its half year and announced a maiden dividend. Another financial services business doing well was the pawnbroker owner **Ramsdens Holdings (LON:RFX)**. Its shares closed the year 108% higher than the IPO price after posting pre-tax profits up by 63% in the first half.

Company	Float date	IPO price (£)	Price end 2017 (£)	Sector	Change (%)
Fusion Antibodies	18/12/2017	0.82	2.13	Health Care	159.76%
Alpha FX Group	07/04/2017	1.96	4.875	Financial Services	148.72%
Ramsdens Holdings	15/02/2017	0.86	1.79	Financial Services	108.14%
Touchstone Exploration	26/06/2017	0.073	0.125	Oil & Gas Producers	72.41%
K3 Capital Group	11/04/2017	0.95	1.58	Support Services	66.32%

Table: Top 5 best performing AIM IPOs in 2017

Company	Float date	IPO price (£)	Price end 2017 (£)	Sector	Change (%)
Integumen	05/04/2017	0.05	0.0143	Personal Goods	-71.40%
i3 Energy	25/07/2017	0.55	0.24	Oil & Gas	-56.36%
FFI Holdings	30/06/2017	1.50	0.775	Financial Services	-48.33%
AfriTin Mining	09/11/2017	0.039	0.024	Mining	-38.46%
Cora Gold	09/10/2017	0.165	0.12	Mining	-27.27%

Table: Top 5 worst performing AIM IPOs in 2017

Losers

At the other end of the market, shares in personal health care company **Integumen (LON:SKIN)** were down by 71% at the year end after slow commercial progress was made and a fundraise in December was completed at just a fifth of the IPO price. While shares in UK oil & gas explorer **i3 Energy (LON:I3E)** closed the year down by 56% on their IPO price, they have since recovered in 2018 after the company received commercial interest to provide funding for a multi-well development programme and its 30th Round application block amounting to c.$200 million. Down by 48% was **FFI Holdings (LON:FFI)**, a provider of completion contracts to the entertainment industry. Towards the end of the year it saw a number of delays and contract cancellations as a result of the various misconduct allegations against senior figures in the US film industry.

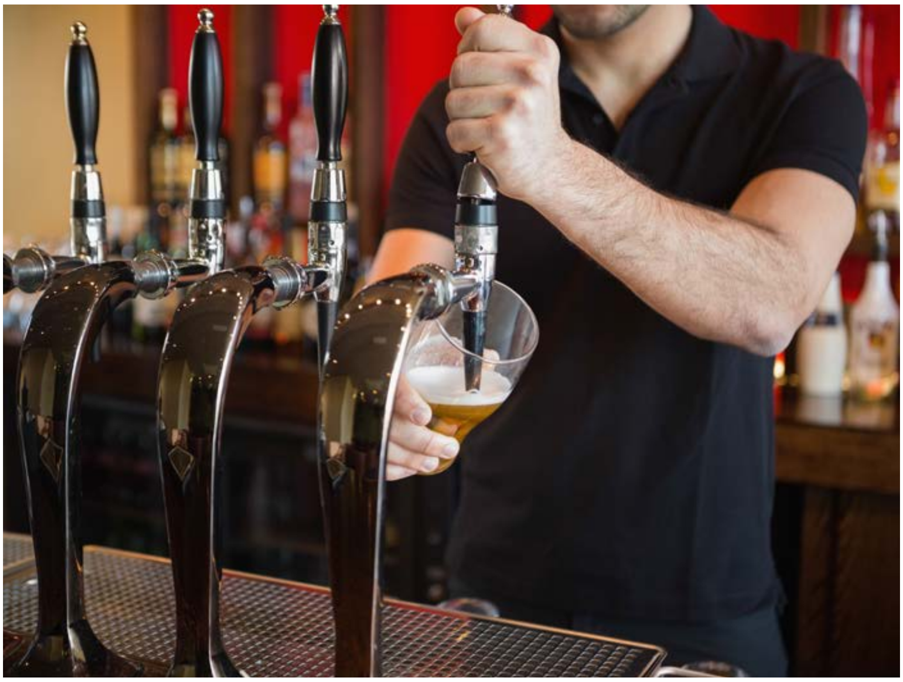
Into 2018 and there have only been three AIM IPOs in the year to date (22nd Feb as I write). Nevertheless, there still remains a good selection of newly listed companies from which investors can find good growth opportunities. Here are three of them:

CITY PUB GROUP

Despite the UK economy ticking along steadily at the moment, with GDP up by an estimated 1.7% in 2018, inflation (at 3% in December), continues to bite, with wage growth lagging behind at 2.5%. Combined with interest rates now starting to rise, this puts increasing pressure on consumers' disposable income, as evidenced by recent troubles seen in the casual dining segment of the restaurant industry.

For example, at the end of January Frankie & Benny's owner **The Restaurant Group (LON:RTN)** revealed that like-for-like sales for the 52 weeks to end 2017 were down by 3%, carrying on a two-year trend of falling figures. Elsewhere, celebrity chef Jamie Oliver has been forced to close a raft of his restaurants, with posh burger maker Byron entering into a company voluntary arrangement in January, planning to close nearly a third of its restaurants as part of a restructuring programme. Despite the headwinds, I believe that one company within the industry looks set to do well over the coming years.

THE CITY PUB GROUP



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City Pub Group (LON:CPC), as the name suggests, is an owner and operator of premium pubs located across southern England. Founded in October 2011, the company had grown its portfolio to a total of 33 boozers by the end of 2017 and listed on AIM in November last year raising a total of £35 million for itself and £11.6 million for selling shareholders. The company's pub portfolio consists of predominantly freehold, managed pubs, offering a wide range of high quality drinks and food tailored to the local clientele. This gives each pub its own individual style and character, in contrast to many of the chain pub operations which are around today.

Also in contrast to many of its competitors, City Pub Group has a liquor led business model (although it does serve food) which the directors believe provides greater predictability over sales and higher margins than a food led business model. Overall, the company aims for a 70/30 sales split of liquor/food. The overall strategy has served the business well, and combined with acquisition led growth saw revenue and EBITDA growing at a CAGR of 34.9% and 44.8% respectively from 2014 to 2016.

"CITY PUB HAS THE STATED INTENTION TO DOUBLE THE SIZE OF ITS ESTATE OVER THE NEXT THREE TO FOUR YEARS."

City Pub is headed up by co-founder and Chairman Clive Watson. Some investors might know him from Capital Pub Company, a business which he also co-founded in 2000 and listed on AIM in 2007 with a valuation of £32.3 million. Capital Pub then expanded its portfolio before it was taken over by Greene King in 2011 for £93 million. Watson has a similar strategy here, with City Pub having the stated intention to double the size of its estate over the next three to four years, looking to acquire 8-10 pubs per annum.

Toasting trading

A recent update confirmed that following steady trading over the Christmas period, total like-for-like sales for 2017 were up by 3.8% and total revenues for the year were up by 34% at £37.4 million. Since IPO the company has advanced its acquisition strategy by exchanging contracts on two freehold sites in Reading and Clapham, London. It has also completed on a leasehold site in Parson's Green, London, which is due to open as a pub serving vegan fare at the end of March. The three deals cost a combined £5.8 million, with refurbishment costs expected to be c.£2.6 million. In addition, the company has acquired the long-leasehold interest (effective freehold) of its King Street Brew House in Bristol, further strengthening and underpinning the balance sheet.

Another round?

While shares in City Pub Group opened up well on their first day of dealings, at the current 171.5p they are up by just under 1% compared to the IPO price.

"CITY PUB HAS A SUPERB MANAGEMENT TEAM WHO HAVE ALREADY DEMONSTRATED THEIR ABILITY TO CREATE VALUE FOR INVESTORS."

The business is now valued at £100.1 million. Providing backing to the valuation is £52.5 million of property, plant and equipment on the balance sheet as at 25th June 2017, with net assets standing at £31.3 million at the period end. This has since been boosted by the £32.9 million of net proceeds received at IPO.

For the current financial year the market consensus is for pre-tax profits of £5.3 million, rising to £6.4 million in 2019. That equates to respective earnings of 7.2p and 9p per share, putting City Pub Group on earnings multiples of 23.8 and 19 times – reasonable in my opinion given the growth being seen. Management have stated their intention to implement a progressive dividend policy, although with brokers pencilling in a payment of just 1.94p for 2018 the yield is low at 1.13%.

While the business is not without its risks, the focus on drinks reduces the exposure to troubles currently being seen by restaurant operators, with it being well funded to implement its growth strategy. Most importantly, City Pub has a superb management team who have already demonstrated their ability to create value for investors. I believe that should the company successfully double its portfolio over the next few years as planned, then the operational gearing effect should justify a valuation of at least twice the current price.

EDDIE STOBART LOGISTICS

There aren't many quoted companies which have their own fan club but **Eddie Stobart Logistics (LON:ESL)** is one of them. Over the years the company has gained fame for its distinctive green, red and white delivery trucks which are traditionally given female names and keenly caught sight of by an army of "Eddie spotters". The business has a history going back to 1940 when Edward Stobart delivered fertilizer in the Cumbrian village of Hesket Newmarket. In 1970, his eldest son, also called Edward, established a road haulage business and moved the headquarters to Carlisle.

Last year saw the return of the company to the stock market after a three year hiatus. The business was previously the Transport and Distribution Division of the FTSE 250 infrastructure and support services business **Stobart Group (LON:STOB)**. However, in March 2014 Stobart made the decision to dispose of 51% of the business for a total value of £280.8 million. Last year's IPO, which was the largest on AIM in 2017, saw £122 million raised at a price of 160p per share, with the majority of the funds being used to pay back £74 million of bank debt and shareholder loans. Also at IPO, the company completed the acquisition of iForce Group, a logistics services provider to e-commerce clients, with £37 million of the IPO proceeds being used to part finance the £45 million total consideration.

As it stands today Eddie Stobart is a leading logistics and supply chain operator focussing on the business segments of E-Commerce, Manufacturing, Industrial & Bulk (MIB), Retail and Consumer. Based in Warrington, the company operates c.2,200 vehicles, 3,800 trailers and 24 distribution centres throughout the UK and Europe, providing its services to a range of national and international customers. Following IPO the strategy is to target significant expansion of market share within the E-Commerce and MIB sectors, along with further select acquisitions.

Trucking on

Eddie Stobart has a good recent track record of growth, with revenues up by a CAGR of 7.7% to £549 million from 2013 to 2016 and adjusted EBIT up at a CAGR of 16.5% to £41 million. Into 2017, and a year end trading update by the company released in mid-January saw a mixed response from investors but on the whole looked positive. Notably, the last quarter of the financial year was said to have seen a marked increase in contract wins, providing good visibility for the current financial year.

Overall, for the year to 30th November 2017 group revenues rose by 12% to £618 million, with underlying EBIT said to be in line with expectations. Across the customer segments, E-Commerce sales more than doubled to £103 million, with eight new contracts won since the acquisition of iForce and the segment on track to represent 25%

of total revenues in 2019. Elsewhere, Manufacturing, Industrial and Bulk sales grew more than 37% to £182 million with Retail up by 11% to £168 million after growth was seen with several UK supermarket groups.

Improved operating margins were said to have been delivered across all sectors, with cash conversion ahead of the previous financial year. Net debt at the period end was £109 million, in line with targeted gearing levels. The company confirmed that it intends to recommend a final dividend for 2017 in line with expectations for 4.4p per share.

Steady Eddie

Despite the good progress having been made since joining AIM shares in Eddie Stobart have fallen by 8% to the current price of 147.5p, capitalising the company at £528 million. The markets are looking for growth in earnings of c.12.5% for the current financial year, taking EPS to 11.78p. That values the business on a PE of 12.5 times, falling to 11 times in 2019 on assumptions for 13.3p of earnings. With a 6.6p total dividend expected for the current year the yield is a healthy 4.47%.

I believe that those valuations look good value for a well run business which has a number of growth opportunities to go for. According to a report from German trade publication DVZ and the German Association of Logistics Suppliers, the overall UK logistics market was valued at £70.3 billion in 2015. That gives Eddie Stobart, which is one of the top 5 operators in the UK, a market share of less than 1%. Berenberg Bank seems to see the opportunities, their analysts recently initiating coverage on the company and slapping on a 190p target, thus implying 29% upside from here. For growth and income Eddie Stobart Logistics shares are worthy of consideration.

"WITH A 6.6P TOTAL DIVIDEND EXPECTED FOR THE CURRENT YEAR THE YIELD IS A HEALTHY 4.47%."

WAREHOUSE REIT

Finally, warehouses may seem like a dull investment but current market trends mean that investors could see some excitement from them over the coming years.

According to a 2017 report from Retail Economics, online sales accounted for 14% of the UK market in 2016 and are forecast to grow to 26% by 2021. That's an almost doubling of the market in five years. With every online order being processed by at least one warehouse, this increased market share is likely to require a significant increase in demand. So called urban warehouses, smaller local hubs which typically handle goods in the "last mile", immediately prior to them being delivered to the customer, are expected to be especially sought after.

As a result of increasing demand, warehouse vacancy rates are estimated to have been falling over the last five years from double digits to just 4%. This low availability of rental stock together with future demand increases give the potential for significant rental and capital growth. Attempting to take advantage of this opportunity is AIM listed **Warehouse REIT (LON:WHR)**.

WARE HOUSE REIT

The company listed in September last year having raised £150 million to invest into a diversified portfolio of UK warehouse assets located in urban areas. One deal had already been queued up on admission, with the company buying the Tilstone Property Portfolio, a portfolio of 27 warehouse

"AN ANNUAL TOTAL RETURN OF 10%, COMBINING DIVIDENDS AND GROWTH IN NAV, IS BEING TARGETED."

assets, for £108.85 million. This comprises a diversified mix of freehold and long leasehold UK warehouse assets, delivering a 7% net initial yield as at 31st March 2017. It is let to 129 tenants, with its top ten by rent roll including blue-chip firms such as Boots, Amazon, Asda and Selco Trade Centres Ltd.

Since the first day of dealings several other acquisitions have been completed including the £26.25 million purchase of four multi-let industrial estates at a net initial yield of 7.5% and a deal to buy a portfolio of seven industrial assets in the North West of England for £18.25 million, reflecting a net initial yield of 7%.

In February, the largest deal post IPO was arranged, with the company exchanging unconditional contracts to acquire the Industrial Multi Property Trust portfolio from main market listed Hansteen Holdings. The £116 million deal brings with it 51 assets, the majority being multi-let UK urban warehouses, and a contracted annual rent roll of £8.5 million. It was funded from existing cash resources along with enlarged debt facilities of £135 million secured with HSBC. This takes the total property acquisitions to date to £279 million and concludes the successful deployment of all funds raised at IPO.

Safe as warehouses

One of the most attractive aspects of the Warehouse REIT investment case is the company's dividend policy – being a REIT (real estate investment trust) it is required to distribute 90% of its net income. The current intention is to pay dividends on a quarterly basis, with a 5.5p per share payment being targeted for the year to March 2019, rising to 6p beyond that. With the share price currently at 99.5p that equates to yields in percentage terms that are slightly higher than their pence equivalents. Additionally, an annual total return of 10%, combining dividends and growth in NAV, is being targeted.

Also attractive is the management team behind the company. Subject to FCA approval, responsibility for management of the portfolio is shortly expected to pass to Tilstone Partners, sellers of the initial property portfolio, whose team has over 95 years of combined commercial property experience. Management interests are also aligned with shareholders, with TPL taking no performance fees and the directors having committed to retaining £16 million of equity, which was issued as part payment for the initial property deal, for two years. Further, members of the board and management team who bought a total of £1.8 million worth of shares in the company at IPO have agreed to be locked in for up to one year.

With analysts at house broker Peel Hunt have a target price of 120p on the shares and the annual 10% target return looking achievable and attractive, Warehouse REIT shares look attractive.

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 DAVID JONES

CHART NAVIGATOR

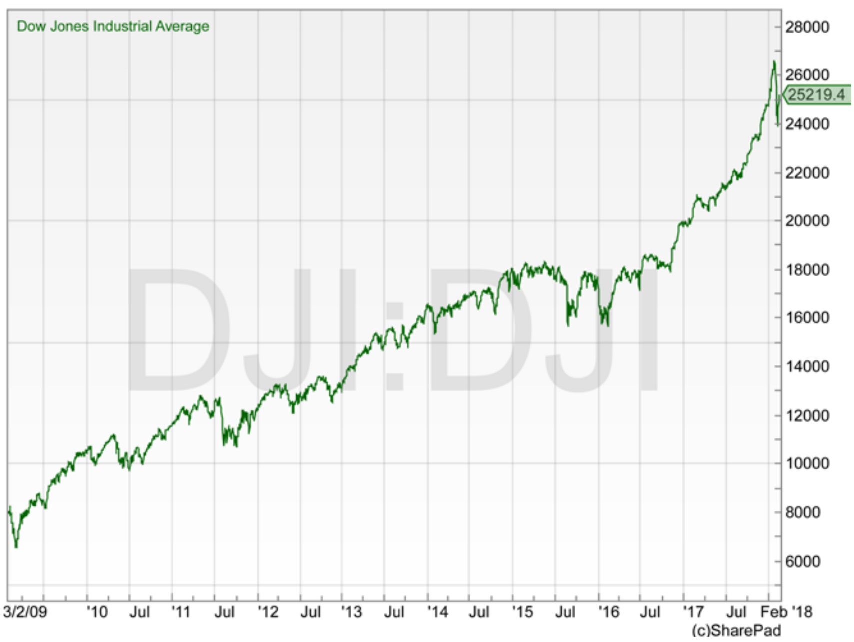
WHERE NEXT FOR STOCK MARKETS?

Given what we have seen in stock markets in recent weeks, it was easy to pick the topic for this month's charting article. Volatility has jumped, world markets fell heavily – is it the beginning of the end of the long trend upwards for shares?

A recent history lesson

Let's go back to where this all started. I will focus on the US index, the Dow Jones Industrial Average, as it really will be the American stock market that ends up dictating where the rest of the world is going to go. The trend that is now in place started from the financial crisis lows in March 2009. Back then, the low for the Dow was just below 6,500 – by the end of January this year it had traded above 26,500.

This market has come a long way in a little under nine years. There is a classic market cliché: "bull markets climb a wall of fear". This refers to the concern amongst investors that, as the market goes higher, surely a crash or correction can't be too far away. But recent years have seen a relatively painless climb. The last bout of major volatility, where it appeared markets were not too sure which way to go, was at the time of the US Presidential Election. It was received wisdom that a Trump win would see a chunk wiped off the stock market. But all the volatility happened in the "out of hours" market ahead of the official open. Since then, markets have continued their wave higher, defying the doomsayers' call for a top.



What went wrong in February?

If there is one universal truth about major moves in markets it is this: like the Spanish Inquisition, no one really expects it. Or maybe more accurately, no one really manages to forecast it. There is always a scrabble afterwards to try and explain why the market has plunged or

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risen. This may help fill newspapers but doesn't really help us much after the fact.

Coming into February, markets looked healthy. January 26 saw the Dow Jones hit fresh all-time highs at 26,616. But by February 9th the index had traded as low as 23,360.

So, what was the reason for the sharp falls? Investors' fears about creeping inflation and the possibility of interest rates rising quicker than expected were a couple of the more popular explanations. The move was arguably exacerbated by a couple of products designed to take advantage of ongoing low volatility in the markets. Plus of course, we have that timeless market classic – fear! We had not seen it for a while but there was definitely the feeling of selling feeding even more selling, like an avalanche picking up speed as it slides downwards. Was this the crash everyone was worried about? Better head for the exits just in case...

How is the trend looking now?

The really short answer to that is – untroubled.

Of course, it does all depend on which trend you are looking at. If we take the 2009 financial crisis lows as our starting point, clearly this is nothing more than the market having the smallest of stumbles – a move which was long overdue by most people's measures. That longer-term trend line comes in around the 18,000 mark. This means that, even if the Dow Jones index was to drop another 20% from current levels, it still would be some distance above the trend line. Let's take a look at some more recent history – the run that markets have enjoyed since the US Presidential Election.

This is a little more interesting. The volatility that markets endured during February saw that one year-plus trend line pierced – but no follow through in terms of extra pressure and selling, leading to steeper falls.

Looking at this chart in isolation, this really is just a pullback towards the trend – it's nothing to worry about. It is the famous "healthy correction" that was definitely long overdue. Now, it was pretty extreme in terms of how quickly it happened. But, given the amount of complacency we had seen in stock markets for months and maybe even years, any sell off always had a high chance of spooking investors who had got used to markets just gently grinding their way out to fresh all-time highs on a very regular basis.

Assuming this is just a correction – what next? The expectation would be for a run back to the previous all-time highs set towards the end of January and, as that trend is still definitely up, a breakout through here and on to fresh highs once more.

What are the danger signs this isn't just a correction?

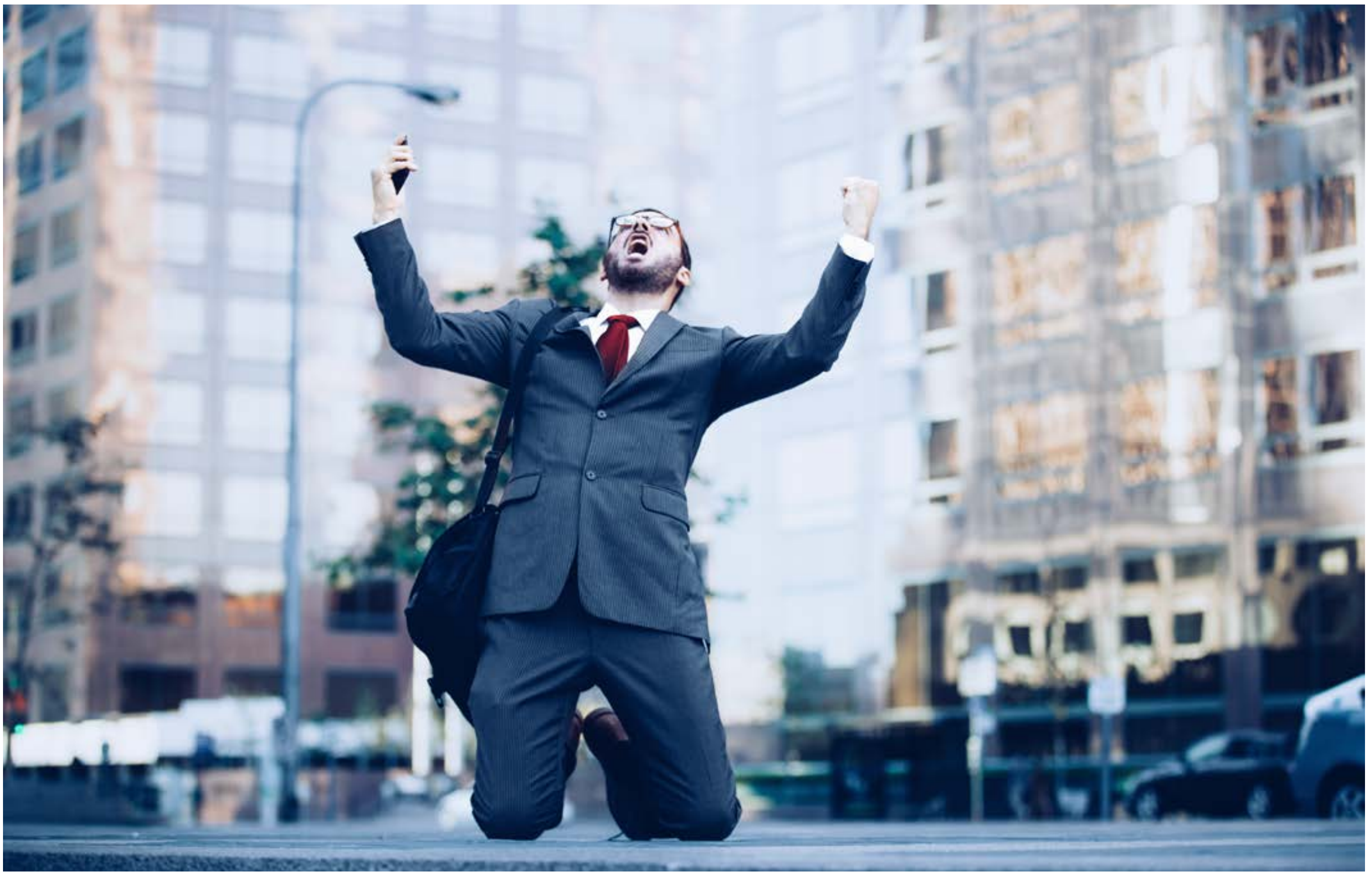
There's always the chance of course

that this bounce away from the longer-term trend line ends up being of the "dead cat" variety – i.e. the market rallies but does not go back to the all-time highs and turns down once again. What do we need to watch for a hint that maybe sentiment is actually starting to shift?

I think there's a straightforward answer to this one. And it is how the market reacts if it does revisit that low from the middle of February, which as mentioned is 23,360 on the Dow Jones. If the falls experienced are just a correction, then once again we should see the buyers stepping in. The psychology behind this is simple enough to understand. Plenty of investors will have watched the markets plunging and then bouncing back – and will be kicking themselves for not buying in. A move back to the old lows would be seen as a second bite of the cherry. So, if the market holds above that 23,360 low then all is well.

However, if the market breaks through then that is when things get a little bit more interesting. So far this is acting as an important bottom, and there has been a collective sigh of relief amongst investors that markets were not going to fall further. If that low is taken out, things are different. A level in the past that brought the buyers back in previously because they thought stocks were something of a bargain has not done the same thing this time around.

"A BREAK BELOW THAT OLD LOW COULD WELL SEE ANOTHER INJECTION OF FEAR INTO STOCK MARKETS AND PILE THE PRESSURE ON FOR ANOTHER MOVE DOWN."



A break below that old low could well see another injection of fear into stock markets and pile the pressure on for another move down.

Regardless of what many talking heads may say, it is very difficult to predict when and how a market will move. As technical analysts, all we can do is use the reference points we have and have a plan in place if those levels get broken or hold. But that gives us a plan that is far more advanced than many who are trading or investing! Markets have definitely got a little more interesting over the past month and the focus now will be just how confident are investors that there is more juice left in the tank if markets turn south once more.

Personally, I think this has been a much overdue reminder of just how volatile markets can be. It has made it more interesting from a short to medium term trading point of view. And I do feel that investors will have been quite spooked by some of the steep falls during February, so it may be some time before we see fresh all-time highs for stock markets.

"THIS HAS BEEN A MUCH OVERDUE REMINDER OF JUST HOW VOLATILE MARKETS CAN BE."

Chart of the Month

Of course, one person's panicking market is another's buying opportunity. So, I thought a good choice for this month would be – a little like the Dow chart – a share that did fall but is showing the potential to bounce back, leaving major trends intact.

Bellway (LON:BWY) is a FTSE 250 company, but is actually just outside the FTSE 100 as, at the time of writing, it was the 110th largest company by market capitalisation on the UK market. It's one of the UK's largest housebuilders. This has been a great sector in recent years and Bellway is no exception – since 2012 the share price is up more than fourfold.

This run higher has not been without its dramas. The housebuilders took some of the biggest hits immediately following the UK's referendum on leaving the EU – but the price recovered and has moved on to fresh highs since.

I think what's interesting here is the slide over the past month or so. It has been quite steep, and the share price has lost nearly 20% – but that doesn't change the bigger picture just yet. Here's a close-up view on the chart.

There are some really big levels to watch here. The old highs from 2016 shown by the horizontal line have not been breached. That comes in around the 2,900p level. An area that has been resistance in the past (stopping the price from going up) can turn into support if it is re-tested.

The other line on the chart is the 200-day moving average. The price has fallen below but this is just early days. Assuming the longer-term uptrend stays intact, it does suggest the share price could be relatively cheap here, compared to where it has been over the past 12 months.

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 FILIPE R. COSTA

HOW TO INVEST LIKE...

DAVID DREMAN

BUY WHAT OTHERS WON'T

"I have fielded criticism from academic and professional experts for more than thirty years, some of it containing sharp personal attacks. Nevertheless, though the fusillades may have sent a few of my feathers flying – not to mention on occasion raising my blood pressure to a frothy level – they have never been able to undermine the work".

— David Dreman in
"Contrarian Investment Strategies: The Psychological Edge"

For the past two years, Master Investor has featured this column as a means of letting our readers learn more about the investment strategies followed by two dozen of the most brilliant minds from the investment world. While the investors reviewed over the last two years differ greatly in their origins and the tools they employ, they also have much in common. None of them is afraid of opposing the herd if they find value; and each one of them makes extensive use of psychology.

The traditional efficient market hypothesis (EMH), which depicts man as an unemotional individual who is able to process large amounts of information to take the best rational decisions, has failed in explaining what really happens. If the EMH really did hold true, investors would be left with just a single decision: the exact allocation of funds between a risk-free asset and the market portfolio. But Nobel-laureates Daniel Kahneman and Richard Thaler showed that, in the real world, psychology merges with mathematical abstractions to create an emotional individual that constantly fails when evaluating information and uses short-cuts instead. As a result, share prices more often than not reflect distorted views. Investors focus on some salient characteristics they observe in stocks, often ignoring hundreds of years of financial records, to follow the crowd without having any real clue as to why.

"THROUGH MERGING PSYCHOLOGY WITH FINANCE, DREMAN WAS ABLE TO CONSISTENTLY BEAT THE MARKET FOR MANY DECADES WITH VERY SIMPLE STRATEGIES."

The recognition of this bias gave rise to a class of contrarian investors who are happy to oppose the herd, whenever they see an opportunity. One of those contrarians is David Dreman. Through merging psychology with finance, Dreman was able to consistently beat the market for many decades with very simple strategies. In the last instalment of "How to Invest Like...", we will take a look into Dreman's breakthrough view on risk and his contrarian investment strategies.

Learn from your mistakes

Dreman was born in Winnipeg, Canada, in 1936. Seduced by his father's success in trading commodities and by his many visits to the trading floor where his father worked, Dreman relocated his life to New York in the 1960s to work in the financial world. At the

"INVESTORS SYSTEMATICALLY OVERPRICE THE 'BEST' STOCKS OF THE MOMENT WHILE UNDERPRICING THE 'WORST' STOCKS."

"HE KEEPS HIS INVESTMENT STYLE VERY SIMPLE, REDUCING THE SELECTION PROCESS TO A FEW WIDELY AVAILABLE RATIOS."

time, investor enthusiasm was at a high, as the stock market was moving higher and beating record highs in price and volume. With the help of low interest rates, conglomerates were surging, as the result of companies bidding up the prices of one another. Dreman followed his colleagues and didn't escape the temptation of getting in on the upside. But, as is so often the case, the market got ahead of itself and Dreman watched his investments get decimated. The "go-go" bubble of the 1960s helped Dreman adopt a more scientific view of the market. He read everything he could about value investing and investor psychology and started developing his own strategies. In particular, he was interested in price ratios as a simple but powerful valuation metric.

Investor Overreaction Hypothesis

The more an investor digs into psychology, the more he is drawn to the quantitative side of the argument. At the extreme, he would be willing to avoid digging into financial statements: that's the essence of Dreman. He keeps his investment style very simple, reducing the selection process to a few widely available ratios. This keeps the process objective and testable, making it easy to verify its superiority (or otherwise).

Dreman doesn't collect fundamental information from stocks in order to try to project anything into the future. In fact, he believes no one can do that with precision in a systematic way – not even analysts. Instead of helping stock prices to converge towards their fundamental values, analysts generate short-term volatility, as their projections are rarely any more accurate than anyone else's guesses. Dreman points out that academic research demonstrates that most medium to long-term analysts' projections are just linear interpolations of the past. There are so many social, political and economic events impacting the equity market every day that no one can guess what's going to happen years in advance. After all, the events that will impact earnings in the future are not even at play as of today.

Investors systematically overprice the "best" stocks of the moment while underpricing the "worst" stocks. The "best" stocks are heavily exposed to negative surprises, which lead to significant downside adjustments. But the upside potential they offer is limited, as sentiment is already positive. Analogously, the "worst" stocks can experience significant upside when bad news turns out to be not as bad as expected, while they also enjoy limited downside. Still, investors seem to disregard the trend, which Dreman explains by pointing to recurrent behavioural bias: people are systematically too confident and optimistic.

Instead of relying on the efficient market hypothesis, which he completely discards, Dreman bases his thinking on the Investor Overreaction Hypothesis (IOH), which makes three key predictions:

(1) Investors tend to systematically overvalue favoured stocks and undervalue out-of-favour stocks;

(2) Investors tend to be overoptimistic in their forecasts for the "best" stocks and too pessimistic for the "worst" stocks;

(3) Over time both above- and below-average performance tends to revert to the mean, due to earnings surprises and other fundamental factors, which results in the underperformance of the "best" stocks and outperformance of the "worst" ones.

Developing a simple strategy

In 1977 Dreman started his own business, Dreman Value Management, which is now in its 41st year of existence, and is currently responsible for managing more than $20 billion in assets. Dreman's strategies mainly consist of selling while others are buying and buying when others are pessimistic about future prospects.

In his first book, *Psychology and the Stock Market: Investment Strategy Beyond Random Walk,* written in 1977, Dreman provides investors with a detailed description of how they can invest profitably. The strategy he explains in the book is based on value, which he believes is well summarised in P/E ratios. Later he improved the strategy through the many books he wrote. In *Contrarian Investment Strategies: The Psychological Edge,* Dreman claims that, while the overall market returned 11.6% per year between January 1970 and December 2010, the simple strategy of just picking low P/E companies would have returned 15.2%. Alternatively, picking the high P/E ratio companies (which more or less corresponds to the herd behaviour often observed in markets) would have returned 8.3%. An investor with $100,000 in 1970 would at the end of 2010 have $9.0 million if he invested in the broad market. The respective figure would be $33.1 million if he used the low P/E strategy but just $2.6 million when following the crowd and picking the high P/E stocks. A simple technique combined with the power of compounding makes a huge difference over time.

Over the years, Dreman's theories have stood up to scrutiny, and he has

TABLE 1 -PRICE-TO-EARNINGS BUY AND HOLD ANNUAL RETURNS

Period: 1970-2010

P/E Quintile	2 Years	3 Years	5 Years	8 Years
Low P/E	15.5%	14.3%	15.2%	15.2%
Market	13.3%	11.9%	12.0%	12.7%
High P/E	9.9%	9.2%	9.4%	10.3%

Source: "Contrarian Investment Strategies: The Psychological Edge", David Dreman (2012) continued working to refine them. In his latest book, *Contrarian Investment Strategies: The Psychological Edge,* written in 2012, he extends the contrarian strategy into four different types: (1) low price-to-earnings; (2) Low price-to-book-value; (3) low price-to-cash-flow; and (4) high yield.

A breakthrough risk theory

Investors fixate too much on daily price movements and thus often conclude that stocks are much riskier than bonds. The problem is that, for the vast majority of investors, the time horizon of their investments is not days, weeks or even months, but rather a few years, if not decades. Under these circumstances, it doesn't matter much if the stock price of XYZ PLC drops 10% tomorrow. What does matter for investors is whether they can reach their goals or not in the time horizon they set at first.

"It is counterproductive for investors with investing time horizons of thirty, twenty, or even five years to focus on short-term fluctuations. Short-term volatility measurements provide an illusion of safety while derailing the higher returns that are provided by holding equity or equity-equivalent products (real estate, housing, better-grade private-equity investments, and so on) over time."

Academics often (if not always) use a T-bill as the benchmark for a risk-free asset. The main reason for this is the fact these instruments have a near-zero probability of default, which means the government always ends up repaying the loan to the investor. But, for Dreman, that is a very narrow view of risk. Dreman believes that a realistic definition of risk should recognise the potential loss of capital through inflation and taxes, while at the same time include the probability the investment will preserve capital over time and outperform its alternatives. To properly evaluate risk over time and across bonds and stocks, one should ask the question: "What are my chances of capturing returns above those provided by bonds and T-bills?"

Dreman analysed market data for long periods of time (1802 to 2010) and with the help of Monte Carlo analysis simulated several different possibilities, in order to understand the superiority of stocks over fixed income after accounting for inflation. He concluded that stocks increase their superiority over bonds and T-bills as the holding period increases. In periods of 30 years or more, stocks outperformed bonds and T-bills 100% of the time. Even in periods of 10 years, the outperformance appeared in more than 80% of the cases. More surprising is the fact that stocks still beat bonds 60% of the time in periods of just one year and almost 50% of the time for T-bills in the same period. Faced with such evidence, the best means an investor has to reduce risk is to completely drop bonds and T-bills and increase his investment horizon.

TABLE 2 – COMPOUND RETURNS AFTER INFLATION AND TAXES

Period: 1946-2010

Holding portfolio for...	***Returns*** Stocks	Bonds	T-Bills	***% of Times Stocks Beat*** Bonds	T-Bills
1 year	4.4%	-2.0%	-2.2%	65.0%	71.0%
2 years	8.9%	-4.0%	-4.4%	77.0%	77.0%
3 years	13.7%	-5.9%	-6.5%	78.0%	81.0%
4 years	18.7%	-7.8%	-8.6%	81.0%	82.0%
5 years	23.8%	-9.7%	-10.6%	80.0%	79.0%
10 years	53.4%	-18.5%	-20.2%	91.0%	88.0%
15 years	90.0%	-26.4%	-28.6%	100.0%	98.0%
20 years	135.3%	-33.5%	-36.2%	100.0%	100.0%
25 years	191.4%	-40.0%	-43.0%	100.0%	100.0%
30 years	260.9%	-45.8%	-49.1%	100.0%	100.0%

Source: "Contrarian Investment Strategies: The Psychological Edge", David Dreman (2012)

But inflation is just part of the story. There is another "horseman of the financial apocalypse" called taxes. As Dreman notes, "if an investor in a 60 percent tax bracket had put $100,000 into long Treasury bonds after World War II, he would have had only $27,000 of his original purchasing power left in 2010". When both inflation and taxes are considered, bonds and T-bills become completely unattractive when an investor factors in the risk of systematic underperformance, as presented in table 2.

The lesson to learn from Dreman's alternative risk theory is that traditional measures of risk like standard deviation or variance tell almost nothing about the odds an investor has of achieving his investment goals over time, which is ultimately the only thing that matters. For that aim, investors should look at historical data and ask questions like: "What are the odds of this investment beating all others over time?"; and "What are the odds of this investment preserving my capital over time?".

A contrarian strategy in practice

As mentioned earlier, Dreman splits his investment strategies into "four flavours of value": low price-to-earnings; low price-to-cash-flow; low price-to-book-value; and high-yield strategies. The most important factor is to only select stocks that show superior performance characteristics and then to take into account diversification issues while trying to minimise risk. The strategy consists of three main steps:

1. **Rank stocks using a price ratio from highest to lowest and select those in the lowest quintile**

   Investors should start by ranking the universe of stocks using one of the above price ratios by highest to lowest. The next step is to select the stocks from the lowest quintile – that is the 20% of stocks that rank lowest – which are exactly those with the best value prospects.

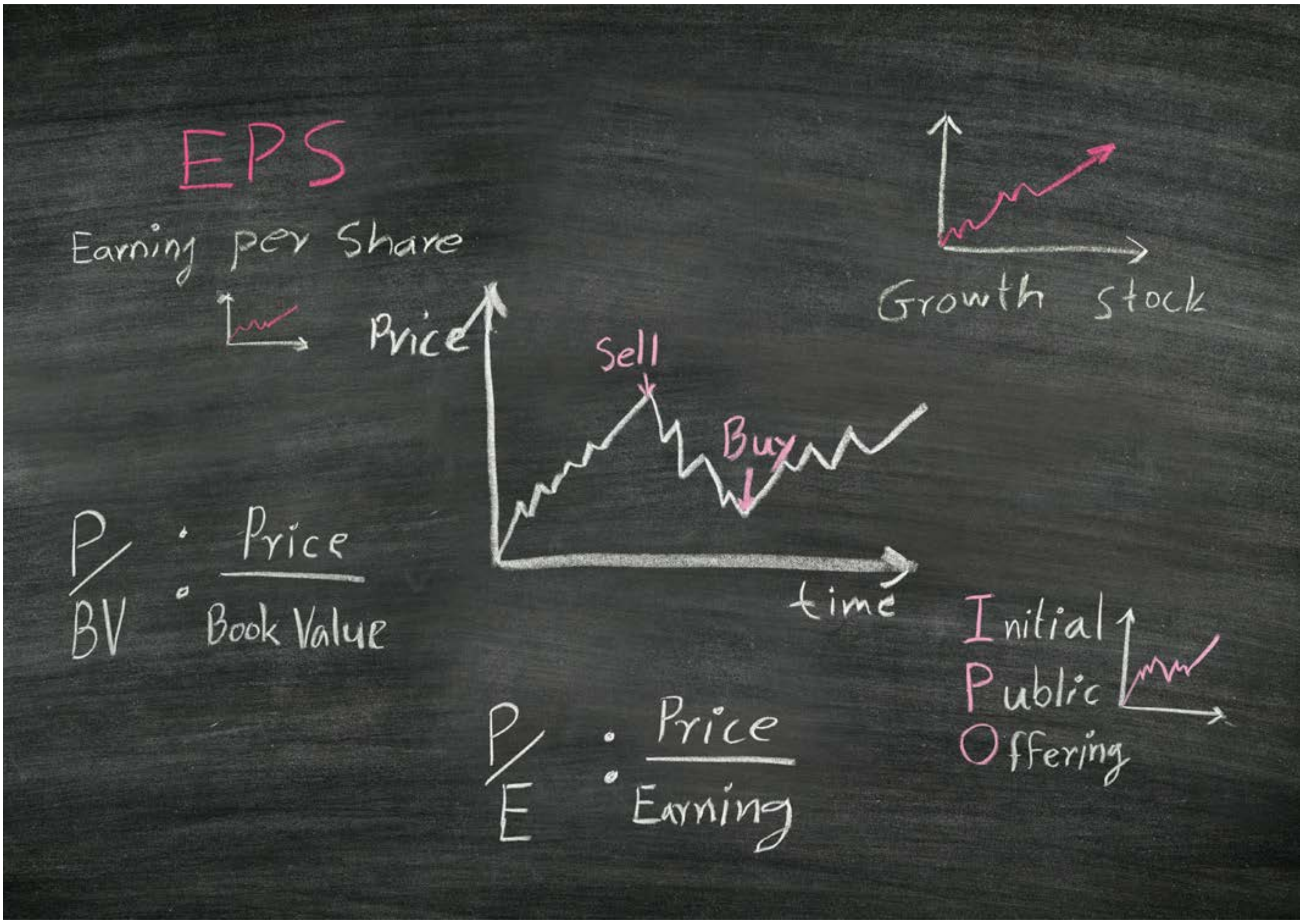
2. **Buy medium to large-sized stocks**

   Dreman believes these companies "are usually subject to less accounting gimmickry than smaller ones", which provides extra protection to investors. Additionally, these companies "are more in the public eye" and share more "staying power". Summing it all, medium to large-sized stocks represent a reduction in risk for investors. Deciding on the exact cut-off isn't straightforward and depends on the universe of stocks an investor is considering. Certainly, all stocks from the Dow, S&P 500 or FTSE 350 would qualify, while most AIM stocks may not.

3. **Diversify**

   Dreman advises investors to choose 30 to 40 stocks, diversified among fifteen or so industries whenever possible. Funds should then be split in equal parts. He believes diversification is essential because the returns of individual stocks vary widely. When we toss a coin, the odds of getting tails are even. If we toss it one million times, we would most likely confirm these odds. But if we toss the coin just a few times, there is a much higher risk of getting tails 60% or 30% of the time. There is always a statistical risk, which can be avoided through diversification.

"IN DREMAN'S VIEW, AN INVESTOR IS BETTER OFF SELECTING SHARES BASED ON MEASURES THAT DON'T REQUIRE MUCH JUDGEMENT, IF ANY AT ALL."



Tables 3 (UK stocks) and 4 (US stocks) show an example selection process meeting the above criteria.

While looking for financial soundness in financial statements can enhance the portfolio selection, one should eliminate forecasting error. In Dreman's view, an investor is better off selecting shares based on measures that don't require much judgement, if any at all. Nevertheless, Dreman suggests a few additional indicators for investors that "are brave enough to dabble in security analysis" in order to further filter the list. Investors may then look for:

- Strong financial position – consider current assets versus current liabilities, debt as a percentage of capital structure, and interest coverage.
- Favourable operating and financial ratios – return on equity, profit margins etc.
- Higher rate of earnings growth than the main market index.
- Above-average dividend yield (and which the company can sustain and increase).

Being a contrarian is lonely

Being a contrarian is not an easy investment approach. As the name suggests, adopting such a strategy means going against the crowd most of the time, which means going through long periods of underperformance. For this to be possible, investors should keep leverage low, such that when things get worse, they can stay in the market. Dreman presents one of the simplest strategies ever adopted, but which has been delivering superior profits over time. In essence, we can summarise it crudely as just picking the stocks with the lowest price-to-earnings ratios.

But how can such a simple and easy-to-replicate strategy outperform the market? In today's market, where many of the protagonists make money out of volatility, and in a world where patience is rare, the simple contrarian strategies seem difficult to implement. As Dreman himself observes, "patience is a crucial but rare investment commodity".

TABLE 3 – PORTFOLIO SELECTION BASED ON PRICE-TO-EARNINGS
Universe: London Stock Exchange

Asset	Industry	Price	P/E	Market Cap. (in millions)	Relative Strength (last 6 months)
3i Group PLC	Financials	936.80	5.60	£9114.0	0.40
Tullow Oil PLC	Oil & Gas	186.65	5.90	£2589.7	21.00
Capita PLC	Industrials	179.80	4.20	£1199.8	-71.60
TalkTalk Telecom Group PLC	Telecommunications	97.70	5.30	£1119.9	-46.00
Mitchells & Butlers PLC	Consumer Services	238.00	5.90	£1018.7	0.40
Pantheon International PLC	Financials	1,870.00	5.90	£1013.8	4.60
John Laing Group PLC	Financials	273.00	5.30	£1001.8	-8.80

Source Data: Sharepad

TABLE 4 – PORTFOLIO SELECTION BASED ON PRICE-TO-EARNINGS
Universe: New York Stock Exchange

Asset	Industry	Price	P/E	Market Cap. (in millions)	Relative Strength (last 6 months)
Office Depot Inc	Consumer Services	303.00	2.40	$1563.8	-30.50
Ciena Corp	Technology	2,299.00	3.10	$3288.6	-13.60
Cenovus Energy Inc	Oil & Gas	733.00	3.60	$9007.0	-11.00
Mallinckrodt PLC	Health Care	1,593.00	3.60	$1523.9	-60.20
Bed Bath & Beyond Inc	Consumer Services	2,163.00	4.70	$3080.4	-29.30
American Axle & Man. Hold. Inc	Consumer Goods	1,572.00	4.90	$1749.6	2.00
Rowan Cos PLC	Oil & Gas	1,316.00	5.20	$1660.8	26.60
Ford Motor Co	Consumer Goods	1,063.00	5.60	$43136.5	-10.70

Source Data: Sharepad

"AS DREMAN HIMSELF OBSERVES, 'PATIENCE IS A CRUCIAL BUT RARE INVESTMENT COMMODITY'."

About Filipe

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

BY DAVID JONES

FORENSIC FOREX

IS THE EURO SET TO DOMINATE THE POUND?

IT'S A GAME OF CAT AND MOUSE AS BREXIT TALKS UNFOLD

Given the fact that you can barely watch the news today without the "B" word rearing its head, I thought it could be timely to take a look at the fortunes of the pound versus its nearest currency neighbour, the euro. The market convention is actually to quote this the other way around to what we are used to seeing in the likes of Thomas Cook in the summer. So, from a trading point of view everyone sticks with euro/pound (EUR/GBP) – let's just look at the bigger picture first.

Although much was made last summer of the strength seen in the euro against the pound – it traded as high as the 0.92 area (one euro would buy 92p) – it has of course been even stronger in the past. If we go back to the dark days of the financial crisis, when there were real worries about the impact of bank failures on the UK economy, one euro would have bought 98p back then. Many expected it to surpass the £1 mark but, as so often happens whenever we get to an extreme of sentiment where the majority of market participants think that a certain move is almost a sure thing, it was time to bet the other way. By 2015, the euro had lost a lot of ground and was worth just under 70p.

That's the history lesson out of the way – so what are the main factors to watch that could push these currencies around?

Hurdles for the pound

It's simple – it's mostly down to how well or badly the Brexit negotiations go. At the moment, the wider market does seem to be taking a mildly optimistic view, with some of the very pessimistic outlook statements made in 2017 having to be revised. This is particularly true when it comes to the pound/US dollar (GBP/USD), for example, with the pound having clawed back a significant chunk of the losses seen since the June 2016 referendum.

Brexit is the big one – but also the Bank of England will play its part. It has already warned that interest rates may end up rising faster than it first thought if inflation starts to pick up. A higher base rate would usually be positive for the pound.

Courtesy of these two factors, the pound does have a slight tail wind at the moment – but an indiscreet statement from a member of the government could take that away very quickly.

Hurdles for the euro

This is something of a more complex argument. Of course, the Brexit negotiations come into play – no side really wants a bad outcome that

"THE POUND DOES HAVE A SLIGHT TAIL WIND AT THE MOMENT – BUT AN INDISCREET STATEMENT FROM A MEMBER OF THE GOVERNMENT COULD TAKE THAT AWAY VERY QUICKLY."

could end up stifling trade between the two economic zones. But understandably for now the main focus is the effect all this has on the pound.

If you take even a passing interest in markets, you will know that plenty of central banks have had some sort of stimulus programme in recent years – the likes of quantitative easing for example. If we refer to this by the somewhat flippant term of "printing more money", this clearly can weigh on the currency affected. The European Central Bank (ECB) continues to scale back the support it has given since the financial crisis, but for the moment at least there is no sign that this is going to completely end. One of the reasons for the reluctance to stop is that the rate of inflation in the eurozone remains relatively low, whilst other regions are gaining ground. European inflation fell in January to 1.3%, compared with a UK rate of around 3%. This does suggest that the ECB would also be in no hurry to raise rates just yet, so it seems unlikely the euro is going to get a boost here in the short term.

There is also the question as to whether the euro is somewhat overstretched across the board, when compared to

other currencies. Since the beginning of 2017, it has risen by 20% against the US dollar. Admittedly last year was a terrible year for the American currency and this year hasn't started much better. But it would be surprising to see another runaway year – and the pound by comparison has fared less well, once again of course following the referendum.

Recent EUR/GBP performance

The last five months have not been the most exciting. You can see that something of a floor has formed in the 0.8700 area for EUR/GBP. There is a clear appetite to be a buyer of the euro on dips back to here, but then little in the way of pushing that risk out much higher. Rallies have been stalling in the 0.9000 area, making for a very quiet market.

"THE REAL TRIGGER FOR WEAKNESS IN EUR/GBP WOULD BE A SLIDE THOUGH THAT 0.8700 ZONE."

The real trigger for weakness in EUR/GBP would be a slide though that 0.8700 zone. This could pick up the pressure on the euro and target a return back to the 0.8300 lows from late 2016 and the first half of 2017.

Given the ongoing Brexit discussions, it shouldn't be too surprising that EUR/GBP has carved out this somewhat uninspiring trading range in recent months. But it does look as if the markets at the moment do not think this is going to be a disaster for the pound – EUR/GBP has fallen back by around 5% from those August highs. It does feel as if the risk here is leaning towards the euro falling. Taking Brexit out of the equation, ongoing stimulus by its central bank is going to keep some pressure on euro gains. That lack of inflation compared to the UK means that the ECB is not on the same path of rate rises as the Bank of England. At the moment it seems like markets are waiting for some sort of breakthrough to really wake up trading in EUR/GBP – but don't be surprised if that ends up being a surprise to the downside, and we see the euro lose some ground against its cross-Channel neighbour.

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

THE INVESTMENT TRUSTS HANDBOOK 2018

THE LATEST THINKING, OPINION, RESEARCH & INFORMATION ON INVESTMENT TRUSTS

EDITED BY JONATHAN DAVIS

Despite having a history stretching back over 150 years, investment trusts remain off the radar of many investors. Yet, they provide the opportunity to reduce risk, lower trading costs, make attractive capital gains and enjoy a decent regular income. That's why some commentators refer to them as, *"the best kept secret in the City."*

The Investment Trusts Handbook is the first edition of a new publication which aims to provide data on the trusts sector as it is today, combined with a range of features and analysis which highlight the opportunities available for investors. Amongst other things, the book is attempting to fill a gap in the market expected to be left by the dreaded MiFID II legislation which is expected to significantly reduce the amount of investment trust research available to private investors.

For those not familiar with the sector, an investment trust is a type of investment fund which sees many investors pool their money together. The combined funds are then invested and managed for them, typically by a professional fund manager. This type of structure has many advantages for investors, including the ability to spread risks over a wide range of assets, economies of scale, low costs and (hopefully) the benefits of the skills of the fund manager. Also, most can typically be held in an ISA or SIPP to enjoy tax benefits. Industry body the Association of Investment Companies estimates that as at 31st January this year a total of 389 trusts held a total of £174 billion of assets.

While having some similarities, investment trusts differ from unit trusts and so called open-ended funds. Crucially, investment trusts are "closed-ended", meaning that a fixed number of shares are issued to initial investors. These shares are then listed on a stock exchange. Because they trade on an exchange, the share price of an investment trust can rise and fall just like any other share. This means that the market cap of the trust can differ from the value of its underlying assets, with trusts typically trading at a modest discount to net asset value (NAV). Also, just like any other listed entity, the company has a board of directors.

Knowledge you can Trust

This inaugural edition of the handbook is headed up by editor Jonathan Davis. He is a prolific stock market commentator and the author of three books: *Money Makers*, *Investing with Anthony Bolton* and *Templeton's Way with Money*. A former columnist for The Independent and the Financial Times, he is also a senior advisor to wealth manager Saunderson House and a non-executive director of the Jupiter UK Growth Trust. Davis himself contributes the Introduction to the book, as well as a section in the Investment Trust Basics chapter, before letting several experienced industry professionals give their own expert guidance.

Private investors are in focus for the first couple of chapters, with former investment manager Max King and research director Mark Dampier writing on how the typical DIY punter can benefit from closed-ended funds. Then, in Insights of an Investment Trust Expert, John Baron provides a practical 11 step guide to a successful investment journey. Historian John Newlands takes a different route by taking a look at Foreign & Colonial, the UK's oldest investment trust, which was formed in 1868 and is still going strong today with investments of £3.7 billion.

The next part of the book provides more Expert Views, with my particular favourite chapter being from Robin Angus, director of Personal Assets Trust, who looks at what he claims to be ten of the greatest investment misconceptions. This is closely followed by a contribution from Fidelity portfolio manager Alex Wright who argues the case for contrarian investing, explaining why it is important to avoid doing what most other investors are doing. Next up are three Interviews with some renowned trust managers, proving further insights into how to successfully spot lucrative investment opportunities.

"THIS IS A DETAILED, INSIGHTFUL AND PROFESSIONALLY WRITTEN COMPENDIUM ON THE WORLD OF INVESTMENT TRUSTS."

Taking a different approach, the next part of the handbook focusses on Analysing Investment Trusts. Here, a number of key concepts are explained, sectors examined and performance evaluated, with other concepts introduced so readers can determine for themselves how to go about finding the best investment opportunities.

The final two chapters, which make up the majority of the book's content, provide a raft of reference information on the investment trust sector. The Calendar chapter provides details of when a number of key trusts are due to report their interim results, final results and hold their AGM over the course of 2018. Finally, the Trust Directory section puts together a wide-ranging list of investment trusts by sector. The directory runs to 371 entities listed in London, Euronext or registered on the Channel Islands with a market cap of over £20 million, as well as a number of property investment companies which adopt a portfolio approach. It provides key data on each trust, including ticker symbol, market cap and information on fees, providing a good starting point for investors who want to go on and do more research themselves.

Overall, this is a detailed, insightful and professionally written compendium on the world of investment trusts. For those new to the industry the book provides all the basic terminology needed to understand how investment trusts work, along with a range of ideas and analysis on how to make the best of the opportunities out there. Those with more experience of trusts will benefit from the insights of finance professionals with collective industry experience amounting to many hundreds of years. For anyone interested in learning more about and making money from investment trusts, this is truly the definitive guide on the market right now.

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

CHOOSE YOUR MEDIA WITH CARE

By the time you read this, the sell-off in global stocks that began in early February may have slowed and stabilised, or it may have accelerated into something more akin to a disorderly collapse. Or we may have no real clarity as equity markets oscillate between violent short-term spikes of greed and fear. Markets are like that. Somebody should tell the financial media.

Not every academic who has ever strayed into discussing financial markets is a blithering idiot. Just most of them. But we should make an honourable exception on behalf of Benoit Mandelbrot. Mandelbrot, the Polish-born scientist and mathematician, who was also father of the Mandelbrot set, was the co-author, with Richard Hudson, of *The (Mis) Behaviour of Markets*. As far as the best-selling author and financial theorist Nassim Nicholas Taleb is concerned, Mandelbrot's book is "The deepest and most realistic finance book ever published."

Harry Markowitz, whose infamous article *Portfolio Selection* in 1952 essentially started rolling the snowball that ended up equating risk with volatility, never deserved his Nobel Memorial Prize in Economic Sciences. That honour should, rightly, have gone to Mandelbrot instead. But Mandelbrot died in 2010, so he will sadly never get his chance.

The riskiness of the market, to a follower of Markowitz, looks a lot like the conventional bell curve of standard deviation. If you happen to look at actual price records, as Mandelbrot did, especially in relation to the market in cotton, you find an altogether different kind of distribution to that of the bell curve. The tails in the market price curve do not flatten out into irrelevance. Rather, they follow a power law that happens to be quite common in nature.

In a power law relationship, a relative change in one quantity triggers a proportional change in another. If you double the length of a square, for example, its total area is multiplied not by two times, but by four.

The same type of power law holds for income distributions (the so-called Pareto principle, the 80-20 rule, shows that roughly 20% of the population accounts for 80% of its wealth). And it also holds, somewhat ominously for those who believe in stable or easily controllable markets, for earthquakes, volcanoes, landslides and forest fires.

Unlike Markowitz, who conjured up an overly simplistic theory with no basis in reality, Mandelbrot developed his own theories having already spent considerable time assessing historical prices. What follow are some of his conclusions.

- Markets are riskier than we think. And certainly riskier than conventional financial theory thinks.

Price movements do not obey the bell curve. Extreme price swings are not the exception. They are the norm.

"NOT EVERY ACADEMIC WHO HAS EVER STRAYED INTO DISCUSSING FINANCIAL MARKETS IS A BLITHERING IDIOT. JUST MOST OF THEM."

- Trouble runs in streaks.

Or as Shakespeare put it,

When sorrows come, they come not single spies

But in battalions!

Market turbulence doesn't just suddenly arise out of a clear blue sky and then evaporate. Outbreaks of turbulence in prices tend to cluster. A wild market open may well be followed by an equally wild full trading session. A chaotic Monday may well be followed by an even more chaotic and turbulent Tuesday.

- Markets have their own personality.

The father of value investing and Warren Buffett's mentor, Benjamin Graham, famously created the manic-depressive character Mr Market to account for the stock market's constant oscillations between hope and terror. As Cullen Roche more recently put it, "The stock market is the only market where things go on sale and all the customers run out of the store."

But when individual investors, institutional fund managers, hedge funds, day traders and sovereign wealth funds come together in the real-world marketplace, a new kind of market personality emerges – both greater than, and different from, the sum of its constituent parts.

Mandelbrot suggests that market prices are determined by endogenous effects specific to the inner workings of those markets, rather than by exogenous, external events. To put it another way, each bull market carries the seeds of the inevitable bear cycle that will follow. Mandelbrot's analysis of cotton prices during the 19th century showed the same broad pattern of price variability as they did in the 1930s, when cotton prices were regulated as part of Roosevelt's New Deal.

- Markets mislead.

In Mandelbrot's words, "Patterns are the fool's gold of financial markets."

The workings of random chance create patterns, and human beings happen to be pattern-recognition experts. We see patterns even where none exist. Financial markets are especially prone to statistical mirages. Following from this, bubbles and crashes are inherent to financial markets and the inevitable consequence of the human need to find patterns in the patternless.

- Market time is relative.

Just as the market has its own personality, so it has its own time signature. Professional traders often speak of a *fast* or *slow* market, depending on their assessment of volatility and newsflow at the time in question.

In a *fast* market, things like market-, stop- or limit orders have limited usefulness. Prices don't necessarily glide smoothly within narrow ranges. Sometimes they gap down or leap up, effortlessly vaulting beyond price limits presumed to protect portfolios from ruin.

"MANDELBROT PULLED BACK THE CURTAIN AND REVEALED THE CHAOS UNDERNEATH. FINANCIAL MARKETS ARE FAR WILDER THAN THE MEDIA WOULD GIVE THEM CREDIT FOR."

Traditional economists have tended to treat the financial markets as a kind of closed system that obeys rigid and preset natural laws. Mandelbrot pulled back the curtain and revealed the chaos underneath. Financial markets are far wilder than the media would give them credit for.

And the role of the financial media in exacerbating panics is not well understood, not least by the media themselves. Consider a spectator watching a football match remotely on television. No matter what he shouts or screams at his television set, in no way can he change what happens on the field of play. Now consider a referee who is also maintaining a running commentary on the same match to an audience of millions. And the match happens to be a trading session for the stock market. The referee is our financial media. It loves nothing more than a good

story. Greed sells. Fear sells. And panic sells. What possible motive would an obedient media person have to downplay a market sell-off? Far better to scream from the sidelines and egg on the viewing public to sell some more stocks. In this way a "normal" correction (Mandelbrot would have maintained there is no such thing) turns into a fully-fledged market rout.

So how do we know whether a bit of mild February drizzle will turn into a devastating March flood? The reality is that we don't. But there are always plenty of media participants who pretend otherwise. The intriguing suggestion of Yuval Noah Harari in his book *Sapiens* is that what discriminates modern man from his lesser developed relatives in the fossil record is, in part, his predilection for good stories. Human beings ***hate*** uncertainty. Why did the stock market fall so heavily yesterday? Will it do so again today? Should I sell some or all of my stock holdings? Should I head for the hills? We hate uncertainty so much we would rather latch on to something – anything – half plausible by way of exposition (in reality: storytelling), rather than live with the not knowing why. As Voltaire is thought to have said, doubt is not a pleasant condition, but certainty is absurd.

"THE BEAUTY OF A BIG SELL-OFF IS THAT IT FORCES YOU TO RE-EVALUATE THINGS."

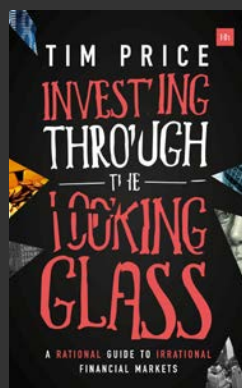
The beauty of a big sell-off is that it forces you to re-evaluate things. You may have told your financial adviser that you can handle volatility, but perhaps you can't, or at least not as well as you thought you could. That may mean your portfolio is fundamentally misaligned. On the other hand, if your portfolio and overall asset allocation are fundamentally sound, a big sell-off may mean that the correct response is: precisely nothing.

Time will tell whether 2018 goes on to become another black statistic along with 1987 and 1929. Within our own client portfolios, we try to live with the uncertainty by favouring broadly defensive value stocks within our equity holdings, and then try to offset the inevitable risk there by holding systematic trend-following funds (price momentum funds, essentially) that have shown an ability to zig when the rest of the market zags. We also hedge our equity risk (and the possibility of a renewed systemic failure) by holding the monetary metals – gold and silver bullion. We used to hold bonds, but now regard the bond markets of the world as fundamentally uninvestible, given how many of them are out there, and given their absolutely derisory yields. There may be other, better ways of maintaining a balanced portfolio, but this version at least enables us to sleep at night.

A final piece of advice. If what you read online is causing you to lose sleep with respect to your portfolio, the chances are that one of two actions may be required. One is to rejig your portfolio until you can live happily with it. The other is to stop reading nonsense on the Internet.

About Tim

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



MARKETS IN FOCUS

FEBRUARY 2018

GLOBAL EQUITIES

Index	Last Month %	YTD%	Proximity to 52w High*
Bovespa	1.0	11.7	
Russian TSI	1.0	10.7	
S&P/ASX 200	-0.4	-1.5	
NASDAQ 100	-1.4	7.3	
CAC 40	-2.9	-0.9	
Euronext 100	-3.3	-1.4	
S&P 500	-3.9	1.7	
FTSE 100	-4.0	-6.7	
Dow Jones	-4.3	1.4	
Nikkei 225	-4.5	-4.6	
DAX Xetra	-5.7	-5.6	
IBEX 35	-5.8	-2.0	
Hang Seng	-6.2	3.8	

COMMODITIES

Commodity	Last Month %	YTD%	Proximity to 52w High*
Cocoa	12.0	23.1	
Iron Ore	8.8	15.2	
Cotton	6.4	9.2	
Palladium	0.6	-2.5	
Coffee	-0.6	0.6	
Copper	-0.8	-3.9	
Gold	-1.7	0.8	
Platinum	-1.8	6.0	
Sugar (No. 11)	-2.7	-5.8	
Crude oil (Light Sweet)	-4.4	2.4	
Silver	-5.0	-3.9	
Crude oil (Brent)	-5.5	-2.5	
Natural Gas	-5.5	-9.2	

FOREX

Pair/Cross	Last Month %	YTD%	Proximity to 52w High*
USD/CAD	4.1	2.1	
USD/CHF	1.4	-3.0	
EUR/GBP	1.2	-0.2	
GBP/AUD	0.4	3.0	
EUR/CHF	-0.3	-1.3	
EUR/USD	-1.7	1.7	
USD/JPY	-2.3	-5.1	
GBP/USD	-2.8	1.9	
AUD/USD	-3.3	-1.0	
EUR/JPY	-3.9	-3.5	

CENTRAL BANKS - RATES & MEETINGS

Central Bank	Key Rate	Next	After
BOE	0.50%	Mar 22	May 10
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%	Mar 06	Apr 03
RBNZ	1.75%	Mar 22	May 10
BOS	-0.50%	Apr 25	Jul 02
BON	0.50%	Mar 15	May 03

FTSE 350 TOP

Sector	Last Month %	YTD%	Proximity to 52w High*
Fidessa Group PLC	59.0	49.2	
Provident Financial PLC	45.0	14.6	
Sky PLC	27.0	33.2	
Royal Mail Group PLC	19.0	22.4	
Sirius Minerals PLC	17.0	16.6	

FTSE 350 BOTTOM

Sector	Last Month %	YTD%	Proximity to 52w High*
AA Ltd	-37.0	-53.1	
Vectura Group PLC	-26.0	-38.2	
Acacia Mining PLC	-25.0	-29.6	
Moneysupermarket.com	-23.0	-26.4	
Sophos Group PLC	-22.0	-13.2	

FTSE 350 SECTORS TOP

Sector	Last Month %	YTD%	Proximity to 52w High*
Industrial Metals	12.0	23.2	
Industrial Transportation	8.6	7.6	
Media	4.4	-0.5	
Automobiles & Parts	3.3	33.9	
Forestry & Paper	1.3	-4.7	

FTSE 350 SECTORS BOTTOM

Sector	Last Month %	YTD%	Proximity to 52w High*
Tobacco	-11.0	-15.5	
Househld Goods & Const	-9.5	-14.7	
Mobile Telecom	-8.9	-13.5	
Real Estate Inv & Serv	-6.7	-8.3	
Gas, Water & Mult	-6.7	-13.7