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MAGAZINE

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THE DIVIDEND KING

HOW ONE TRUST GREW ITS DIVIDEND FOR MORE THAN HALF A CENTURY

PLUS...

LA DOLCE VITA

DON'T WRITE OFF THE ITALIAN MARKET

TED BAKER

THE PERFECT DIVIDEND GROWTH STOCK?

TRUMP'S TRADE WAR

HOW TO MAKE A PROFIT FROM IT

MELLON ON THE MARKETS

REALITY IS SINKING IN FOR THE FANGS

WELCOME

Dear Reader,

Years of low interest rates have eaten into the income of savers and pensioners alike and pushed them into the arms of the stock market. While this brings with it greater capital risk, it also offers the potential to earn a decent level of income from dividends – certainly much greater than anything on offer from savings accounts – whilst also achieving capital growth over the long term.

The UK stock market has strong dividend credentials, with one of the highest dividend yields on offer anywhere in the developed world. However, there are also many pitfalls for investors looking to generate a high level of income from stocks. A high dividend yield can often be the hallmark of a 'value trap' where the dividend is unsustainable and/or the company has poor future prospects. As such, investors should tread with care and not just reach for the highest yield.

This month's issue features two of my favourite dividend investors – Job Curtis of Janus Henderson and Gervais Williams of Miton. The former manages the City of London Investment Trust, which boasts over half a century of dividend increases. My interview with Job can be read on page 10, and is a great place to start if you're looking for insights into what constitutes a good dividend payer.

Meanwhile, Gervais's piece on page 16 highlights the challenges facing income investors and advocates a more flexible strategy to capture dividends from more overlooked areas of the market. Certainly, a large share of dividend income comes from just a small coterie of very large companies, many of which have questionable growth prospects. With this in mind, casting the net a little wider might not be a bad idea.

We all need to generate an income in retirement, and with more of us than ever taking control of our retirement pots, we hope you'll find this month's issue a good source of inspiration.

Calling all female investors!

What do you want from us to help educate and empower you in your investments? Do you want a female investor diary? Interviews with female investor role models? Female-centric topics like funding your maternity leave through investing or how to invest for your children's futures? If you are reading this and think you would like to see us sharing more female focused content, please do get in touch with any suggestions or just to let us know you'd find it useful. Please email your suggestions to Amanda Taylor at amanda@masterinvestor.co.uk.

Thank you!

Best regards,
James Faulkner
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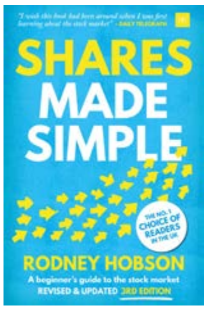

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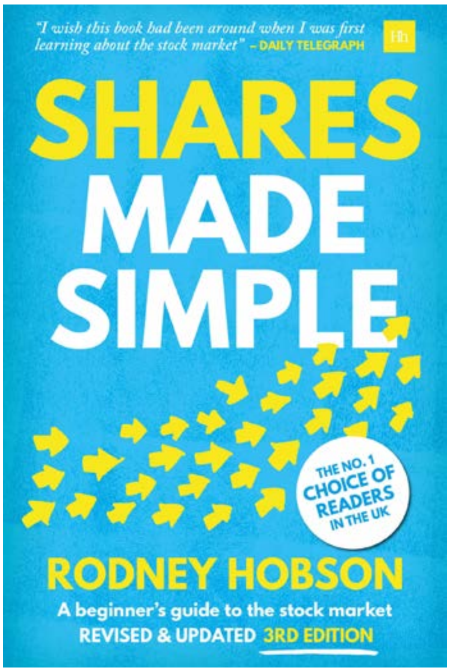

BY JIM MELLON

MELLON ON THE MARKETS

The summer fry continues, with wildfires all across the US and Europe – and even in the Arctic. Apparently, the reduction in wind speeds below the jet stream (in part caused by the large number of wind farms which have been built in the past decade) is causing its trajectory to change. Climate change is here, and mankind's efforts to counteract it are just not sufficient. This is a theme I am going to look at more closely in the coming months.

Reality sinks in for the FANGs

On the subject of climate, it seems that the benign conditions under which some markets, at least, have prospered might be changing, and not in a good way. One such crack is the recent precipitous decline in **Facebook (NASDAQ:FB)**, which in one tumultuous session fell by as much as a quarter, representing the single biggest destruction of stock value in history. I have long railed about Facebook being a timewaster's charter for its two billion adherents, and it seems that even some of those are cutting the cord.

Facebook is important, because it – along with the other FANG stocks and one or two others, such as **Boeing (NYSE:BA)** – has represented almost all of the outperformance of US markets in the last couple of years. It is interesting, in this context, to note that in Europe, where there are no comparable tech champions, there has been woeful underperformance in key indices.

I also note that **Amazon (NASDAQ:AMZN)** came out with excellent results, largely on the back of their web services division, and that analysts have revised their targets

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“I REMAIN PESSIMISTIC ABOUT THE US MARKET FOR THIS YEAR AND THE NEXT.”

"DON'T DISCOUNT THIS IN INVESTMENT CALCULATIONS."

upwards. It is undoubtedly the case that Amazon is the best of the FANGs, but at the current rate of earnings it is about 90x forward earnings. Yes, when they stop investment in so many new areas, presumably margins will improve further, but for such a large company, with the world's richest person at the helm, 90x earnings is a heck of a stretch.

Even more ridiculous are the valuations attached to such luminaries of the tech scene like **Tesla (NASDAQ:TSLA)**, whose CEO does seem to have, ahem, anger management issues.

The fact remains that the US market is expensive, and the one-off stimulus from tax cuts and energy prices to S&P companies is just that – one time. The Fed is tightening, both by shrinking its bloated balance sheet, albeit in a gradualist way, but also by hiking interest rates. The US economy is running hot, with seven million more job vacancies than people to fill them, and with that going on, there is a substantial headwind for any stock market gains.

As such, I remain pessimistic about the US market for this year and the next, and further point to the fact that US companies are quite leveraged, having engaged in M&A and share buybacks (financial engineering) for years now.

And as for the famous FANGS, the Euro Commission fine on **Alphabet (NASDAQ:GOOGL)** of about $5 billion last week isn't by any means the last bad behaviour sanction which will be meted out. All of these tech companies are stuffed full of cash, and presumably that cash is a source of temptation (rather like the banks used to be) for governments everywhere.

For these companies, there also remains regulatory risk. Will Amazon be allowed to keep killing traditional retailers ad infinitum? Will Google be regulated like a utility? Will Facebook be reined in, and be categorised as a news source in itself rather than as a platform? These are questions all of us should be asking – at some point, the pass-the-parcel game will come to an end and tears will flow.

Brexit and the Italian question

In the meantime, what a hash Brexit appears to be. I would like to think that we are at the moment of maximum hysteria before a (soft) deal is concluded, but Monsieur Barnier doesn't seem to think that Mrs May's carefully crafted proposals cut la moutarde. I have a feeling that because of the absolutely appalling handling of the negotiations in the last two years, there will now be a second referendum, and that with a few concessions from Europe, Remain will win.

I have always advocated for a much softer Brexit than the ideologues, and my general view is that it isn't life and death either way. Note how the UK economy is still chugging along in the face of the gloomiest of predictions at the time of the plebiscite, and how sterling is holding quite steady.

My concern about the UK with regard to the eurozone was mainly pegged to the worry that Italy might blow up, and that the whole ship would sink quickly. The Italian problem has not gone away and indeed could flare up rather like a summer wildfire any time.

I attach a graph showing the imbalances – rather like an overdraft at the ECB – in the so-called Target 2 calculation, which Italy and Spain now have relative to the Germans. In the event that Italy walked away from the euro, it would represent a massive write down which would imperil most of the European banking system.

The Italians would default on an unsustainable debt, reclaim the lira and merrily devalue to try to restore their long-lost competitiveness. Don't discount this in investment calculations. A super smart hedge fund guy I know has his principal bet against Italy – so just be careful and watch and wait. And of course, Europe's early growth spurt at the beginning of this year appears to have petered out.

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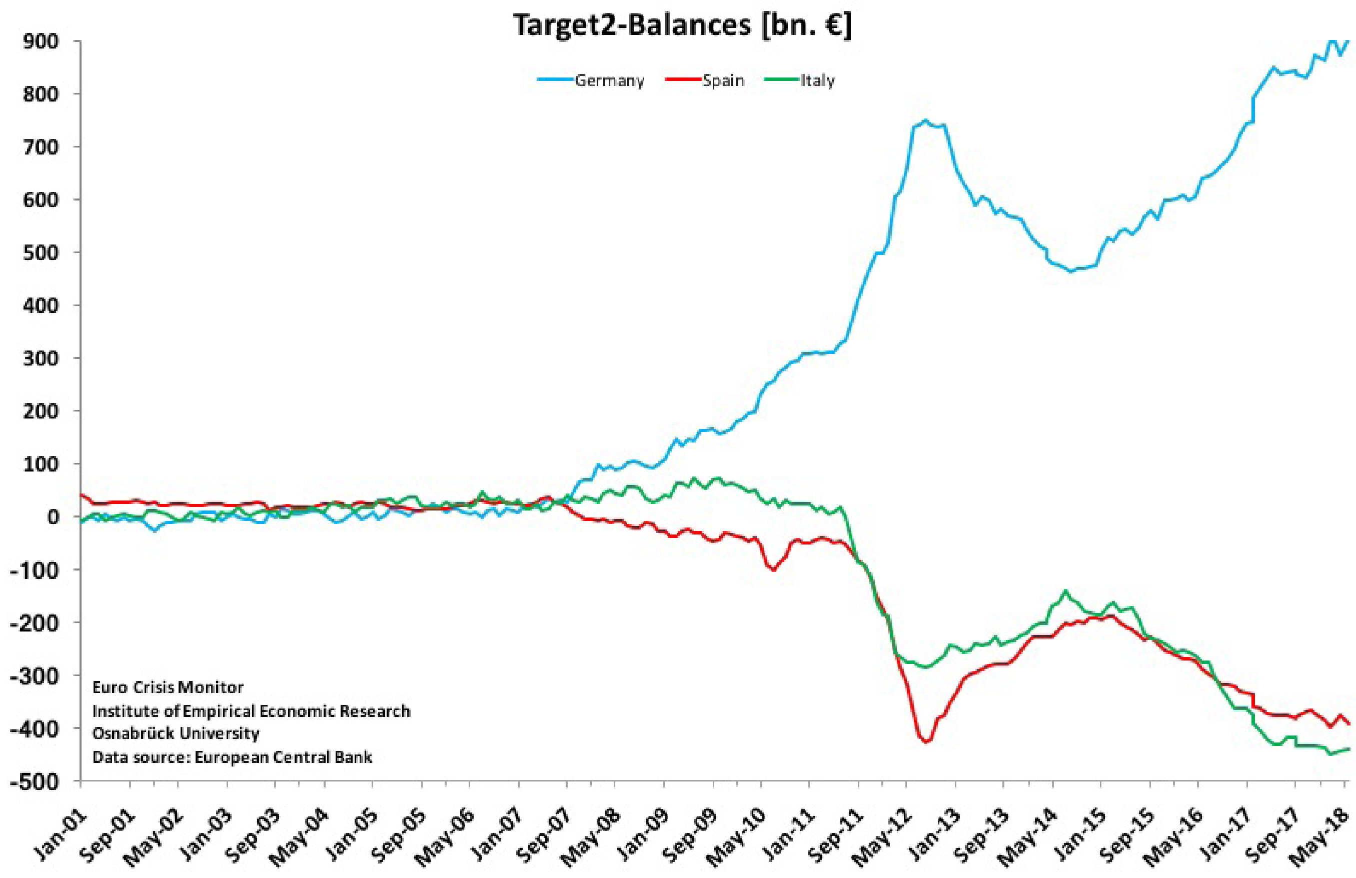


The risks are to the downside

Further East, emerging markets have done very badly this year, partly as a result of the Federal Reserve sucking dollars out of the world money supply, and partly for specific reasons (e.g. concern about debt levels in China).

The Bank of Japan has signalled a willingness to tweak its ludicrous zero yield policy on Japanese Government bonds, because, as it stands, the banking system is severely compromised if it doesn't make such a change. I still think that if you have to hold a specific market, it's best to hold Japan. It's cheap, companies are reforming fast, and pension funds and individuals are underinvested in the stock market.

"I STILL THINK THAT IF YOU HAVE TO HOLD A SPECIFIC MARKET, IT'S BEST TO HOLD JAPAN."

I've been wrong on gold so far this year, but because I am a believer that inflation is insidiously worming its way back, I am holding my ground. In terms of stuff we are looking at, we like the look of some bombed out auto companies such as **VW (GR:VOW)** and **Peugeot (UG:EPA)**. But tread with caution, as I think generally there is more downside risk than upside at the moment.

Getting back to the FANGs, I noted that in the quarter that Facebook just announced, one million people exited its all-embracing arms. I was one of them. I have been talking about the malign effects of social media for some time, so in order to avoid being branded a hypocrite, I have exited social media completely.

And I can tell you it feels great!

Happy Hunting!

Jim Mellon

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 JAMES FAULKNER

SHARPE MINDS

HALF A CENTURY OF DIVIDENDS

AN INTERVIEW WITH JOB CURTIS OF CITY OF LONDON INVESTMENT TRUST

The City of London (LON:CTY) investment trust has raised its dividend each and every year for more than half a century. That's some achievement! Its manager, Job Curtis, has been at the helm for more than half that period. I caught up with Job to see how he's managed to maintain such an impressive track record of income growth. (The following transcript is taken from the video interview which can be watched here.)

James Faulkner: Hi Job. Thank you for speaking with Master Investor. The City of London trust is focused on income investors – primarily UK equity investors. Can you give us a brief overview of the trust's investment parameters and objectives?

Job Curtis: *Yes. We're in the UK equity income sector, so we're invested at least 80% in the UK stock market. We're predominately in the large cap stocks in the FTSE 100, though we do have mid cap as well and we have a small amount overseas. We provide an above-average yield compared with the UK equity market. We've got a very long record of growing our dividend every year.*

JF: OK. So, the yield at the moment is just over 4%, I think?

JC: *It's around 4%, yes.*

JF: And the yield on the FTSE is somewhere around 3.8% or something like that at the moment?

JC: *3.6%, yes.*

JF: What do you look for in a good dividend stock? What are the specific traits that you look for?

JC: *Well, what we're looking for is the mixture of income and growth. I mean, income on its own is not enough, and a bit like life, companies are either going forwards or backwards. So, the company needs to be generating enough cash in order to both pay the dividend and also to invest enough for the future and the future growth for their profits and business.*

> **"THERE ARE PERIODS WHEN GROWTH IS VERY MUCH IN VOGUE, BUT IN THE LONG RUN DIVIDENDS ARE VERY IMPORTANT."**

We look in a lot of detail into the sort of cash characteristics exhibited by the businesses we're investing in. Certain types of industries need less investment than others and are able to have a higher payout ratio and may have more modest growth prospects. So, the portfolio is kind of a blend of companies and I have got some lower yields in the portfolio to provide more growth.

In the very long run we have actually outperformed the index by quite a degree. So, in fact, in a way, dividends are

"INCOME ON ITS OWN IS NOT ENOUGH."

the secret part of investing and actually a lot of the long-term returns come from income. There are periods when growth is very much in vogue, but in the long run dividends are very important.

JF: And going forward, with rates being so low I suppose the dividend income is going to be a greater component of returns?

JC: *Well, rates have been very low for a while as we know. They were cut down to 0.5% towards the end of the financial crisis in 2009, and have stayed very low ever since. So, in actual fact, it means that an equity income trust such as ourselves is popular because it's very hard to find that type of yield that we're providing, around 4% – you can't find it in bank deposit accounts – and we're providing income growth as well.*

But, but having said that, it's actually been a good period for growth stock investing in recent years. The world markets have really been led by the so-called FAANG stocks in America, the Facebooks, Apples, Alphabets etc. So, I wouldn't say that this is necessarily purely a good era for income investing; it's been a good era overall for stock markets.

JF: And the trust itself has got a really impressive record of dividend growth. I think it's 52 years of annual increases in dividend payment now?

JC: *Yes.*

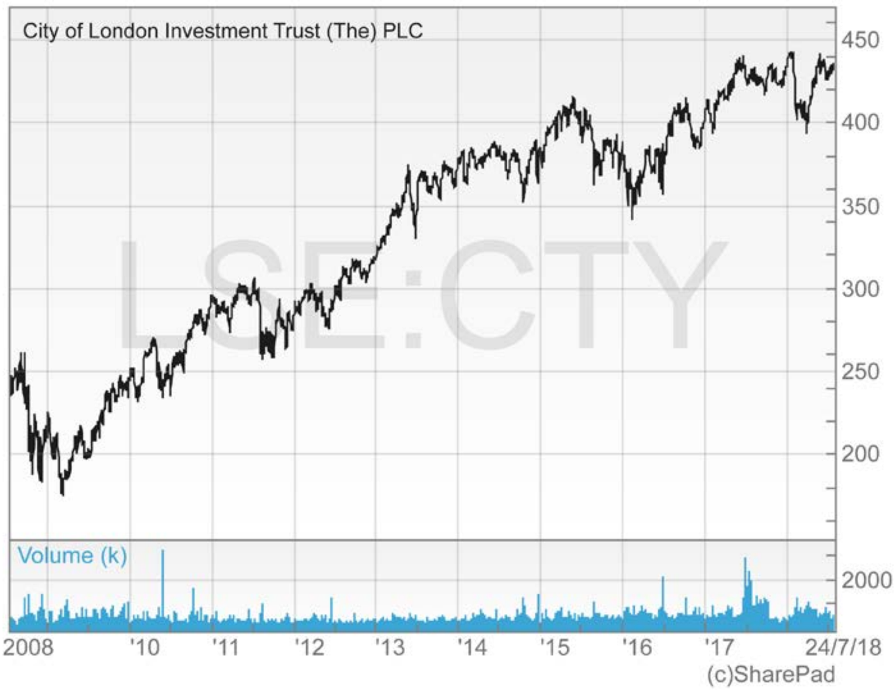
JF: And you yourself have been there for around 27 years?

JC: *Yes, just passed my 27th, yes.*

JF: So, what's your secret to dividend success?

JC: *Well, I think you've got to be in the right companies – the companies that have provided and are well placed to provide consistent dividend growth. And that obviously requires work and analysis and judgment.*

But the investment structure does have certain advantages, and unlike open-ended funds we don't have to fully distribute all our income every year, so we can hold back up to 15%. So that means you build up a revenue reserve and then in the years when there are dividend cuts across the market then you can use that reserve to carry on growing the dividend. So, actually, out of the 27 years I've been manager, seven years we've had to dig into reserves, so I couldn't have achieved that record and the trust wouldn't have achieved that record if we'd been open-ended. It just wouldn't have been possible.



JF: And there's a lot of debate surrounding the OEIC versus the trust structure. What else is it about the investment trust structure that enables that superior performance, do you think, over the long-term?

JC: *Well, I think it's horses for courses and, you know, some people will prefer open-ended. But certainly, one aspect that investment trusts can utilise is gearing (i.e. borrowing), but this is not to everyone's taste. We do it in a conservative way, but certainly in a rising market that will enhance returns.*

And then investment trusts also have independent boards of directors who provide an extra level of scrutiny and they're also there to act in shareholders' interests, so they're there to negotiate fees, for example. Some investment trusts have higher fees than OEICs, but in general trusts have lower fees, and our ongoing

charges are particularly low – 0.42% last year, which is much lower than you'd find in an equivalent OEIC.

JF: What about Brexit? Obviously, the situation at the moment is utterly confusing, nobody really knows what's going on. How is that impacting investors such as yourself at the moment?

JC: *Well, I think it is a very difficult situation to read and it changes quite a lot. But I think the important thing to remember is you're investing in companies, and on the UK stock market over 70% of the profits come from overseas, so that gives you a sort of insulation really from looking primarily from a UK perspective.*

But, to some extent the UK's being shunned both by domestic investors and global investors. And so, if you take a relatively sanguine view, that may be throwing up quite a lot of value actually in some of the domestic sectors. So, I think it would be a mistake to ignore some of the domestic sectors, particularly if we get a favourable outcome, as there could be a lot of opportunity there.

At City of London we're mainly in the large international companies but we do have our fair share of domestic companies, like house builders where I'm also quite keen on prospects.

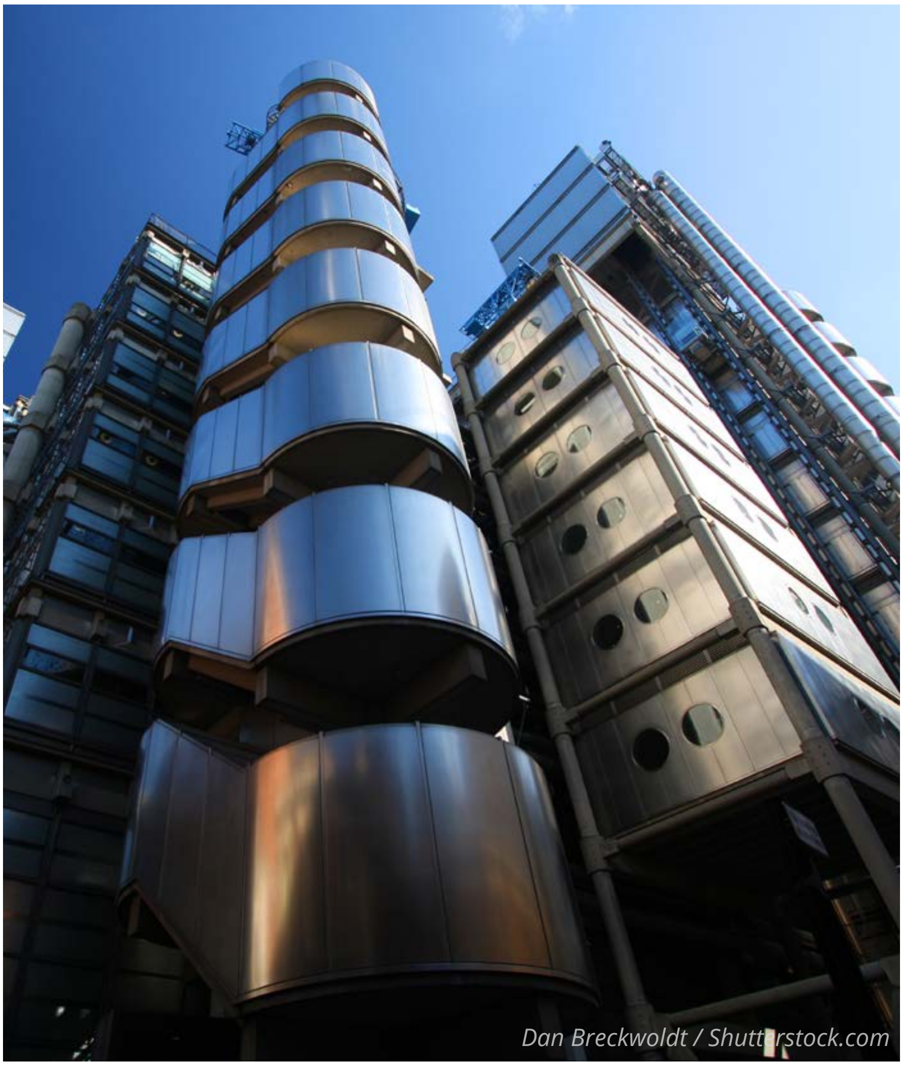
JF: And while we're on the subject of value, a lot of people have been looking at the US markets in particular and thinking they look quite toppy at the moment. The UK market looks quite a lot cheaper. What's your view on valuations from a long-term perspective at the moment?

JC: *Well, I think the UK market does look good value relative to the trailing measures we look at like dividend yields or P/E ratios. Some people try to do it on a cyclically adjusted basis, but again it doesn't look bad value compared to some of the other markets. The US has got this big technology sector which has really caught the imagination of people, and certainly, the companies there are doing remarkable things, but they have very high valuations. But because they are growing their revenues so rapidly, people are willing to put them on a very high valuation. We don't really have a big technology sector in the UK, so it's not completely comparing apples with apples, but the market certainly looks good value relative to fixed interest. The yield on the market is 3.6% and you've got mid-single digit dividend growth. Ten-year gilts, meanwhile, are yielding about 1.3%.*

I think the UK market does look reasonable value at the moment, but we've had a long bull market – markets have been going up for the best part of nine years – and so obviously people do get a bit anxious. But, certainly, on the measures I look at, companies seem in good shape and so I'm pretty happy with it myself.

JF: Which sectors in particular and which companies in particular are you finding value in at the moment?

"I THINK IT WOULD BE A MISTAKE TO IGNORE SOME OF THE DOMESTIC SECTORS."



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What are you buying and selling?

JC: *Well, I was going to suggest an idea which works quite well as a pair, as you might put it. I quite like the oil sector at the moment, I mean Shell and BP. Both are very big companies...*

JF: Both have had quite a good run.

JC: *They've had a good run, but people were worrying a year or so ago whether they'd have to cut their dividends and now they're actually covering their dividends with free cash, as they've reduced their costs dramatically. And, of course, the oil price has moved up quite sharply over the last year and global growth has boosted demand for oil and supply has been constrained, particularly when you throw in renewed sanctions on Iran.*

So, the oil majors are in a good place and they're both yielding over 5% at the moment. These are very big companies and they're not going to perform like a small cap stock might, but I think they look pretty solid at the moment.

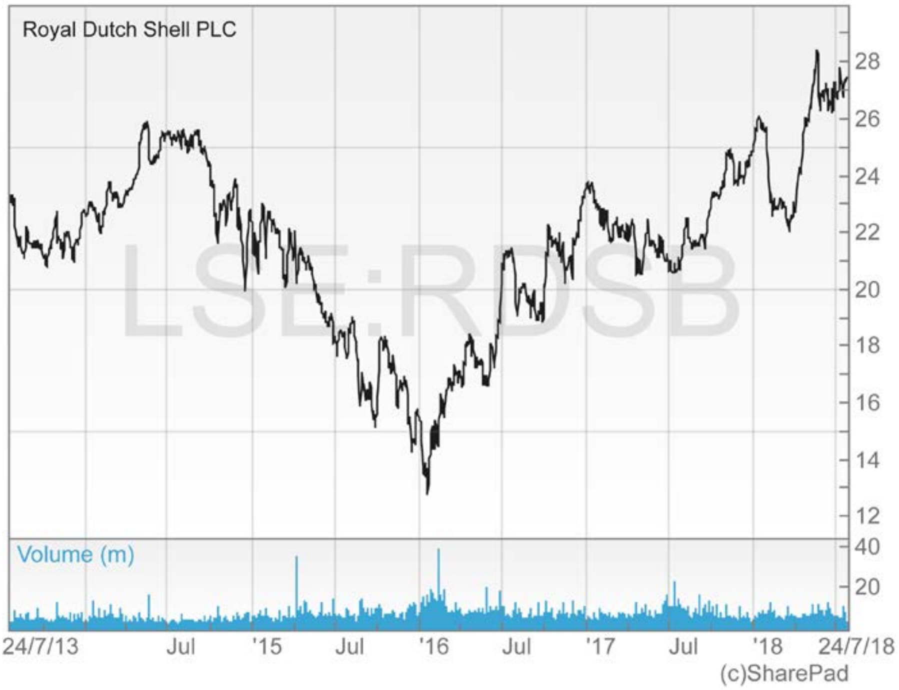
And then, the one I wanted to connect with them or combine with them was actually Carnival, which is the biggest cruise company in the world. It's a dual-listed stock 80% listed in the US and 20% listed in the UK.

Cruising is actually quite a good growth area. It's a relatively good value holiday compared with the equivalents on land and it appeals to some of the older parts of the population and benefits from the good demographics, but Carnival quite cleverly have lots of different brands within their companies – so, they have got brands that appeal to the younger generation as well.

I think the shares haven't performed at all well over the last year or so and that's because obviously fuel is a big component of costs for the ships and so the market tends to mark them down when the oil price is going up. They're producing some steady growth, but I think it is the sort of stock where if I'm actually wrong and the oil price does have a setback, then Carnival will certainly be...

JF: It's a hedge.

JC: *Exactly. So, it'd be a good combination to have either Shell or BP and Carnival as a combination, I think.*



About Job Curtis

Job Curtis is Director of Global Equity Income at Janus Henderson Investors, a position he has held since 2006. He has been Portfolio Manager of the City of London Investment Trust since 1991, and is also co-manager of the Global Equity Income and Global Dividend & Income strategies. Job joined Henderson in 1992 following Henderson's acquisition of Touche Remnant, where he had served as a unit trust and investment trust manager since 1987. Prior to this, he was an assistant fund manager at Cornhill Insurance from 1985 to 1987, and a graduate trainee at Grieveson Grant stockbrokers from 1983 to 1985. Job holds a MA in philosophy, politics, and economics from Oxford University and is an associate member of the Society of Investment Professionals. He has 35 years of financial industry experience.

JF: OK. And what about the interest rate environment? Because a lot of people see interest rates rising in the near term. How does that impact you as an income investor? Are you worried about that?

JC: *Well, I think you have to take a step back. Obviously, they were cut from 0.5% down to 0.25% after the referendum and then that's been reversed so we're back at 0.5%. And the Bank of England sort of blows hot and cold a bit, but it looks as though we might be in for another 25 basis-point hike, so they go to 0.75%. Well, that is still nothing compared to what you're getting in the stock market at 3.6% or City of London at 4%.*

Given how the Bank of England are agonising about whether they'll increase it from 0.5% to 0.75%, I think the kind of interest rates that I was used to when I was growing up seem a long way away. And there's certainly arguments out there that there's so much more debt around and also deflationary forces like Amazon and internet retail generally, not to mention general capacity in manufactured goods, but we are in a much lower interest rate environment than we have been in the past.

JF: So you think the natural long-term interest rate could actually now be lower than it has been in the past?

JC: *Oh, I think that's what all the indications are. I mean you wouldn't have 30-year gilt yields at 1.72% or whatever they are today if that was not definitely the belief in markets. But, certainly, it's a slightly different picture in America where the Federal Reserve has been increasing their interest rates more rapidly and 10-year yields are much higher than they are in the UK.*

"I THINK THE INTEREST RATES WE'VE NOW GOT IN THE UK ARE ABNORMALLY LOW AND I THINK WHAT THE US IS DOING IS GOOD."

I think the interest rates we've now got in the UK are abnormally low and I think what the US is doing is good, I think they're kind of normalising interest rates. But I think we are in a much lower inflation era than we were back in the 1970s or '80s, so I think you would expect interest rates to be lower than they were then, but I would expect to see them markedly higher than they are now over the next few years.

JF: OK. Job Curtis, thanks very much.

JC: *Thank you.*

WATCH THE VIDEO INTERVIEW

Job Curtis: Janus Henderson Investors

James Faulkner, Editorial Director at Master Investor, interviews Job Curtis, Fund Manager at Janus Henderson Investors

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About James

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

BY GERVAIS WILLIAMS

CASTING A WIDER NET

INCOME STRATEGIES IN VOLATILE MARKETS

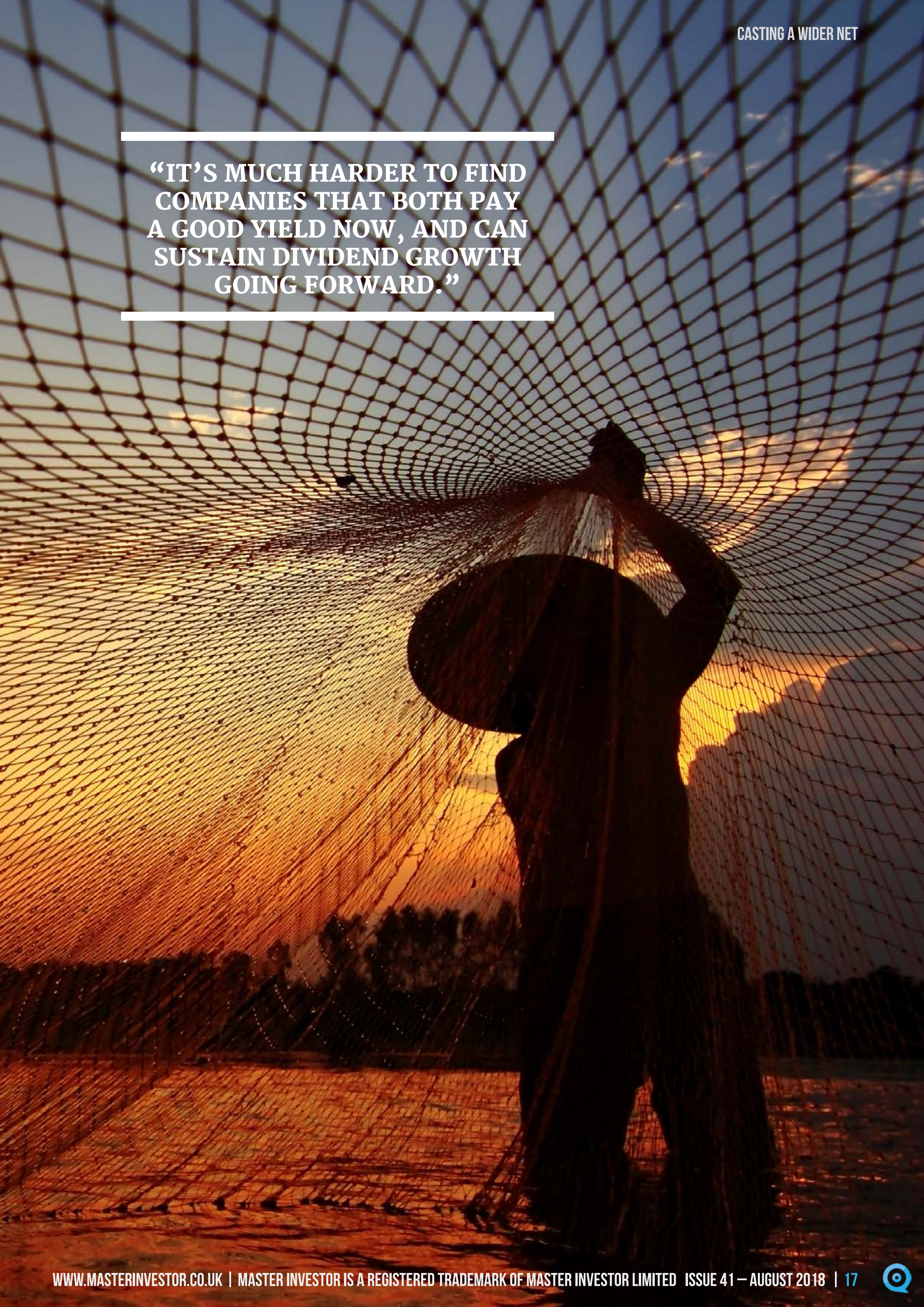
In theory, it's all so easy. The long-term returns on a portfolio of income stocks are intimately related with just two metrics – the initial yield at the time of purchase, and the long-term growth of that income stream. So, if the portfolio yields say 3.5% at the start, and grows its income at 5% per year thereafter, then the long term return is likely to be somewhere around 8.5%. So, that makes things clear – just select stocks that deliver good and growing dividend income.

In practice, it is a little more complex. Markets don't move in smooth curves, and therefore the portfolio return varies from day to day as the valuation of the underlying equities moves up and down with the wider market. However, over time, the effect of the daily or yearly market fluctuations becomes less and less significant. So, ultimately, over a couple of decades or more, this factor becomes marginal, as the valuation effect becomes more and more diluted over the period of investment. Effectively, the valuation of the market may vary, but it tends to be within a range over the very long-term. Sometimes it is near the top of the range, and at other times it's near the bottom, but most of the time it is somewhere between.

So even in practice, it's a case of remaining wholly focused on the yield at the time of purchase, and the growth of that dividend thereafter; and when it comes to investing, the yield at purchase is fairly clear. The principal uncertainty is the growth of the dividend thereafter. A glance in the rear view mirror appears reassuring. Generally, dividend growth has been pretty good over the last decade. Indeed, dividend growth over the last two or three decades has been pretty good, in spite of the Global Financial Crisis in 2008, and the dividend cuts around that time.

The cracks are showing

Yet this easy overview isn't quite so reassuring under scrutiny. The last three decades have been extraordinary. Three tailwinds have enhanced equity returns so they have been exceptional. The world would have grown anyway, but with the globalisation of world trade, world economic expansion has been enhanced by circa 45% since 1990. This has been good for all companies, but most particularly larger companies that have grown at a much faster rate than normal. Second, corporate profit margins have doubled across many Western economies since 1985. So, whilst overall turnover growth has been good for the last three decades, profit growth and cash generation has been even better. Thus, earnings growth has been excellent over the last three decades. Finally, the surge of low-cost imports has more than offset the inflationary pressures of the extra growth, so inflation has remained benign and government borrowing costs have come down to ultra-low levels. This has boosted the valuation of all assets, including corporate bonds, property and equities. So, the



"IT'S MUCH HARDER TO FIND COMPANIES THAT BOTH PAY A GOOD YIELD NOW, AND CAN SUSTAIN DIVIDEND GROWTH GOING FORWARD."

valuation of markets is at the top end of the long-term range currently, and therefore it's much harder to find companies that both pay a good yield now, and can sustain dividend growth going forward.

Note this statement: Whilst everything looks good in the rear-view mirror, there are questions as to whether the historic trends will persist into the future. Specifically, the tail winds of globalisation appear to be coming to an end. Prior to the Global Financial Crisis, productivity improved, and this tended to boost the growth of corporate cash flow. However, productivity has stagnated over the last decade or so, with the market distortions of Quantitative Easing, and other factors. Therefore, corporate cash flow has not grown as well as previously. This has led the tax take to slow, and governments around the world have been forced into austerity. In addition, the lower growth in cash flow has made it harder for companies to sustain dividend growth. Many have fudged it for now, through bringing dividend cover down to somewhat risky levels. But perhaps most importantly, the absence of organic cash flow growth has led to disappointing wage growth. Over the last decade, wages have stagnated for a large part of the population. So, when the electorate are asked whether they want more globalisation, an increasing proportion are voting for something different. In the US it is Trump, in Italy it is the Five Star movement, and in the UK it is Brexit. This profound change in the political agenda is now coming through in an equally deep-seated change in economic policy.

We can see the scale of this change coming through on a daily basis. For example, Trump has introduced major tax cuts, and extra incentives for US corporates to repatriate their overseas cash holdings. Both of these policies may have boosted the US economy for now, and precipitated a series of US interest rate rises, along with Quantitative Tightening (the opposite of Quantitative Easing) being introduced. The net effect of these policies is that international cash is now being channelled back into the US, as indicated by the rise in the US dollar over recent months.

The drawdown on international cash

"WE MAY BE AT THE POINT WHERE THE LONG DECADES OF EASY MARKETS MAY HAVE ALREADY PASSED THEIR PEAK."

is already becoming a major problem for those that have become overly dependent on access to international capital. Note how quickly the Turkish Lira has collapsed since the US dollar started to rise. The big question is to what degree will these factors affect China, given that it has been the main engine of world growth over the last decade. The growth is of course welcome, but it is important to note that it too has been reliant on international debt – and there are indications that the drawdown in international cash is now making it harder for them to fund the growth. The Chinese RMB has been dropping back as the US dollar has started to rise. China isn't in a great position to offset the pullback in overseas lending through ramping up internal debt, as the authorities are already concerned about losing control of their inflationary pressures.

In short, China is in danger of suffering a proper growth setback at pres-

ent. Note how commodity prices are already sensing this. The price of copper, known as "Dr Copper" given its bellweather status, has broken down abruptly over recent weeks – another indicator that the downside risks are not trivial. We may be at the point where the long decades of easy markets may have already passed their peak. The world economy may already be moving into the post-globalisation period of sub-normal expansion, along with the possibility of a global recession along the way.

Dividend cuts appear likely

If this prognosis is correct, then corporate margins may start to peak out as well. Sub-normal growth and declining margins are a recipe for falling corporate profits and dividend cuts. Even marginal reductions in corporate cash flow could precipitate dividend cuts given that dividend cover is already at the risky end of the spectrum. Dividend cuts are toxic to investors.

Furthermore, those with the highest debt balances could be the doubly vulnerable. Remember the scale of share price setbacks in the banking sector in 2008. Often their dividend cuts were followed up with emergency rights issues, which permanently diluted those who were unable to buy the extra shares. Several companies went on to announce a series of emergency rights issues, and the downside dilution was horrendous. A few even went bust, so the original investors were effectively forced sellers at the bottom – thereby depriving them of any chance of any recovery potential on their investment. Note that some ten years later, the share price of the **Royal Bank of Scotland plc (LON:RBS)** is still a long way off its pre-crisis price, and it's still not back on the dividend list.

So, it's worth keeping in mind that the success of equity income strategies *is wholly dependent on the underlying companies' ability to sustain a degree of dividend growth*. Yet, prior to setbacks, the mainstream indices are often dominated by sectors that are the most vulnerable to disappointment. For example, the banking sector represented 15% of the FTSE 100 Index in 2007. Other markets had even more extreme positions – the Financials sector represented 33% of the ISEQ Index in Ireland in 2007! In this context, it is worth reflecting on the current sector concentration within the FTSE 100 Index. At the end of June 2018, the Energy sector alone accounted for 17.0% of the index. When other correlated assets such as Commodities are included, this weighting rises to 34.7%. Equally, Banks still account for 12.7% if the index, and when other financials are also considered, then this sector represents 19.9% of the FTSE 100 Index. In addition, note that Consumer Staples and Consumer Discretionary together account for another 25.2%. If the pattern of the past were to reoccur, then many of these kinds of stocks could carry the greatest risks of dividend cuts.

"THE SUCCESS OF EQUITY INCOME STRATEGIES *IS WHOLLY DEPENDENT ON THE UNDERLYING COMPANIES' ABILITY TO SUSTAIN A DEGREE OF DIVIDEND GROWTH*."

Ideally, risks of this kind can be offset through diversification overseas. However, globalisation has been international by its nature, so other mainstream exchanges are also dominated by the same sectors – Financials, Commodities and Fast Moving Consumer Goods. Hence a multinational oil company listed in London is very closely correlated with others listed in the US or Europe. Correlation is a real concern going forward.

As a further worry, when the next setback occurs, there is little scope to use any further monetary or fiscal stimulus. There isn't much scope to cut UK interest rates, and the Government isn't likely to be keen to step up the budget deficit after it has taken so many years to bring the previous deficit under control. So, there is a danger that, even were the next economic setback to be relatively mild in intensity, it could persist for much longer than normal.

"THE MASSIVE MOMENTUM IN GROWTH STOCKS HAS DIVERTED INVESTORS' ATTENTION AWAY FROM SMALLER INCOME STOCKS."

Casting the net a little wider

I would argue that this is a really good time for some independent thinking. Investment strategies defined by the mainstream indices have the disadvantage of making them overly-reliant on a narrow range of sectors, mainly those that have been successful in the past. This problem is even more acute when dividend income is considered, with many UK equity income funds reliant on an even narrower range of industry sectors. There will be a number of mainstream stocks that do buck a setback should it come, but nature teaches us that monocultures like this tend to carry greater downside risk at times of stress. In contrast, areas with good bio-diversity tend to be more resilient, and have the ability to recover relatively quickly after a major setback. Hence, if the past multi-decade trends are coming to an end, then this is a good time to widen the opportunity set.

One of the principal advantages of a wider investment universe is the potential to invest in companies operating in a much wider range of industry sectors – including many that are not well represented in the mainstream indices. Alongside, by implication, a multi-cap approach will also include more companies that are able to sustain good and growing dividends even at times of economic slowdown. Furthermore, stock specific risk is diversified through holding a larger number of smaller individual holdings.

Perversely, even at this late stage in a bull market, there are still plenty of quoted small and micro cap income stocks that are not looking especially expensive in valuation terms. Over the last four years, the massive momentum in growth stocks has diverted investors' attention away from smaller income stocks. In addition, professional small cap investors traditionally focus on growth stocks anyway, which means they tend to underappreciate ordinary companies with modest but sustained dividend growth, in their pursuit for something more exciting.

These factors have been evident in the first half of 2018 when a step-up in market volatility has been a feature. The FTSE All-Share Index fell 6.9% in the first quarter, and then rose 9.2% in the second. In contrast, the FTSE AIM All-Share Index was a lot more resilient. It fell just 3.1% in the first quarter, followed by a 7.1% rise in the second quarter. So, over the half year, the FTSE AIM All-Share Index actually rose 3.8%, which compares with a smaller rise of 1.7% in the FTSE All-Share Index. Similar resilience is found elsewhere. The FTSE Fledgling Index is an index of London Stock Exchange listed companies that are too small to be included in the FTSE All Share Index. Over the first quarter, the FTSE Fledgling Index fell 2.8%, and during the second it rose by 7.9%. So, it too delivered a 4.9% return over the half year, which is comparable with that of the FTSE AIM All-Share Index.

In conclusion, this is a really good time to think ahead. Since 1945, economic cycles have typically lasted 58 months, whereas the current economic cycle has already persisted for nearly 110 months. So, this is a good time for all investors to be more open-minded and selective in their investment strategies.

Gervais Williams

Gervais joined Miton Group plc in 2011 and is also Senior Executive Director. His fund management career extends to over 30 years including 17 years at Gartmore Group Ltd, where he was head of UK Small Companies. Gervais is a member of the AIM Advisory Council, chairman of the Quoted Companies Alliance and a board member of The Investment Association. In 2016, Gervais published *The Retreat of Globalisation: Anticipating Radical Change in the Culture of Financial Markets*, in which he outlines why he thinks the culture of financial markets will change more in three years than it has in the previous thirty.

One opportunity is to consider investing across a wider investment universe. The really good news for UK investors is that the UK market is much deeper than many others, with many smaller, overlooked stocks. Perhaps equally important at this time, equity income strategies that avoid the worst of the dividend cuts, have a history of delivering premium returns in volatile markets. As a side-benefit, the extended opportunity set in the UK includes a wide range of industry sectors, and so the nature of multi cap returns provides a welcome degree of diversification. With globalisation fading, and the deep-seated changes coming through in political and economic trends, all these features may be particularly relevant going forward.

Risks

The value of stock market investments will fluctuate and investors may not get back the original amount invested.

Past performance is not a guide to future returns.

Forecasts are not reliable indicators of future returns.

Investment in the securities of smaller and/or medium sized companies can involve greater risk than may be associated with investment in larger, more established companies. The market for securities in smaller companies may be less liquid than securities in larger companies. This can mean that the Investment Manager may not always be able to buy and sell securities in smaller and/or medium size companies.

In certain market conditions companies may reduce or even suspend paying dividends until conditions improve.

Notes to Editors:

This document has been prepared in response to a request from Master Investor to be used by the journalist.

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MFP18/xxx.

BY NICK SUDBURY

FUNDS IN FOCUS

HOW TO BUILD THE IDEAL INCOME PORTFOLIO

The key objective of an income portfolio is that it should generate a sufficient yield for the investor's current and future needs, without exposing their capital to any unnecessary risks. For most people the easiest way to do this is by putting together a suitably diversified range of income generating funds.

There are many funds and investment companies that pay regular distributions, and by combining four or more into a portfolio it should be possible to achieve a reliable monthly income from a number of different underlying markets and asset classes. When held in an ISA, the income and gains would all be tax-free.

Patrick Connolly, a Certified Financial Planner at Chase de Vere, Independent Financial Advisers, says that the key is to not to consider the funds in isolation, but to look at the overall portfolio in the context of the investor's circumstances, objectives and attitude to risk. "This means getting the asset allocation right and worrying about the yield on different investments and asset classes later."

Don't just look at the current yield

Bonds typically pay a better initial yield than equities, but don't normally offer much in the way of income or capital growth. It depends where a fund invests, but a higher yield is often indicative of a higher level of risk.

"If investors focus on achieving the maximum level of initial income, this is likely to mean being exposed to higher risk areas and having very limited growth prospects, increasing the danger not only of capital losses but also that the effects of inflation will reduce the real value of their capital and the spending power of their income over time," explains Connolly.

Equity funds typically pay a lower yield to start with, but have the potential to increase their income over time as the underlying companies grow their earnings and dividends. Investors can spread the risk by putting some of their money into other asset classes, such as fixed interest and commercial property, which both produce a regular income and provide some protection if stock markets fall.

Darius McDermott, MD of Chelsea Financial Services, says that investors need to look at a fund's ability to grow its dividend over time, which is particularly important in a rising interest rate environment.

"It's also important to make sure that the fund is well-diversified. The advantage of a fund that invests across different regions is that it will reduce the risk, while opening up a wider set of attractive income opportunities."

Sustainable income

Sam Murphy, Associate Director, Investment Companies Research at Numis Securities, says that income-conscious investors need to be aware of a fund's dividend policies, as these can vary significantly between funds and asset classes.

"Some funds focus on capital growth and pay a dividend that will vary with underlying revenues, while others aim to pay a constant, progressive or inflation-linked dividend."

UK domiciled open-ended funds like OEICs and unit trusts are legally required to distribute all of the income that accrues in the portfolio during the course of their accounting year, so if some of their holdings run into problems and reduce their dividends, the total paid out by the fund could be lower than the year before.

Investment companies have more flexibility as they are allowed to retain up to 15% of their annual in-

"INVESTORS NEED TO LOOK AT A FUND'S ABILITY TO GROW ITS DIVIDEND OVER TIME."

"A NUMBER OF FUNDS HAVE ATTEMPTED TO INCREASE THEIR ATTRACTION TO RETAIL INVESTORS THROUGH ENHANCING DIVIDENDS BY PAYING THEM FROM CAPITAL PROFITS."

come. This is added to their revenue reserves, which can be used to smooth the annual dividend payments from one year to the next, so as to produce a steadily increasing stream of income for their shareholders.

"The UK Equity Income investment company sector has built up average reserves of 0.72 years' worth of dividends. We believe that funds which have a robust revenue reserve are less likely to cut dividends in tougher times," explains Murphy.

Another key point to check is the dividend cover, which measures the extent to which a fund's dividend is supported by income from the underlying portfolio investments. Those funds with a fully covered dividend offer a more sustainable level of income.

It is also important to be aware that a number of funds have attempted to increase their attraction to retail investors through enhancing dividends by paying them from capital profits. The problem with this is that it will exacerbate NAV declines in periods where markets fall.

Low risk income portfolio

Investors who are only willing to tolerate a low level of risk can earn a decent 3.49% yield from a simple four-fund portfolio. The selection that has been put together by Chase de Vere consists of good quality funds, run by proven managers, and aims to provide a diversified exposure to UK and global equities, fixed interest and commercial property, while still producing a reasonable level of income.

Connolly says that **Threadneedle UK Equity Income** is an ideal core holding that has a very consistent track record. "The managers adopt a contrarian approach, meaning they don't hold the biggest dividend paying companies if they don't like them. Not all stocks have to pay a dividend and they are happy to take a long-term approach and ride out any volatility."

His second selection is **Artemis Global Income**, which he describes as a fund that consistently outperforms. "The manager does a great job of managing risks by investing in different types of companies, including core holdings that produce stable dividends, growth and cyclical companies, and also special situations opportunities."

The third holding in the portfolio is **Fidelity Extra Income**, which benefits from a hugely experienced investment manager, and invests in 60% investment grade bonds and 40% high yield bonds, which means that it can provide good diversification from stock markets and a reasonable yield.

Connolly's final pick is the **M&G Property Portfolio**. "This is a very diversified and geographically spread fund that invests in physical bricks and mortar property. It is designed to be a 'sleep easy' fund, which focuses on good quality properties that have good lease lengths and low void rates."

Low risk portfolio selected by Chase de Vere

Fund	Weighting	Yield
Threadneedle UK Equity Income	25%	3.80%
Artemis Global Income	25%	3.41%
Fidelity Extra Income	35%	3.57%
M&G Property Portfolio	15%	2.94%
Total	**100%**	**3.49%**

Medium risk investment company portfolio

Laith Khalaf, Senior Analyst at Hargreaves Lansdown, says that when looking for income it's easy to be seduced by the yield on an investment company, but this isn't a measure that should be taken in isolation.

"The track record of the manager in producing a growing income over the long term is also a key consideration, as is the total return, because it's very difficult to grow your income if your capital is heading in the opposite direction."

He has chosen an equally weighted medium risk portfolio of four UK Equity Income investment companies, with the resulting portfolio offering an initial yield of 3.1%.

"Each of these companies is run by a skilful manager with an established long-term track record. A diversity of manager styles should help the portfolio to perform well in a range of market conditions, rather than being overly reliant on one type of stock or sector," he says.

"IT'S EASY TO BE SEDUCED BY THE YIELD ON AN INVESTMENT COMPANY, BUT THIS ISN'T A MEASURE THAT SHOULD BE TAKEN IN ISOLATION."

Medium risk portfolio selected by Hargreaves Lansdown

Investment Company	Weighting	Yield
Edinburgh Investment Trust	25%	3.9%
Finsbury Growth & Income Trust	25%	1.9%
Temple Bar Investment Trust	25%	3.3%
Troy Income & Growth	25%	3.4%
Total	**100%**	**3.1%**

A more diversified medium risk alternative

Murphy says that **JPMorgan Claverhouse (LON:JCH)** is an attractive option, with a 3.5% yield and a track record of dividend growth lasting 45 years, backed up by revenue reserves equal to 1.2 years' worth of dividends.

"The experienced managers focus on large and mid-cap UK equities using a bottom-up, stock-picking approach with an emphasis on quality, momentum and value. Performance has been strong following a strategy review in March 2012 that switched the emphasis to a more fundamentally-driven, higher conviction portfolio within a

> **"INVESTORS WHO ARE WILLING TO TAKE ON MORE RISK CAN TARGET FASTER LEVELS OF DIVIDEND GROWTH AND GREATER CAPITAL GROWTH."**

framework of risk controls that limit relative positions versus the benchmark."

His second selection is **Aberdeen Diversified Income & Growth (LON:ADIG)**, which seeks to achieve returns of LIBOR+5.5% per annum over rolling five-year periods with a volatility equivalent to 40-50% of equities.

"The aim is to offer a portfolio that is genuinely diversified by asset class, with the managers seeking to manage risk through diversification rather than by investment in low return assets, and allocating capital to areas including Listed Equities, Emerging Market Debt, Property, Infrastructure and Insurance-linked investments."

Murphy's other multi-asset pick is **Seneca Global Income & Growth (LON:SIGT)**, which changed its benchmark in July 2017 to CPI plus 6% per annum (currently around 8.8%).

"The portfolio's equity exposure has been cut from 57% to 54% over the past six months, and is likely to fall further as the manager expects a global bear market in equities in 2019, with a recession in 2020. The fund has a 3.7% yield, which grows at least in line with inflation."

His final selection is **TwentyFour Select Monthly Income (LON:SMIF)**, which invests in a diversified debt portfolio. The focus is on securities with an "illiquidity premium" that are not suitable for open-ended funds, which fuels the relatively high yield of 6.7%.

Medium risk portfolio selected by Numis Securities

Investment Company	Weighting	Yield
JPMorgan Claverhouse	25%	3.5%
Aberdeen Diversified Income & Growth	25%	4.3%
Seneca Global Income & Growth	25%	3.7%
TwentyFour Select Monthly Income	25%	6.7%
Total	**100%**	**4.55%**

High risk fund portfolio

McDermott says that investors who are willing to take on more risk can target faster levels of dividend growth and greater capital growth. "Over the long term, it is the dividend-growers that will stand investors in better stead, rather than simply opting for funds with high – and sometimes stagnant – yields."

The first selection in his four-fund high-risk portfolio is **Marlborough Multi-Cap Income**, which is yielding 4.16%. It aims to generate an attractive and growing level of dividend income by investing mostly in UK equities, and provides exposure to a diversified 135-stock portfolio.

"Unlike most of its peers, this fund invests mostly in small and medium-sized companies. While this area of the market tends to be higher risk, manager Siddarth Chand Lall believes there is a wider range of hidden gems here, which have further scope to grow their dividends over time," explains McDermott.

High risk portfolio selected by Chelsea Financial Services

Fund	Weighting	Yield
Marlborough Multi-Cap Income	25%	4.16%
Schroder Asian Income	25%	3.59%
Baillie Gifford Japanese Income Growth	25%	1.7%
Fidelity Enhanced Income	25%	6.42%
Total	**100%**	**3.97%**

His second pick is **Schroder Asian Income**, which invests at least 80% of its assets in equities in the Asia Pacific region ex Japan. The £1.3 billion fund has a fairly diversified portfolio of 68 stocks and is yielding 3.59%.

Third on the list is **Baillie Gifford Japanese Income Growth**, a fairly new fund that has a growth tilt to it. At 1.7% the yield is lower than some of its peers, but McDermott believes that it has significant dividend and capital growth potential.

"A lot of Japanese companies have high levels of cash on their balance sheets yet still don't yield much, so there is significant scope for long-term dividend growth in this market."

His final selection is **Fidelity Enhanced Income**, which has an attractive yield of 6.42%. Managers Michael Clark and David Jehan use covered call options alongside a core of UK dividend-paying equities. This means that the fund could lag during market rallies, but has one of the highest yields in the sector.

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 RICHARD GILL, CFA

FROM ACORNS TO OAK TREES

SMALL CAP INCOME SPECIAL

THREE STOCKS OFFERING DIVIDENDS AS WELL AS VALUE

As mentioned in my book review this month, investors can benefit from shares in three ways. The first, and most exciting, is through capital gains. This is often the main reason people get into investing in equities, attracted to the idea that they could multiply their initial stake many times over and retire to a holiday home in the sun. Another way is through shareholder perks. But these are nothing more than a minor bonus, typically amounting to discounts on products or free merchandise.

The third, frequently lucrative and often under-appreciated way, is via income distributions, more commonly referred to as dividends. According to the recent Link Asset Services' Dividend Monitor report, underlying UK dividends (excluding special payments) grew by 7.1% to reach a record £30.7 billion in the second quarter of this year.

As well as providing funds for the country's pension pots and money for individuals to spend on consumption, dividends offer investors the potential to enjoy the double effect of a rising share price and annual compounding via re-investing. The "total return" effect, defined as performance after dividend income is reinvested back into shares, can be powerful. For example, while the FTSE 100 has gained just 11.8% since 1st January 2000 the FTSE 100 Total Return index has delivered a 114% gain over the same period.

While the UK's largest dividend payers – HSBC, Shell, and BP – comprise almost a quarter of the total dividends paid out in Q2 this year, there are also a clutch of small cap companies which make regular and growing payments to investors. My analysis of AIM shows that 28% of companies listed on the junior market currently pay a dividend, rising to 81% of FTSE Small Cap companies.

Having sifted through them, here is my selection of three consistent dividend paying companies, which have a good track record of increasing, or at least maintaining, the payment, and have interesting opportunities elsewhere in their investment cases.

JAMES HALSTEAD

Many investors will be familiar with the commercial flooring manufacturer **James Halstead (LON:JHD)** as it is one of the most successful companies to have ever graced AIM with its presence. A family business founded over 100 years ago, Halstead has grown to become a leading commercial flooring manufacturer and distributor, with its main operations located in the UK and Europe. Amongst many others, recent projects include the Kitéa Furniture stores in Morocco and the Tullibardine Whisky Distillery in Perth & Kinross.

Since the company moved from the Main Market to AIM in 2002, its share price has risen by 1,540%, driven by a more than fourfold increase in pre-tax profits over the past 15 years. What's more, investors have enjoyed over 40 years of rising dividends and several special dividend payments along the way due to the highly cash generative nature of the business. Currently capitalised at £864 million, James Halstead is an AIM "blue-chip" and currently the 19th largest by market cap. If it was listed on the Main Market of the LSE it would easily make the FTSE 250.

Profits on a roll

The latest set of annual numbers reported yet another year of record revenues and profits, with sales growing by 6.5% to £240.8 million and pre-tax profits up by 2.5% at £46.6 million for the 12 months to June 2017. More recent interim numbers showed steady growth continuing, with revenues up 5.4% at £126 million and pre-tax profits up by 2% at £23.7 million for the six months to December. Net cash was solid at £47.5 million at the December period end, with the net cash flow from operations being strong at £15.93 million.

James Halstead
JAMES HALSTEAD plc
COVERING THE WORLD

At the end of July the company pleased the market with a solid trading statement, saying that full year results for the 12 months to June 2018 would show record revenues and profits in line with the previous year. At the top line, UK turnover grew by 3% despite difficult trading conditions, especially amongst high street retailers. However, adverse price pressure on raw materials was holding back the benefits of export currency gains on profits.

Good underlaying business

Investors have been used to James Halstead shares trading in a continual uptrend since the turn of the century. However, they have recently slipped back quite significantly, falling back from an all time high of 542p in May last year to the current 386p. Should earnings for 2018 be in line with last year at around 17.6p, as suggested in the recent trading update, then the shares trade on a multiple of 22 times. For a quality business with such a good

“THERE COULD BE THE POTENTIAL FOR ANOTHER SPECIAL PAYMENT IN THE NOT TOO DISTANT FUTURE.”

track record that looks like reasonable value to me.

In terms of income, assuming the previous year's full year dividend payment of 13p per share is maintained, then the current yield on offer is a reasonable 3.37%. Although dividend cover on that basis would only be 1.35 times there is plenty of cash on the balance sheet for the payment to, at very least, be maintained. The last time a special dividend was announced, net cash stood at around £56 million so with £47.5 million of cash at last count there could be the potential for another special payment in the not too distant future. This looks all the more likely following the recently aborted potential acquisition of loss making flooring business **Airea (LON:AIEA)**.

WALKER GREENBANK

"Everyone needs a joker in the pack". Someone once said that to me after they bought Woolworths shares in late 2008. Woolworths went bust shortly afterwards. But having a slightly riskier share in your portfolio, as long as you fully understand the investment case, is still something investors should consider every so often if there is the potential for large gains.

Walker Greenbank PLC

My joker in the pack is **Walker Greenbank (LON:WGB)**, a luxury interior furnishings company which operates factories in Loughborough and Lancaster. As well as designing, manufacturing and selling wallpapers, fabrics and paints to the well heeled middle classes, the company makes significant income from the use of its designs on a range of interior products such as bed linen, rugs and tableware. Main brands include Sanderson, Morris & Co, Harlequin, Zoffany, Scion, Clarke & Clarke and Studio G.

Having put in a pretty impressive performance since the last financial crisis in 2009, unfortunately the company has been forced to warn on profits three times within the last nine months. If that wasn't enough there was even a late-night fire at the Loughborough factory last December which damaged a printing machine. (To be fair, quoted companies experiencing fires have had worse outcomes!) Overall, the events of the past 12 months have seen the shares tumble from highs of around 240p seen at this time last year to a current five and a half year low of just 78p.

Rolling down

The most recent profit warning came at the end of July and was sneakily snuck out to the market just three minutes before market close on a hot summer's day when no-one was watching. In it the company blamed lower than expected margins on a big licensing agreement for materially revising down its expectations for licensing income as a whole in the current year. Combined with tough trading conditions being seen in July the company is now looking for adjusted profit before tax (excluding share-based incentives, pension charges and non-underlying items) for the year ending 31st January 2019 to be in the range of £9.5 million – £10 million, down from £12.5 million in 2018.

Have the shares fallen to such a level that there is a value opportunity?

Well, assuming that profits come in at the top of the new expected range, and applying a 20% tax charge, then we are looking for £8 million of net profits on current expectations. With a current market cap of £55.3 million, the prospective earnings multiple is just 6.9 times. That looks cheap, but in my view the shares will only be re-rated if the company finally gets out of the profit warning cycle and meets its own tar-

gets. We should also remember that there are still six months of the current financial year left, so plenty of time for another warning, especially if the key autumn trading period doesn't go as expected.

> **"THE HISTORIC YIELD IS CURRENTLY A CHUNKY 5.6%."**

Back to the bull case and Walker Greenbank is now trading at below its net asset value of £61.6 million as at 31st January 2018. Even if we strip out £31.8 million of intangibles the business has over half its market cap backed by tangible balance sheet assets. On the downside there was net debt of £5.26 million at the period end along with a pension deficit of £7.3 million. However, by no means does the company look to be in a doomsday situation, as operating profits for last year covered both pension charges and finance costs combined almost 15 times over. What's more, the company also has £12.14 million of headroom on its banking facilities.

Cheap paper?

Walker Greenbank first attracted my attention for this feature due to its decent track record of dividend growth. While not being as long as James Halstead's, the company returned to the dividend list after nine years in 2010 and has increased the payment every year since. Last year's dividend was 4.37p per share, which means that the historic yield is currently a chunky 5.6%. That payment could be under threat following the recent turbulence but I note that dividend cover for last year was high at 3.3 times adjusted earnings, so there is a decent amount of headroom to play with.

The risks here are clear. But I think the markets have over-reacted to recent news. Walker Greenbank remains decently profitable, doesn't look to be in any kind of imminent financial distress, and offers the potential for a high yield and share price recovery over the coming years should trading begin to improve.

PARK GROUP

Finally, **Park Group (LON:PKG)** is another AIM success story, the shares having risen by 475% since bottoming out in the depths of the financial crisis in July 2008, with the dividend having grown for eight years in a row, more than doubling over that time. The company is a provider of value-added prepaid gift, reward and savings products to the corporate and consumer markets, with sales coming through digital channels, a direct sales force and a network of agents. This is a market which according to the UK Giftcard & Voucher Association is worth c.£5.6 billion per year. Trading is split between two divisions, a Consumer business and Corporate business.

In Consumer (57% of revenues), Park has been helping people across the UK budget for Christmas since 1967 via its savings schemes, with 436,000 customers using its services in the last financial year. In Corporate (43% of revenues), under the brand Love2shop Business Services, Park is the UK's largest provider of multi-redemption gift cards, vouchers and digital reward propositions, principally to the incentive and reward markets. It serves over 34,000 organisations, supplying programmes and products to reward and incentivise both staff and customers.

Income is earned from service fees paid to Park by partner retailers, leisure and other service providers based on the face value of money spent via Park's cards and vouchers, as well as from interest on all pre-paid cash until the obligation to the redeemers has

Park Group plc

been settled. Park's FCA-authorised pre-paid card offering includes both physical and digital cards and is underpinned by its proprietary flexecash card infrastructure, developed in house and introduced in 2010.

Christmas is coming

Given the focus on Christmas savings, Park is a very seasonal business, with around three-quarters of revenue earned during the second half of the financial year. As such, the results must be read on a full year basis to get a full picture of how trading is progressing.

For the year to 31st March 2017, while revenues fell by 4.7% to £296.2 million, pre-tax profits rose by 4.1% to £12.9 million, mainly due to a lower cost of sales. Enhancing the investment case, Park is decently cash generative with a debt free balance sheet. Net cash from operations in 2018 was £9.27 million, representing 89% of net profits, with net cash standing at £40.3 million at the year end.

Following the results there was further good news, with the company signing new collaborations with retail giant Arcadia Group, Courtesy Shoes Ltd., (owner of Wynsors World of Shoes), Office Outlet (formerly Staples), DJM Music Ltd., and Fat Face. These new additions mean Park's gift vouchers are now accepted by more than 175 national brands and over 20,000 high street stores across the UK, and almost 100 brands are now flexecash accredited.

Park your cash?

While shares in Park Group have fallen by 23% since last November, the markets are currently valuing the business at £128.2 million. That rates the business on a multiple of 12.3 times historic net profits, not bad for a consistent company with a strong balance sheet and income attractions. The historic yield is currently a good 4.4%, with the dividend cover being reasonably comfortable at 1.84 times.

"PARK IS DECENTLY CASH GENERATIVE WITH A DEBT FREE BALANCE SHEET."

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 JAMES FAULKNER

MOVERS AND SHAKERS

"STEADY AND SUSTAINABLE" GROWTH

AN INTERVIEW WITH ANTHONY COOMBS OF S&U PLC

S&U (LON:SUS) Plc is a company with a long and distinguished record of profit and dividend growth, operating in the consumer credit space. Despite operating in what many would consider to be a relatively cyclical sector, Advantage, its motor financing arm, has just delivered its 19th successive year of record profits. I caught up with Anthony Coombs, Executive Chairman, to see how he does it.

James Faulkner: Thanks for taking the time to speak with Master Investor. I approached S&U for the current issue of the magazine because the theme is income investing – and S&U has a very long and distinguished dividend record. But before we get into the nitty gritty, can you give our readers a brief overview of how the business has performed and evolved in recent years? There have been a few changes since I last covered the shares back in 2014!

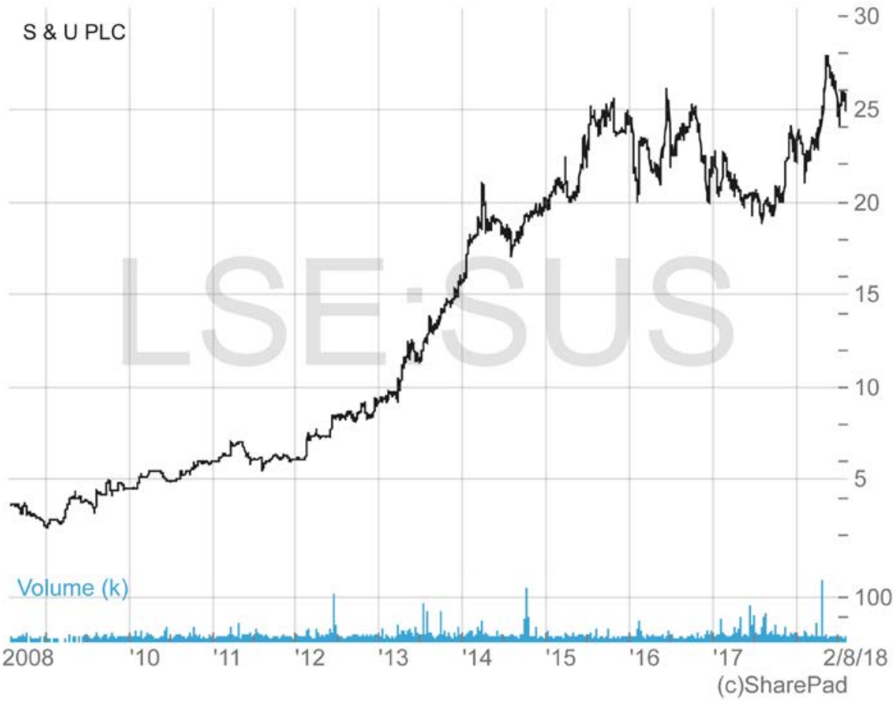
Anthony Coombs: *The past five years since 2014 have been a period of rapid and sustained growth at S&U in both assets and earnings per share/profitability. On a like for like basis, Total assets are up from £110 million in 2014 to £265 million in 2017/18 and equity has risen from £69.4 million to nearly £153 million in the same period. Earnings from continuing operations have increased from 62.2p per share to 203.8p. Dividend paid over that period has consistently risen from 54p per ordinary share to 105p, whilst dividend cover has varied from just over twice to 1.94 last year.*

In August 2015 we sold the 77-year-old Home Credit business, Loans@home4U to NSF for £82.5 million and then ploughed the vast majority of the proceeds, after a special dividend, into our remaining Motor finance Business, Advantage Finance. Based in Grimsby, and founded by S&U in 1999, it has achieved a remarkable – and possibly unique in the quoted finance sector in the UK – 19 years of consistent growth and record profits. Last year it made £25.2 million.

In 2016/17 we decided to pilot a new property bridging finance business, Aspen Finance. It has an initial 18-month capital allocation of £20 million, and has now grown its loan book to £16 million and is profitable. The pilot will be reviewed in the second half of this financial year and present signs look positive.

JF: Most people who follow the financial news are aware that new car sales have gone into reverse gear of late. However, Advantage is focused on the used car market, which has put in a much more resilient performance. The number of used cars bought on finance in the UK grew by

"OUR LONG EXPERIENCE IN HOME CREDIT HAS TAUGHT AS THAT THE SUCCESS OF ANY FINANCE BUSINESS DEPENDS UPON WHAT IT RETURNS IN CASH RATHER THAN IN BOOK DEBT GROWTH."



"WHILST WE HAVE BEEN GROWING AT 25/30% COMPOUND OVER THE PAST FIVE YEARS, WE HAVE NEVER PUSHED SALES TARGETS – FOR SOUND COMMERCIAL AND REGULATORY REASONS."

6% in 2017 and by 12% in value. This contrasted with a 7% decline in the number of new cars sold on finance in 2017. What is it about the used car market that makes it a more resilient proposition for lenders?

AC: *First, bear in mind that the new car market has only fallen from what were the record levels of the past two years. Second, the new car market comprises about 2.5 million vehicles per year, against a used car market of a consistent 7/7.2 million per year since 2004, reaching 8.11 million in 2017. The used car market's resilience is due firstly to the better value of the cars and hence lower finance risk. Our average loan is £6,000 and most of the car's highest depreciation has been taken already. Second, the quality of used cars has risen dramatically over the past two decades. This has meant that they are more valuable to customers and hence better security. Third, this implies customers, especially in our non-prime area of the market, value their cars as tools of the trade, generally for work or for family purposes rather than as saleable assets. They buy for that reason, which makes the cars more a utility rather than a discretionary purchase.*

JF: You describe the market you service as "non-prime". What is the typical customer profile for Advantage and why does this represent such an attractive niche?

AC: *Non-prime customers are all working, of stable address and decent citizens with good intent. Occasionally in the past that good intent may have been outweighed by temporary and unforeseen cash flow pressures, which may have impaired their credit record with the prime lenders. These have been under regulatory and commercial pressure over the past ten years and hence have rejected applications from millions of well-intentioned and deserving potential borrowers. They have provided Advantage with a market of about 25,000 customers a year, at sensible margins, or approximately 1% of the total financed used car market.*

JF: Advantage has continued to tighten the lending criteria for new customers. Do you foresee a weakening of economic conditions or is this simply an effort to rebalance after a rise in impairments of late?

AC: *We peerage on a rate to risk model. The latter changes both with repayment experience, and our increasingly sophisticated analysis of it, and with how we perceive the future. Undoubtedly there has been an uptick in impairment recently, although this is still within the ten-year average for Advantage and general debt quality remains good. Partly this may have been brought about by a sustained period of real income constraint and by some customers informally borrowing more to compensate. Indeed, recent statistics showed the average Briton borrowing £900 per annum more than they earned. Although the labour market remains strong in the UK, we should prudently expect these macroeconomic features to persist. Hence our slight adjustment to underwriting criteria earlier this year, from which early signs indicate an improvement in new customer scores.*

JF: Advantage currently has a market share of c. 1%. Presumably there's a lot more to go at in terms of the addressable market for Advantage? How do you balance growth against the need to protect credit quality?

AC: *Market share and balancing growth and debt quality is the perennial conundrum for any lending business. Our long experience in Home Credit has taught us*

About Anthony

Anthony joined S&U in 1975 and was appointed Managing Director in 1999 and then Chairman in 2008. Between 1987 and 1997 he served as a Member of Parliament and was a member of the Government. Anthony serves on the Executive of the Consumer Credit Association and chairs its Public Relations Committee and is a director of a number of companies and charities including chairing the trustees of the National Institute for Conductive Education.

that the success of any finance business depends upon what it returns in cash rather than in book debt growth. So far this year our monthly collections are up 20% on the same period last year on a 15% increase in net receivables. However, our mantra is "steady SUSTAINABLE growth" which requires constant vigilance on quality. Whilst we have been growing at 25/30% compound over the past five years, we have never pushed sales targets – for sound commercial and regulatory reasons. Although we have only about 10% of our niche market, our growth will depend upon the repayment experience we have, and our expectations of the macro-economic market backdrop.

JF: How does the competitive landscape look for Advantage right now? I seem to remember that S&U took a lot of business that the banks had rejected after the crisis. Are the banks making a comeback now that they (largely) have their houses in order?

AC: *Our market is one which requires considerable underwriting and collections skill if good returns are to be made and customers treated properly. Our long experience of this market makes market entry for others difficult. Hence, although there has been some change amongst our competitors, with some new entrants, particularly from abroad, and others retreating to prime lending, the overall competitive environment remains stable. The banks are certainly not mounting any comeback within it and are unlikely to do so.*

JF: You recently moved into property-based bridging finance through your Aspen venture, as a means to diversify the business following the disposal of the Home Credit division. What are the attractions of this market for S&U and what long-term ambitions do you harbour for this business?

AC: *We searched the specialist finance field for opportunities in 2016. Prices were unrealistic for acquisitions, so we opted to repeat a start-up, as we had with Advantage nearly twenty years before. The bridging finance ticks a number of boxes. The potential margins are good, security, with sensible underwriting, is strong, and loans are short term meaning that exit was facilitated if the business strategy wasn't successful. Equally important, the bridging finance market has considerable potential. Mintel estimated that it would grow nationally from £5 billion in 2017 to £8.8 billion by 2020. Whether it does or not, we are seeing considerable demand for short-term loans from refurbishers of Britain's generally poor housing stock. They either sell on or, for higher priced properties, rent into the burgeoning short-term lettings market.*

JF: This month's cover story is devoted to income investing, and S&U has a very impressive record of dividend payments stretching back 26 years. Moreover, the dividend has grown each year except for one year during the financial crisis where it was held. What is the key to delivering such consistent dividend growth?

AC: *Steady sustainable, and reasonably predictable profit growth is obviously a pre-requisite. Behind this is an ambitious but conservative approach to building the business. This eschews opportunities which appear unsustainable for those which are based on long-term demand for proven products.*

JF: It cannot hurt that management have a sizeable stake in the business and their interests are aligned with ordinary shareholders. How important is 'skin in the game' when it comes to making the right long-term decisions for a company?

AC: *This kind of approach to business is rooted in the identity of interest between the managers for eighty years, the Coombs family, who account for over 50% of the equity (I myself have about 12/13%) and shareholders generally. It results from a long-term view of the company, its customers and employees, which is increasingly rare in the UK nowadays but resonant of the Mittelstand family companies which powered the German post-war economic resurgence, and which, to a lesser extent, still do.*

JF: In your opinion, is the British consumer financially prepared for another recession?

AC: *Whilst the savings rate is very low, and levels of consumer debt have been rising (although, as the FCA have recognised, more in the credit card and personal loans sectors than in used car lending), consumers are insulated against a downturn to a greater extent than in 2008. First, overall money supply is under better control and the banks better supervised and capitalised. Second, the labour market is strong, and employers seem prepared to retain workers, albeit on lower real wages and "flexible" contracts. Third, the FCA has tightened the regime around both customer affordability and the forbearance on collections, required by Treating Customers Fairly. Fourth, interest rates are historically low and likely to stay that way. All this has limited the downside for consumers from recession.*

About James

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

BY JOHN KINGHAM

IS TED BAKER THE PERFECT DIVIDEND GROWTH STOCK?

Ted Baker (LON:TED) is an interesting company. It started life in 1988 as a single store in Glasgow, selling its own brand of men's shirts. 30 years later it's listed in the FTSE 250, has several hundred stores and concessions and generates revenues of more than £500 million and net profits of more than £50 million. That happy little success story is somewhat interesting, but as an investor what's more interesting is the company's near-perfect growth record.

Ted Baker listed on the stock exchange in 1997, and from then onwards its revenues and dividends (which it started paying in 1999) have increased every single year. And if it wasn't for a minor one-year decline after the financial crisis, its profit growth would be just as impressive. As a cautious investor I find that very interesting, along with its double-digit growth rate over the last decade and near-3% dividend yield.

"TED BAKER LISTED ON THE STOCK EXCHANGE IN 1997, AND FROM THEN ONWARDS ITS REVENUES AND DIVIDENDS (WHICH IT STARTED PAYING IN 1999) HAVE INCREASED EVERY SINGLE YEAR."

Both defensive and diverse

Ted Baker's super-consistent growth and near-obliviousness to the Global Financial Crisis suggest it's a defensive company, as does its listing in the defensive Personal Goods sector. However, there's a small question mark over its defensiveness, as it has significant retail operations, and retail is mostly a cyclical business. For example, **Next (LON:NXT)** (the high street fashion retailer and one of my current holdings) looks very similar to Ted Baker as far as I can see, and yet Next is listed in the cyclical General Retailer sector.

Despite this ambiguity, I'm willing to accept that Ted Baker may be more defensive than the average retailer, especially given its atomic clock-like consistency.

As well as being relatively defensive, Ted Baker is relatively diverse

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"ONLY SIX COMPANIES ON MY STOCK SCREEN HAVE A 100% TRACK RECORD OF REVENUE, EARNINGS AND DIVIDEND GROWTH, AND TED BAKER IS ONE OF THEM."

within its niche of affordable luxury fashion. For example, it is primarily a UK business, but almost half its revenues come from overseas. Its biggest business is selling clothing through retail stores and concessions, but retail generates less profit than its wholesale and license businesses combined (where wholesale allows other companies to sell Ted Baker products and licences allow other companies to use the Ted Baker brand on stores or products of their own). Ted Baker is known for men's shirts, but shirts are now just a small part of its product range and it sells more womenswear than menswear.

There are pros and cons to diversity in business, and in my experience companies that diversify into unrelated areas usually hit the rocks at some point. For Ted Baker, its diversity seems to be in the Goldilocks Zone; not too much and not too little.

Sustained, rapid growth

Over the last ten years, Ted Baker's revenues, earnings and dividends all grew by an average of about 19% per year. That's impressive, but a couple of years of exceptional growth have skewed that figure upwards. Looking at median rather than mean growth, the growth rate falls closer to 13%, but that's still very impressive.

Where did all that growth come from? Everywhere, mostly. By that I mean the company's overall retail, wholesale and licence revenues have each gone up by around 400% to 500% over the last decade. However, growth in the overseas and online businesses was higher, with US & Canada revenues going from £9 million to £120 million and online going from almost nothing (or at least not worthy of separate mention in the annual results) to £100 million today.

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Why has the company been able to grow so quickly? Sadly, I have no idea. I am

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no fashion guru and my wife will attest to that. All I can say is that the combination of Ted Baker's quality, price and style in both its products and stores, along with the intangible qualities of its brand, are something that its target audience (which doesn't include me) seem very happy to open their wallets for.

Of course, there are no guarantees that this sort of growth will continue, but even far more modest growth could justify the current share price (and I'll have more to say on that later).

Insanely consistent growth

There are just over 200 companies on my stock screen and all of them have a ten-year unbroken record of dividend payments. However, only six companies on my stock screen have a 100% track record of revenue, earnings and dividend growth, and Ted Baker is one of them.

I know from experience that this sort of super-reliable growth can in fact be merely the boom phase of a larger cycle, with an inevitable bust phase just around the corner. That doesn't seem to be the case with Ted Baker, partly because of the length of its "boom" and partly because it doesn't operate in a highly cyclical sector (at least relative to mining or oil & gas companies). You only have to look back at Ted Baker's results prior to the last ten years to see that its consistent growth record extends pretty much all the way back to 1997 when it joined the stock market. Such a long and virtually unbroken record of growth really is exceptional.

Extremely high profitability

As with its Growth Quality (my term for consistency), Ted Baker's profitability is also high. I measure profitability as the median ten-year return on capital employed (where capital employed is fixed capital plus working capital) and once again Ted Baker is in an elite group.

This time the elite group is retailers with average returns on capital of more than 20%. Again, there are six of them including Ted Baker's rivals Next and **Burberry (LON:BRBY)** (both of which I already own). At the bottom end sits **Marks & Spencer (LON:MKS)** with its 9% average profitability. I know which end of the scale I'd rather invest in.

Why is high profitability important? There are two main reasons: It makes growth easier during booms and it protects profits during busts.

On the growth side, it's much easier to build a new £100 million factory when you're confident that factory will generate profits of £20 million. Even if you had to borrow every penny of the £100 million, you could pay it off in about five years with the factory's profits and then you'd own it outright, along with its £20 million profits. But if you build a £100 million factory that will only produce £5 million in profit, then it's likely to take at least 20 years to pay off the debt (and that's not including debt interest, which would make building this low-return factory an even worse idea).

On the profit protection side, it depends on the mix of fixed and variable costs, but higher profitability usually means a company can absorb input price rises (e.g. rising raw material costs) and output price falls (e.g. lower shirt prices during a recession) more easily. You can think of fat profitability literally as fat, where a calorie deficit (i.e. lower revenues and higher expenses) reduces your fat percentage but doesn't negatively affect your health (assuming the calorie deficit doesn't go on for too long).

It's possible to stretch the fat analogy further by saying that skinny people (companies with skinny profitability) are likely to die first when there's a famine (recession). And once the skinnies are dead, the fat people (companies with fat profitability) can eat the food that would have gone to the skinny people (i.e. gain market share), or perhaps even eat the skinny people (acquire assets – human or otherwise – from skinny dead competitors at knock-down prices).

That's a slightly odd and mildly unpleasant analogy, but hopefully it shows that fat profit margins and fat returns on capital employed are something to look out for as an investor, and something to aim at for most companies.

Absolutely acquisition-free

One way to drive growth is to borrow money from the bank and use it to buy other companies. This is a very easy way to boost revenues, and if the acquired company generates more profit than the loan costs in interest then profits and perhaps even dividends will go up too.

This sort of strategy can drive double-digit growth for years, *if* management are willing to consistently spend more on acquisitions than they make in profits. However, this is often a bad strategy. The acquired companies add complexity and take management's focus away from the company's (often struggling) core business. And when the next downturn arrives (which it always does, eventually) the whole thing can collapse like a house of cards in a hurricane.

This highlights another attractive feature of Ted Baker, which is that it hasn't loaded up on acquisitions. In fact, as far as I can see, every ounce of its double-digit growth over the last decade has been generated by the company's core retail, wholesale and license businesses, which is exactly what I like to see. This means no expensive integration projects; no disgruntled employees to strip out; no imaginary synergies to find and no piles of acquisition rocket fuel (debt) to pay back. Instead, Ted Baker prefers to focus on improving its core business and then expanding that business across the globe.

> "EVERY OUNCE OF ITS DOUBLE-DIGIT GROWTH OVER THE LAST DECADE HAS BEEN GENERATED BY THE COMPANY'S CORE RETAIL, WHOLESALE AND LICENSE BUSINESSES."

No defined benefit pension and comfortable debt position

And speaking of the extremely powerful and potentially dangerous rocket fuel known as debt, Ted Baker seems to have that under control as well. Yes, it does have debt on its balance sheet; enough so that I wouldn't describe it as a low-debt company. But with five-year average net profits of £44 million and total borrowings of £130 million, its borrowings-to-average-earnings ratio of around three is comfortably below the UK average of four.

Just as importantly, the company is relatively young and like most younger companies it has no defined benefit pension scheme. This is good because it removes the risk of the pension tail wagging the corporate dog, which is something you'll often see with older companies that have enormous pension liabilities.

An excellent company, but what could go wrong?

Excellent is a subjective term, but if it means above average growth, above average consistency, above average profitability, below average acquisitions and below average levels of debt and pension obligations (and capex too, although I didn't mention that above), then Ted Baker is an excellent company.

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> **"DESPITE THIS GLORIOUS TRACK RECORD, TED BAKER'S SHARES ARE DOWN BY MORE THAN 30% OVER THE LAST THREE YEARS."**

But there's a yawning chasm between excellent and perfect, and there is no guarantee that Ted Baker's future will be as impressive as its past. So, what could possibly go wrong?

A million things, of course. But the single biggest risk in my opinion is that Ted Baker somehow repeats the disaster that was the Burberry "chav cap"; the plaid baseball cap so beloved of a segment of society that the majority of Burberry's customers would rather not be associated with.

This is the double-edged sword of brand-based companies. Yes, Ted Baker can charge lofty prices for their shirts because for some people wearing the Ted Baker brand is worth it (and I'm sure the shirts are nice, too). But all it takes is one badly thought-through licence deal, and the Ted Baker name could be used to sell toilet paper. And even though that toilet paper deal may be profitable in and of itself, the remaining 99% of the company's profits could be flushed down the pan because of the negative association.

Of course, I have no idea whether anything like that will happen, but at least the Burberry disaster is recent enough so that it still provides an excellent example to all fashion retailers of what not to do.

Is Ted Baker a bargain or a value trap?

Despite this glorious track record, Ted Baker's shares are down by more than 30% over the last three years. That isn't exactly what I'd call a dream investment. To be honest, I don't see any specific reason why the shares have fallen so far. Yes, the current retail environment is tough, but if you look at the company's results they're still going in the right direction (i.e. upwards).

To me this decline looks more like a change of market sentiment from over-optimistic to less-optimistic. For example, back in 2015 when the shares reached 3,500p, the dividend was just 40p, giving Ted Baker a dividend yield of 1.2%. With that sort of yield you need the dividend to grow by almost 9% per year if you're going to get double-digit returns. That's a big ask, especially if you want double-digit gains for a decade or more.

With perhaps less optimism in the price, the dividend yield today is a far more reasonable 2.6%, thanks to a higher 60p dividend and a lower 2,300p share price. That yield requires dividend growth of "only" 7.4% per year to produce double digit gains (assuming the share price increases in line with the dividend), which is still optimistic but perhaps more realistic given Ted Baker's historic growth rate.

So, today's share price doesn't look completely insane, based on the dividend yield, but there's a small fly in the ointment. The small fly is that Ted Baker's longer-term valuation ratios (PE10 and PD10, the price to ten-year average earnings and dividend ratios) are a bit too high. This is largely down to the company's rapid growth, where earnings and dividends a decade ago were tiny relative to today's. Even so, the ratios are high enough to make me uncomfortable.

As a rule of thumb, I don't like to invest in companies where PE10 and PD10 are above 30 and 60 respectively, as prices beyond that level can only be justified by impressive (and difficult to obtain) growth long into the future. In this case, Ted Baker's PE10 and PD10 ratios are 31 and 65 respectively. Admittedly these are only just over the limit, but they're over the limit nonetheless. Having said that, and to muddy the waters somewhat, those rules are only rules of thumb and I'm happy to override them if I think the company is worth it. And in this case, I think it might be, given (among other things) Ted Baker's super-consistent double-digit growth and entirely reasonable 2.6% dividend yield.

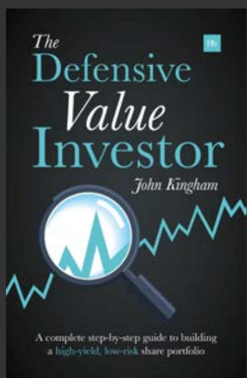
Taking all of that into account, my conclusion is this: I like Ted Baker, it appears to be an excellent company and at its current share price I think it's likely to produce above average returns over the next five or ten years (although of course there are no guarantees). And when I make my next purchase in August, I think there's better than even chance it'll be Ted Baker.

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 DAVID JONES

CHART NAVIGATOR

HOW TO COMBINE INCOME INVESTING WITH TECHNICAL ANALYSIS

Given the theme of this month's issue is investing for income, I thought it would be timely to revisit a previous article from last year looking at precisely this. To the uninitiated, charting and technical analysis is just for short-term traders squinting at a 10-minute chart of the Dow and trying to figure out in which direction the next 50-point move is going to be. It is of course very true that charts are favoured by many a short-term trader in all sorts of markets – but they are also a very effective tool for the longer-term investor. And also, many experienced chartists, me included, would argue that identifying and following longer-term trends is easier and more reliable than trying to jump on where you think the price of gold is going to go by lunch time.

Finding high yielding shares

The core of this approach revolves around the idea of these longer-term trends, but it does not start from there. As we are talking about investing for income the beginning of the strategy is identifying a short list of solid dividend-paying shares. With interest rates still risibly low for money on deposit, perhaps one criterion is to identify shares that have a historical dividend yield of at least 4%. This is the start of the search, and if we focus our attention on the FTSE All Share constituents, this presents a list of 169 shares, out of more than 600 All-Share members at the time of writing.

The problem with really high yielders

Surely the easiest way to invest for income is to buy the highest yielding shares and just wait for the dividends to roll in, right? Of course, this is not the case. Let's take one of the tops in terms of yield at the moment – high street business **Debenhams (LON:DEB)**. Based on dividends paid out in the past, the yield is currently in excess of 25%. To the uninitiated this can seem like free money but of course there are two risks here. You get your dividend but the share price plunges, eroding your capital; and/or the company cannot make dividend payments at the same rate as previously. This way, the historical yield ends up being just that – something that happened in the past! Let's take a look at the Debenhams chart.

This one picture neatly encapsulates the risk of investing based purely on the dividend yield. For the sake of illustration, let us assume the dividend yield a year ago was 10% – a very healthy amount of return, and the share price was 45p. We will also assume that dividends were paid out at that amount, so £1,000 invested would have returned £100 in income (10% yield). However, the £1,000 was invested at 45p per share – Debenhams is currently trading at 12p. The fact that income has been received is scant consolation for an investment that has lost more than 70%

"IDENTIFYING TRENDS – WHETHER THEY HAVE BEEN IN PLACE FOR JUST A FEW MONTHS OR MANY YEARS – IS A VERY USEFUL WAY OF COMBINING THE APPROACH OF PROTECTING OUR INVESTMENT CAPITAL FROM A FALLING SHARE PRICE, WHILST BEING PAID TO HOLD THE SHARES."

of your invested capital. As companies share prices plunge, the historical yield does of course go up – but it can point to much deeper problems that should put off the income investor.

Dividend & trend combine

The list of healthy-yielding shares should just be the starting point. Other analysis can be applied: does the dividend cover suggest it will have no problem continuing to pay out for the foreseeable future? Are profits growing to meet investors' income expectations? These are perfectly valid fundamental factors to examine – and I would suggest another simple approach is to look at the price chart. Going back to Debenhams above, the share price had been falling since the end of 2012 – and this has continued over the last 12 months. A falling price should make the income investor wary, regardless of how attractive the historical yield has been.

A simple filter that can quickly cull a significant portion of the list is to just look at shares that have gone up over the last year. Income investing is arguably a more defensive strategy, so let's at least whittle the list down to companies that have been doing well, rather than trying to pick the next turnaround play ahead of the rest of the market. This brings our list down to a much more manageable 41 different companies. Basic Materials business **Evraz (LON:EVR)** is the best performer of this bunch from an historical yield point of view, coming in at over 8%.

"A FALLING PRICE SHOULD MAKE THE INCOME INVESTOR WARY, REGARDLESS OF HOW ATTRACTIVE THE HISTORICAL YIELD HAS BEEN."

The share price of Evraz has been in a clear uptrend, shown by the arrow, for the last 12 months. So, anyone investing for the yield during 2018, for example, will also be sitting on some capital growth as the share price has risen. This really is the "having your cake and eating it" result that we all strive for! But actually, the price started rising in early 2016, and the trend was well established by the current year. Contrast this with the Debenhams example – when investing for income it is usually a safer approach to pick a high yielder that has already turned its fortunes around, rather than trying to pick the bottom for a falling share price.

Dividend, trend & turnaround...?

Psychologically, plenty of investors do have a problem in buying shares that have been going up for a while, despite the fact that there are plenty of examples of long-term trends that go on and on and on. For the more thrill-seeking investor there is another twist on spotting income shares with interesting charts. This is one I must admit to using myself on a regular basis as well, and it is just tweaking the trend criteria. An historic yield above 4% is still the basic requirement – the changes are made to what the share price has done over the past 12 months and more recently. Rather than going up for the past 12 months the share price has to have gone down. But, it needs to have risen for the past three months – this is where the turnaround aspect comes in. Once again, applying this to

the FTSE All-Share still gives us a good list of prospects – at the time of writing there were 43 shares that met these criteria.

One of the highest yielding shares in the list is utilities business **Centrica (LON:CAN)**. And the five-year chart shown is a great example of why utilities are not always a boring, safe, long-term home for your money. Since September 2013 the share price has lost more than 60% of its value – another example where the fact you are receiving an income stream for being a long-suffering holder is only small consolation. But perhaps things are changing. Since February of this year it has had, so far at least, a sustainable recovery. The hardened chartist would probably want to see that major downtrend broken before considering buying in, but this slightly different approach can help highlight other opportunities for the investor who is happy to take on a little more risk in the search for increased capital growth on top of the income potential.

As usual, neither of these approaches are rocket science and both start with the fundamental figure of how much historical yield the share price has delivered. As we saw at the beginning with Debenhams, a high yield figure is not even half of the story – we have to delve deeper. But identifying trends – whether they have been in place for just a few months or many years – is a very useful way of combining the approach of protecting our investment capital from a falling share price, whilst being paid to hold the shares.

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.

Chart of the Month – Imperial Brands

Of course, this month's chart uses the income-hunting approach outlined above – and it almost fits into both criteria. The dividend yield is a healthy 6% and the share price of **Imperial Brands (LON:IMB)** (the old Imperial Tobacco) has risen over the past three months – but has been falling for a couple of years.

It's an interesting one from a long-term trend point of view – the share price has made incredible progress since 2000 when this long-term trend started, and is a great example of how trends really can persist... Until they don't of course!

What has caught my eye is that the shares are trying to shake off that two-year slide, coinciding with running into that longer-term uptrend. It is early days, but if you believe Imperial's fall from grace has been overdone, then with such a good yield and strong longer-term performance it looks like one worthy of further investigation.

BY VICTOR HILL

OPPORTUNITIES IN FOCUS

LA DOLCE VITA

WHY THE ITALIAN MARKET IS MISUNDERSTOOD BY INVESTORS

If the Italian economy is a basket case, how come most Italians live so well? Despite well publicised fiscal problems, Italy is home to some of the world's foremost companies and many very wealthy people. Its quality of life is unrivalled, even by comparison to other European countries.

My task this month is to persuade readers that Italy is mis-perceived by mainstream media. It is an astonishingly wealthy country which, while addicted to luxury, still manages to accumulate savings. It has a remarkable science base (as it has had since the Renaissance, being the home of Galileo), a strong engineering tradition and outstanding universities which serve it well in contemporary hi-tech industries. It has world-class fashion, film and furniture sectors. Italians are pre-eminent designers. And it is a manufacturing powerhouse, second only to Germany in the EU.

If its architecture, heritage and sunshine lure tourists in incredible numbers from all over the world (it is the world's fifth most visited country), its cuisine and music delight them further. Italians are amongst the best educated, most cultured and best dressed people in Europe. And everyone, rich or poor, knows how to cook and eat.

And yet there is unemployment, criminality and exclusion. Italy is on the front line of the modern European migrant crisis. A "populist" and Eurosceptic government came to power in June after decades of centrist government, signalling that not all is well. Italians perceive that they have not done well out of the much-vaunted European currency union. Italy's growth record this century has been desperately disappointing, largely due to the fact that the country's historic tendency to devalue the currency is no longer available.

How is it that such a blessed, dynamic and unique country has fallen off investors' radars? Should they take a second look?

"ITALY IS RECKONED TO HAVE PRIVATE WEALTH COMPARABLE TO THE VERY RICHEST COUNTRIES ON EARTH."

Un bel paese

Let's get a few things straight. Italy has a huge economy and is a major trading nation. Italy's economy is the third largest in the eurozone (obviously after those of Germany and France). It has the eighth largest GDP in the world in nominal terms and the twelfth largest in PPP terms. Italy was the world's eighth largest exporter with exports of $514 billion in 2016. Its major trading partners are the other EU nations, which take nearly 60 percent of its exports. Outside the EU, its most important markets are the United States, which takes about seven percent of its exports, and neighbouring Switzerland, which takes just under six percent.

Until the *economic miracle* which followed WWII and which lasted until about 1990, Italy was predominantly an agricultural nation – but agriculture is still important both economically and culturally. Italy is a food lover's paradise, partly because, unlike in certain other so-called *advanced* countries, families still sit down together regularly to share a meal. In 2015 Italy ranked eighth on the Economist's *Quality of Life Index*[i]. (The UK was ranked 29th.)

Despite recent reports that Italy is near bankruptcy, having a debt-to GDP ratio of about 132 percent, the Italian state controls the third largest gold reserves in the world. Italian citizens are also inveterate savers: most adult Italians have substantial savings, often in the form of bonds issued by the country's banks.

Italy is reckoned to have private wealth comparable to the very richest countries on Earth. Some of Italy's leading families include the fabulously wealthy Agnelli, Ferrero and Del Vecchio dynasties. Many large companies remain in private family hands, as a result of which Italy's stock market capitalisation accounts for a lower proportion of GDP than in other countries.

Estimates suggest that Italy has over 1.4 million people with a net worth greater than $1 million. The country's total national wealth of nearly $12 trillion represents the fifth largest cumulative net worth globally. The richest man in the country is supposedly Maria Franca Fissolo Ferrero who controls the Ferrero foods empire. He

Table 1: Italy – Key Facts

Population:	60,483,973 (2017 estimate)
Land Area	301,340 square kilometres
GDP	$2.399 trillion
GDP/ Capita	$39,499 (ranked 32 in the world)
Exports:	$519 billion
Imports:	$452.2 billion (2017)[ii]
Religion:	74.4% Roman Catholic/ 22.6% no religion/ 3% other

The Italian stock market

The Borsa Italiana SpA (BIT), based in Milan, is Italy's only stock exchange. Privatised in 1997, the operating company has been a subsidiary of the London Stock Exchange Group PLC since 23 June 2007. The Italian market currently has 353 stock listings (less than other major European markets) with an aggregate market capitalisation of about $3 trillion at the end of last year. The main index for the Italian market is the FTSE-MIB. To 31 July this index was up just over two percent. But that figure disguises the fact that the Italian market was powering ahead from March to mid-May this year when it gained over ten percent in ten weeks! Since then the Italian market has been subdued due to the perception of increased political risk. That negative sentiment could dissipate rapidly if the new government acquires a reputation for economic competence.

and his family are thought to be worth about $26 billion. *Nutella*, the chocolate hazelnut spread, was invented by his grandfather, Pietro Ferrero. It is an international brand which still sells in more than 160 countries. Many readers, or at least their children, will have enjoyed this incredibly successful product with their breakfast!

Italy is also a very important manufacturing country – being second only to Germany in the EU in terms of industrial output. It has world-class automobile (NB **Fiat-Chrysler Automobiles (BIT:FCA)**), shipbuilding, marine engineering and household appliance manufacturers.

Italy is the third largest net contributor to the EU budget after Germany and the UK. When the UK leaves the EU Italy will be the second biggest net contributor. That will become a major issue in Italian politics – about which I shall have more to say soon.

Growth

Despite very frequent changes of government, Italy's economy expanded at more than the European average over the 45 years after WWII to about 1990. This period is now referred to as the *economic miracle*. However, since the launch of the single currency some 20 years ago, Italy's growth has been below the European average. The Italian economy was severely impacted by the economic slowdown which followed the global financial crisis of 2008.

"SINCE THE LAUNCH OF THE SINGLE CURRENCY SOME 20 YEARS AGO, ITALY'S GROWTH HAS BEEN BELOW THE EUROPEAN AVERAGE."

Italy's high level of public debt has largely come about because of high levels of government spending in the form of generous transfer payments (especially pensions for state employees) and infrastructure investment (Italian roads are excellent). Yet government spending has failed to reignite robust economic growth. The Italian economy is forecast to grow by 1.6 percent this year and by 1.4 percent next year[iii].

As a result of sustained low growth, the level of unemployment has risen, especially amongst the younger demographic. Anecdotally, it seems that a large number of young Italians continue to live with their parents long after having graduated from college or university. Italy's unemployment rate was 10.9 percent at the end of February (the best figure since August 2012) compared with just 3.5 percent in Germany.

The North-South divide

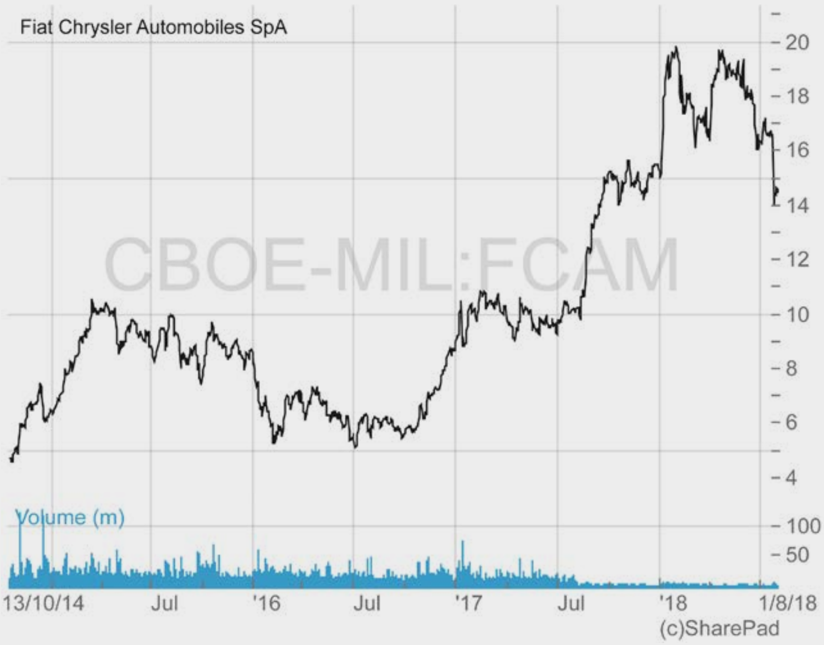
Italy is both economically and culturally beset by a North-South divide, with the line of division roughly running through its ancient capital, Rome. Average GDP-per-capita in northern and central Italy significantly exceeds the EU average, while some regions and provinces in southern Italy fall dramatically below that level. To some degree this is a historic legacy. Northern cities like Turin, Milan and Venice have been rich since the Renaissance, while Naples and Taranto have always had more than their fair share of poverty. Since Italy's industrial revolution which took place at the tail-end of the 19th century, most of the new factories were located in the north, especially in Turin (still home to Fiat) and in Milan (still home to Pirelli).

The economic divide has driven a cultural divide. North Italians, famously hard-working and good with money, overwhelmingly live in cities and live a cosmopolitan lifestyle, exhibiting a strong appetite for luxury goods. Southern Italians, in contrast, live predominantly in small towns and in the country. They are prey to much higher levels of unemployment and to widespread organised crime.

Italy's corporate champions

There were nine Italian companies in the Fortune-500 list in 2016. Here are 12 of Italy's largest industrial companies to watch.

Fiat Chrysler Automobiles (BIT:FCA), headquartered in Auburn Hills, Michigan, USA, London and Turin (where the board meets). Since the merger of the two great and historic automobile manufacturers, one quintessentially American and the other fundamentally Italian, in October 2014, this multinational has kept its Italian accent. It had revenues of $133.2 billion last year and net income of about $4.2 billion. The company's share price almost doubled between August last year and mid-January this year. On 30 July its shares were trading at €14.44 – so up more than 40 percent on a 12-month basis. The shares are also listed in New York (NYSE:FCAO) and Paris (ETR:2FI).



CNH Industrial (BIT:CNHI) manufactures agricultural equipment, construction equipment, trucks and commercial vehicles, buses (including Iveco, based in Turin), specialist vehicles and marine engines. 41.9 percent of its stock is owned by Exsor, a Netherlands-based vehicle of the Agnelli family. It had sales of $27.36 billion last year and net income of $1.62 billion. Its shares have roughly followed the Italian market and are currently, at €9.98, only marginally above their level 12 months ago.

Ducati Motor Holding (owned by Audi AG (FRA:NSU)). Headquartered in Bologna, Ducati produces classic Italian motorcycles, clothing and accessories. Audi acquired 100 percent of Ducati's voting stock via Automobili Lamborghini SpA in July 2012.

Piaggio (BIT:PIA) is an Italian motor vehicle manufacturer, which manufactures a range of two-wheeled motor vehicles and compact commercial vehicles under seven brands: Piaggio, Vespa, Gilera, Aprilia, Moto Guzzi, Derbi, and Scarabeo. Its corporate headquarters are located in Pontedera. The company was founded by Rinaldo Piaggio in 1884, initially producing locomotives and railway carriages. This is a mature industrial sector but earnings are consistent even if margins are low. The share price has pretty much flat-lined over the last 12 months.

Pirelli (BIT:PIRC) is a global leader in the manufacture of car and vehicle tyres. Founded in 1872 the company had revenues of €5.35 billion last year and net income of €263 million. As of November last year Marco Polo International Italy (a holding company for ChemChina, a Chinese state-owned enterprise) held 63 percent of the company's shares. Its shares are up by some 15 percent over the 12 months to the end of July, though with some volatility.

Enel (BIT:ENEL) is Italy's number one electricity and natural gas producer. Founded by the Italian State in 1962, ENEL was partially privatised in 1999. The Italian government still holds 25.5 percent of the stock. The company has a range of power plants but discontinued its nuclear programme in the 1980s. It operates power plants in more than 20 countries including France, Russia and the USA. The company had revenues of €70.59 billion in 2016 and net income of €3.79 billion. On 30 July the company's shares were trading at €4.70 – well down from their 12-month high of €5.58 in December last year.

Edison, the energy major is owned by France's **EDF (EPA:EDF)**.

A2A (BIT:A2A) is a utility company headquartered in Brescia, Lombardy. It produces and distributes gas and electricity. It provides water and is engaged in waste management. With latest 12-month earnings at €373 million, analysts expect these to grow to €385 million next year. The share price is, at €1.58, a little above the level of €1.44 12 months ago.

Terna Group (BIT:TRN) is a transmission system operator (TSO) based in Rome. It operates through Terna Rete Italia, which manages the Italian transmission grid. With 72,900 kilometres of power lines or around 98 percent of the Italian high-voltage power transmission grid, Terna is the first independent electricity transmission grid operator in Europe and the sixth in the world based on the size of its grid. Revenues were €2.25 billion last year with net profit of €668 million. Its shares are trading about where they were 12 months ago.

Eni (BIT:ENI) *(Ente Nazionale Idrocarburi)* is a multinational oil and gas company headquartered in Rome. Considered one of the global oil majors, it has operations in 79 countries, and is currently the world's eleventh largest industrial company with a market capitalisation of about $90 billion. The Italian government owns a 30 percent golden share in the company, 3.9 percent held through the state Treasury and 26 percent held through the *Cassa Depositi e Prestiti.* Another 2.012 percent of the shares are held by the People's Bank of China. It had revenues of €70.1 billion in 2017 and net income of €3.43 billion. Its shares have fared well over the last 12 months, up by over 22 percent to €16.44.

Candy is a private company with its HQ in Brugherio (just outside Milan). It manufactures numerous home appliances.

Indesit SpA, based in Fabriano in Le Marche is a global leader in household appliances, especially washing machines and dishwashers. It is owned by **Whirlpool Corporation (NYSE:WHR)** of the USA.

De'Longhi (BIT:DLG) is a third leading Italian manufacturer of home appliances and boilers. Its share price is down over 12 months from nearly €28 to just over €24.

Agribusiness

There were 1.6 million farms in Italy in 2010 – down by 32.4 percent since 2000 – covering 12.7 million hectares, 63 percent of which were located in Southern Italy. The vast majority of these are family-operated and small, averaging only 8 hectares in land area. The total annual production of the fishing industry in Italy from sea-fishing and aquaculture, including seafood, is around 480,000 tons.

Italy is the largest producer of wine in the world, and one of the leading producers of olive oil, fruits (apples, olives, grapes, oranges, lemons, pears, apricots, hazelnuts, peaches, cherries, plums, strawberries and kiwifruits), and vegetables (especially artichokes and tomatoes).

The most famous Italian wines are probably Chianti from Tuscany and Barolo from Piedmont. Other famous wines include Barbaresco, Barbera d'Asti, Brunello di Montalcino, Frascati, Montepulciano d'Abruzzo, Morellino di Scansano, and the sparkling wines Franciacorta and Prosecco. The latter has become hugely popular in the UK in recent years as a sparkling party drink and a Champagne substitute.

Italy also specialises in regional cheeses, often protected under the quality assurance labels DOC/DOP. This geographical indication certificate, which is attributed by the EU, is considered important in order to avoid confusion with low-quality mass-produced imitations.

The main players in Italy's important food and beverage sector are Ferrero (private) which had sales of €10.6 billion in 2016, Barilla (private) with sales of €3.4 million in 2015, **Autogrill (BIT:AGL)**, Italy's premier catering group, Lavazza (private – espresso coffee), Perfetti Van Melle (the third largest confectionery manufacturer in the world after **Mondelez International (NASDAQ:MDLZ)** and Mars Inc (private)).

Manufacturing

Italy has a smaller number of global multinational corporations than other economies of comparable size, but there are many small and medium-sized enterprises, often clustered together, which are considered to be the backbone of the Italian economy. Much of Italian manufacturing is focused on the export of niche market and luxury products. As a result, Italy has been more able to compete with emerging economies whose main competitive advantage is their lower labour costs. Italian manufactured goods generally have an excellent reputation for quality.

"ITALY IS THE LARGEST PRODUCER OF WINE IN THE WORLD."

Leonardo SpA (BIT:LDA)

One of the most strategically important corporations in Italy's corporate firmament is Leonardo (formerly Finmeccanica – rebranded in 2016 as part of a major re-structuring). This is a global leader in the defence and aerospace sectors. Leonardo and its predecessor have absorbed a number of smaller aerospace companies and armaments companies such as Augusta Westland (helicopters), and Beretta (the iconic manufacturer of handguns). Last year revenues were €11.527 billion but net income was only €833 million. The company's shares have not fared well over the last 12-month period. In November of last year they slumped by 30 percent after a profit warning. Analysts expect that revenue growth will be faster than profits growth as margins decline. This has put a dampener on the share price. On the other hand, the product pipeline is encouraging. In the space sector, Leonardo is active mainly through joint ventures Telespazio (Leonardo 67 percent – **Thales (FRA:CSF)** 33 percent) and Thales Alenia Space (Leonardo 33 percent – Thales 67 percent).

In the northwest of the country there is a group of cutting-edge players located in the Milan-Turin-Genoa industrial triangle. Companies here manufacture machinery, automotive components, aerospace components and marine technology. In the northeast and in central Italy, there are a large number of family-owned businesses which are engaged in specialist craftsmanship. They specialise in clothing, leather products, footwear, furniture, textiles, machine tools, spare parts, appliances, and jewellery.

The Italian banking sector

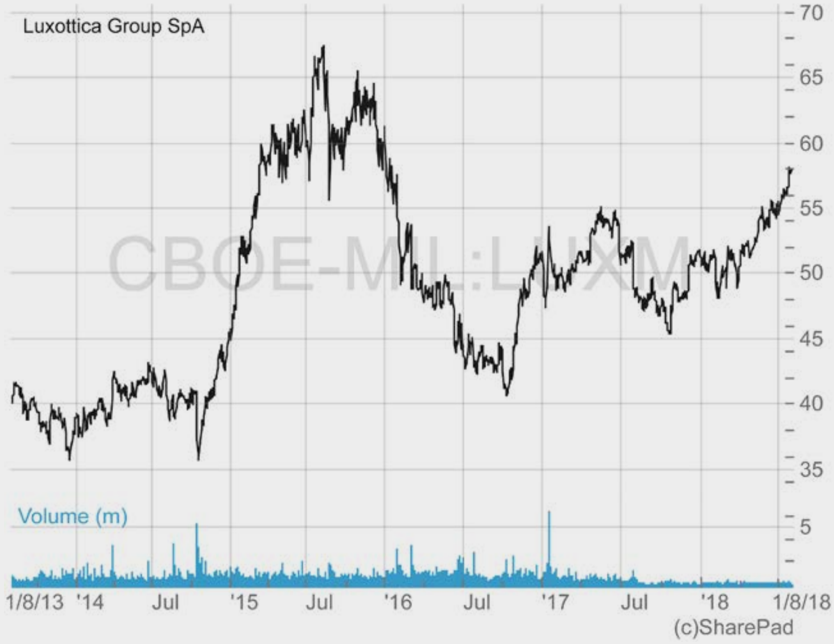
The origins of modern banking can be traced to medieval and early Renaissance Italy, where the first banks emerged in wealthy cities such as Florence, Lucca, Siena, Venice and Genoa.

Table 2: Italy's largest companies

Rank (World)	Rank (Italy)	Company	HQ	Revenue (€bn)	Profit (€bn)	Employees (World)	Main sector
19	1	Fiat	Turin	152.6	0.83	225,587	Automotive
49	2	Generali Group	Trieste	102.6	2.25	74,000	Insurance
65	3	Eni	Rome	93.0	*1.33*	80,911	Petroleum
78	4	Enel	Rome	83.9	2.44	62,080	Electric utility
224	5	Intesa Sanpaolo	Turin	42.2	3.04	90,807	Banking
300	6	UniCredit	Milan	34.6	1.88	117,659	Banking
305	7	Poste italiane	Rome	34.1	0.61	142,268	Postal services
404	8	Telecom Italia	Milan	26.6	*0.44*	66,025	Telecommunications
491	9	Unipol	Bologna	21.5	0.30	14,223	Insurance

Giants of fashion

Italy's amazing fashion and apparel sector includes numerous world-beating iconic brands which command premium prices across the globe. Amongst these are Gorgio Armani (private, based in Milan with revenues of €2.9 billion); Gianni Versace (private, Milan, revenues of €669 million); Dolce & Gabbana (private, Milan); Gucci (private, Florence, US$4.3 billion); Benetton (private, Ponzano Veneto, €1.5 billion); Diesel (private – owned by OTB, Molvena, €2.9 billion); and **Prada SpA (HKG:1913)** with revenues of nearly US$4 billion in 2016. Other brands of note include **Luxottica (BIT:LUX)**, based in Agorda, which manufactures eyewear (spectacle frames etc.) and which had €9.157 billion of revenues last year. Its shares were up by nearly 18 percent over the 12 months to the end of July.



"THE OVERWHELMING THREAT TO THE ITALIAN BANKING SECTOR IS THEIR HUGE PORTFOLIOS OF NON-PERFORMING LOANS."

The English word *bank* is derived from the Italian *banco* – a table on which money was counted.

One of the most famous Italian banks was the Medici Bank, set up by Giovanni di Medici in 1397. The earliest known state deposit bank, the Bank of Saint George, was founded in 1407 in Genoa, while **Banca Monte dei Paschi di Siena (BIT:BMPS)**, founded in 1472, is the oldest surviving bank in the world (though it has had a few problems in recent years).

UniCredit (BIT:UCG) is one of the largest banks in Europe by market capitalisation and **Assicurazioni Generali (BIT:G)** is the second largest insurance group in the world by revenue after AXA.

As I have reported in the Master Investor website on many occasions, the overwhelming threat to the Italian banking sector is their huge portfolios of non-performing loans. This problem is likely to persist for some time.

Politics

The Italian election took place back on 04 March – when the right-wing *League* (*Lega* in Italian – formerly the Northern League), together with its partners in the centre-right coalition emerged as the largest bloc with 37 percent of the national vote and 265 seats in the Chamber of Deputies. The populist *Five Star Movement* emerged as the largest single party with 32 percent of the vote and 227 seats out of 630.

81 year-old former Prime Minister Silvio Berlusconi refused to play the role of power-broker, saying that his conservative *Forza Italia* party would not seek to join the government. If the *Lega* are sometimes characterised (unfairly in my view) as neo-fascists, the 5-Stelle are often branded anarchists. What could possibly unite them?

What the leaders of the insurgent 5 Star Movement and the conservative League agree on is that the EU is causing Italy harm. Firstly, it has failed to stop mass migration to Italy from across the Mediterranean. The immigrants are overwhelmingly black Africans who alight with the help of people traffickers from Libya. Secondly, they deeply resent the Maastricht criteria by which eurozone member states must reduce their fiscal deficits to three percent of GDP or less in order to bring their national debts down to 60 percent of GDP. Thirdly, they oppose reform of Italy's indulgent pensions system – and virtually all other spending cuts.

In practice, the Maastricht criteria have never been rigorously enforced and

Creative Lab / Shutterstock.com

Italy's debt-to-GDP level is currently around 132 percent. But the country has been compelled to make cuts all the same, lest that metric soar out of control. And Italians do not like it.

After nearly two months of political deadlock, President Sergio Mattarella gave the law professor, Giuseppe Conte, the task of forming a new cabinet in the last week of May. He was to have led a populist coalition to be formed between the Five Star Movement and the League, which had reached substantial agreement on a government programme.

However, on 27 May 2018, Signor Conte renounced the office due to differences between the League's leader, Matteo Salvini, and the President. Signor Salvini had wanted the university professor Paolo Savona as Minister of Economy and Finances – but President Mattarella adamantly opposed him, considering Signor Savona too Eurosceptic and "anti-German". In his address after Signor Conte's withdrawal, President Mattarella declared that the two parties wanted to bring Italy out of the eurozone, and as the guarantor of the Italian Constitution and of the country's stability he could not permit this.

Some radicals from both the Five Star Movement and the League called for the president's impeachment, saying that he did not have the constitutional right to reject the coalition deal. But President Mattarella just ignored this. And on 28 May 2018 he appointed the independent economist Signor Carlo Cottarelli as Prime Minister of Italy – but just to lead a caretaker government until such time as Italy could hold new elections. Signor Cottarelli, an alumnus of the LSE, who has worked at the International Monetary Fund and with the Banca d'Italia, is a mainstream Europhile economist.

> **"ORDINARY ITALIANS ARE FEELING THE PINCH."**

The populist ball was to have been kicked into touch – much to the temporary relief of Paris and Berlin. But the markets took a dim view of these machinations. On 29 May European bourses opened down and continued to haemorrhage value all day. In the event, late on 31 May, President Mattarella re-appointed Signor Conte as PM – and he was sworn in on Friday, 01 June. Matteo Salvini was appointed Minister of the Interior and Luigi di Maio, the Five Star leader, became Minister of Labour. Giovanni Tria, another academic economist, was appointed Finance Minister.

Another round of elections would probably have repeated the outcome of the March election. Support for the patriotic, conservative League has surged in recent opinion polls – the promise of a flat tax of 15 percent is particularly appealing. The Five Star Movement, which is predominantly popular in the poorer South – *il Mezzogiorno* – promises a citizen's income of €780 a month for the unwaged.

Italy has made economic progress of late, at least in the eyes of the ECB. It is running a current account surplus of 2.8 percent of GDP by creating internal deflation within the eurozone whereby prices and wages fall relative to those of eurozone neighbours. But that's the problem – ordinary Italians are feeling the pinch.

After another election it would have been more difficult for the president, who has lost political capital, to defy the wishes of the two largest parties in parliament. Italians will not tolerate more EU-driven austerity; nor do they want another technocratic government imposed by Paris and Berlin – remembering how President Sarkozy and Chancellor Merkel imposed Mario Monti as PM in November 2011.

During the election campaign Signor Salvini said: *We couldn't give a damn about bond spreads. It's NO to Berlin, NO to Paris and NO to Brussels. Italians are going to decide for Italy from now on.*

The League-Five Star agreement came close to suggesting that Italy could launch its own digital currency which would function in parallel with the euro as a first step to Italy recovering its own currency. This was the brainchild of Claudio Borghi, the League's economic spokesman. But while many talk of a future outside the eurozone, there is no evidence that this would be overwhelmingly popular.

What the new government portends

In my view, despite extreme fiscal challenges, the Italian state is very unlikely to go bankrupt any time soon. In contrast to Greece, about 72 percent of Italian debt is owned by Italian entities. In fact, much of the outstanding government papers are held by retail investors – provident Italians who are happy to invest in their own government so long as they receive a yield above the cash markets. In this respect, Italy can be compared to Japan, which has a much higher level of debt-to-GDP of over 225 percent, much of which is funded by domestic retail investors.

Nor is Italy going to fall out of the eurozone – despite the contempt in which many Italians hold the ECB, the *Bundesministerium der Finanzen* and Brussels in general. Precisely because the Italians are provident, they know that an exit from the eurozone would beggar the value of their savings.

Yannis Varoufakis explained in his excellent book *Adults in the Room*, why the Greeks just could not leave the eurozone when they had the chance – even though staying in meant a protracted regime of extreme austerity. The Italians are richer than the Greeks and have much more to lose from a collapse in the monetary union which – though many British Brexiteers might wish that to come to pass – is extremely unlikely to happen. Even if there is a systemic European banking crisis (much more likely) the abandonment of the euro would make any potential bank bailout impossible.

The new "populist" (I have grave reservations about that word) government will set Italy in a new direction. First and foremost, Italy under Signor Salvini, De Maio and Conte is already adopting a much tougher policy towards immigration. They will be much less indulgent of multi-culturalism and all that that entails. Signor Salvini has already been disobliging about the Italian gypsy population, though he admitted that if they are truly Italian citizens they cannot be deported.

When Signor Conte met President Macron in Paris on 15 June the French president appeared to throw his weight behind Signor Salvini's vision of a "fortress Europe" which would close its doors to the flow of migrants crossing the Mediterranean from Africa and send back many who have already arrived. This was a change of tune by the president who had earlier described Italy's refusal to take in 629 African migrants aboard the *Aquarius* as "cynical and irresponsible".

Signor Salvini has strong support from the Hungarian government of Viktor Orbán and others. It is now Frau Merkel whose views on immigration are out of line. We can expect migration policy to dominate European affairs going forward – a much bigger deal than Brexit. Paradoxically then, a populist, right-wing Eurosceptic Italian government is likely to set the agenda for Europe as a whole and become more influential than its predecessor.

Italy and Brexit

Signor Salvini is extremely supportive of Brexit and the plight of the British in negotiating their withdrawal from the EU. On 29 July, in a published interview with the *Sunday Times*, he said that Britain should either "impose itself or they [will] swindle you...I hope it can be an opportunity for the British". This was after the EU Chief Brexit negotiator, Michel Barnier, had effectively rejected Mrs May's *Chequers Plan*.

That does not mean that Italy is itself edging towards the European exit. Under Italian law it would require a change to the constitution even to vote on EU membership, and most Italians know instinctively which side their bread is buttered. So *Italexit* (which I know some hedge funds are betting on) is highly unlikely to happen – even if our Italian friends cheer the plucky British on from the side-lines.

Action

The key question is whether the economic policies of the new Italian government can re-dynamise the Italian economy and give it back its growth mojo. It is currently too early to say – but we shall probably have some idea by Christmas. In the meantime, the Italian market does offer some high-quality stocks on a selective basis – though it would be prudent to avoid the financial sector.

If you are dazzled by the allure of Italy, as I am, one fund to follow is the Schroder International Selection Fund Italian (ISIN: LU0106238719), which has consistently outperformed the Italian benchmark. Its three-year annualised return stood at just under 10 percent on 30 July – but note that it is only up 0.52 percent year-to-date. The fund allocates to about 50 Italian stocks and debt instruments. *Buon viaggio!*

About Victor

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

i See: https://www.economist.com/media/pdf/QUALITY_OF_LIFE.pdf
ii See: http://www.worldstopexports.com/italys-top-10-imports-2
iii See: https://uk.reuters.com/article/uk-italy-economy-forecasts/new-italy-forecasts-to-raise-2018-gdp-growth-to-1-6-percent-government-sources-idUKKBN1HQ2AH?il=0

BY FILIPE R. COSTA

THE MACRO INVESTOR

HOW WILL TRUMP'S TRADE WAR IMPACT YOUR INVESTMENTS

"Every man lives by exchanging."

Adam Smith, in
***An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776**

One of the most important observations in the history of economic thinking is that only through trade can society raise its living standards. In primitive societies, man used to live in small groups and had to produce everything needed to survive. As a consequence, living standards were basic. The evolution of society and the introduction of money as a medium of exchange allowed each man or group of men to specialise in some task and then exchange the surplus created.

As Adam Smith observed in his seminal work *An Inquiry into the Nature and Causes of the Wealth of Nations*, specialisation through the division of labour is key to increasing productivity. By the time he wrote the book, the division of labour was done at the factory level, where workers were split up and committed to different parts of the process. Today, the division of labour has increased in scale, as it occurs at an international level, where big multinationals split their supply chains across the globe.

While globalisation creates many challenges at different levels, at least there is one undeniable feature stemming from it: globalisation leads to higher global output. The appropriation of that output is a different story, but without international trade, we would all be significantly poorer.

If, at any point, barriers to free trade are imposed, there will be excess output that can't be traded. The incentive to invest and specialise diminishes, and global productivity and output would be expected to suffer. The exact distribution of losses will certainly depend on the level of specialisation of each part involved, on its size, on trade-to-GDP ratios, and on many intricate geopolitical factors. Some countries stand to lose more than others but, as a whole, the world is expected to suffer.

In a free market economy, a tariff is an artificial way of raising prices to help inefficient companies stay in business, allowing them to sell their products at higher prices. Tariffs reduce competitiveness and lead to inefficiencies, which sooner or later must translate into higher prices paid by consumers. Still, the cur-

"WITHOUT INTERNATIONAL TRADE, WE WOULD ALL BE SIGNIFICANTLY POORER."

rent US administration, led by Donald Trump, insists on increasing protectionism, as they argue that the US is suffering from unbalanced trade terms with countries like Canada, Mexico, Germany and China, just to mention a few. While this happens, uncertainty is created, and investors must rethink their market exposure.

Everyone's a loser

In order to gain some leverage in trade deals, Donald Trump has already imposed tariffs on many US imports while also announcing billions of dollars in new tariffs to be implemented later this year. While the strategy may lead to positive results against smaller countries like Canada and Mexico, it is unlikely to work well against China and the EU, due to the size of these last two trading blocs. Some simple data helps us to understand why.

In 2016, EU exports to the US accounted for 20.8% of total EU exports, which makes the US the top destination for EU products. In terms of exports-to-GDP, the above number represents a ratio of 16.7%, which is large by any standard. We could safely say that the EU depends heavily on the US as an export market for its products.

But if we look in the reverse direction, the picture isn't much different. US exports to the EU accounted for 18.7% in that same year, representing a share of 12.6% of GDP. While these last figures seem to depict a softer link than the reverse, the EU market is still the most important destination for US exports. If we look a little deeper into the bilateral movements between these countries, we further understand that neither one is in a position to threaten the other. The EU is the largest investor in the US, accounting for nearly 60% of total foreign investment in the country. The US is also the most important foreign investor in the EU, with a share of 40% of total investment in the region. With these numbers in mind, I wouldn't expect the EU to soften its tone against the US. But neither would I expect Trump to go much further from here, as the EU would quickly close its market to some high-profile US multinationals.

What has been done so far?

On January, Donald Trump approved tariffs of up to 30% on imports of solar panels and up to 50% on dishwashing machines, arguing that such imports have caused "serious injury" to domestic manufacturing. The main target was China, but the EU wasn't happy with the measure either and brought the case to the WTO. Later, in March, the US extended tariffs to steel and aluminium products, imposing a tariff of 25% on the first and 10% on the second. The reason invoked was that imports of steel and aluminium threatens America's national security. But, regardless of the motivations, such a measure directly impacts China and the EU, which are the world's largest producers of the metals.

The trade wars have been gathering speed. In March, the US announced

"IN 2016, EU EXPORTS TO THE US ACCOUNTED FOR 20.8% OF TOTAL EU EXPORTS, WHICH MAKES THE US THE TOP DESTINATION FOR EU PRODUCTS."

duties targeting $32 billion of imports from China affecting more than 700 products, which were imposed earlier this month, and additional duties targeting $14 billion still to be imposed. In July, the US announced an extra $200 billion to be targeted on Chinese imports. These successive announcements since the beginning of the year target $296 billion of goods entering the US, which represents 15.7% of total US imports.

The reverse of the coin shows retaliation from the affected countries. China is already targeting $32 billion in US goods and has $15.4 billion pending. The EU imposed duties on $4.2 billion in US goods and is about to launch duties on another $4 billion. Mexico, Canada, India and Turkey are embroiled in this trade war too – particularly Canada, which has been heavily affected by a long-standing partner. Currently, $79 billion of goods leaving the US are targeted by duties, which represents 5.1% of US exports.

For now, US partners have refrained from taking severe retaliatory measures against the US, fearing the economic havoc that could derive from it, at a time when the world still lives in the shadow of the financial crisis. But this war may well escalate.

A question of 'when' and 'how bad'?

Donald Trump is trying to "Make America Great Again" through the reinforcement of nationalism and protectionism, which has historically failed. On the one hand, the recent past shows that Trump pushes for the extremes in order to gain some leverage in negotiations, just to later turn softer in tone. But, on the other hand, Trump is already targeting almost $300 billion in imports with duties, which if retaliated against fully could lead to a reversion of global trade trends and drastically increase the odds of a recession. At the same time, protectionism increases inefficiency and consumer prices are expected to rise. As expressed in the words of David French, senior vice-president for government relations from the National Retail Federation:

> *"The threat to the US economy is less about a question of 'if' and more*

about 'when' and 'how bad.' Tariffs on such a broad scope of products make it inconceivable that American consumers will dodge this tax increase as prices of everyday products will be forced to rise..."

At the time of writing, Trump is confident. But can we blame him? He has good reasons to be confident, as the unemployment rate is at historical lows, currently sitting at 3.8%, and GDP is growing at an astounding annual rate of 4.3%. But, no matter how great the numbers seem to be, the Federal Reserve looks a little less confident, as expressed in the Minutes from the central bank's June meeting:

"...many District contacts expressed concern about the possible adverse effects of tariffs and other proposed trade restrictions, both domestically and abroad, on future investment activity; contacts in some Districts indicated that plans for capital spending had been scaled back or postponed as a result of uncertainty over trade policy."

There's a feeling that trade wars may end up derailing the current path of economic expansion. The level of uncertainty is already rising, and some sectors are turning wary about the future. In the same report, it can be read:

"...contacts in the steel and aluminium industries expected higher prices as a result of the tariffs on these products but had not planned any new investments to increase capacity. Conditions in the agricultural sector reportedly improved somewhat, but contacts were concerned about the effect of potentially higher tariffs on their exports."

The US agricultural sector is fearing the effects of tariff retaliation. For now, it is too soon to forecast a recession, but depending on the next developments, that could change quickly.

How to play the trade wars theme

As is well documented by academic research, a full-blown trade war would damage global output and could precipitate a global recession. The investment industry is already suffering from the increased protectionism, due to the uncertainty it is creating. The ETF industry, for example, which has been growing quite rapidly during the last four years, has suffered significant headwinds during the first half of 2018. Inflows into ETF products declined by 33% versus the same period last year. ETFs focusing on Emerging Markets and European equities have been suffering significant outflows, as these asset classes are often seen as vulnerable to damage from trade wars.

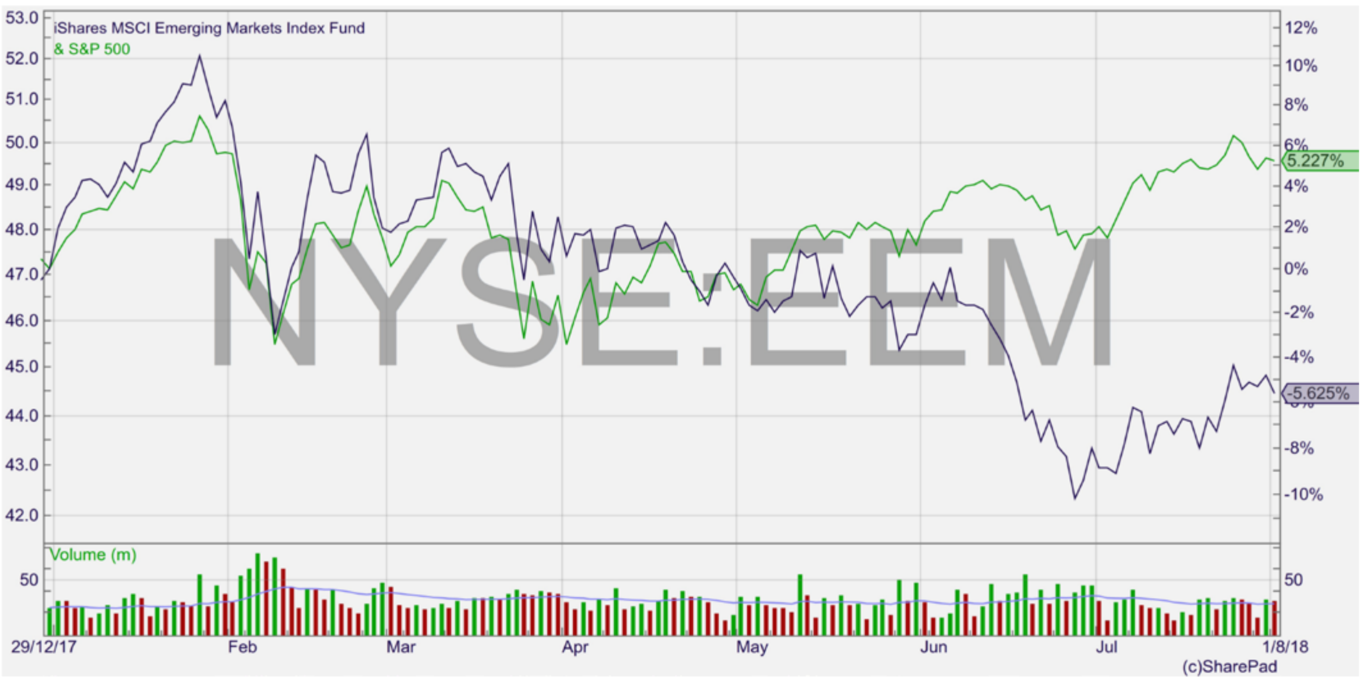
Emerging markets

Deciding on the best investments to make during a trade war isn't straightforward, as losers and winners are difficult to identify and may change over time. In fact, a full-blown trade war may end in a global crisis, which would penalise equities across the board. But the Emerging Markets asset class is particularly vulnerable to a rise in global uncertainty and protectionism. Reducing exposure seems like a good deal by now, in particular at a time when the US yield curve is flattening rapidly. If we compare the year-to-date performance of the S&P 500 with the **iShares MSCI Emerging Markets ETF (NYSEARCA:EEM)** we notice a divergence since the beginning of May. Emerging Markets equities are on the decline while the S&P 500 is still holding tight.

"THERE'S A FEELING THAT TRADE WARS MAY END UP DERAILING THE CURRENT PATH OF ECONOMIC EXPANSION."

Technology sector

The technology sector is a double-edged sword. So far this year the sector has been doing particularly well due to the excellent earnings these companies are achieving. While the S&P 500 is up 5%, the Nasdaq composite is up 13.6%. But most companies



are highly dependent on China. Companies like **Nvidia (NASDAQ:NVDA), Apple (NASDAQ:AAPL), Intel (NASDAQ:INTC), Broadcom (NASDAQ:AVGO), Micron Technologies (NASDAQ: MU)**, among many others, crucially depend on the competitive pricing they get for components made in China.

The **SPDR Technology Select Sector ETF (NYSEARCA:XLK)** is composed of the most important technology multinationals. More than 10% of the total revenue of the components of this ETF comes from China. If the trade wars intensify, this ETF will be exposed to high volatility and would be a good candidate for a short sale.

Besides being heavily exposed to the US–China trade wars, this ETF is a little overvalued relative to the broad market. For the last two years it rose twice as much as the S&P 500. With the unemployment rate at historically low levels and GDP rising above its potential rate, we may be approaching a market top. The odds are turning against the sector.

Materials sector

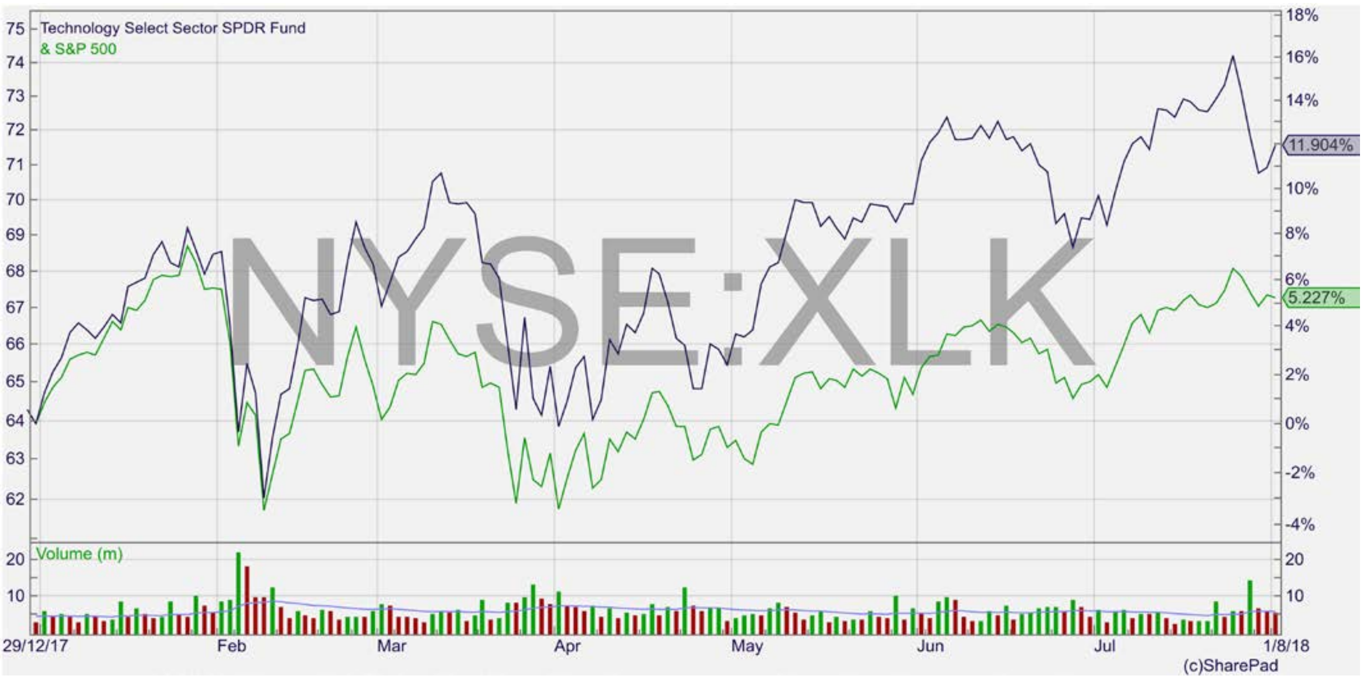
On the positive side we have the materials sector, which has negligible exposure to the US-China trade wars and stands to benefit from the imposition of trade duties. The whole materials sector is a good bet, in particular the US steel and aluminium producers that Trump promised to protect.

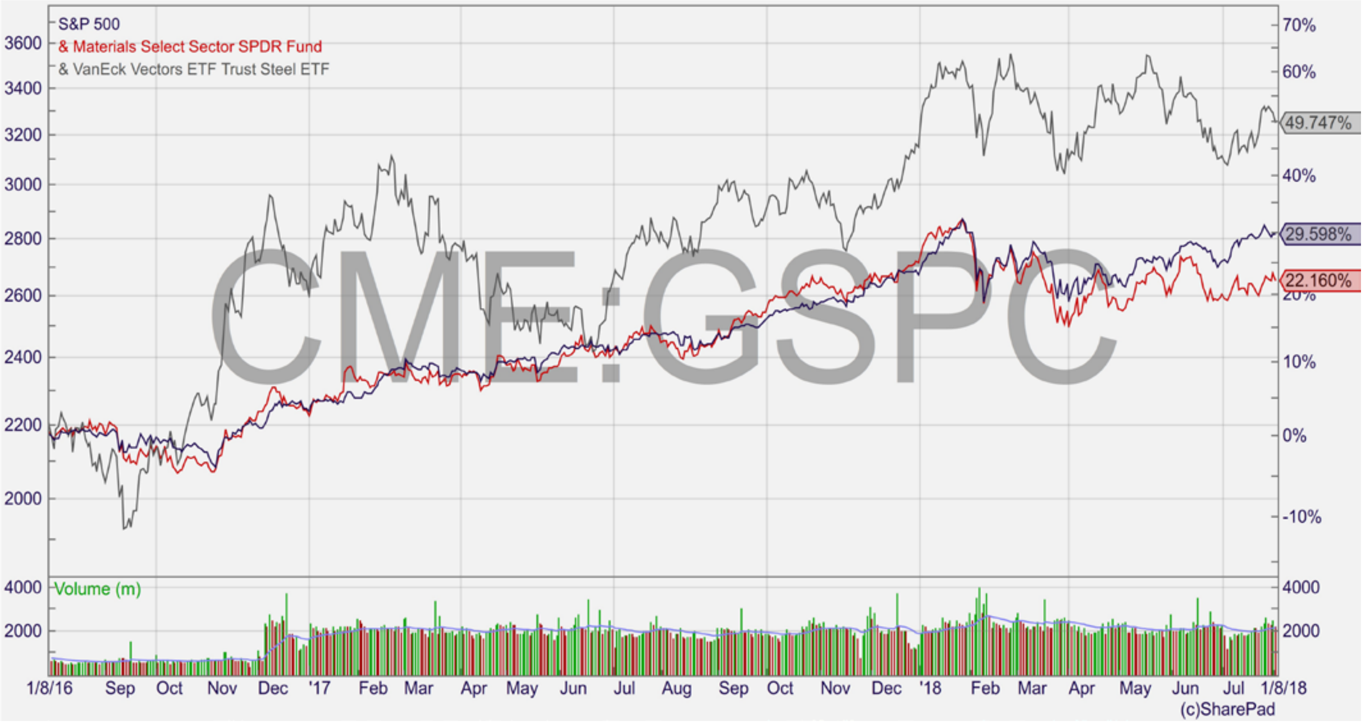
In fact, getting exposure to the US materials sector is not only a bet on trade wars but also on the ongoing promises made by Donald Trump to revive US manufacturing and rehabilitate the country's ageing infrastructure.

A way of getting exposure to the broad sector is through ETFs. Two ETFs stand out from the crowd:

1. **Materials Select Sector SPDR (NYSEARCA:XLB)**

This ETF is composed of large capitalisations engaged in the extraction or production of natural resources. The materials sector often accounts for just a tiny part of broad-based benchmarks, which means investors get underexposure to it when investing in





typical market benchmarks. Adding this ETF to a portfolio gives a good tilt to a sector that is positively exposed to the trade wars. Currently the Materials Select Sector SPDR holds 25 equities, with top holdings being **DowDuPont (NYSE:DWDP), Praxair (NYSE:PX), Ecolab (NYSE:ECL), LyondellBasell Industries (NYSE:LYB**), and **Air Products and Chemicals (NYSE:APD)**. All companies are based in the United States.

2. VanEck Vectors Trust Steel ETF (NYSEARCA:SLX)

This ETF targets steel producers and companies that service and supply them. The holdings are spread across equities around the world, with the US making 37% of the fund, followed by Brazil with 17% and the UK with 12%. The top five holdings are **Rio Tinto ADR (NYSE:RIO), Ternium ADR (NYSE:TX), Vale ADR (NYSE:VALE), Vedanta ADR (NYSE:VEDL)** and **Tenaris ADR (NYSE:TS)**.

Domestic-oriented companies

Another way of playing the trade wars is to avoid multinationals and invest in companies that derive most of their income in the US market. The **iShares Russell 1000 Pure US Revenue ETF** invests in US companies that derive at least 85% of their revenue domestically.

The fund is well diversified with 418 holdings and offers investors a tilt to a theme often praised by Donald Trump – the US domestic market. Top holdings are **Bank of America (NYSE:BAC), UnitedHealth Group (NYSE:UNH), Home Depot (NYSE:HD), Wells Fargo (NYSE:WFC)**, and **Berkshire Hathaway (NYSE:BRK.B)**. The performance of this fund has been flat so far in the year, but if the trade wars intensify, it may quickly improve.

"IF THE TRADE WARS INTENSIFY, THIS ETF WILL BE EXPOSED TO HIGH VOLATILITY AND WOULD BE A GOOD CANDIDATE FOR A SHORT SALE."

How far is Trump willing to go?

Since elected President at the end of 2016, Donald Trump has promised to "Make America Great Again". He believes America agreed unfair trade agreements in the past and is trying to gain leverage to renegotiate these deals in a more favourable manner. So far, investors haven't taken him seriously regarding the promised trade wars. But we can't ignore the fact that $300 billion of goods, once free to cross frontiers, are now attracting tariffs. How far is Trump willing to go? Is the US in a good position to win a trade war against China and the EU? We don't really know the answer. The trade war will most likely be limited in time and scope because, in a full-blown conflict, all countries stand to lose. But in the meantime, the ground is shifting, and some companies are seeing their position improve while others are experiencing turbulence. Avoiding large US multinationals heavily dependent on China while increasing exposure to the domestic US market is a way of exploring the current trends.

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

CAN THE POUND REBOUND?

It has been three months since we last looked at the state of the pound – and in that time the previous positive sentiment has done something of a u-turn, so it seems worthy of another visit.

In April this year, the pound/US dollar (GBP/USD) exchange rate was trading at its best levels since the EU Referendum vote back in June 2016. It had moved above the 1.4300 mark – expectations were for a rate rise in May of this year and the feeling was that the progress of the Brexit negotiations was better than expected. But fast forward to today and the pound has lost around 9% of its value against the dollar since those April highs – what went wrong?

Why has the pound slid so heavily?

A few months ago, the broad expectation was for the Bank of England to raise interest rates in May. To use gambling parlance, it was accepted as an almost "nailed-on" certainty. But as May drew closer, the economic data for the UK started to look somewhat shakier than the central bank was expecting. In the first quarter of the year, the UK economy showed a paltry rate of growth coming in at just 0.1%. Add in lower than expected inflation, and suddenly the Bank's case for raising the interest rate looked less than solid. So, rates stayed put!

On top of this, the changes we have seen in the UK government in recent months did not help. With both David Davis and Boris Johnson exiting stage left, it is perhaps not too surprising that the market's view towards the pound has shifted somewhat, to say the least.

Back in May, I wrote that "Even if the rate was to drop 10c (1,000 points) from here, back to the 1.3000 level, the trend would still be up, and it would just mean that the price has returned to a more normalised value". Although, at the time of writing, I did not think that GBP/USD would have got here quite as quickly as it did.

What next?

This is, of course, always the million-dollar question when it comes to markets. This is still an exchange

"THIS IS STILL AN EXCHANGE RATE THAT IS VERY MUCH DRIVEN BY RUMOURS AND RUMBLINGS SURROUNDING THE UK'S BREXIT DISCUSSIONS."

rate that is very much driven by rumours and rumblings surrounding the UK's Brexit discussions – and any resulting rifts within the government. Towards the end of July, it was announced that Prime Minister Theresa May would be leading Brexit negotiations – so far this has been taken well by the market. But, as we have seen, sentiment can turn very quickly, so any further political resignations suggesting the Theresa May government is not particularly united could translate into further falls for the pound.

Then there is the Bank of England. Following the disappointment of no rate rise in May, the current thinking is that we are finally going to see this happen in August. However, there has already been the fly in the ointment of disappointing data during July – almost replaying the concerns ahead of the expected May decision. On the balance of probabilities, it seems unlikely that the central bank is going to disappoint the market again, so for now, the August rate rise looks likely to go ahead. We could see a short-term boost when this is announced, but foreign exchange markets are always volatile over these sorts of announcements. What it will do, assuming it happens, is calm the market's nerves and increase expectations for further rises, which should put more of a solid floor under any recovery for GBP/USD.

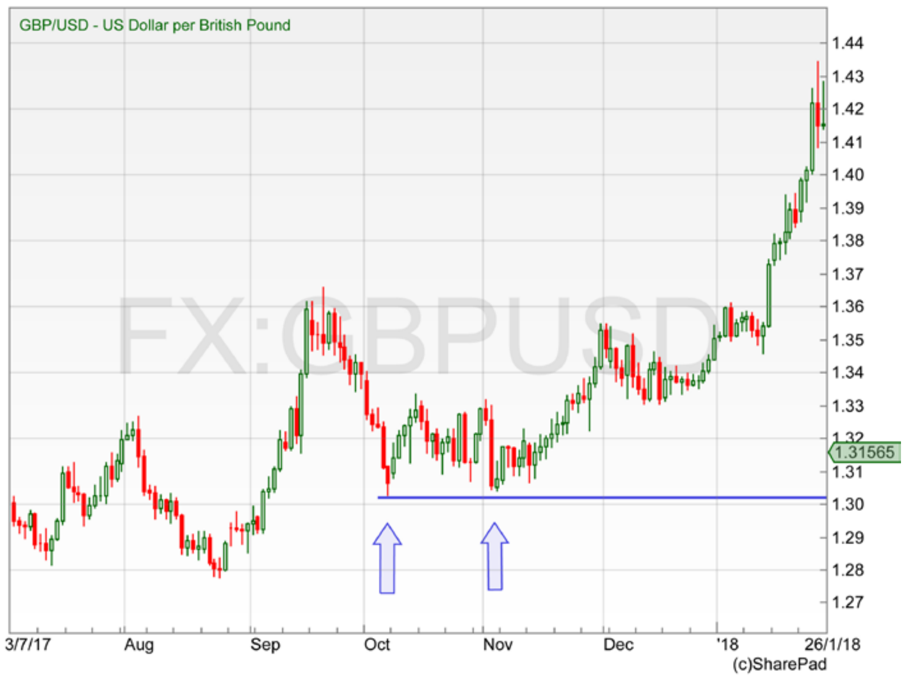
The technical view

As mentioned above, the 1.3000 area was seen as a floor for GBP/USD. From October through to the middle of November 2017, this emerged as a support level for the market, before the run out to the highs above 1.4300. The autumn lows saw buyers repeatedly step in to stop any sell-offs – suggesting that 1.30 was an area where the market saw value.

It is still the area to watch. Admittedly, the slide of the last three months did end up punching below this level with GBP/USD trading as low as 1.2960 on 19 July. So, let's say that 1.2950/1.3000 is the big level of support we should be watching for the pound at the moment. A move below here would put the currency pair at its worst levels since September of last year, and suggest another move lower is starting, with last summer's lows in the 1.2600/1.2800 zone the target.

But while these recent lows hold, it seems the interesting play here is to bet on a recovery. It may be some time before we see the heady heights of 1.43 scaled again, but the recent July support is going to be the focus for many traders. If the market sells off again and holds above those lows, then the argument that an important level has been reached will be strengthened. However, let's not get too carried away with a recovery starting very quickly – we still have the problem of the trend over recent months.

This has done an excellent job of stopping any rallies by the pound. Just when it looks as if the worst is behind the slide, GBP/USD rolls over and plunges lower once more. At the moment, it would take a sustained move through the 1.3300 area to shake this



"WHILE THESE RECENT LOWS HOLD, IT SEEMS THE INTERESTING PLAY HERE IS TO BET ON A RECOVERY."

dogged trend off. So, although the case can definitely made that the chances of a recovery from current levels look better than a coin-toss, a little patience would not go amiss here.

Perhaps the interest rate rise from the Bank of England (assuming it does actually go ahead) will end up being the catalyst that puts GBP/USD on a firmer footing and tees up a longer term recovery, after what has been a torrid few 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 RICHARD GILL, CFA

BOOK REVIEW

SHARES MADE SIMPLE

A BEGINNER'S GUIDE TO THE STOCK MARKET

BY RODNEY HOBSON

No matter how successful a person becomes at one thing in life, they have to start with the basics. Genghis Khan had to learn how to read a map before conquering most of Central Asia. Margaret Thatcher read the Wealth of Nations (reportedly keeping a copy in her infamous handbag) as she revitalised the UK economy in the 1980s. And Jim Bowen had to learn his craft on the northern club circuit before becoming one of the greatest entertainers of the past 50 years. It is the same with investment – and where better for any Warren Buffett of the future to start, than the classic beginner's guide *Shares Made Simple*?

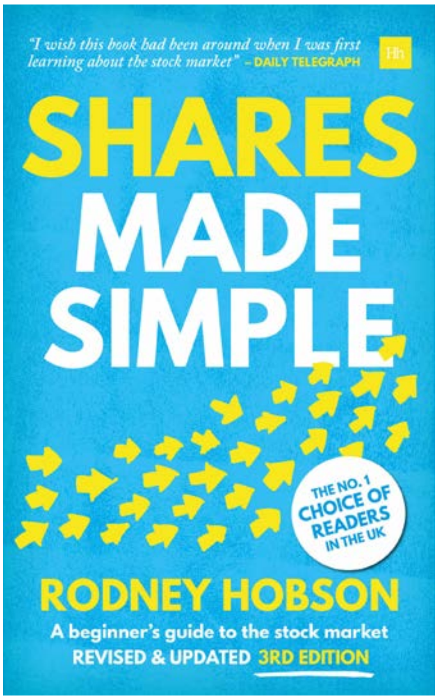
Author of *Shares Made Simple*, Rodney Hobson, is an experienced financial journalist who has held senior editorial positions with a range of publications in the UK and Asia and is currently Editor of Ipreo, an international financial services group. He has also been News Editor for the Business section of The Times, Head of News at Citywire and Editor of Shares magazine. I have reviewed a number of Hobson's other books over the years, including *Small Companies Big Profits, Understanding Company News, How to Build a Share Portfolio* and *The Dividend Investor*, but not the Inspector Amos mystery series which Hobson has written in addition to his investment titles.

> "SHARES MADE SIMPLE IS WRITTEN WITH THE BEGINNER INVESTOR IN MIND."

Equities easily explained

Shares Made Simple is written with the beginner investor in mind, both those who are new to the world of equities and those who might have already had a dabble at dealing but want to deepen their knowledge of the stock market. The book is organised into five chapters, which logically follow on from one another, explaining in simple terms exactly how shares work. This is the third edition of a book which was first published in November 2007, just months before the great financial crisis started to take hold, with the text updated to explain the main concepts with topical case studies.

To kick off, Chapter One explains exactly what shares are, how they are created, why they exist and how companies are run. More interestingly, what you get as an owner of shares is then covered. Investors usually enjoy gains from shares in two ways, from



"AN EASY TO READ AND JARGON FREE GUIDE ON HOW EQUITIES WORK."

receiving dividends out of annual or semi-annual profits and from capital gains by selling shares to someone else for a higher price than they bought them. But Hobson also covers the often forgotten third way of benefitting from shares, shareholder perks. Shareholders in Marks & Spencer, for example, get sent money saving vouchers every year, while owners of Newbury Racecourse can enjoy a free day at the races.

With the basics covered, Chapter Two delves into the world of the stock market and how shares are traded. The role and history of the London Stock Exchange is explained, from its beginnings in the coffee houses of Lombard Street (now a Sainsbury's), through to the Big Bang of the 1980s and today's role as one of the world's major trading venues. For investors who like something a bit more exotic, Hobson covers the Alternative Investment Market (AIM) and the benefits and pitfalls of investing in shares listed on the popular junior exchange.

Moving on, Chapter Three takes a look at companies themselves, and perhaps most importantly, explains how to read and interpret company accounts. This is perhaps the highlight of the book for me, with Hobson giving clear and simple guidance on how to go through each element of an income statement and balance sheet. While covering basic accounting concepts, this section will set up any investor for life in this core investment skill. Finally in this section, he gives guidance on how to spot any potential nasties in company statements, cutting through the PR spin and how to find out what is really going on with your investment.

Having built up some good knowledge, Chapter Four gets to the exciting part: how to invest. Hobson explains how to find a stockbroker to trade with and the various types of trading accounts available, from execution only to the more modern direct market access. Following this is brief coverage of the foundation of an investor's toolkit, how to analyse data to decide which shares to invest in. Fundamental concepts, such as the dividend yield and price earnings ratio are discussed, along with the basics of chart based analysis techniques including floors, ceilings and the mysterious narrowing triangles.

Finally, Hobson takes a look at the weird and wonderful world of takeovers. While this might be a slightly more advanced topic for the beginner investor, mergers & acquisitions can be very exciting due to their ability to deliver large gains within a short period of time. The various types of takeover are discussed, along with how the different stages of deals work and how investors might make a return. The lesson is to be a holder of shares in a company being taken over, as acquirers often pay a decent premium to the pre-bid share price. Identifying companies about to be taken over, however, is a slightly more advanced matter.

A simple investment

Shares Made Simple does exactly what it says on the tin, providing beginner investors with an easy to read and jargon free guide on how equities work. Hobson is a master of his craft, using his many years of journalism experience to create a work which should remain in the bestsellers list for years to come, just like it has done for the past decade. Not only is it a perfect primer for amateur investors, and those who work in the finance industry, the book is also a useful reference guide for those professionals who might need a quick refresher from time to time.

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

HOLDING OUT FOR A HERO

For the best part of the last year, my spare moments have been spent being transfixed by a remarkable book – William Manchester and Paul Reid's magisterial three volume biography of Winston Churchill, *The Last Lion*. Churchill's entire life was eventful, but it's the second volume ('Alone, 1932-1940') which has the eeriest resonances for the modern reader during Britain's Brexit crisis.

Here, for example, is Manchester on the strange way in which almost the entire British establishment fell under the spell of Hitler and the Nazis:

> The foreign secretary, Sir John Simon, had his own euphemism for the rebuilding of the Reich's armed might. It was "parity". His resolve – and the cabinet's – was to sanction an expanding German army while disarming the French, until, after an infinite number of carefully monitored phases, both nations possessed the same number of soldiers, tanks, artillery pieces, warplanes and warships.
>
> *The Times* thought it "essential" that the Germans be permitted "to build the forbidden weapons at once." Restoring Germany's martial might would restore her pride and strengthen her feelings of security; then Germany and England, "in company," would launch a program of genuine, large-scale disarmament. The prime minister was first impressed, then inspired. Thus was the seed of the extraordinary MacDonald plan implanted. Its first tenet was that England, as the conscience of Europe, would divest herself of her most formidable weapons. ***The press, the universities, labour unions, and every sounding board of public opinion would enthusiastically endorse the plan.*** When the League of Nations Union conducted a nationwide poll, the Peace Ballot, it found that 10.4 million Britons favoured international disarmament, while 870,000 – about 8 percent – opposed it.

This next extract is from Boris Johnson's more recent account of the appeasement crisis, first published in [The Daily Telegraph]:

> David Lloyd George had been so dazzled by the Führer that he compared him to George Washington. Hitler was a "born leader", declared the befuddled former British prime minister. He wished that Britain had "a man of his supreme quality at the head of affairs in our country today". This from the hero of the First World War!
>
> *The Daily Mail* had long been campaigning for Hitler to be given a free hand in eastern Europe, the better to beat up the bolshies. "If Hitler did not exist," said the Mail, "all western Europe might now be clamouring for such a champion."
>
> *The Times* had been so pro-appeasement that the editor, Geoffrey Dawson, described how he used to go through the proofs taking out anything that might offend the Germans. The press baron Beaverbrook himself had sacked Churchill from his *Evening Standard* column on the grounds that he was too hard on the Nazis. Respectable liberal opinion – theatre types like John Gielgud, Sybil Thorndike, GB Shaw – was lobbying

"INVESTORS WHO SEEK A SMOOTHER RIDE FOR THEIR INVESTMENTS MAY FIND SAFER HAVENS IN FOREIGN CLIMES."

"NEVER IN A MILLION YEARS DID I EXPECT THE FORCES OF THE ESTABLISHMENT TO TRADUCE 17.4 MILLION PEOPLE AND THEIR VOTES SO ABYSMALLY."

for the government to "give consideration" to talks.

Of course, the mood had changed in the last year; feelings against Germany had hardened. All I am saying – in mitigation of Halifax – is that, in seeking peace, he had the support of many British people, at all levels of society. And so the argument went on, between Halifax and the prime minister, for that crucial hour.

It was a stalemate; and it was now – according to most historians – that Churchill played his masterstroke. He announced that the meeting would be adjourned, and would begin again at 7pm. He then convened the Cabinet of 25, ministers from every department – many of whom were to hear him as prime minister for the first time.

The bigger the audience, the more fervid the atmosphere; and now he made an appeal to the emotions. Before the full Cabinet he made a quite astonishing speech – without any hint of the intellectual restraint he had been obliged to display in the smaller meeting.

He began calmly enough: "I have thought carefully in these last days whether it was part of my duty to consider entering into negotiations with That Man."

And he ended with this almost Shakespearean climax: "And I am convinced that every one of you would rise up and tear me down from my place if I were for one moment to contemplate parley or surrender. If this long island story of ours is to end at last, let it end only when each one of us lies choking in his own blood upon the ground."

At this the men in that room were so moved that they cheered and shouted, and some of them ran round and clapped him on the back.

Churchill had ruthlessly dramatised and personalised the debate. By the time the War Cabinet resumed at 7pm, the debate was over; Halifax abandoned his cause. Churchill had the clear and noisy backing of the Cabinet.

Within a year of that decision – to fight and not to negotiate – 30,000 British men, women and children had been killed, almost all of them at German hands. Weighing up those alternatives – a humiliating peace, or a slaughter of the innocents – it is hard to imagine any modern British politician having the guts to take Churchill's line.

He had the vast and almost reckless moral courage to see that fighting on would be appalling, but that surrender would be even worse. He was right.

Having cast my vote for 'Leave' in June 2016, I rashly thought that having won the referendum against the combined mass of the British establishment, almost all of the City, the CBI, the TUC, almost all economists, almost all conventional media and a highly partisan Bank of England, that Brexit would mean Brexit, and would simply drop into our laps like the gentle rain from heaven. Clearly, that view was, with hindsight, foolishly naïve. But never in a million years did I expect the forces of the establishment to traduce 17.4 million people and their votes so abysmally. If, as seems increasingly likely, we drift towards one of the most serious constitutional crises in our nation's history, it will not be because the Leave campaign won. It will be because the British establishment never even acknowledged the will of the people and, worse still, did everything in its power to overturn or frustrate it. That is not democracy, that is treason. The referendum was democratically approved in Parliament, and both major parties made delivering Brexit a core part of their manifesto pledges at the last General Election. Those who seek to overturn Brexit should be forced to go and live in a banana republic where overturning legitimate vote choices is a way of life.

The British philosopher John Gray, almost immediately after the referendum, made the following (now hugely prescient) comments about the result:

> Predictably, there is speculation that Brexit will not happen. If Britain can vote for Brexit, it is being argued, surely anything is possible. But those who think the vote can be overturned or ignored are telling us more about their own state of mind than developments in the real world. Like bedraggled courtiers fleeing Versailles after the French Revolution, they are unable to process the reversal that has occurred. Locked in a psychology of despair, anger and denial, they cannot help believing there will be a restoration of an order they believed was unshakeable.

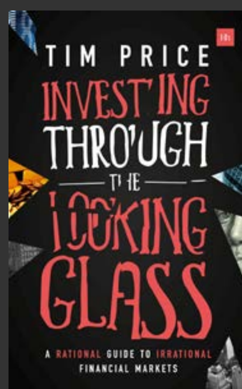
We expect political crises in banana republics. We do not expect them in the birthplace of modern democracy. Members of Continuity Remain have already done huge damage to Britain's political legitimacy. While one hopes there is time and the wherewithal to remedy the situation, investors who seek a smoother ride for their investments may find safer havens in foreign climes. I worry for my country and I am ashamed of the dismal democratic vacuum that passes for our government.

We are now more than two years on from the Brexit referendum of June 2016, in which 17.4 million Britons voted to leave the European Union – the largest vote for anything, ever, in the history of the United Kingdom. It is impossible to watch the Brexit crisis two years later without being reminded of the 1930s appeasement crisis – when seemingly almost the entire British nation, including its politicians, its intellectuals, its media, most of its major institutions, and its civil service, whilst fearful of the threat of advancing Bolshevism, fell under the spell of an untrustworthy continental dictator negotiating in bad faith. One man could see what they could not, and was willing to fight to defend the cause of democracy and national self-interest. So where is our Churchill today?

"THOSE WHO SEEK TO OVERTURN BREXIT SHOULD BE FORCED TO GO AND LIVE IN A BANANA REPUBLIC WHERE OVERTURNING LEGITIMATE VOTE CHOICES IS A WAY OF LIFE."

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'.



AUGUST 2018

INVESTOR EVENTS DIARY

EVERY WEDNESDAY

Event:	SR Live
Organiser:	SyndicateRoom
Time:	12:30
Place:	Webinar
Link for tickets:	https://www.syndicateroom.com/events/sr-live

TUESDAY, 11 SEPTEMBER

Event:	Fund Twenty8 launch
Organiser:	SyndicateRoom
Time:	Evening
Place:	London TBC
Link for tickets:	Register interest by emailing amanda@masterinvestor.co.uk

TUESDAY, 28 AUGUST

Event:	4th Mayor of London's TechInvest – FinTech
Organiser:	UKBAA and Mayor of London
Time:	15:30-18:30
Place:	London's Living Room City Hall The Queen's Walk London SE1 2AA
Link for tickets:	http://techinvest.london/event-4-fintech-investors

TUESDAY, 18 SEPTEMBER

Event:	Panel Discussion: MIFID II Impact on Research and Stock Market Liquidity
Organiser:	IR Society / NEX Exchange / Shoos-miths / Hardman & Co
Time:	08:00-09:30
Place:	Shoosmiths, 2 Hardman Boulevard, Spinningfields, Manchester, M3 3HF
Link for tickets:	https://www.eventbrite.co.uk/e/mifid-ii-revolution-blues-tickets-47544961259

WEDNESDAY, 19 SEPTEMBER

Event:	Panel Discussion: MIFID II Impact on Research and Stock Market Liquidity
Organiser:	IR Society / NEX Exchange / Blankstone Sington / Hardman & Co
Time:	12:30-14:00
Place:	Blankstone Sington, Walker House, Exchange flags, Liverpool, L2 3YL
Link for tickets:	https://www.eventbrite.co.uk/e/mifid-ii-revolution-blues-tickets-47544961259

THURSDAY, 1 NOVEMBER

Event:	Master Investor: Investing in the age of longevity
Organiser:	Master Investor
Time:	10:00
Place:	Wellcome Collection, 183 Euston Rd, Kings Cross, London NW1 2BE
Link for tickets:	https://www.eventbrite.co.uk/e/investing-in-the-age-of-longevity-tickets-47844757959

FRIDAY, 9 NOVEMBER

Event:	Manchester Investor Show
Organiser:	Investor Conferences (UK)
Time:	09:30-17:00
Place:	Mercure Manchester Piccadilly, Portland Street, Manchester M1 4PH
Link for tickets:	https://www.eventbrite.co.uk/e/manchester-investor-show-2018-tickets-44687126398

FRIDAY, 9 NOVEMBER

Event:	Master Investor: Manchester
Organiser:	Master Investor
Time:	17:30
Place:	Mercure Manchester Piccadilly, Portland Street, Manchester M1 4PH
Link for tickets:	https://www.eventbrite.co.uk/e/master-investor-manchester-keynote-seminar-with-jim-mellon-tickets-47986867011

MARKETS IN FOCUS

JULY 2018

GLOBAL EQUITIES

Index	Last Month %	YTD%	Proximity to 52w High*
Bovespa	8.9	3.7	
Dow Jones	4.7	2.4	
DAX Xetra	4.1	-1.4	
S&P 500	3.6	5.1	
CAC 40	3.5	3.5	
Euronext 100	3.2	4.2	
NASDAQ 100	2.7	13.5	
IBEX 35	2.6	-1.7	
Russian TSI	1.9	0.8	
FTSE 100	1.5	-0.5	
S&P/ASX 200	1.4	3.5	
Nikkei 225	1.1	-0.1	
Hang Seng	-1.3	-5.3	

COMMODITIES

Commodity	Last Month %	YTD%	Proximity to 52w High*
Cotton	6.8	19.8	
Iron Ore	4.5	-0.6	
Gold	-1.7	-5.8	
Platinum	-2.0	-9.9	
Palladium	-2.2	-12.5	
Silver	-3.9	-9.4	
Copper	-4.6	-14.2	
Natural Gas	-4.8	-5.9	
Coffee	-5.1	-8.7	
Crude oil (Brent)	-6.5	10.8	
Crude oil (Light Sweet)	-7.9	13.2	
Cocoa	-11.5	20.0	
Sugar (No. 11)	-13.9	-22.8	

FOREX

Pair/Cross	Last Month %	YTD%	Proximity to 52w High*
EUR/JPY	1.1	-3.7	
USD/JPY	1.0	-1.1	
EUR/GBP	0.7	0.0	
AUD/USD	0.2	-5.2	
EUR/USD	0.0	-2.7	
EUR/CHF	0.0	-1.0	
USD/CHF	0.0	1.7	
GBP/USD	-0.7	-2.7	
GBP/AUD	-0.9	2.7	
USD/CAD	-0.9	3.2	

CENTRAL BANKS - RATES & MEETINGS

Central Bank	Key Rate	Next	After
BOE	0.50%	Aug 02	Sep 13
ECB	0.00%	Sep 13	Oct 25
FED	2.00%	Aug 01	Sep 26
BOJ	-0.10%	Sep 19	Oct 31
SNB	-0.75%	Sep 20	Dec 13
BOC	1.50%	Sep 05	Oct 24
RBA	1.50%	Aug 07	Sep 04
RBNZ	1.75%	Aug 09	Sep 27
BOS	-0.50%	Sep 05	Oct 23
BON	0.50%	Aug 16	Sep 20

FTSE 350 TOP

Company	Last Month %	YTD%	Proximity to 52w High*
Vedanta Resources PLC	26.8	1.7	
John Laing Infrast Fund	18.7	14.1	
Meggitt PLC	15.6	17.9	
Stagecoach Group PLC	12.7	-2.2	
Homeserve PLC	12.6	22.1	

FTSE 350 BOTTOM

Company	Last Month %	YTD%	Proximity to 52w High*
TP ICAP PLC	-33.6	-47.1	
Playtech PLC	-28.6	-37.3	
Sophos Group PLC	-24.4	-16.0	
Indivior PLC	-20.2	-26.5	
Just Group PLC	-19.8	-36.4	

FTSE 350 SECTORS TOP

Sector	Last Month %	YTD%	Proximity to 52w High*
Industrial Metals	9.0	30.8	
Tobacco	8.3	-15.0	
Fixed Line Telecom	6.8	-15.6	
Pharma & Biotech	5.8	14.4	
Chemicals	5.6	18.2	

FTSE 350 SECTORS BOTTOM

Sector	Last Month %	YTD%	Proximity to 52w High*
Food Producers	-7.3	-13.1	
Electricity	-6.0	-3.6	
Software & Comp Serv	-4.1	-24.4	
Gas, Water & Mult	-3.8	-8.2	
Health Care Equip & Serv	-1.8	2.9