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THE UK'S NO.1 FREE INVESTMENT PUBLICATION

INVESTING FOR GROWTH

PLUS...

CORRECTION OR BEAR MARKET?

HOW MUCH LONGER CAN THE BULL MARKET LAST?

GOLD TO SHINE AGAIN?

RISK-OFF TRADE COULD SEND INVESTORS FLOCKING BACK

WH SMITH

A SOLID CHOICE FOR DIVIDEND GROWTH

JUMP ON THE BANDWAGON

OUR GUIDE TO IDENTIFYING AND FOLLOWING TRENDS

WELCOME

Dear Reader,

Welcome to the November issue of Master Investor Magazine. This month, we explore the theme of Investing for Growth. Of course, everyone wants growth from their investments, right? That's true, but as human beings we have a tendency to focus disproportionately on the present, which can lead to an overly conservative approach to investing.

This is especially true when it comes to investing for retirement. The average pension fund still invests heavily in fixed income products, even during the early stages of a plan when the recipient still has many decades to work and can tolerate a greater level of volatility in their annual returns. Although a high fixed-income allocation has served investors well in an environment of declining interest rates, the outlook looks less favourable now that rates appear to be on the up.

So-called 'lifestyle' plans dictate allocating a greater proportion of a plan's assets to fixed income and other 'low risk' products as retirement approaches, but this approach could be exposing many people to unnecessarily inferior levels of long-term returns, especially if they have the flexibility to remain invested through income drawdown rather than cashing in their pot in order to buy an annuity.

Similarly, putting too much emphasis on income in a portfolio can also be detrimental to long-term returns, particularly in a world where change is accelerating, and established players are being disrupted at an unprecedented rate. In this context, allocating even a small amount of a portfolio to growth equities can provide a useful hedge and help to ensure your overall capital maintains and grows its purchasing power over the long term.

Best regards,

James Faulkner
Editor

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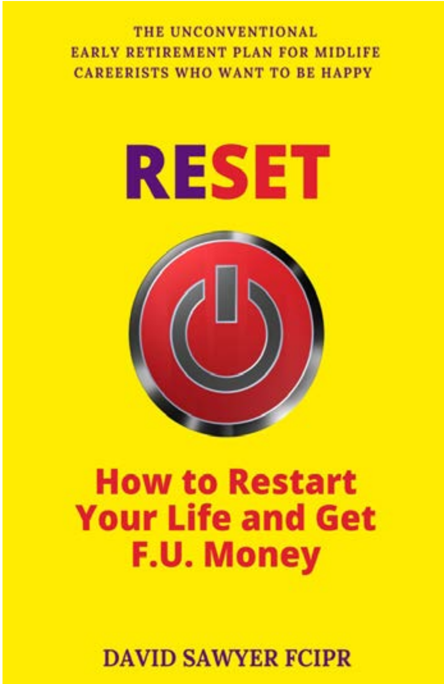

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BY JIM MELLON

MELLON ON THE MARKETS

This letter is being written on Emirates Airlines on an exceptionally long journey from Sydney to London (28 hours, 7 hours layover in Dubai). Among the many things running through my jet-lagged mind include the thought: *How do the Gulf airport hubs survive the arrival of a host of very long-haul flights (e.g. via Quantas Perth to London)*?

Airlines like Emirates, Qatar and Etihad have built enormous networks based on passenger interchange and having a huge flow of passengers through their airports (Dubai Airport is NOT good in my experience). Once people can go from wherever to wherever, will they bother to go on airlines that stop en route? I have to believe that relative to their tiny size, the airline business is important to countries such as Dubai, and probably drives quite a lot of in-transit tourism.

However, being stuck on a plane for more than 17 hours is probably not good for the body and soul. So, maybe there will still be a role, and besides I only get caviar on Emirates, so I think I will stick with it!

Related, and I think interesting, is that some US airlines make more money from their loyalty schemes than from their actual operations. This is because card companies and

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"AT LONG LAST, MY CALL ON THE FAANG STOCKS IS COMING RIGHT."

Lewis Cheng / Shutterstock.com

others buy miles to "reward" their users, and that money – and lots of it – flows to the airline's bottom line. After all, you can only use these miles when the airlines have empty capacity – and in many cases, that is a forlorn hope, at least in my experience with our very own flag carrier.

But it also probably means that US airlines – which in the past were hugely buffeted by oil prices and a downturn in load factors in recessionary conditions – may be able to weather the storm better. When I was a young US fund manager, airlines were a no-no, and the great Warren Buffet so-described them with choicer words, but maybe now they are worth watching. They are still indescribably awful to fly on, though, staffed as they are by inattentive unionised and self-entitled people, and of course, a packing system that would do a sardine factory proud.

Return to Oz

I haven't exactly counted how many times I have been to Australia, but it's well over a hundred and I love it very much. I have some of my best friends there, and it is indeed a lucky and seemingly generally happy country. I am concerned, however, to see the Economist magazine of this week eulogizing the place, praising its rapid growth and sound economic policies. Firstly, those sorts of hagiographic articles (see Business Week c.1989 regarding Japan) normally foretell or coincide with a peak in fortunes. Secondly, I don't think all is well with the Australian economy – the banks are far too exposed to residential and commercial property, consumers are highly indebted, and a lot of GDP growth is the result of immigration. There is also a tax on anything and a lot of rules that an observant and large bureaucracy assiduously enforces.

Beware of magazine writers paying your country a visit with praise in mind!

I did get to watch Prince Harry sweep by in his cavalcade – and watch his expert and attuned performance on TV. I imagine that Australia will one day be a Republic, but there are strong ties that bind us in the UK to them and they seem to my casual eye to be getting stronger, not weaker.

Lessons learned

Now, to money. At long last, my call on the FAANG stocks is coming right, with my No.1 bugbear **Facebook (NASDAQ:FB)** falling fastest. But the warnings of coming regulations, banking-like fines, mounting competition and slowing growth is all becoming clear. These stocks are to be avoided.

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"I THINK THAT THE US MARKET (AND POSSIBLY, EVERYTHING ELSE, EXCEPT JAPAN) IS NOW IN CONFIRMED BEAR MARKET TERRITORY."

Tesla (NASDAQ:TSLA) falls in the same category. I don't know what sort of stuff goes on there, and I am not going to speculate, but I do not believe this company in any way still justifies its ridiculous valuation.

I put my hand up to support the emergency share placement for **Patisserie Holdings (LON:CAKE)**, but it was closed by the time I got there. I honestly can't fathom what has gone on there, but clearly the finance director was up to no good – and certainly very good at covering his tracks.

When everything seems too good, it normally is. This is a lesson I try to take every day. But we are all blindsided from time to time (hopefully not in our own businesses though).

Some years ago, I bought shares in **Synergy Pharmaceuticals (NASDAQ:SGYP)**, it being from the US. This company has an approved drug (for constipation) on the market, but sales have proved disappointing and the company made the fatal error of trying to build its own sales network, and worse, borrowed money to do it. It now looks terminal and although my position wasn't large, it still hurt.

Another lesson learnt – in biopharma, don't build your own sales force except for a rare indication, and repeat the old mantra every day: *a dollar of debt can sink the biggest ship.* This company had a market capitalisation of well over $1 billion. It is now $100 million. Patisserie had a worth of $550 million. It is now going to be a small fraction of that.

Mamma Mia!

Overall, I think that the US market (and possibly, everything else, except Japan) is now in confirmed bear market territory, and being short bonds, long cash and gold (which is acting better) is the right strategy.

But, I am impressed by some results in my area of minor expertise – **Gilead (NASDAQ:GILD)**, at around $68 per share, is very cheap and can be safely bought, and as a co-founder of **Biohaven (NYSE:BHVN)**, this company looks increasingly convincing, currently at around $35 per share.

Meantime, Brexit grinds on, but towards a soft mattress of no great import. Much more importantly, as I keep banging on, is Italy, which is Mamma Mia – and not in an Abba, but a D minus way.

This next week is going to be a test of my faith in Juvenescence – as soon as I get back, I launch into various events, including the Master Investor Longevity Forum, which is going to be a blast. Then it's off to NYC for two days (one night) for more longevity stuff, then straight back to the Isle of Man for more of the same. And in recent weeks, Singapore, Hong Kong, Australia and, of course, Israel (wonderful) have been on the agenda.

I better start taking the (longevity) drugs!

Happy Hunting!

Jim Mellon

Your chance to hear more from Jim Mellon

We are delighted to have Jim presenting at our pioneering event in Manchester.

Master Investor Manchester (9 November 2018)

Exclusive keynote seminar packed with Jim's investment predictions and leftfield ideas. Find out where the Master Investor is putting his money in 2019 – an evening not to be missed!

Find out more and sign up:
https://masterinvestor.co.uk/events/master-investor-manchester

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

GOING FOR GROWTH

AN INTERVIEW WITH LAURA FOLL OF HENDERSON OPPORTUNITIES TRUST

James Faulkner: The Henderson Opportunities trust seeks to deliver capital growth from a portfolio of primarily small-cap equities. What's the environment like for growth investors at present? Are valuations looking stretched or is there still lots of value out there?

Laura Foll: *It's a good environment to be a growth investor. Companies that have strong forecasted earnings growth and are delivering at or beyond these forecasts are (on the whole) performing well. For the growth investor in the UK there is a wide variety of genuinely exciting smaller companies in which to invest, and we are finding most of these opportunities at the moment on AIM.*

I would describe valuations as 'mixed' – there are certainly some companies where the market cap looks high relative to the current levels of sales and earnings, but we often also come across companies where we are surprised (positively) at the multiple we are being asked to pay given the level of earnings growth available. I think this reflects the breadth of companies that we are able to invest in given we are looking across all market caps (from AIM to the FTSE 100).

JF: Do you take a top-down or a bottom-up approach? Which sectors in particular do you find yourselves being drawn to right now?

LF: *We take a bottom-up approach based on meeting company management. Therefore, the sector weightings are more of an 'output' rather than something we explicitly target, and often broad sector classifications tell you little about the end market exposures of a company. As an example,* ***Boku (LON:BOKU)****, a technology company that allows companies like Spotify to charge customers through their mobile phone*

> **"FOR THE GROWTH INVESTOR IN THE UK THERE IS A WIDE VARIETY OF GENUINELY EXCITING SMALLER COMPANIES IN WHICH TO INVEST, AND WE ARE FINDING MOST OF THESE OPPORTUNITIES AT THE MOMENT ON AIM."**

"WE WORRY MORE ABOUT INDIVIDUAL STOCK VALUATIONS THAN THE DIRECTION OF THE MARKET AS A WHOLE."

bills, is classified as an Industrial, in the same sector as companies such as ***Rolls-Royce (LON:RR.)****. The two companies should not move together!*

JF: What criteria do you look for when you select stocks for the trust?

LF: *First and foremost, we look at their capacity to grow earnings. A company where earnings are forecast to stand still will often end up in decline faster than analysts are expecting. Once we are comfortable that a company has the capability to grow, we take a number of other factors into account, including the quality of the management team, whether there are strong barriers to entry in the industry, uniqueness of the product and valuation.*

JF: One of the beauties of investing in smaller companies is the fact that they are relatively under-researched and off the beaten track for most investors. Can you give our readers a few examples of companies in the portfolio that you feel have yet to be fully appreciated by the market?

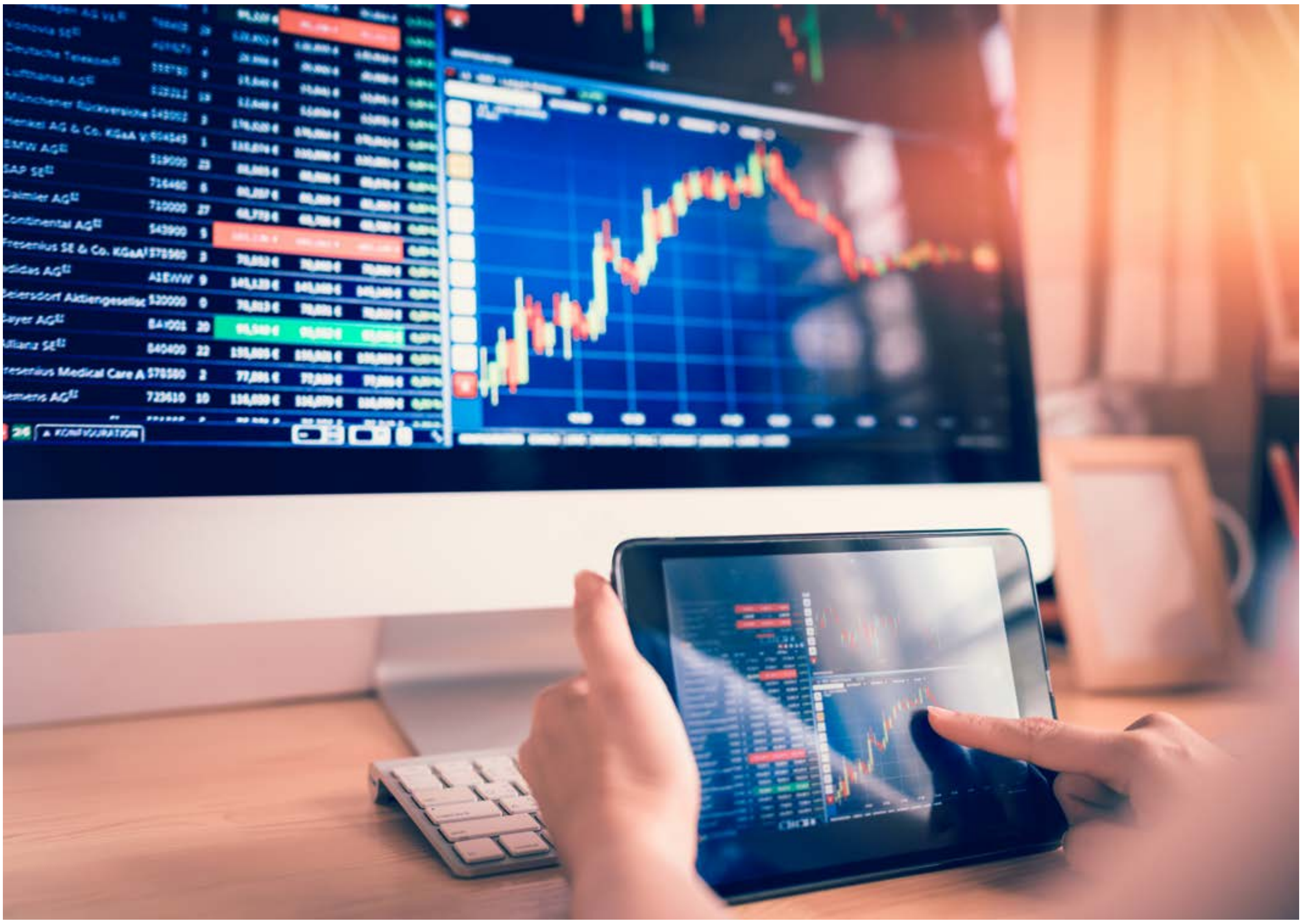
LF: *An addition to the portfolio this year has been* ***Zoo Digital (LON:ZOO)****, which provides dubbing and subtitle services to content producers. This has been listed on the market for a long time and on traditional valuation multiples (such as price/earnings) looks highly rated. However, sales growth is inflecting and the desire of content producers to roll out content quickly and internationally is increasing demand for their comparatively lower cost services.*

A portion of the Opportunities Trust portfolio is in recovery situations, where companies have fallen out of favour, but we still see good scope for earnings growth over the long term. In the current market environment, where a company disappoints relative to forecasts the share price reactions are severe, and this can present us with opportunities. Two recent additions in this area have been ***Eve Sleep (LON:EVE)*** *(a mattress manufacturer) and* ***Quiz (LON:QUIZ)*** *(a clothing retailer).*

JF: Small cap stocks fell heavily on the news of the Brexit vote, yet they have bounced back strongly since then. But given that a no-deal Brexit now looks like a distinct possibility, how do the risks for smaller companies stack up versus their larger counterparts?

About Laura Foll

Laura Foll is a Fund Manager at Janus Henderson Investors, a position she has held as part of the Henderson team since 2014. Laura joined Henderson in 2009 as part of the graduate scheme. She was subsequently named a global analyst on the value and income team and later an assistant fund manager for the Global Equity Income Team. She was named Co-Fund Manager on Lowland Investment Company in 2016 and on Henderson Opportunities Trust in September 2018. Laura graduated from the London School of Economics with an honours degree in economic history with economics. She holds the Chartered Financial Analyst designation and has nine years of financial industry experience.



"IN THE CURRENT MARKET ENVIRONMENT, WHERE A COMPANY DISAPPOINTS RELATIVE TO FORECASTS THE SHARE PRICE REACTIONS ARE SEVERE, AND THIS CAN PRESENT US WITH OPPORTUNITIES."

LF: *There is a definite risk from a no-deal Brexit, but this is best looked at on a company by company basis, rather than on a small cap versus large cap basis. Some of the small cap companies held (for example, a small subset of the fund is in early stage companies that have often been spun out of universities) should be relatively insulated from a no-deal Brexit as they are quite binary in nature. However, that is not to downplay the risks of a no-deal Brexit and there are certainly companies held that will be negatively affected by it. For example, we hold relatively little in retailers, but if sterling was to fall following a no deal Brexit, this would mean higher input costs for them, which they may struggle to pass on to the end consumer.*

Ultimately, our view of how best to mitigate Brexit risk is to hold a deliberately diverse mix of companies and aim to pick companies with experienced management teams that will be best placed to guide the company through a potentially difficult time.

JF: The trust is currently trading at a significant discount to NAV. Does that reflect a certain pessimism about the outlook for smaller companies given how late we are in the cycle right now?

LF: *The discount exists for a number of reasons. First and foremost is, we think, negativity towards the UK as a whole, and this is reflected in the wide discounts that can be seen in the UK Smaller Companies, UK All Companies and UK Equity Income sectors. There is also a rational (small) discount for the underlying illiquidity in some of the small stocks held.*

JF: One of the risks growth investors face is that of overpaying – especially if growth disappoints. How do you avoid overpaying for growth, and can you provide any examples from the portfolio of where you got it wrong and why?

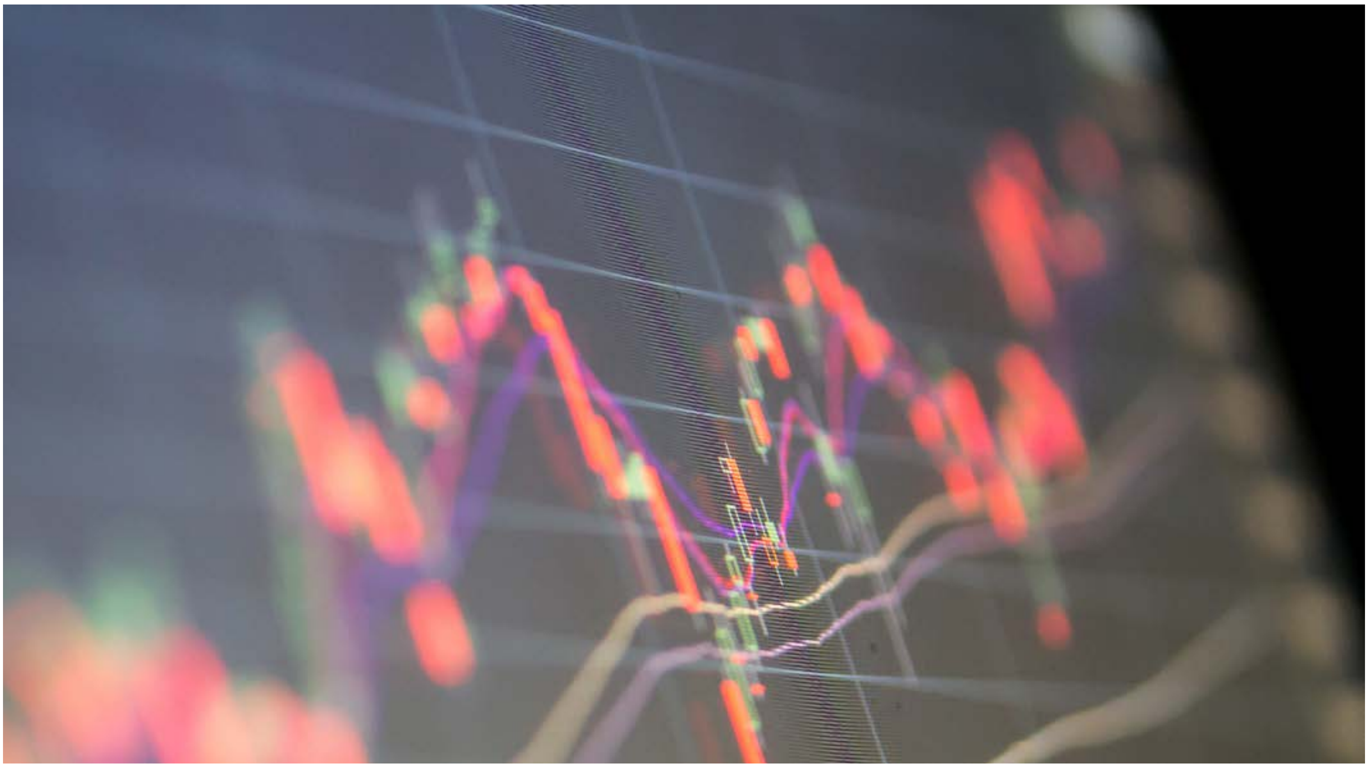
LF: *It's a very good question, as valuing growth companies can be difficult (there is often no 'backstop' for valuation, such as a net asset value). What we have found works well is, at the point of investing, paying close attention to valuation (and we often look at, for example, market cap adjusted for debt relative to sales for this). After investing, if the shares do re-rate, we will then reduce but in small portions, as we have found it is best to 'run our winners'.*

The largest detractor year to date and one which in hindsight we got wrong was Conviviality, which was an alcohol distributor and also owned the 'Bargain Booze' franchise. This had been a much-loved smaller company as the management team had built (what looked like) a good track record of acquisitions, buying, for example, the Matthew Clarke alcohol distribution business. In hindsight the valuation had become too high for a low margin business, and we had not appreciated the lack of internal controls within the business. The lesson learned is to not get carried away with what should be low multiple businesses. In other words, keep reminding ourselves of what the nature of the business is, and if in that context the multiple looks high, reduce the position.

JF: Many successful growth investors talk of the importance of cutting losers from the portfolio early and running winners. Is this good advice? How do you decide when to sell out of a position?

LF: *We advocate running our winners, and when we do reduce, tend to do so in small size (as long as the original reason for owning still holds true).*

We are less strict on cutting losers, and sometimes this can be right as markets can be too short term. Rolls-Royce would be a good example of this. The shares performed poorly between the end of 2013 and the end of 2015 due to heavy investment in new engines for the next generation of planes, which put pressure on earnings. We added to the position during this period as we felt Rolls-Royce was becoming well entrenched in the next generation of planes and this would lead to strong earnings growth in future. Since the trough, Rolls-Royce has



performed well, so it was right to hold onto the shares and add to the holding on weakness. Therefore, there is no strict sell discipline within the Trust, and in a period of weakness, we will carefully consider whether to sell (or often add) to the position.

“WE ADVOCATE RUNNING OUR WINNERS, AND WHEN WE DO REDUCE, TEND TO DO SO IN SMALL SIZE.”

JF: You are big investors in AIM and your weighting to the junior market has increased significantly of late. AIM has a mixed reputation with investors. However, it is internationally recognised as one of the world's leading growth markets. What's your take? Is it simply a case of treading carefully or could more be done to improve corporate governance on AIM?

LF: *We think the next generation of growth companies in the UK can be found on AIM, and this is where a number of the best performers in HOT in recent years have derived from (for example **Blue Prism (LON:PRSM)** or **Keyword Studios (LON:KWS)**). Therefore, while over the long term the performance of AIM as a market has been quite poor, at the individual stock level there have been some great successes (such as **Asos (LON:ASC)**, which is still listed on AIM), and these are what we need to find!*

You do, however, need to tread carefully and a big part of this is making sure we meet the management teams of any potential new AIM holdings. In small cap investing there is not a deep management 'bench', therefore there needs to be a strong CEO and CFO driving the company. The lack of regulation is of course a risk for AIM investing but it is also an opportunity – it makes it easier for companies to raise capital and this nimbleness in raising funds for growth is one of the key advantages of AIM.

JF: Presumably, as growth investors you must also have to be optimists? Are you concerned that this bull market is one of the longest on record? Are the companies in your portfolio prepared to withstand another downturn, should it transpire?

LF: *I wouldn't say we need to be optimists but we need to entertain what 'could' happen in order to value shares. For example, **4D Pharma (LON:DDDD)** 'could' find a drug that treats huge potential end markets such as Crohn's disease, but that is not to say that it will, as drugs are at a very early stage of development.*

We worry more about individual stock valuations than the direction of the market as a whole. This is particularly relevant for HOT, as it does not closely resemble its benchmark (the FTSE All-Share). That being said, when a recession does (inevitably) come, we need to be aware of which companies we own are most exposed. The best protection we can have for this is diversity – in other words making sure that we are not overly exposed to one end market or geography.

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.

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

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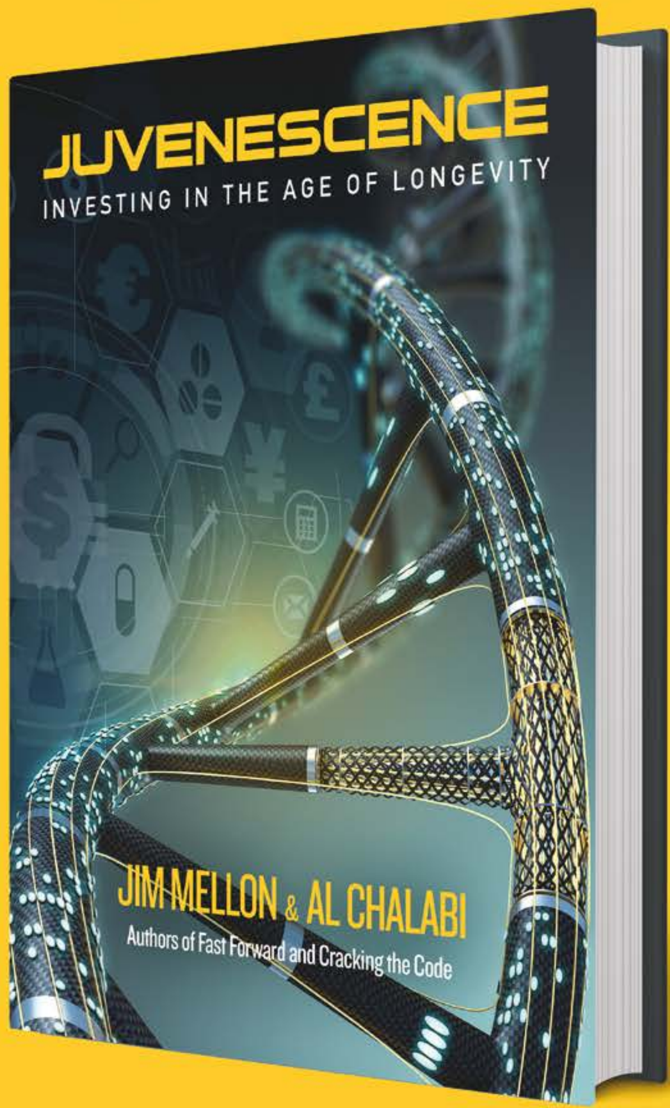
Ageing is familiar to all of us, and yet up until now the science has been something of a mystery. But with new leaps in science, the stock market is scenting opportunities too. So, whether you're an investor looking to make some money, a movie star looking to keep your looks, or a life scientist keeping up with the latest thinking, this could be a truly revitalising read.

"Jim Mellon and Al Chalabi have once again written the gold standard guide to investing in a key emerging area of technology. The combination of technological advances to extend human healthspan and the rapid ageing of populations worldwide will ensure that this sector becomes one of the hottest places to invest in this coming decade."

David A. Sinclair, Ph.D.
Professor of Genetics
Harvard Medical School



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BY NICK SUDBURY

FUNDS IN FOCUS

THE BEST GROWTH FUNDS

One of the most effective ways to increase the capital base of your portfolio is to invest in growth stocks. These fast-growing companies tend to plough most of their earnings back into the business and where successful this enables them to increase the rate of expansion even further.

A growth stock can be defined in a number of different ways, but generally it means a business that is growing faster than the market as measured by its sales, margins, profits or earnings.

The last decade has been a particularly good time to be a growth investor, with these sorts of stocks leading the recovery from the Financial Crisis. For example, over the 10 years to the end of September 2018, the MSCI World Growth index generated an annualised return of 10.45%, which was well ahead of the 7.84% produced by the equivalent value index.

Darius McDermott, MD of Chelsea Financial Services, says that for the majority of the past decade, growth has been the dominant style. "As economies have exhibited low growth and interest rates have been historically low, investors have gravitated towards growth styles and stocks in order to achieve a better growth rate. Even though some of these stocks have become expensive, investors have been happy to pay more for better growth prospects."

If you expect global economic growth to remain fairly muted and interest rates to stay relatively low for longer, then growth stocks could continue to outperform. The main risk is that you could easily end up overpaying if a company fails to meet its high expectations, which is why a well-run growth fund could offer a decent solution.

UK Growth funds

Adrian Lowcock, Head of Personal Investing at Willis Owen, says that UK growth stocks have been better at protecting investors from the troubles of Brexit because they tend to have an international focus with regards to the business and corporate earnings.

"Growth companies in the UK currently tend to be quality growth that shows its value over the longer term, not shorter-term rapid growth. This looks attractive in a low interest and low inflationary world and when the latter starts to rise the quality factor comes in as these are the sorts of companies that can raise prices."

When it comes to the funds, McDermott recommends **Liontrust Special Situations**, where the managers look for firms with 'intellectual capital', which includes strong distribution networks, recurring revenue streams and products with no obvious substitutes. The resulting portfolio consists of businesses that can grow their earnings independently of the wider economy.

"OVER THE 10 YEARS TO THE END OF SEPTEMBER 2018, THE MSCI WORLD GROWTH INDEX GENERATED AN ANNUALISED RETURN OF 10.45%, WHICH WAS WELL AHEAD OF THE 7.84% PRODUCED BY THE EQUIVALENT VALUE INDEX."

The big sell-off: buying opportunity or rotation into value?

At the start of October there was a sharp sell-off in growth stocks, with the main catalyst being the rise in 10-year Treasury bond yields in the US. The declines were led by the tech-heavy NASDAQ index, but also spread to growth-oriented funds like **Scottish Mortgage (LON:SMT)** and popular growth names such as Fevertree Drinks.

Ben Willis, Head of Portfolio Management at Chase de Vere, says that a lot of growth companies still display highly visible earnings year-on-year, but many of these stocks have seen their share prices grow tenfold.

"As we are now moving into a rising interest rate environment and quantitative tightening, the earnings streams from these companies may not justify the price being paid and investors may look towards undervalued areas of the market, where appreciating share price potential may be looking attractive. Growth investors need to be mindful as to how long growth has outperformed value and how the macro conditions are changing."

Willis prefers **Lindsell Train UK Equity**, which he says has produced exemplary outperformance over several years. "The fund invests in high quality, cash generative and durable companies, with the manager, Nick Train, paying particular attention to certain sectors such as consumer goods, media, pharmaceuticals and retail financial services."

US growth

Lowcock says that growth in the US is different to the UK and is largely driven by the technology sector, where the growth rates are huge and have supported even larger valuation rises.

"The challenge for investors is to decide whether it is still justifiable to buy that future growth at current prices. It is very hard to know when such rapid growth slows, but when it does there can be a hard landing. Investors need to remember the price you pay is important for the returns you get."

"THE CHALLENGE FOR INVESTORS IS TO DECIDE WHETHER IT IS STILL JUSTIFIABLE TO BUY THAT FUTURE GROWTH AT CURRENT PRICES."

His preferred US growth fund is **Artemis US Select**, where manager Cormac Weldon has a strong track record and an established team to support him. They meet company management on a regular basis and supplement that by actively seeking opposite (sell-side) views to ensure a thorough understanding of the key drivers of growth. Despite the high-conviction nature of the portfolio, the fund is often less volatile than its peers.

Other overseas markets

For European exposure Willis recommends **Threadneedle European Select**, which he says is a similar fund to Lindsell Train UK Equity in that the management team target businesses that exhibit pricing power and high barriers to entry. This approach has enabled them to construct a concentrated portfolio of high-quality growth names, and the performance over the last few years has been excellent.

McDermott singles out **Jupiter European**, which is managed by Alexander Darwall, who looks for stocks with long-term growth prospects. "He puts great store in finding companies with exceptional management talent and clear business plans, in niche markets with dominant distribution and pricing power. On an average day he will see or speak with at least three companies."

It is a different situation in the Emerging Markets as these benefit from structural growth driven by the favourable demographics. In theory the region should deliver good long-term capital growth, but it is a risky and volatile area that is under pressure from the strong US dollar and the threat from the trade war.

Lowcock suggests **Fidelity Emerging Markets**, where he says manager Nick Price is supported by a strong team of analysts across the main emerging market economies. "The fund is constructed with a best-of-breed approach, with companies included exhibiting quality growth that have superior and sustainable return on assets; strong, unleveraged balance sheets; shareholder-friendly management; and reasonable valuations."

On a shorter 12-month view, McDermott believes that Japan is the most likely country to continue to see growth, as Prime Minister Abe has just

FUND OF THE MONTH

The key growth recommendation from the investment trust team at Numis is the £502 million **Edinburgh Worldwide (LON:EWI)** trust. Managed by Baillie Gifford, the trust has an out-and-out focus on long-term growth.

EWI's managers form part of the firm's successful six-strong Global Discovery team that looks for companies that are innovating to solve large problems and reshape their industry; where the management have a clear strategy for growth; an emerging competitive advantage and limited direct peers; and a business model that can be scaled-up to take advantage of the opportunity.

It is a similar approach to the larger and better known Scottish Mortgage, except that Edinburgh Worldwide focuses on smaller global growth companies with a market cap of less than $5 billion, although it will continue to hold the stocks if they go on to exceed this figure.

According to Numis, the portfolio is earlier stage than SMT, but more diversified, with around 98 holdings. Almost 60% of the fund is currently invested in the US, with the largest holdings including the likes of MarketAxess, Ocado Group, Alnylam Pharmaceuticals, Lendingtree, Wayfair, and GrubHub.

Fund Facts

Name:	Edinburgh Worldwide (LON:EWI)
Type:	Investment Company
Sector:	Global Growth
Total Assets:	£502m
Launch Date:	July 1998
Current Yield:	0%
Net Gearing:	1%
Ongoing Charges:	0.87%
Website:	www.bailliegifford.com

Edinburgh Worldwide has a strong long-term performance record against both its benchmark and its peers. It has also had a decent 12 months despite the recent sharp sell-off that has affected all growth-oriented funds. Numis has a high regard for lead manager Douglas Brodie and consider the fund to be an attractive long-term investment.

"SCOTTISH MORTGAGE HAS MASSIVELY OUTPERFORMED ITS MSCI WORLD BENCHMARK OVER THE LAST FIVE YEARS."

won a ruling party election that has helped to ensure that his reforms have continued backing. His preferred fund is **Baillie Gifford Japanese**.

"The manager looks for companies that have one of four primary requirements: positive industry background, durable competitive advantage, strong financial characteristics, and management attitude aligned to the interests of shareholders. The emphasis on structural change within the portfolio should continue to benefit from the government's current economic strategy," he says.

Investment trusts

The investment trust team at Winterflood Securities have several growth-oriented funds on their list of recommendations for 2018, including **Scottish Mortgage (LON:SMT)** and **Monks (LON:MNKS)**, which are both managed by Baillie Gifford along similar lines to the fund of the month, **Edinburgh Worldwide (LON:EWI)**, which is described above.

Scottish Mortgage has massively outperformed its MSCI World benchmark over the last five years due in part to its emphasis on online platform stocks in the US and China, like Amazon and Tencent. It has a highly concentrated portfolio, with the 10 largest holdings accounting for more than half of the £7.5 billion of assets, and has the scope to invest up to a quarter of the fund in unquoted companies.

Baillie Gifford took over the management of Monks in March 2015 and has completely transformed its fortunes with the improvement in performance eliminating the wide discount. MNKS has a significantly more diversified portfolio than Scottish Mortgage and provides a lower risk way to benefit from the firm's best ideas.

Small cap growth

Winterflood's small-cap recommendation is **Standard Life UK Smaller Companies (LON:SLS)**, which has been managed by the highly regarded Harry Nimmo since September 2003. Nimmo has a higher growth bias than the rest of his peer group and looks to invest in strong business franchises that have the potential for significant earnings growth.

At the end of August he had put together a concentrated 52-stock portfolio, with the largest holdings including the likes of Fevertree Drinks, Dechra Pharmaceuticals and JD Sports. This emphasis on quality growth has generated considerable long-term outperformance.

One of the growth selections from Numis is the £749 million **Henderson Smaller Companies (LON:HSL)** trust. The firm says that manager Neil Hermon focuses on businesses with good growth prospects, sound financial characteristics and strong management, which are trading at a valuation level that does not reflect these strengths. This is usually summarised as growth at the right price, or GARP for short.

At the end of August Hermon had put together a diversified portfolio of 108 different holdings, with the largest positions in companies such as Bellway, Cineworld Group, Victrex, Renishaw and Intermediate Capital Group.

Along with many of its smaller companies peer group, the fund suffered around the time of the Brexit vote, but it recovered strongly in the second half of 2016 and followed this up with NAV growth of 30% the year after. Hermon has built up a strong long-term track record, with NAV total returns of 17.7% per annum since he took over as manager in late 2002 versus 14.0% per annum for the benchmark, yet despite this the shares are trading on a 9% discount to NAV.

"HERMON HAS BUILT UP A STRONG LONG-TERM TRACK RECORD, WITH NAV TOTAL RETURNS OF 17.7% PER ANNUM SINCE HE TOOK OVER AS MANAGER IN LATE 2002 VERSUS 14.0% PER ANNUM FOR THE BENCHMARK."

Quality will out

Numis also recommends the £1.1 billion **JPMorgan Emerging Markets (LON:JMG)** trust, which has established a good long-term record via its focus on quality growth companies. They say that manager Austin Forey aims to be "as different as possible, both from the competition and especially from the benchmark", and take strong views that are expressed with conviction. This includes a willingness to hold larger positions, and to exploit the closed-ended structure by investing more in smaller companies.

The manager has built a concentrated 59-stock portfolio with the three largest country weightings being China (26.3%), India (20.8%), and South Africa (11.9%). This approach has allowed him to deliver strong relative returns for shareholders, with the shares up 227% over 10 years versus the 182% increase in the benchmark, but with the region currently out of favour, the shares are available on a 12% discount to NAV.

If you would rather invest in a more tightly defined growth mandate you might want to consider **Allianz Technology (LON:ATT)**, **Biotech Growth (LON:BIOG)** or **Woodford Patient Capital (LON:WPCT)**, all of which are included on Winterflood's list of recommendations for the year.

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

FAST GROWING SMALL CAPS TO BEAT THE AUTUMN BLUES

While most equity investors have felt some pain over the past month, it's not been a good October for small cap fans in particular. Demonstrating this, after reaching a near 11 year high in September, the FTSE AIM All Share index has since shed around 12% of its value, putting it in negative territory for the year. Small cap investors have also had to put up with several instances of corporate jiggery-pokery, including the high profile financial collapse of cake business Patisserie Holdings (LON:CAKE) and questionable accounting at gas and electricity supplier Yu Group (LON:YU.).

Nevertheless, a clutch of small caps are still delivering strong growth in earnings amidst the market malaise. Here are three such companies which have recently posted strong numbers and, in my opinion, look worth considering for inclusion in a growth portfolio.

PELATRO

One company which has been ticking along nicely over the past year or so, but seems to be off the radar of investors, is marketing software specialist Pelatro (LON:PTRO). The business was founded in 2013 with the objective of offering specialised software to telecoms companies (telcos) to help them develop "precision" marketing campaigns. Pelatro does this through its flagship platform mViva, which uses big data analytics and artificial intelligence to process and analyse data from phone subscribers and reveal patterns, trends and key behavioural traits.

Telcos use this data to develop marketing campaigns focussed on each individual subscriber (hence the term "precision"), helping them to offer products and deals that are more relevant and personalised to them. This is important in improving customer retention rates and increasing average revenues per user in a market which is maturing and seeing high levels of customer "churn". Pelatro claims that its clients have experienced an increase of up to 5% of annual incremental revenue per end user through the upselling of products using its services – that's a big number when applied to millions of subscribers.

PELATRO
Be Relevant

After listing on AIM in December 2017, raising £3.8 million for the company at 62.5p per share, in July this year Pelatro completed a major transaction, acquiring the business and certain assets of Danateq for an initial payment of $7 million. Like Pelatro, Danateq uses data analytics to provide campaign management solutions to telcos but also offers additional complementary products. Following the acquisition, the business now offers a suite of products branded as the mViva Multichannel


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Marketing Hub consisting of the mViva Contextual Marketing Solution, mViva Loyalty Management Solution, mViva Intelligent Notification Manager and mViva Emergency Credit Solution.

"WHILE PELATRO IS A SMALL BUSINESS, IT IS GROWING FAST."

As well as providing new products to sell to its existing customers, the Danateq acquisition doubled the number of subscribers on the company's platforms from 160 million to 325 million and the number of customers from 8 to 12. In line with its international focussed growth strategy, the deal gave Pelatro immediate entry into Central Europe and is expected to help accelerate entry into Western Europe over the next 18-24 months, to add to its existing presence in Latin America, Africa and Asia. To finance the initial consideration, £6 million was raised in a placing at 73p per share, with up to $5 million also due if profit targets are hit. The acquisition is expected to be immediately earnings enhancing.

Traction with telcos

While still small in size, Pelatro has grown quickly from a standing start. From 2015 to 2017 revenues grew almost tenfold to $3.15 million, with pre-tax profits soaring from just $30,000 to $1.1 million. As you can see from those figures, this is a highly profitable operation, with gross margins being around 75%. The record performance in 2017 was driven by four new customer wins for mViva during the year, with current customers now including the likes of Robi Axiata, Smart Dialog, Bahamas Telecom and Inwi.

Things have got more exciting following the year end, with April seeing the company win its largest ever contract. The deal, worth $1.7 million, is with a Central Asian subsidiary of an unnamed Western European telco, which has more than 6 million customers. Pelatro will implement mViva for the client and will also guide the telco in setting up a customer value management department, with the majority of fees expected to be recognised this year. This is a crucial win for the company as it has found that once it makes an initial sale into a new telco group, it finds it easier to sell mViva products to other group subsidiaries.

Results for the six months to June 2018 showed a continuation of the growth trends, with revenues up by 53% at $2.38 million and pre-tax profits up by 24% at $1.2 million. More recently, in October the company announced that it has been selected by industry giant Telenor to supply its Loyalty Management Solution to the operations of Telenor globally. Danateq had already been supplying its Contextual Marketing Platform to three Telenor companies and this agreement has been expanded to include the loyalty product. Pelatro is now presenting to several of Telenor's operating companies a view to implementing and supporting this offering.

Dial in the profits

Trading in Pelatro shares has been somewhat subdued since IPO, with them hitting a high of 89.5p in early January before falling to the current 69p. At that price the company is capitalised at £22.4 million. House broker FinnCap is currently looking for 15.4 cents of earnings in 2019, which at current exchange rates equates to c.12p per share. That puts the shares on a forward earnings multiple of just 5.75 times.

While Pelatro is a small business, it is growing fast and, in my opinion, the current valuation looks too low. With net cash of $1.6 million as at 30th June this year, the balance sheet looks reasonably strong, although trade receivables are a concern, with the $2.68 million at the period end representing more than six months worth of historic revenues. It's also worth noting that the company capitalises large amounts of its development expenditure, a perfectly acceptable method of accounting but one which is not as conservative as it could be. Nevertheless, FinnCap has a target price of 115p, which implies 67% upside from the current price.

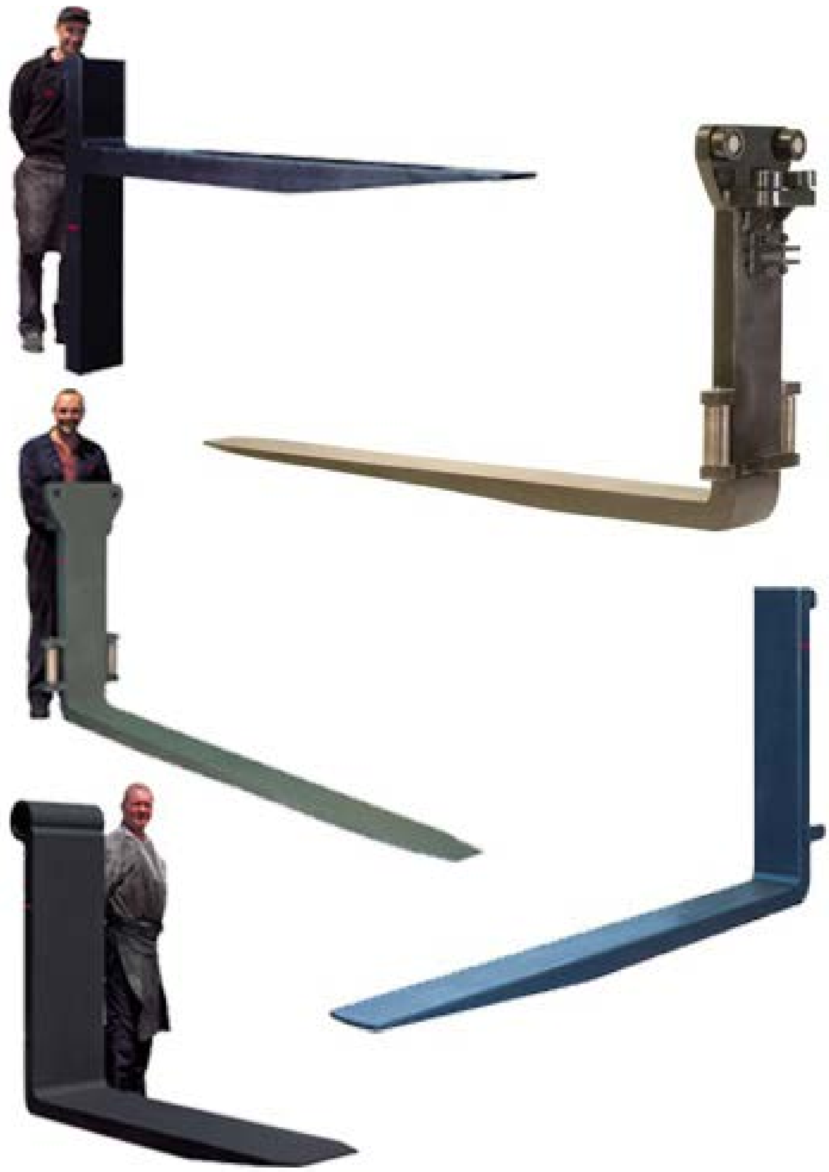
MS INTERNATIONAL

At first glance **MS International (LON:MSI)** looks to be a bit of a dull business. The company is very slow on the newsflow front (typically only releasing interim and full year results), does little on the PR front, has a quiet bulletin board and a corporate website that looks like it was designed in 1998. But take a look at the numbers and things get a bit more exciting.

MSI™
MS INTERNATIONAL plc

Dealing in Donny

With a head office in Doncaster and operations in Brazil, Germany, Poland, The Netherlands and US, MS International is a unique business, operating



across the four divisions of Defence, Forgings, Petrol Station Superstructures and Petrol Station Branding. The company was previously listed on the Main Market of the LSE but moved to AIM in 2013 following a review of its needs. Executive Chairman Michael Bell is the majority shareholder, with a 29.3% stake, and has been with the company since 1972.

Defence is the largest division by revenues, making up around a third of sales last year. Based in Norwich, MSI-Defence Systems specialises in gunnery weapon systems through to navigational plotting tables, tactical shelters and underwater systems, being a major supplier of equipment to the UK Royal Navy and over 40 other navies worldwide. The Forgings division is unsurprisingly engaged in the manufacture of forgings, with Doncaster based subsidiary MSI Quality Forgings forging steels ranging from carbon, low alloy, stainless, duplex, super duplex and super alloys. Other subsidiaries specialise in the manufacture of fork-arms for the fork lift truck, construction, agricultural and quarrying equipment industries.

Elsewhere, the Petrol Station Superstructures division is engaged in the design, manufacture, construction, branding, maintenance and restyling of petrol station superstructures. These include structures such as convenience stores, canopies, retail, food & refreshment outlets and car wash buildings, with the company's operational centres being in the UK, Poland and Netherlands. Finally, the Petrol Station Branding division is engaged in the design and installation of the complete appearance of petrol stations. Services include the conception, production, supply, installation and fitting of all established advertising and operating products for the gas station sector, with customers including the likes of Avia, BP, ESSO, Shell and Texaco.

Defence up, petrol down

In June MSI released some cracking numbers for the financial year to 28th April 2018, with total group revenues for the period up by 26% to £68.1 million. With margins relatively flat and costs controlled well, the operational gearing kicked in and sent pre-tax profits up by 165% to £4.04 million. Earnings more than doubled to 20.5p, growing slightly less than pre-tax profits due to a higher effective tax charge. Net cash at the period end was a chunky £15.87 million and while there was no debt there was a modest pension liability of £6.42 million.

"NET CASH AT THE PERIOD END WAS A CHUNKY £15.87 MILLION."

Across the divisions, Defence had a good year, with profits up by 43% at £2.6 million after a good year for export sales and new product offerings. Forgings was the only division in the red but it cut losses by 26% to £0.54 million following the first phase of full production from a new facility in the US. Trading was tough in Petrol Station Superstructures, with the division just about breaking even after posting a £0.96 million profit in the previous year. This was a result of major customers accelerating the divestment of their company owned stations. However, Petrol Station Branding posted a profit of £2.17 million, from a loss of £0.29 million, following strong demand for station rebranding.

Value and Income

Shares in MSI spiked in value to a c. five-year high of 236.25p following the release of the full year results in June, but since then have dwindled to 188.5p. That capitalises the company at just £31.6 million, with the enterprise value being just £15.9 million if we strip out the net cash on the balance sheet as at 28th April. The shares, therefore, trade on a historic price to earnings multiple of just 9.3 times, falling to 4.7 times on an ex-cash basis.

If last year's dividend of 8.25p per share is maintained then the shares also offer an attractive yield of 4.4%. That looks likely given the current net cash position, dividend cover of almost 2.5 times and historic free cash flow yield of 5.9%.

Unsurprisingly, there are no forecasts in the market for MSI, so investors will have to wait until around late November/early December for the interim results to see how trading is progressing. The only clue we have so far is from the full year results when the company commented, *"...we are continuing to move the business forward on an upward trajectory and are well positioned to support and develop opportunities..."* Despite the lack of detail here, I believe that the current valuation provides a significant margin of safety for investors.

JUDGES SCIENTIFIC

One company that has delivered strong returns for investors over the past ten years or so is scientific instrument business investor **Judges Scientific (LON:JDG)**. From the 2009 nadir of 59.5p, the shares have since surged by over 4,000%, with decent dividends also having been paid along the way.

Judges' current business model is focussed on a "buy and build" strategy, looking at acquiring growing companies in the area of scientific instruments. A turning point in the company's history was in April 2005, when the business was re-admitted to AIM following the acquisition of fire testing equipment business Fire Testing Technology. This was the beginning of a strategy focussed on taking advantage of positive long-term trends in a sector which is being driven by worldwide investment in higher education and a optimisation across science and industry.

Judges Scientific plc

As of today the company consists of 16 businesses, primarily UK-based, with products sold worldwide to a range of niche markets including higher education, scientific communities, manufacturers and regulatory authorities. The strategy is focussed on selectively acquiring businesses that generate sustainable profits and cash, with support and advice being provided to their management teams.

Some of the key companies in the Judges' portfolio include: Armfield, which designs and manufactures equipment for engineering education & research and for the food, beverage, dairy, edible oil and pharmaceutical industries; Scientifica – which develops equipment for use in the neuronal electrophysiology, two-photon imaging and optogenetics markets; and GDS Instruments – a developer and manufacturer of equipment and software used for the computer controlled testing of soils and rocks.

Orders, orders

Judges has an excellent track record, having grown adjusted earnings from 28p in 2009 to 131.9p in 2018, with dividends rising from 3.7p per share to 32p over the same period. While things haven't always gone in a straight line, with some down years (see chart), the current year to date has been a record one for the company, with revenues in the six months to June 2018 rising by 13% to £37 million. Of that, 5.7% came from organic growth – that is from businesses owned at the same time in the previous year. Organic order intake was up by 2.3% compared with H1 2017, with the order book amounting to 15 weeks' worth of sales.

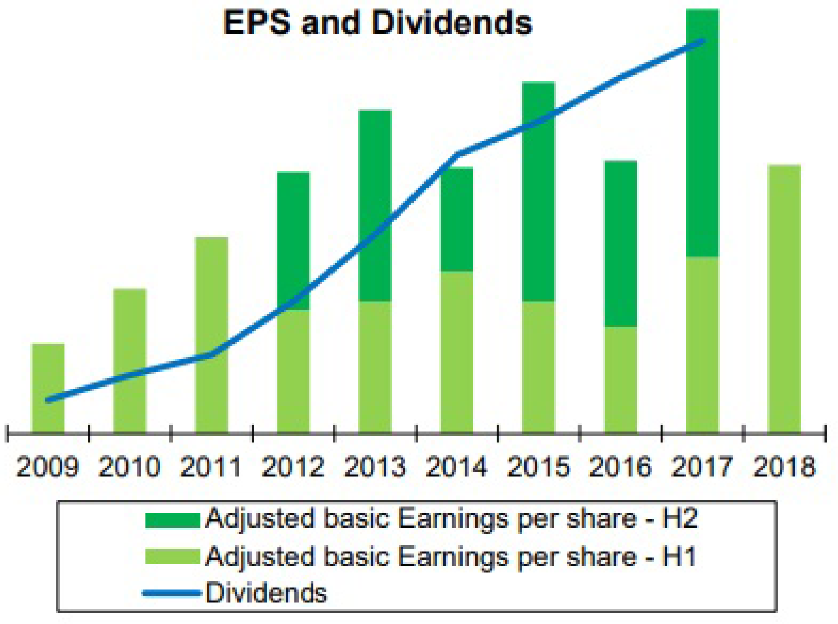
One thing to note about the P&L account is that a large percentage of sales are made overseas, with over 85% of goods being exported. Therefore, movements in exchange rates have a significant influence on the numbers. A quarter of revenues are made in euros, with around two-thirds coming in the form of US dollars. The first half of this year saw adjusted pretax profits rise by 50% to £6.6 million, with the figures being boosted by a weak pound. The outlook for the full year was strong, with adjusted profits and earnings expected to be ahead of previous expectations.

Courting investors

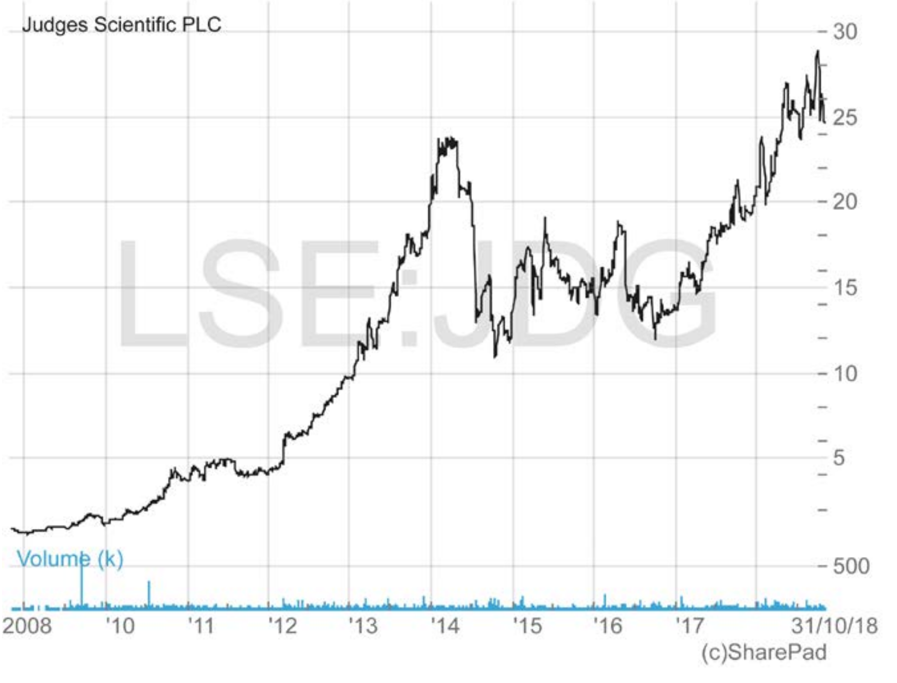
Given the company's excellent track record, shares in Judges Scientific currently trade on a relatively high historic earnings multiple of 18.7 times. But that doesn't look too expensive to me given the current growth profile, as demonstrated in the interims. The historic dividend yield is just 1.3% but will probably be higher this year given that the interim payment was hiked by 20% and was covered seven times by adjusted earnings.

Potential investors should be aware that sales can be affected by short-term customer spending variability, as experienced in 2016, along with the exchange rate exposure mentioned above. The balance sheet has a £2.1 million pension liability but is reasonably strong overall, with adjusted net debt of £2.2 million as at 30th June 2018. Cash balances were £14.4 million at the period end with the company having a £35 million finance facility in place to further fund its expansion.

In my view, the 14% fall in the shares since the start of October could provide a good entry point for growth hunters.



"FROM THE 2009 NADIR OF 59.5P, THE SHARES HAVE SINCE SURGED BY OVER 4,000%."



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 NEIL HERMON

OVERSEAS INVESTORS ARE CAPITALISING ON BREXIT FEARS

UK equities are out of favour among international investors, but foreign companies are comfortable enough with the UK's long-term future to buy up British businesses – at attractive valuations. Neil Hermon, fund manager of Henderson Smaller Companies Investment Trust, explains why.

Away from the media circus surrounding the UK's exit negotiations with the EU, overseas companies are quietly taking advantage of the pessimism towards UK equities by buying British businesses at attractive valuations.

Overseas companies are seeing value in the UK; in fact, 2017 was the first year since 2011 that British companies saw a net increase in direct foreign investment. The trend can be seen building from 2015, when there were 145 merger and acquisition (M&A) deals involving overseas investors (inward M&A). In 2016, inward M&A deals increased by 80% to 262 and in 2017 there were 259 deals.

The first quarter of 2018 followed suit with 75 deals and Q2 statistics show 182 completed inward M&A deals – although this increase is mainly a result of a new methodology for collecting M&A data by the UK's Office for National Statistics, namely around capturing smaller company deals.

The numbers suggest that if we don't notice the value in UK equity markets, others will. Henderson Smaller Companies Investment Trust has been a big beneficiary of this trend, with small and medium-sized companies in the UK attracting the interest of overseas companies.

Foreign takeovers

Since January 2017, the Trust has profited from 10 M&A deals whereby a company we held in the portfolio was acquired, with seven of those deals involving an overseas buyer.

A recent example of such corporate activity is US private equity firm Silver Lake Partners' takeover of ZPG Group, which owns property website Zoopla and price comparison service uSwitch. We bought ZPG at 332p per share in January 2017 and sold it for 489p in June, representing a total return of 42.9% over the 18-month period.

Another example is Fenner, a polymer technology firm that provides engineering solutions across a variety of markets. The company was acquired by French conglomerate Michelin this summer for about £1.2 billion. We first bought a position in Fenner in April 2017 at 316p and sold it for 609p, representing a total return of 82% in just over 12 months.

These examples demonstrate not only the opportunities for growth investors in the UK's small and mid-cap markets, but also the confidence overseas investors have in British companies. That message is easily lost amid the furore of Brexit, but there are good reasons why global investors are putting money in the UK.

"THE NUMBERS SUGGEST THAT IF WE DON'T NOTICE THE VALUE IN UK EQUITY MARKETS, OTHERS WILL."

About Neil Hermon

Neil Hermon is Director of UK Equities at Janus Henderson Investors, a position he has held since 2013. Neil is also a Fund Manager on the International Long/Short Equity strategy. Neil joined Henderson in 2002 as head of UK smaller companies and Fund Manager of Henderson Smaller Companies Investment Trust. Prior to Henderson, he served as head of UK smaller companies for General Accident Investment Management (later to become CGU plc). He began his career at Ernst & Young as a chartered accountant. Neil graduated from Cambridge University with a MA (Hons) in mathematics. He is an associate of the Institute of Chartered Accountants of Scotland (CA) and an associate member of the UK Society of Investment Professionals (UKSIP), and has 29 years of financial industry experience.

“THE TRUST HAS OUTPERFORMED THE NUMIS SMALLER COMPANIES INDEX ON A TOTAL RETURN BASIS IN 14 OF THE PAST 15 YEARS.”

A Great British brand

The UK is a well established brand with a long history of international trade, and it was considered the easiest place in Europe to do business in the World Bank's *Doing Business* report. We have a strong rule of law that shields British businesses from corruption and criminality, and this will remain a strength of the UK's corporate culture when it leaves Europe's political union.

The UK is home to some of the best universities in the world and leads in Europe as the number one destination for higher education. This means UK companies are well placed to recruit top talent from around the world. The country's central geographic location helped it to become a global superpower, and this could be a supportive factor in developing a new network of trade agreements.

Sterling may have suffered since the referendum – and it could become a source of further frustration as the months roll on – but it remains one of the UK's strengths. An independent currency and central bank working towards a resilient and robust economy is a huge positive as the UK undergoes this transitional period.

Big opportunities in smaller companies

We think now is a good time to buy UK small and mid-cap. Valuations are certainly reasonable; the UK market is cheap by international standards and offers good value relative to historic levels.

We are mindful of the UK's situation with Brexit negotiations entering their final stages. We might see the UK economy do well or badly on the back of the Brexit deal, which is why the Trust's portfolio is geographically diverse in terms of revenues; almost half of the sales made by the portfolio companies go overseas. This diversification, we think, is important as we edge closer to the Brexit deadline.

Henderson Smaller Companies Investment Trust has a strong growth bias and a track record of delivering superior total returns for shareholders over a medium to long-term horizon. In fact, the Trust has outperformed the Numis Smaller Companies Index on a total return basis in 14 of the past 15 financial years.

A £1,000 lump sum investment in the Trust on 31 October 2002 would now be worth £12,577 (as at 30 October 2018), with a compound return of 17.4%. That's not to say we are going to live off past glories, because they won't guarantee future results, but we will continue to employ the same principles and consistent strategy that has rewarded our shareholders.

BY DAVID JONES

CHART NAVIGATOR

BACK TO BASICS

IDENTIFYING AND FOLLOWING TRENDS

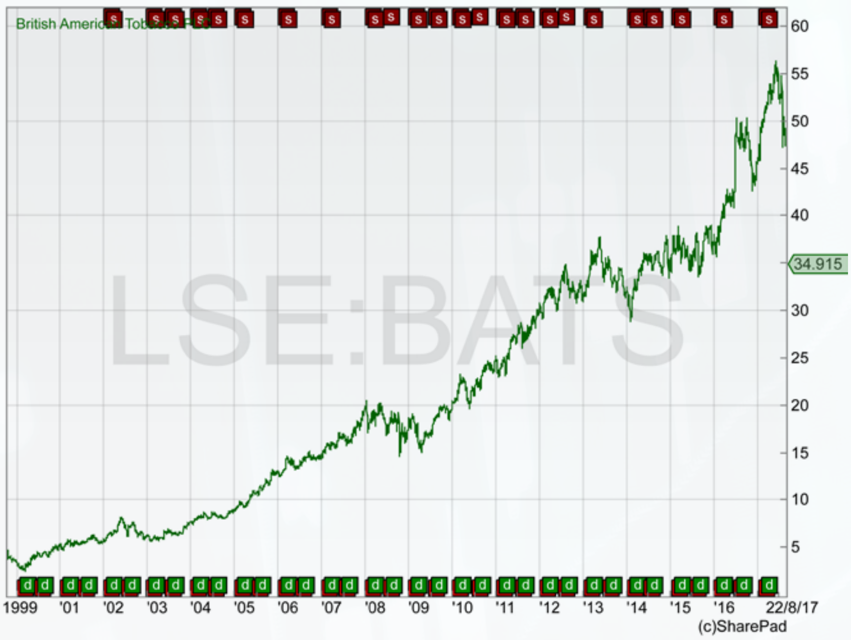
Given that the theme for this month's magazine is investing for growth, I thought it would be a good opportunity to go right back to the basics of charting, and cover the subject of identifying and following trends.

Wouldn't it be great to have a portfolio where all the shares just went up every year, requiring minimum maintenance apart from just watching the profits grow? Whilst this investing nirvana is probably unobtainable, there are shares out there that have proved to be, with hindsight, solid steady performers year in and out – until, of course, they stop doing exactly that. One 'well-chosen' example is **British American Tobacco (LON:BATS)**.

£1,000 invested in British American Tobacco at the end of 1999 would have grown to more than £18,000 by mid-2017. The trend has actually turned lower since then, but I think the chart above is a great illustration that markets *do* trend and the main job of the chart-biased investor is to identify a trend, buy in and hold on for as long as that trend continues.

Unfortunately, lots of us as investors cannot resist the call of the counter-trend. We see a share price that has spiralled down and ask ourselves, "just *how* low can this really go?" The temptation to catch a falling knife seems to be hard-wired into us humans – we all love a per-

British American Tobacco 1999 to 2017

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> **“WHAT WE SHOULD BE DOING IS IDENTIFYING SHARES THAT ARE IN UPTRENDS AND LOOKING TO JUMP ON BOARD WITH THE ASSUMPTION THAT TREND WILL CONTINUE – UNTIL PROVED OTHERWISE.”**

AstraZeneca May 2016 to March 2018

ceived bargain. But I am sure we have all learnt that just because we have decided that the shares cannot go any lower, quite often the market has a different view, and that down trend continues. So, what we should be doing is identifying shares that are in uptrends and looking to jump on board with the assumption that trend will continue – until proved otherwise.

The easiest way of identifying an uptrend is by using trend lines.

Here's a more recent example. The share price of **AstraZeneca (LON:AZN)** had been making steady progress from mid-2016 through to the beginning of 2018. Of course, markets do not move in straight lines – they usually move in ebbs and flows of lows and highs. The definition of an uptrend is a series of higher highs and higher lows – and we just about have that in the AstraZeneca chart above.

When drawing trend lines in an uptrend, it's a sloping line from left to right that sits underneath the lows. The assumption is that any weakness will be 'caught' by the trend line and the share price will recover. So, drops by the share price towards the trend line would be viewed as buying opportunities – and only if the trend line is breached does the investor start to worry that the trend is changing.

As can be seen from the above chart, this trend following strategy would have paid off from March 2018 onwards. AstraZeneca's share price moved away from the trend line and rose from £48 per share to a high of £61 by August. Of course, it would be naïve to expect this approach to work all the time, but, as a way of tilting the investing odds even slightly in your favour, following trends does make sense – at least much more sense than betting that an out of favour share will turn its fortunes around.

Trend reversals – Feeding our inner bottom-fisher!

I think it is hard for all of us to resist the temptation of trying to pick turning points, so an additional approach could be to spot downtrends that are running out of steam. As mentioned previously, the trend-line is expected to keep the trend under control – until

AstraZeneca May 2016 to Present

Burberry March 2015 to March 2016

things change. So spotting this change in a downtrend can give us the potential to get in early on the start of a new trend.

Here's an example of a downtrend starting to run out of steam. Luxury goods business Burberry saw its share price caught in a downtrend, capping any rallies, for much of 2015. But the rally at the start of 2016 was different and the shares managed to break out of the downtrend – a suggestion that sentiment was starting to shift.

Because a trend changes, it doesn't necessarily mean jump in now. Often it is best to be patient and wait. I think major shares are a little like oil tankers in the way that they can change direction, but they tend to do so infrequently and over a gradual period of time. As demonstrated in the above chart, following the downtrend break, Burberry rallied, then fell back towards the old low, and then recovered to start the new trend. So, if we are spotting trend reversals, the break of the trend-line is just the first sign – we don't have to buy in straight away, but it might be time to start paying a bit more attention to the share in question for a buying opportunity in the weeks ahead.

Spotting winners, through trend spotting, every time is far from guaranteed, but the idea is that just a handful of shares will go on to be significant gainers (like British American Tobacco), leading to the overall outperformance of your portfolio.

Burberry March 2015 to October 2017

Charts of the month

It's a difficult time in markets at the moment, with volatility back with a bang. The volatility has put plenty of trends under pressure – but the trends are still out there. I have selected two charts for this month's charts of the month: one is of a company that continues to chug along and the other is of an old stalwart that looks to be shaking off its long downtrend.

Diageo

Like British American Tobacco, beverages business **Diageo (LON:DGE)** is an example of a share that has trended well over the decades. You can see from the above chart that the trend has done a good job of stopping any major sell-off – most recently in the 2,500p area. Assuming that this trend continues, the expectation would be for the share price to run back up to, and possible breakthrough, the recent high of 2,900p. At the moment it would take a fall below 2,500p to suggest that the latest uptrend is in trouble.

BT

Pity the long-term holder of BT. It peaked around the 1,100p mark during the dotcom bubble and has not come anywhere close since. As the chart above shows, it has been in decline since early 2016, more than halving in price. That really has been a wonderful downtrend. The company has been one that I have had my eye on for quite some time (because of the attractive dividend yield), but the downtrend has always convinced me to stay away.

But, are things finally changing for the telecoms company we all love to hate? That could well be the case. The strength over recent months has finally seen the downtrend breached for the first time. However, as the Burberry chart above shows, the first breach of a trend line is not necessarily the prerequisite to then go piling in. BT has definitely gotten more interesting from a recovery point of view, and, as long as any weakness from here does not breach the major low of 200p, then we could well see a new trend higher begin to form over the months ahead.

> **"THE FIRST BREACH OF A TREND LINE IS NOT NECESSARILY THE PREREQUISITE TO THEN GO PILING IN."**

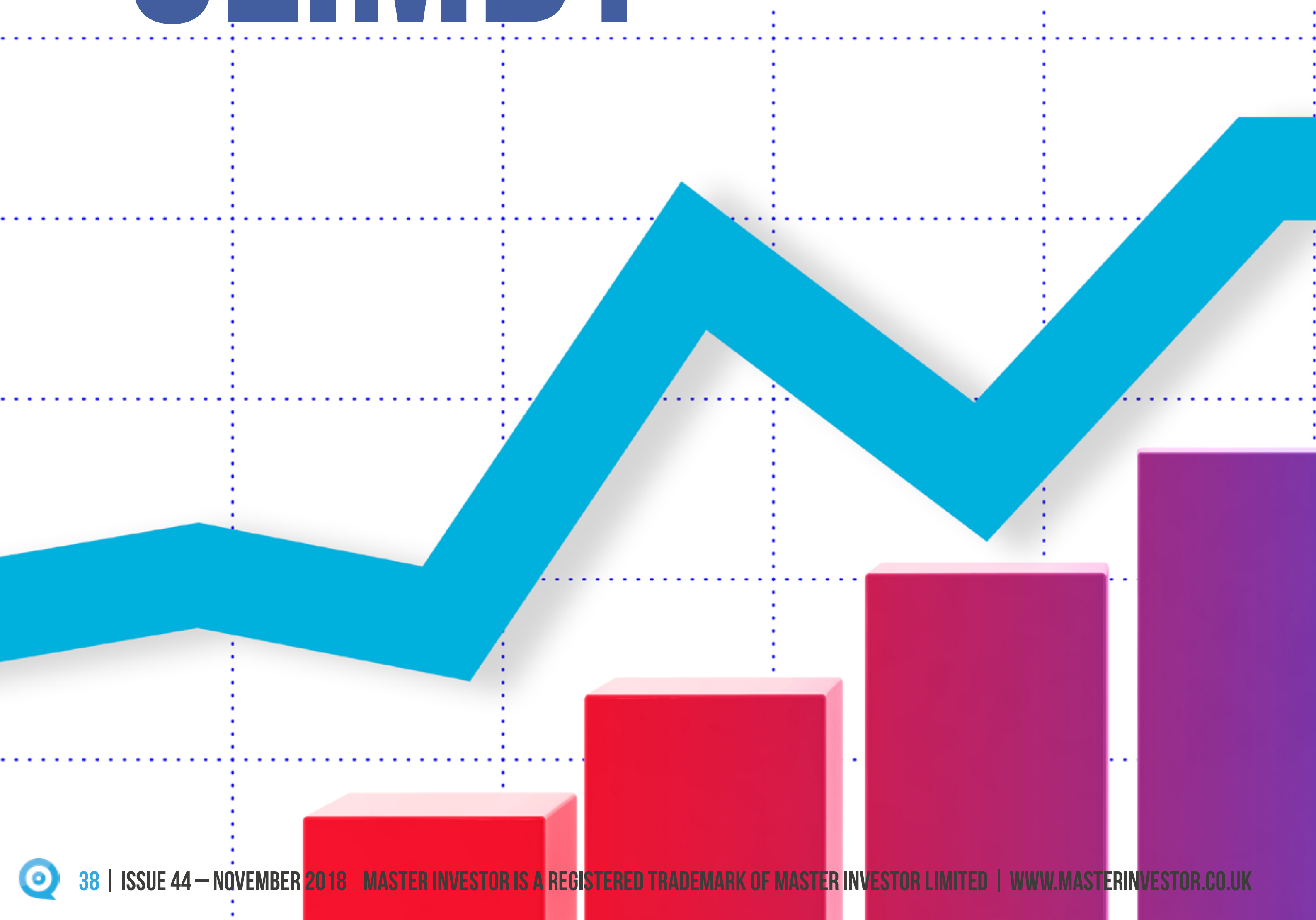
About David

David Jones qualified as a technical analyst in 1995 and started his City career as a currency analyst. He then went on to work for trading companies CMC Markets and IG Group as Chief Market Strategist. Since leaving the industry in 2013 he has been a presenter on BBC Radio 5 Live's Wake up to Money programme and the Chartist for Shares magazine. He is an active trader and private investor.

BY FILIPE R. COSTA

THE MACRO INVESTOR

HOW HIGH CAN FAANG STOCKS CLIMB?



After a 273% rise in just four years, investors need to prepare themselves for the worst.

"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets."

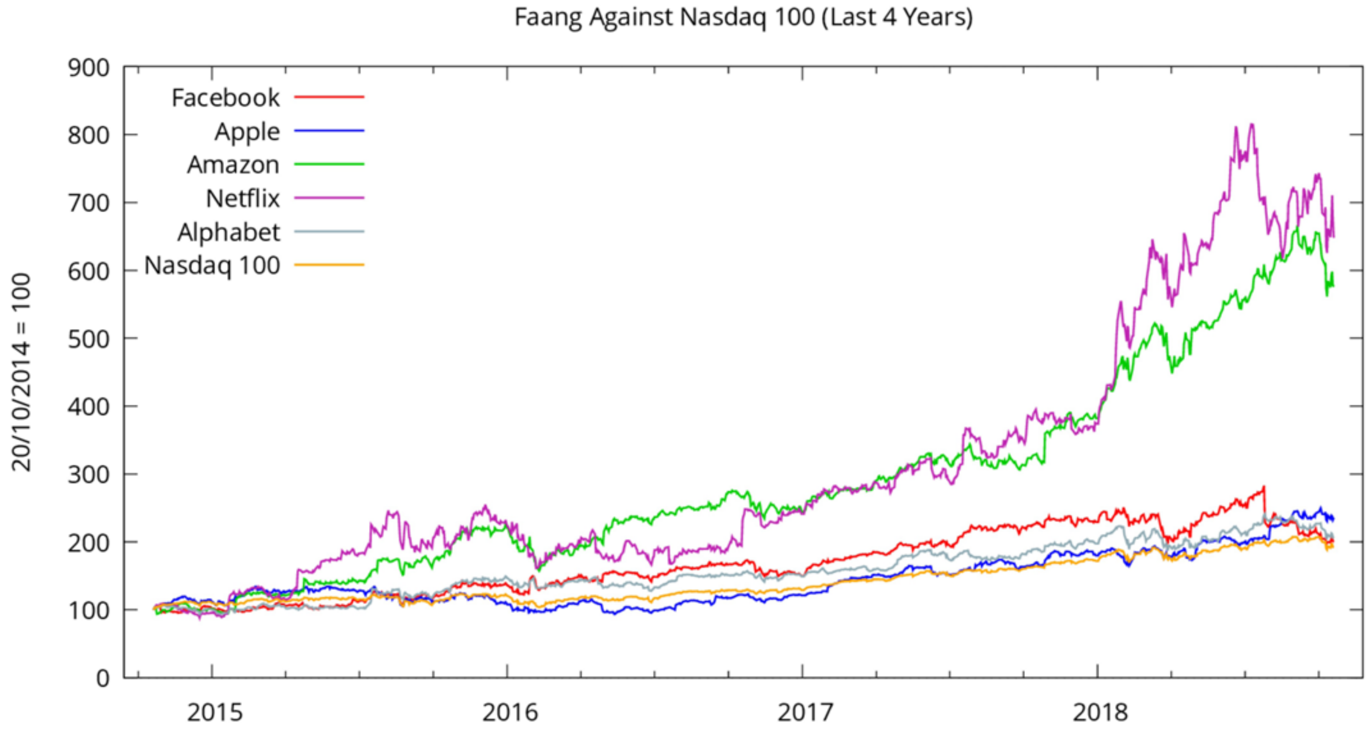
- Peter Lynch

An impressive run

The US equity market has been pretty impressive over the last nine years. After being decimated during the 2007-2009 financial crisis, equities found a way up, replacing the accumulated losses with significant gains that have pushed them towards new all-time highs. The run has been impressive, both in terms of gains and duration. On average, bull markets last around seven years, but this time around the bull market is approaching its tenth year.

The period after Armageddon is historically the best for investors in terms of returns (because share prices are usually depressed following panic selling), and this time is no different. The broad market, here proxied by the S&P 500, is up by 57% over the last four years, which translates to an annual compound rate of 11.9%. That's a lot more than its historical rate of return. A mix of favourable economic conditions and bold monetary and fiscal policy have helped maintain the bull market's strength and to stretch it over a longer period of time.

The run in technology stocks, in particular, is even more impressive, with the Nasdaq 100 index up by 92% in just four years. But that shouldn't come as any surprise, as when sentiment is running wild, investors tend



to buy more of the things that are difficult to value.

The FAANG stocks – namely **Facebook (NASDAQ:FB), Apple (NASDAQ:AAPL), Amazon (NASDAQ:AMZN), Netflix (NASDAQ:NFLX)** and **Alphabet Google (NASDAQ:GOOGL)** – are among the market's five most popular and best performing tech stocks. During the last four years, these stocks have gained an average of 273%, thereby surpassing the most optimistic of bold market predictions. Facebook's share price has doubled, Apple is up by 135%, Amazon gained 476%, Netflix is up by a whopping 548%, and Alphabet increased by 107%.

But, by the tenth year of the bull market, at a time when we're in the late-cycle phase of the business cycle, it's time to challenge the growth prospects of technology shares in general and the FAANG stocks in particular.

Today's winner is tomorrow's loser

FAANG stocks are today's fashion stocks. Everybody loves the iPhone, living without Netflix is unthinkable, and googling for answers is now part of our daily activities. But, just because most of the products and services that the FAANG stocks provide today seem absolutely unrivaled, it doesn't mean they will last forever.

"A RECENT REPORT BY MCKINSEY GLOBAL INSTITUTE CLAIMS THAT THERE IS MUCH MORE MOBILITY IN THE WINNER-TAKE-ALL WORLD THAN FIRST THOUGHT."

A recent report by McKinsey Global Institute claims that there is much more mobility in the winner-take-all world than first thought. On one side, the report shows that top, well-known brand names hold a large share of the market in terms of economic profit, with the top 10% of the world's 6,000 largest companies holding as much as 80% of this market. The top 1% alone captures 36% of the pie.

But, on the other hand, these top earners are not bullet-proof. Mckinsey's report shows that about half of the top 10% fell out of that upper tier in every business cycle, and that 40% of those dropouts then go on to become the bottom 10% of earners.

The study shows two important points about today's companies. First, income is not well distributed, with top earners taking a large share of the market in terms of profits. Second, competition at the top is tough, with top earners being disrupted with relative ease.

In today's world, many of the top earners are companies that are able to exploit the value of intangible assets, such as software, patents, brand names and data. Netflix is a good example of how technology can revolutionise a business. At first it was a nationwide video rental company that was nearing bankruptcy. But then it replaced physical rentals with online streaming services and then the explosive growth rates began.

But what goes up very fast, must come down even faster. In a globalised world, companies are widely exposed to a *sentimental consumer* that acts in a herd-like manner. And at any moment, everything may change.

Businesses like Netflix and Facebook are constantly being challenged by the competition and are under intense scrutiny from consumers. Many of our younger readers will probably not be aware of what happened to the once leading browser Netscape, Altavista search, and more recently the social network hi5. They are examples of how fast things may change. The more intangible a business is, the greater the discount an investor should put on its potential growth. Netflix subscribers and Facebook users can vanish much faster than consumers at a retail shop.

A bullish market doesn't last forever

As the earnings season kicks off, investors are becoming a little anxious about tech stocks in general and the FAANG group in particular. As I have previously commented on, we are now in the late-cycle phase of the business cycle, which by historical standards is not that favourable for technology stocks. The stocks that are part of the FAANGs are not considered technology stocks in a strict sense, but they do have many things in common with them.

Sooner than later, there will be a market correction, and companies with more conservative valuations will do better than those with valuations that are based on lunatic growth projections and in which a significant part of the valuation is made up of intangible assets.

During the late-cycle phase, stocks start to look overvalued, due to declines in overall demand, increases in interest rates and declining GDP growth rates. Profit margins tend to deteriorate and inventories pile up. Investors become more selective and conservative. Sectors like materials and energy tend to outperform, as they usually benefit from a rise in inflation. But, the general sentiment starts to deteriorate and valuations for technology stocks come down to earth. Indeed, it's not unusual to see prices in these technology companies halve at the first signs of smoke.

With the Nasdaq 100 up by 100% and the FAANG stocks up by 273% in the last four years alone, investors should take a deeper look at each stock to check whether risks are mounting and whether growth prospects justify the high-flying prices.

A closer look into the FAANGs

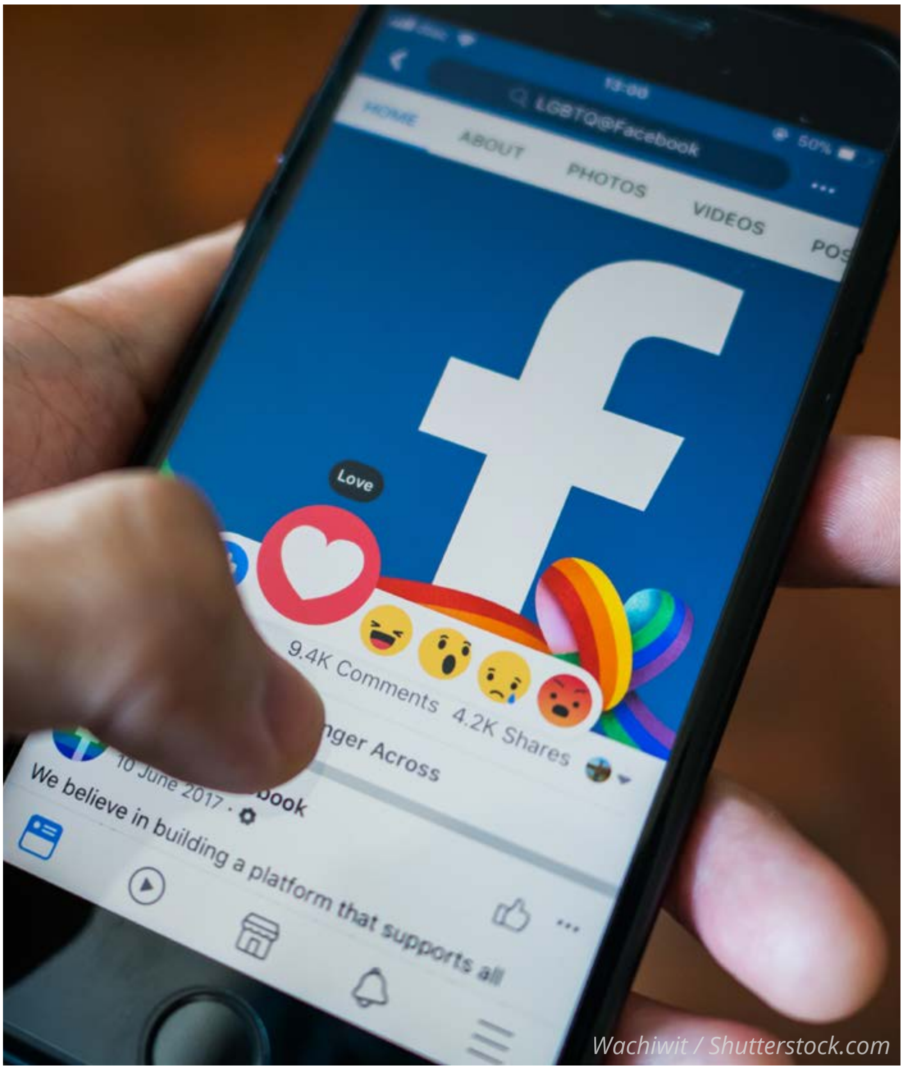
Let's take a closer look at each of the five companies that make up the FAANG stocks. For the purpose of this analysis, I will concentrate on past numbers, which are objective, as opposed to projections, which are prone to error and heavily influenced by sentiment. While past numbers certainly suffer from some flaws, they can give a more reliable picture of what's going on. What really matters is to understand how profitable a company is; how much margin it has to weather the bad times and competition; how well is it employing investors' money; and how cheap its shares are. Therefore, I collected data on nine simple accounting ratios for the five-year period 2013-2017, plus the trailing twelve month period ending on the second quarter of this year, which corresponds to the latest available numbers[i]. While it doesn't capture the whole picture, these ratios are more than enough to give us an idea on how over- or undervalued each company may be at this moment.

Facebook (NASDAQ:FB)

Facebook has been under fierce scrutiny recently, due to the fake news phenomenon and a few privacy concerns. But apart from these subjective points, we can objectively say that the company is today much more solid than it was a few years ago (in particular before its IPO).

Out of the five FAANG companies, Facebook is one of my favourites. And it's doing a much better job than Alphabet in terms of selling ads. Both its EBIT[ii] margin of 49.9% and EBIT yield[iii] of 5.5% are double that of Alphabet's. Facebook's ROCE is also high at 31%.

"OUT OF THE FIVE FAANG COMPANIES, FACEBOOK IS ONE OF MY FAVOURITES."



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The EBIT yield is a much better alternative to the PE[iv] ratio. If inverted, EBIT yield gives a ratio comparable to the PE ratio. In the case of Facebook, the inverted EBIT yield turns into a *price-to-operating-profits ratio* of 18.2x, which compares with its debt-adjusted PE ratio of 22.9x. While both are still on the high side, they're reasonable. In my opinion, the high and stable ROCE figures and sufficient EBIT yield justify buying Facebook, to keep long-term.

Apple (NASDAQ:AAPL)

During Tim Cook's era, Apple has not been able to innovate as much as it did during Steve Jobs' prolonged and legendary tenure. But, Tim Cook has done a great job of making Apple products – in particular the iPhone, which is currently responsible for more than half of the company's profits – widely available. Even though the iPhone has remained more or less the same over the years, Apple has maintained its profit margins, with gross margin fluctuating between 38% and 40% and EBIT margin hovering around 30%. Despite the growing competition and slowing momentum in terms of iPhone and iPad sales, the company has maintained a portfolio of products that assure a very high profit margin.

In terms of valuation ratios, Apple's debt-adjusted PE is high at 19.1x, but still below its peers. EBIT yield is now at 6.5%, slightly above Facebook, but still not at the best levels. The compensation comes in the form of a high ROCE. Apple is not cheap, but it seems like a quality business. In comparison to Facebook, Apple has the advantage of having a more tangible business. In my view, current prices justify a long-term buy, even if the timing is not perfect.

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"APPLE IS NOT CHEAP, BUT IT SEEMS LIKE A QUALITY BUSINESS."

Songquan Deng / Shutterstock.com

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Amazon (NASDAQ:AMZN)

Despite its long track record of significant innovation that has helped to make it the biggest online retailer, Amazon's stock is very expensive right now, and that, in my view, makes it unattractive.

Amazon's strategy of setting low prices in both online retail and web services, mixed with very high warehousing costs derived from keeping high inventories, has certainly helped destroy its competition, but it has also hurt its own profitability. Its gross margin is decent at 23.8%, but after paying for fulfillment, marketing, technology and other operating costs, the leftover margin sinks to a paltry 3.7%. As a consequence, EBIT margin comes in at an unattractive 0.9%, which means the company is significantly overvalued. This overvaluation is supported by a debt-adjusted PE ratio of 121.6x. For a company that is about to expand its business to lower margin segments like online grocery, these numbers are especially worrying. Growth expectations are too high for a mature company like this.

Amazon shares trade on a price to NAV[v] of 25.5x and a price to TNAV[vi] of 42.4x. Again, these numbers are based on high expectations of the company's ability to significantly exploit its intangible assets. Jeff Bezos is one of the most talented chief executives, but these numbers suggest to me that now is a good time to sell the shares.

Netflix (NASDAQ:NFLX)

What I wrote on Amazon in terms of valuation largely applies to Netflix; the shares are significantly overvalued.

Investors' sentiment on the stock has been boosted by the company's triple-digit EPS growth. But such growth will not last, and it certainly doesn't justify a debt-adjusted PE ratio of 95.1x. In Greenblatt's world[vii], an EBIT yield of 1% mixed with a ROCE of 11.2% is just too low to ever think about buying. The low EBIT yield is further confirmation of the stock's overvaluation. In Facebook's case, EBIT yield is low, but ROCE is very attractive, which isn't the case here. Additionally, Netflix EBIT margin is just 10.8%, which seems too low for this kind of business.

In summary, the numbers suggest investors should stay away from Netflix. Unlike Amazon, Netflix doesn't provide any kind of safety. While the company has been pouring money into its own video productions, its business is easily replicable. Amazon has Prime Video, and Disney will launch its own streaming service very soon. Unless management is able to create some moat, Netflix will be in trouble very soon.

"UNLESS MANAGEMENT IS ABLE TO CREATE SOME MOAT, NETFLIX WILL BE IN TROUBLE VERY SOON."

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VALUATION RATIOS FOR FAANG STOCKS

	Year	2013	2014	2015	2016	2017	TTM
FACEBOOK	**Period Ending**	**31/12/2013**	**31/12/2014**	**31/12/2015**	**31/12/2016**	**31/12/2017**	**30/6/2018**
	Debt-adjusted PE	86.8	69.7	77.3	31.4	27.7	22.9
	EPS growth	5930.0	85.7	16.4	169.2	53.6	43.9
	Price to turnover	17.5	16.7	16.7	12.2	11.3	9.4
	Price to NAV	8.9	5.8	6.8	5.7	6.2	5.7
	Price to NTAV	10.0	14.7	13.0	8.7	8.4	7.6
	EBIT yield (EBIT/EV) %	2.1	2.4	2.2	3.9	4.7	5.5
	ROCE %	18.0	18.0	14.6	23.0	28.8	31.0
	Gross margin %	76.2	82.7	84.0	86.3	86.6	85.2
	EBIT margin %	35.9	40.3	35.0	45.6	50.7	49.9
APPLE	**Period Ending**	**31/12/2013**	**31/12/2014**	**31/12/2015**	**31/12/2016**	**31/12/2017**	**30/6/2018**
	Debt-adjusted PE	11.6	15.4	12.2	14.2	22.6	19.1
	EPS growth	-10.0	13.6	42.9	-9.9	10.8	25.3
	Price to turnover	2.6	3.4	2.7	2.9	5.1	4.4
	Price to NAV	3.6	5.5	5.4	4.8	8.6	9.7
	Price to NTAV	3.8	6.0	5.8	5.2	9.2	9.7
	EBIT yield (EBIT/EV) %	11.7	8.8	11.1	9.4	5.8	6.5
	ROCE %	33.4	31.9	37.0	26.4	24.3	26.2
	Gross margin %	37.6	38.6	40.1	39.1	38.5	38.3
	EBIT margin %	29.4	29.5	31.3	29.1	29.0	28.8
AMAZON	**Period Ending**	**31/12/2013**	**31/12/2014**	**31/12/2015**	**31/12/2016**	**31/12/2017**	**30/6/2018**
	Debt-adjusted PE	285.5	2760.4	233.1	123.6	248.7	121.6
	EPS growth	3056.0			204.2	16.9	229.4
	Price to turnover	2.5	1.6	3.0	2.7	5.0	4.3
	Price to NAV	19.0	13.3	24.1	18.8	31.8	25.5
	Price to NTAV	26.2	19.3	33.5	24.8	61.4	42.4
	EBIT yield (EBIT/EV) %	0.4	0.2	0.7	1.2	0.5	0.9
	ROCE %	5.1	1.0	7.9	12.1	7.6	11.8
	Gross margin %	15.7	17.4	20.5	22.1	22.9	23.8
	EBIT margin %	1.1	0.2	2.1	3.2	2.4	3.7
NETFLIX	**Period Ending**	**31/12/2013**	**31/12/2014**	**31/12/2015**	**31/12/2016**	**31/12/2017**	**30/6/2018**
	Debt-adjusted PE	131.2	64.5	193.9	163.7	192.5	95.1
	EPS growth	629.3	107.4	-54.8	53.6	190.7	180.0
	Price to turnover	5.1	3.8	7.4	6.1	12.6	10.0
	Price to NAV	16.8	11.4	22.5	20.3	41.1	29.7
	Price to NTAV	16.8	11.4	22.5	20.3	41.1	29.7
	EBIT yield (EBIT/EV) %	1.0	2.0	0.6	0.7	0.5	1.0
	ROCE %	8.1	10.4	5.0	5.2	6.4	11.2
	Gross margin %	28.7	31.8	32.3	31.7	34.5	39.5
	EBIT margin %	5.2	7.3	4.1	4.6	6.2	10.8
ALPHABET	**Period Ending**	**31/12/2013**	**31/12/2014**	**31/12/2015**	**31/12/2016**	**31/12/2017**	**30/6/2018**
	Debt-adjusted PE	27.0	25.6	30.6	26.7	48.2	42.4
	EPS growth	13.2	0.4	19.7	20.9	-30.3	-24.7
	Price to turnover	6.8	5.5	7.2	6.1	7.1	6.3
	Price to NAV	4.3	3.5	4.5	4.0	5.1	4.8
	Price to NTAV	5.4	4.3	5.4	4.6	5.9	5.5
	EBIT yield (EBIT/EV) %	3.5	3.7	3.1	3.6	1.8	2.1
	ROCE %	18.1	16.2	16.6	17.7	18.7	18.9
	Gross margin %	60.4	61.1	62.4	61.1	58.9	57.4
	EBIT margin %	29.3	26.3	27.4	27.7	27.4	26.0

Source: Sharepad

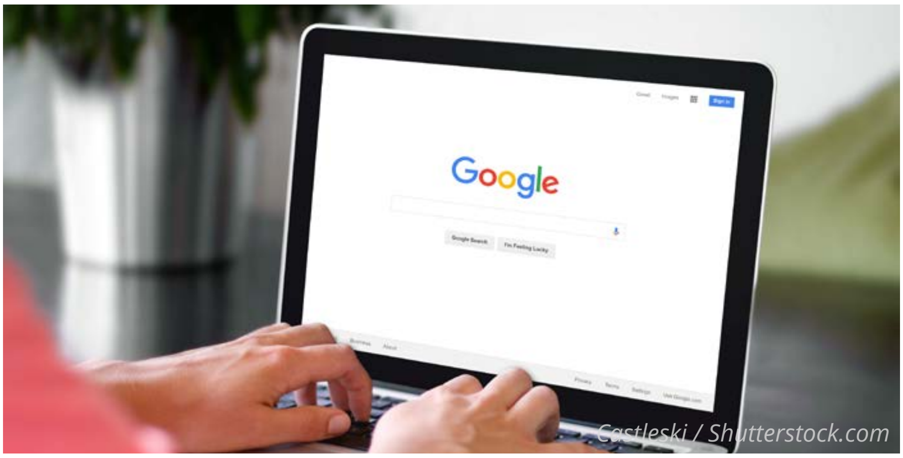
Alphabet (NASDAQ:GOOGL)

Alphabet is involved in urban innovation, healthcare, wireless services, and, indirectly through venture capital, several other businesses, including Uber, Flatiron Health and Slack. This may explain the lower profit margins and the lower returns on capital when compared with Facebook. Still, the company relies heavily on revenue from advertisements, and, for that matter, it is doing a worse job than Facebook. Alphabet's EBIT yield of 2.1% converts into a price-to-operating-profit of 47.6x, which suggests to me a slight overvaluation. Alphabet is still a quality company, but its share price is expensive. Still, I would keep the stock for now, if I owned it.

Some FAANGs have no teeth

My first final note is directed towards the FAANG stocks composition. Usually, a group is composed of a number of elements with similar characteristics. But, even with just five elements, the FAANG stocks could not be more dissimilar. Amazon and Apple rely heavily on sales of physical products, while Facebook and Alphabet live mainly on advertisement revenue. In the eyes of consumers, Apple comes with an unrivaled brand name, while Netflix can be easily repacked with a different name. Amazon and Alphabet are expanding their businesses and turning into conglomerates, while Apple is primarily a phone company. A lot more could be said here.

My second note comes as an investment warning. I believe that we are at a very sensitive phase of the business cycle right now, where quality is everything. Investors will become more conservative when sentiment fades and those companies with the highest valuations will suffer the most. In conservative terms, I believe the FAANG stocks are overvalued. In general, they are employing too much capital and delivering low operating profits. Still, Facebook and Apple are carrying the most conservative valuations and are offering the best investment opportunities. Amazon and Netflix seem significantly overvalued and are good candidates to sell. And Alphabet is just unattractive at current prices.



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About Filipe

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

i Investors should check for the availability of third quarter earnings reports that will become available during the next few weeks for most companies.
ii Earnings Before Interest and Taxes. It is a measure of operating profits.
iii EBIT yield is the ratio of EBIT to Enterprise Value. It's a kind of an inverted price ratio, where price corresponds not just to equity but to the whole company.
iv Price to Earnings.
v Price to Net Asset Value.
vi Price to Net Tangible Asset Value.
vii See Greenblatt, J. (2010); The little book that still beats the market (Vol. 29); John Wiley & Sons.

BY JOHN KINGHAM

DIVIDEND HUNTER

WHY WH SMITH COULD BE A SOLID CHOICE FOR DIVIDEND GROWTH

When I think of WH Smith (LON:SMWH), I think of a company which sells products that are either in decline (physical newspapers, magazines and books), can be purchased more easily online (note paper, pencils, exercise books) or are basically extinct (CDs, DVDs and vinyl records). In other words, my default mental image is of a company destined to become the next Woolworths.

However, if you look at WH Smith's financial results over the last decade, you'll see a company which has grown its earnings and dividends per share by about 10% per year, every year. That's pretty amazing, especially for a company that is over 200 years old.

With a current dividend yield of around 3%, this is no high-yield bargain, but combined with its double-digit dividend growth record, some would say it looks like a solid choice for dividend growth investors.

A tale of two businesses (part 1): High street

The Woolworths-like business I described above is WH Smith's high street business. It's the familiar high street newsagent we all know and (possibly) love, and it's in long-term decline. It's in decline because many of its core products are now mostly consumed online (e.g. books, music) and many others have appeared in supermarkets (e.g. pens, pencils, paper, school exercise books, etc.).

This decline is already well-established. In 2010, the high street business had 573 stores which generated revenues of £860 million and £51 million of operating profit. Fast forward to 2018 and while the number of stores has increased to 607, revenues from those stores have fallen by £250 million to just £610 million. However, despite losing such a large amount of revenue, the high street business still managed to squeeze out £60 million of operating profit in 2018, almost 20% more than in 2010.

"THIS IMPRESSIVE INCREASE IN PROFITABILITY HAS BEEN DRIVEN BY A RELENTLESS FOCUS ON COSTS, PRODUCT MIX AND PRODUCTIVITY."

This impressive increase in profitability has been driven by a relentless focus on costs, product mix and productivity. In fact, WH Smith's focus on costs has seen it languish near the bottom of the Britain's Best High Street Retailer list (via Which? Magazine) for eight years. There is even a dedicated Twitter profile showing pictures of the company's worn and torn carpets and damaged product stands.

"SOME PEOPLE WILL THINK THAT TATTY STORES ARE A SIGN OF A POORLY RUN BUSINESS. I THINK IT SHOWS THAT MANAGEMENT ARE SERIOUS ABOUT MAXIMISING SHAREHOLDER RETURNS."

Some people will think that tatty stores are a sign of a poorly run business. I think it shows that management are serious about maximising shareholder returns. How so? Because running a publicly-traded business is about maximising long-term returns to shareholders and not maximising customer happiness, staff happiness or anything else. Yes, these things often overlap, but often they don't.

In the case of WH Smith, management could easily have chosen a route that was more popular with customers. They could have spent vast amounts of money refurbishing the company's high street stores. There would have been gleaming WH Smith stores up and down the land; a proud reminder of the company's 200-year history and position as a much-loved British company. But in my opinion (and management's), that would have been a huge mistake.

The stores would have become more expensive to run and maintain, which would have eaten into the company's cash flows. I don't think nicer, cleaner WH Smith stores would have increased revenues very much, because WH Smith is a convenience store, not a destination store. People shop in WH Smith because it's there when they're out and about. While you're in the high street you might remember that you want a pencil, so you pop in and buy one along with a magazine that caught your eye and a can of something fizzy. Do you care about dirty carpets? Probably not. But if your visit is pre-planned, like a weekly shop at the supermarket or a day out visiting some snazzy fashion shops, you're much more likely to take things like the state of the carpet into account. So yes, tatty and tired stores are bad for some companies, but not for all. And probably not for WH Smith's high street business.

The cash that could have been spent on those carpets has been put to better use (probably), as dividends, share buybacks and investments into the company's rapidly growing travel business.

A tale of two businesses (part 2): Travel

More people around the world are travelling by air, rail and car more often, and they want to be able to buy something to read and something to eat while they're doing it (although hopefully they won't be reading while driving). Lucky for them, they can now find WH Smith stores or concessions in airports, railways, motorway service stations, hospitals and anywhere else where a sandwich and a magazine will come in handy.

So, unlike its declining high street business, WH Smith's travel business is still growing, and in the last few years it's grown to be the largest part of the business in terms of both revenue and profit. The international part of the travel business is growing fastest of all and has expanded from 16 units in 2010 to 286 units in 2018. In terms of

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"THE INTERNATIONAL BUSINESS HAS GONE FROM BASICALLY NOTHING A DECADE AGO TO GENERATING 20% OF THE COMPANY'S PROFITS TODAY."

profit, the international business has gone from basically nothing a decade ago to generating 20% of the company's profits today.

Much of this travel growth has been fuelled by cash extracted from the high street business. In some ways this is similar to the early days of Buffett at Berkshire Hathaway. Back in the 1970s, Berkshire's declining textile business was starved of investment as the cash it generated was taken away and reinvested into higher return businesses such as insurance. It may have been sad to see the Berkshire Hathaway textile business fall into terminal decline, but Buffett was 100% correct to redirect cash away from that low return business and into higher return businesses.

The same logic applies to WH Smith's declining high street business and its expanding travel business. Cash should flow to wherever returns are highest, and in this case that means away from the high street and into the travel business.

So that's a brief overview of the two sides of WH Smith. Let take a look at the company's accounts and then think about a target buy price.

Consistent double-digit growth

At first glance, it may seem as if WH Smith is on a fast road to nowhere because its revenues haven't grown at all in more than a decade. If anything, they've declined slightly. This is obviously not good and doesn't tie up with the company's 10% annual earnings and dividend per share growth rate. There are two main reasons for this.

The first reason is profit margins. WH Smith's net profit margin has increased from around 5% in 2009 to around 9% today, so for every item sold it makes about twice as much profit today as it did a decade ago. That's good and it's largely a result of the company's infamous high street-related cost cutting tactics and Scrooge-like behaviour.

The second reason is share buybacks. Over the last ten years, the company has bought back around 30% of its shares. This means each remaining share now represents a far bigger slice of the company pie, and that in turn means that per share revenues, earnings and dividends have increased handsomely. This is true even though the overall pie (i.e. the company) hasn't grown much at all.

For many, this sort of aggressive use of share buybacks is somehow morally wrong, but in reality it's just another way to return cash to shareholders. Buybacks make financial sense as long as management think the purchased shares will produce better returns than a reasonable hurdle rate, such as the market's average return (about 7% per year).

Share buybacks are also a very flexible way to return excess cash to shareholders. If a company has a lot of extra cash it can buy back more shares, but if cash flows get a little tight it can temporarily cancel any planned buy-

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backs. This is much less distressing to investors than a dividend cut, which is almost universally hated by income investors.

Dividends well-covered by free cash flows

As I just mentioned, WH Smith buys back a lot of shares to boost per-share returns and return cash to shareholders. In order to do that it must (or should) be generating excess cash (free cash) beyond that required to pay the dividend. And that is indeed the case.

Over the last ten years, the company has consistently generated enough maintenance free cash (i.e. cash from operations, minus debt interest, minus the depreciation of its existing fixed assets) to pay the dividend twice over. This cash is paid out as a mix of dividends and buybacks. Hopefully the fact that dividends are consistently well-covered by free cash means the dividend should (should!) be relatively safe, although of course there are never any guarantees.

Small debts and a big pension

WH Smith has almost no debt, which as far as I'm concerned is a good thing.

Nick Beer / Shutterstock.com

It's possible to boost profitability and returns by taking on more debt, but for cyclical companies like retailers it's often more trouble than it's worth. However, the company does have a large financial obligation in the form of a billion-pound defined benefit pension scheme.

Although the scheme has a negligible £11 million deficit, which is being reduced by a £3 million annual cash payment from WH Smith, the real risk is the size of the overall scheme. At just over £1 billion, the total pension liability is about ten-times the company's recent net profits, which have averaged around £100 million.

A pension-to-profit ratio of ten is enough to make me avoid a company, so for me this is a potential red flag. However, in this case the pension size is only just 'too big', the deficit is tiny, and the company has strong cash flows, so WH Smith's pension scheme probably isn't large enough to stop me from investing.

"WH SMITH IS EXACTLY THE SORT OF COMPANY I LIKE TO INVEST IN."

Target purchase price

Overall then, WH Smith is exactly the sort of company I like to invest in. It has a long track-record of per-share revenues, earnings and dividend growth, it doesn't have a lot of debt, it's highly profitable and has good cash generation. It does have a big pension, but I would still be more than willing to invest at the right price.

At the time of writing, the company has a share price of 1,782p. That gives it a 3% dividend yield, which is slightly below a FTSE All-Share tracker's yield of around 3.4%. However, given that WH Smith's dividend growth record is far above average, that slightly below average yield still looks attractive.

For example, to get the average rate of return for equities of 7%, the dividend would only have to grow by 4% per year (i.e. 3% dividend yield plus 4% dividend growth equals 7% total return, all else being equal). So, on the face of it, the current price seems attractive.

Another way to think about valuations is by using a stock screen which ranks stocks according to whatever criteria are relevant to you. In my case, my stock screen ranks companies based on their ten-year growth rates, growth quality and profitability, and then by share price relative to earnings and dividends. On that screen, WH Smith ranks 15th out of about 200 companies. That's very close to the top, and well within the top 50 zone that I prefer to buy from. So according to my stock screen, WH Smith is attractive at its current price.

In fact, the company is still attractive, according to my stock screen, at 2,200p. However, at that point it starts to reach valuation levels that I'm not entirely comfortable with. For example, at 2,200p the dividend yield would be 2.5%, which is about as low as I'm willing to go with new investments. And the company's PE10 and PD10 ratios (price to ten-year average earnings and revenues) would also reach the limits of my comfort zone, at 31 and 65, respectively (my limits are 30 and 60 for those ratios).

On that basis, **my current purchase price for WH Smith is anything below 2,200p.**

Obviously, the current price is already below this, so in theory I would be happy to buy WH Smith today. But in practice I don't expect to own WH Smith anytime soon. The reason is that my portfolio is currently slightly overweight the UK (53% of its revenues come from the UK compared to my preferred limit of 50%) and 71% is invested in cyclical sector stocks (compared to my preferred limit of 66%). It also already holds three companies from the general retailer sector, and I don't like to have more than three holdings (out of 30) from one sector.

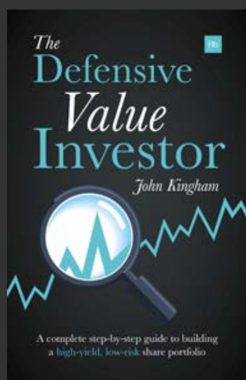
So, while I like WH Smith and I also like its price, it just isn't a good fit for my portfolio at the moment. That's a shame, but if I want my portfolio to remain highly diversified then I'll have to avoid WH Smith, at least for now.

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 VICTOR HILL

OPPORTUNITIES IN FOCUS

TAKING THE PULSE OF THE WORLD ECONOMY

HOW MUCH LONGER CAN THE BULL MARKET LAST?

There's an awful lot of economic and financial news out there. A lot of it is worrying and some is encouraging. You'd be forgiven for being perplexed.

There's a major trade war on the go between the USA and China – initiated by the USA. Europe is caught in the crossfire. There's the little matter of Brexit. Interest rates are on the rise in the USA – and prospectively in Europe too. This has upset emerging markets, with Turkey's and Argentina's currencies in free-fall. Silicon Valley is still booming – but are the tech giants not flying just a little too close to the sun...?

There are red lights flashing on the dashboard of the global financial system. The IMF recently warned that, a decade after the financial crisis, the world's banks are still overly exposed to the "doom-loop" (its phrase, not mine) of risky government debt. This comes at a time when Italian government bond yields are spiking, prompting the new populist government in Rome to accuse Brussels of waging *bond warfare.* An Italian default – with the inevitable collapse of its banking system – would cause contagion throughout the eurozone.

And the timing could not be worse, since the ECB is about to bring an end to its programme of quantitative easing (QE – printing money) at the end of this year. The US, of course, ceased QE some two years ago, and has enjoyed robust growth this year.

Stock markets in the US, Europe and Japan, however, have held up, overall. The Dow Jones Industrial Index nearly hit another record high after the NAFTA new deal was announced on 01 October, with the Dow registering 26,951.81 on Wednesday, 03 October. But during the week of 08 October (October is a dangerous month for markets) there was a global wobble – the FTSE-100 even falling below 7,000 at one point. On 10 October the Dow lost more points than on any other trading day but two.

There are also spooky things going on in global bond markets, which are often ahead of the game. Real estate prices are slipping south in the UK – and elsewhere. There are rumours of currency wars. Are the bulls turning into bears?

This month I want to separate the deep news from the persistent noise reverberating through the global media by examining the underlying trends with a forensic eye. There are profound causes for concern – but for macro investors there are also opportunities, if you know where to find them.


112,86
166,03
120,46
145,73

Mercator's projection

Some people look at two-dimensional maps of the world – usually Mercator's projection, which has been in use since 1569[i]. In fact, it is still, 450 years later, the standard two-dimensional view of the world, even though it distorts reality. I prefer three dimensions: I have a globe on my desk.

When you examine the globe in three dimensions you understand things you can't disinter from Mercator's projection. For example, that at any moment, half the world is always in darkness while the other half is in daylight. At every given moment, somewhere it is sunrise. Or that the seasons are determined by the Earth's axial tilt. (This has a range of between 22.1 and 24.5 degrees over a 41,000-year cycle – because the Earth wobbles in its otherwise serene orbit around the sun. It is currently estimated at 23.44 degrees and decreasing – I wonder how many climate zealots know that?)

In the same way, when investors look at the world economy two-dimensionally, they miss things. In three dimensions, they can see how things – and trends – connect.

For me, the three dimensions of global analysis are: global financial markets, underlying economic fundamentals (GDP growth etc.) and geopolitics. I only have room for the first two this month. In December's issue I'll deal with geopolitics.

The US equity markets: towards the inflection point?

The current bull market began in Q1 2009 – nine and a half years ago, over which time the S&P 500 has risen by over 330 percent. On 09 March 2009 the forward P/E ratio on the S&P 500 (at a level of 677) was a multiple of 10.3. On 30 September 2018 (at a level of 2,914) the multiple was 16.8. That is not stratospheric. Consider that at the inflection point of 24 March 2000 the forward P/E was at 27.2 times. Further to that the market fell by 49 percent before reaching its nadir on 09 October 2002. The market correction that followed the bursting of the dotcom bubble was almost as bad as the market correction that followed the Credit Crunch (financial crisis of 2007-09).

Moreover, the dividend yield on the S&P 500 has risen significantly. In March 2000 it was 1.1 percent. In October 2007, just as the banks started to tumble, it was 1.8 percent. On 30 September it was 2.0 percent – as compared with the 10-year Treasury bond yield of 3.1 percent. So, the opportunity cost of investing in the US market, even if you think the market has no upside at all, is only just over one percent.

For income investors, the best dividend yields can be found with utilities (4.4 percent) and commercial services (4.0 percent) – so both offer better income than Treasuries. Technology stocks overall pay the lowest dividends, though of course, **Apple Corporation (NASDAQ:AAPL)** is an exception.

Corporate profits in the USA are still on the up and the consensus amongst analysts is that earnings will increase in Q3 and Q4. That arises both from continued increases in revenues plus increased margins, not least amongst the tech giants (the FAANGs plus **Microsoft (NASDAQ:MSFT)**), which largely account for the outperformance of the US market relative to Europe.

Much of this additional profit has been used to conduct share buy-backs, which are now at record levels, amounting to over $700 billion in September. This obviously puts pronounced upward pressure on valuations.

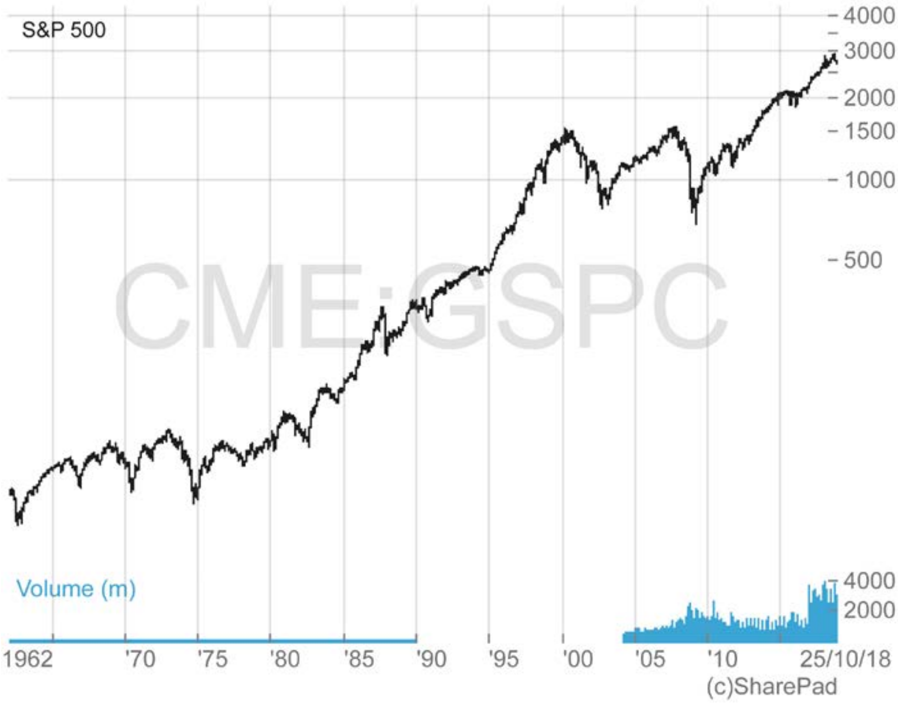
In terms of company size, small companies have experienced better stock market returns than mid-size and large companies. In terms of sectors, the winners include the technology companies which, overall, are up by 655.8 percent since the market low of March 2009. But don't overlook consumer discretionary stocks, which are up by 765.1 percent; financials, up by 548.8 percent; and health care, up by 422.2 percent. In the ongoing dance between cyclicals and defensives, currently JP Morgan thinks that cyclicals look relatively cheap relative to defensives.

"CORPORATE PROFITS IN THE USA ARE STILL ON THE UP AND THE CONSENSUS AMONGST ANALYSTS IS THAT EARNINGS WILL INCREASE IN Q3 AND Q4."

joreks / Shutterstock.com

Share market declines from all-time highs over the long-term

If you look at the US equity markets over the long-term since 1945 (so, 73 years) it's clear that there were 11 major stock market declines – plus two short-term corrections. (That makes 13). I've tried to summarise these events in the table below.



"AS LONG-TERM MARKET ANALYSTS, WE SHOULD NOT REGARD THE CURRENT 10-YEAR STOCK MARKET BOOM AS ENTIRELY UNPRECEDENTED."

Table 1: Major US stock market declines since 1945 (S&P 500 Composite)

Year	Event	Top-to bottom market decline %	Duration (months)
1948-49	Recession	-21%	16
1953-54	Recession	-15%	16
1957-58	Recession	-22%	12
1960-61	Recession	-14%	12
1962	Cuban Missile Crisis	-28%	7
1969-70	Recession (Vietnam War)	-36%	18
1973-75	Recession	-48%	6
1980	Recession	-17%	9
1981-82	Recession	-27%	18
1987	Black Monday "Flash Crash"	-34%	10
1990-91	Recession	-20%	6
2001	"Dotcom bubble"	-49%	12
2007-09	Credit Crunch (Financial Crisis)	-57%	21

If we go back over an even longer timescale, since 1900, we see that the stock market trend line since about 1950 is pretty much a continuous upward slope with a few plateaus. From 1900 to 1920 the US stock market went nowhere. In the *Roaring Twenties (The Age of Innocence* (1920) and *The Great Gatsby* (1925)), as we know, the stock market soared until the Great Crash of October 1929 – which gave rise to the Great Depression. The US market only recovered its 1929 level in 1955 – and the same is true of car production.

The Post-War Boom lasted 20 years. The end of this great boom was foreshadowed by the Nixon Shock (1971), when President Nixon cut the peg between the US dollar and gold. But the proximate cause was the Yom Kippur War (October 1973), further to which OPEC (dominated at the time by Gulf Arab states) tripled the oil price.

The Reagan-Clinton booms also lasted nearly 20 years until the "dot.com bubble" of 2000. Yes, there was *Black Monday* on 19 October 1987 – a minus 20 standard deviation event which is "theoretically" impossible – but that just looks like a blip on the long-term chart. During the years of President Clinton, the US stock market was clocking up annual returns of 25-35 percent. These were the years preceding and following the collapse of the Soviet Union, when it could be said that *America had won the Cold War.* It was also the two decades when computers were transformed from niche products for geeks into mainstream consumer necessities.

That was partly what fuelled the dot.com bubble – when any start-up which offered a model for using the internet to offer services was accorded an absurd valuation (whether they made money or not). It was even fashionable in early 2000 to say that P/E based pricing models were "old-fashioned". The hangover from the dot.com bubble was perpetuated by the slow-motion car crash of the (Second) Gulf War of 2003. It was only after that that the market recovered – powered largely by financial stocks.

Then the Credit Crunch (aka the financial crisis) of 2007-09 struck – the worst stock market fall since the Great Crash. As discussed, since March 2009 the only way has been up – and in the first stage of the Trump Bump it was just a steady escalator rather than a roller-coaster. Volatility made a comeback only in Q1 2018.

So, as long-term market analysts, we should not regard the current 10-year stock market boom as entirely unprecedented. The Post-War Boom and the Reagan Era plus the Post-Cold War Booms both lasted nearly 20 years. If the current upswing is comparable – then we might have another ten years of market gains to look forward to.

Table 2: Perspective on the US equity market over the very long-term

Dates	Name of Period	Description
1900-1920	"Progressive Era" & WWI	The market largely flat-lined. The Great War had little impact. Small market cap with a small number of large quoted entities.
1920-1929	"Roaring '20s"	Smooth pronounced upward trend in stock prices until Black Tuesday on 29 October 1929. Many new listings.
1929-1933	Great Depression	Steady consecutive falls in stock market values.
1933-1940	"New Deal"	Roosevelt's programme of public works reinvigorated the US economy which slowly climbed out of depression. By 1940 the US market had regained its 1927 level.
1940-1953	WWII, early Cold War & Korean War (1950-53)	The US market fell gently during WWII and recovered only slowly after the peace of 1945. The Korean War was a further dampener on stock prices. By 1953 the market recovered its 1940 level.
1953-1973	Post-war Boom	Steady and robust market growth with a few rather minor cyclical downturns.
1973-1980	"Stagflation" & the Oil Shocks of 1973 & 1979	The US stock market made zero gains over the 1970s but experienced huge volatility.
1980-2000	Reagan-Clinton Era	Steady stock market growth – but with one spectacular short-term correction in 1987.
2000-2007	Dot.com Bubble (2000) followed by 9/11 (2001) and the Gulf War (2003)	Protracted suppressed markets followed by slow recovery, especially in financial stocks.
2007-2009	Credit Crunch	Massive stock market crash following the collapse of Bear Stearns (24/03/2008) and then Lehman Bros (15/09/2008).
2009-present	Obama recovery followed by "Trump Bump"	The slow recovery in stock prices was given a boost by the election of President Trump and the fiscal policies of his administration.

Sadly, however, as I shall show next month, contemporary geopolitics is casting some long shadows. It is unlikely, in my opinion, that the unbridled optimism of the 1950s emanating from the USA *(Hi, Honey I'm home…)* or the hubris of the 1980s and 1990s *(Hasta la vista, baby…)* will ever be emulated in the future.

Japan

Even if investors in US equities should not rush to the exit, there may be an argument to reduce exposure to the US market in favour of other markets. In a recent newsletter[ii] Morgan Stanley recommended that global equity investors who wish to reduce their US exposure should accumulate Japan. One reason for this is that return on equity (ROE) for Japanese companies has been consistently rising in recent years.

"IN A RECENT NEWSLETTER MORGAN STANLEY RECOMMENDED THAT GLOBAL EQUITY INVESTORS WHO WISH TO REDUCE THEIR US EXPOSURE SHOULD ACCUMULATE JAPAN."

Before the inception of Abenomics six years ago, the ROE for the Japan MSCI stood at just 4.4 percent – 8.6 percent less than Emerging Market stocks. Now it is at 9.8 percent, only 2.4 percent less than the Emerging Markets.

What accounts for this massive uptick in ROE?

Firstly, the Japanese economy is no longer suffering from deflation. Secondly, capital expenditure, not least in the robotics arena, is well up, driving improvements in productivity. Thirdly, as in the USA, cuts in corporate taxes have fed through into higher profits. Fourth, Japan has at last succeeded in huge improvements in the quality of

"THE US EQUITY MARKET, OVERALL, IS FAIRLY RELAXED ABOUT INTEREST RATES RETURNING TO MORE 'NORMAL' LEVELS."

its corporate governance – the revelations of the Olympus scandal in 2017[iii] were a massive wake-up call.

Collectively, these factors determine that the Japanese economy is no longer as sensitive to the value of the yen as in the past. Furthermore, Japan's growth is entirely self-funded and therefore the Japanese economy is not exposed to increases in US rates. Morgan Stanley thinks that Japanese ROE could rise to 12 percent by 2025, further stimulating the Japanese stock market's trailing P/E ratio.

The Japanese economy was growing at a clip of 1.3 percent in Q2 2018. In August, unemployment stood at 2.4 percent. Wage growth, after years of stagnation, is robust. Japan's *lost decade* is but a distant memory (though a salutary lesson).

The impact of rising rates

In economics, it's not so much the rate prevailing now but expected interest rates in the future that impact the market. Naturally, current expectations tend to be extrapolations from interest rate changes in the recent past. Given five Fed rate rises since Q4 2014, and a further four more rises expected by the end of 2019, the markets now expect that the Fed Funds rate will reach 3.13 percent in 2019 and 3.38 percent in 2020.

In financial theory the price of a stock should be equal to all the future cash flows to be derived from holding that stock discounted at the opportunity cost of capital. The cost of capital is the risk-free rate (obtained by reference to government bond yields) plus an appropriate equity risk premium. When interest rates rise, all things being equal, so do government bond yields and the risk-free rate increases. So, in theory, when interest rates rise, stock prices fall.

European bourses

Although eurozone stocks have been weak, the Euronext 100 peaked in May. Germany's DAX peaked in January and it's now down by around 15 percent. Switzerland has gone in a similar direction, though it's only down by around 10 percent from its January peak.

The eurozone economy is still growing, but the rate of growth seems to be declining – it was down to just above 2 percent in Q2. It looks like growth in Italy may have altogether stalled in Q3. On the jobs front, eurozone unemployment is down to 8.1 percent – just a smidgen above the Q4 2007 low.

In practice, increases in rates over the next two years to over three percent have already been priced into current stock indices. So, the US equity market, overall, is fairly relaxed about interest rates returning to more "normal" levels after a decade in which rates have been suppressed to historically "abnormal" levels by central bankers.

Bond markets

Things are less sanguine in the bond markets. In the first week of October, the ratings agency Fitch warned that global bond markets face a rude shock as the Fed seeks to extract excess liquidity from the financial system in order to contain inflation, which is currently running at 2.19 percent in the US. (In the UK it is now 2.4 percent.) The European Central Bank (ECB) is supposed to follow the Fed's lead before the end of this year. Forget *quantitative easing* (QE); we are now entering a phase of *quantitative tightening* (QT, anyone?).

Since 2009, the Fed, the ECB, the Bank of Japan and the Bank of England collectively injected an average of $1.2 trillion of liquidity into the markets each year. This peaked at $1.7 trillion in 2016. This year, the figure is a matter of a few hundred billion. In 2019, it will be minus $500 billion as QE is unwound. Accordingly, the Fed's balance sheet has already started to shrink. By Q1 2019, the aggregate balance sheets of the G-4 central banks will be in sharp decline.

Global bond yields have already started to respond; even German Bunds and Japanese long bonds are ticking upwards. The cost of debt is about to rise across the globe.

Madame Lagarde, the Managing Director of the IMF, warned that surging bond yields were a "wake-up" call for highly indebted countries and companies. She observed that global debt had risen by 60 percent since the financial crisis to $182 trillion. (One trillion is one thousand billion – an unimaginable number.) I wrote last March about how this might play out in a piece entitled, *The Twilight of the Zombies*. We now realise that, as well as zombie corporations, there are numerous zombie countries, of which Italy is just one.

It should be noted that the *real* US 10-year bond yield (minus the inflation rate) is still only 0.86 percent, which, in historical terms, is still extremely low. The effect of QT will be to check inflationary pressures and thus real rates are likely to rise quicker than nominal rates. Some of the ECB's money-printing is reckoned to have leaked into the US debt markets, further suppressing yields. Those funds will soon flow home.

Hedging costs for European and Japanese investors who hold US bonds have risen. Japan's $3.4 trillion life insurance sector is the largest user of such instruments.

China and Emerging Markets

The Chinese market has fared horribly this year. The Shanghai Composite peaked at the same time as Germany's DAX (the two countries are huge trading partners) and is now down almost 30 percent. Hong Kong's Hang Seng has a similar story to tell.

Yet Chinese GDP still grew at an amazing 6.7 percent in Q2 2018, but the tra-

Messages from beyond the yield curve

Many economists have noted that the real story in the bond markets is that the yield curve is almost flat. As at 30 September the yield on 3-year Treasuries was 2.88 percent while that on 30-year Treasuries was 3.19 percent – a mere 31 basis points higher. The ancient lore of the bond markets holds that a very flat yield curve portends trouble. If investors cannot glean higher returns by holding longer maturities, it could suggest that rates of return in the near future are likely to dip – probably as a result of a recession.

On the other hand, if bondholders expect interest rates to rise, and therefore bond prices to fall, they may favour the short-term end of the market in the hope that they can re-invest those funds in higher-yielding papers when they mature. There is also a supply-side issue here. Under Treasury Secretary Steve Mnuchin, the US Treasury has been funding much of its requirements at the short end and rolling debt over frequently, leading to a relative dearth of new long-term issues.

In the high-yield bond sector – often overlooked by mainstream institutional investors – given benign economic conditions, the default rate has fallen to just 2 percent against a 30-year average of 3.6 percent. The default rate in high-yield ("junk") bonds reached about 11 percent in Q1 2008.

On 04 October the former Republican congressman from Texas, Ron Paul, stated that the bond markets are giving investors a dire message about the state of the nation's economy[iv]. According to Mr Paul, the recent jump in Treasury bond yields suggest the US is barrelling toward a potential recession and market meltdown. His remarks came as the benchmark 10-year Treasury yield rallied to a seven-year high reflecting fears of rising inflation.

I could add that the correlation between stock and bond market indices has been in long-term decline over the last 30 years[v]. The correlation is currently minus 0.4. Chilled stock market investors might conclude that the bond markets can go hang – as many have.

jectory of its growth curve is negative. By 2022 its growth rate will be 5.8 percent. What is worrying about China is that debt levels have soared. Chinese government and household debt are still well below those of the USA – but non-bank corporate debt has risen to exorbitant levels.

Emerging markets have been heading south this year, with a few exceptions. The Ibovespa Brazil index has recovered since the first round of the presidential election on 07 October. (As I write I do not know the outcome of the second round on 28 October. It looks like it will be Mr Bolsonaro of the Social Liberal Party – even though he is not at all socially liberal.) The Russian and Indian markets, however, have both been poor performers.

Table 3: China and USA debt as a proportion of GDP[vi]

	China	USA
Government	47.8%	99.0%
Household	49.4%	77.3%
Non-bank corporate	164.1%	73.5%

The "BRICS" was an acronym coined by a Goldman Sachs economist who was then put into the House of Lords as a minister but then lost his political address. It is a useless coinage. But then so is *Emerging Markets*. A much more useful measure of advancement is to quantify what percentage of the population belongs to the *middle class.* There are robust IMF-World Bank metrics to gauge this.

Last year, 12 percent of India's population was "middle class". China scored at 30 percent, Brazil at 52 percent, Mexico at 70 percent, and South Korea at 90 percent. I'd love to know what the figure is for Russia – but it must be similar to Brazil's. Once we know how much of a population is middle class we can surmise how much they value education, travel and services – we have an insight into their aspirations.

India will grow by an estimated 7.4 percent in 2018. It has world-clout culture and a rapidly evolving financial system; it is a technology powerhouse; it is a vibrant democracy with a space programme. It is also a land of haves and have-nots. Half of its population (that's 600 million people) have access to sanitation – and the other half do not. Standards of public health in China are much higher.

In terms of currencies the headline disasters are the Turkish lira (down 50 percent against the dollar this year) and the Argentinian peso. But overall, pretty much all EM currencies have lost ground against the dollar, and as such their poor returns have been made even worse when expressed in dollar terms. The Indian rupee, the Russian rouble, the South African rand and the Brazilian real have all fallen.

> **"WHAT IS WORRYING ABOUT CHINA IS THAT DEBT LEVELS HAVE SOARED."**

On 19 October Bank of England Governor Mark Carney told an audience in New York that the growth of investments in emerging markets – from $50 trillion to $80 trillion over the last decade – could provoke a "fire sale" in turbulent markets. He said that $30 trillion of those assets were illiquid. A failure to sell these in stressed conditions could cause *contagion*.

The London Market

Back in late May this year I penned a piece entitled *Footsie 8000 – What's not to like?* It seemed that the FTSE had finally broken out of its long-term range boundary and was heading north at last. But it was not to be. Despite the

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"IT'S TIME FOR FUND MANAGERS TO JUSTIFY WHY INVESTORS SHOULD BE IN UK EQUITIES AT ALL."

glorious summer in the UK, the fog of Brexit never lifted in the financial markets.

The FTSE-100 index, it must be said, is an extremely odd one in that it is very detached from the economic fundamentals of its host economy. This is for two reasons. Firstly, there are a lot of constituent listings there – miners, oil majors, commodity traders (think of **BHP Billiton (LON:BLT)** or **Glencore (LON:GLEN)**) – which conduct only a very small proportion of their business in the UK. Second, there are UK-domiciled companies which generate much of their income overseas. When the pound falls against the dollar their sterling income stream rises. That was partly why the post-Brexit devaluation of sterling had only an attenuated impact on the London market.

It is sobering to reflect that the FTSE-100 brushed 7,000 on Millennium Eve (31 December 1999) and it is pretty identical as I write this nearly 19 years later – down about six percent on the month. (Of course, that does not reflect dividend pay-outs, which are currently running at over 4 percent – so much better than cash.) That is why UK-based equity investors should focus on the FTSE-250 or the FTSE-All Share indices rather than the weird FTSE-100.

The FTSE-All Share has fared much better in the 21st century – up from 3,000 to 3,811 as I write – so up by 27 percent in 19 years. Still, that's not particularly impressive. It's time for fund managers to justify why investors should be in UK equities at all.

The "doom loop"

In the first week of October the IMF warned that the world's banks are highly exposed to risky government debt which it calls the *doom loop*. In many countries – Italy is an extreme example – most government bonds are snapped up by domestic banks because they require little capital to be allocated against them under the Basel III capital adequacy regime. Italy's banks hold nearly 10 percent of the country's approximately €2 trillion of debt – which stands at 132 percent of GDP.

As yields on distressed government debt rises – currently the case in Italy – so the mark-to-market value of those bonds diminishes and the banks which hold those bonds have to allocate additional capital.

If the Italian government defaults on its obligations then the entire Italian banking system would collapse overnight. As I have written recently, Europe's French and German masters will move Heaven and Earth to stop that from happening. Italy is now looking like the weak link in the eurozone chain, as Greece was in 2010-12. I have expressed the view that, come the hour, the Italians will prefer to remain in the eurozone rather than launch some experimental digital currency. But Italy, a $2 trillion economy, has the heft to put the entire eurozone under economic strain for some time to come.

Fiscal pressures

In fiscal 2018 the government of the USA will borrow $1 to finance every $5 that is spends. (It will spend about $4.1 trillion.) Last year the US budget deficit amounted to 3.5 percent of GDP. In 2028, according to JP Morgan, it will be 5.1 percent of GDP.

What is worrying when economists look at the debt profiles of rich developed nations is that sustained fiscal deficits have led to rising levels of national debt – even during relatively benign economic conditions. The consensus amongst mainstream Keynesian economists, really from the 1930s to the Credit Crunch of 2007, was that governments should borrow in times of recession in order to spend in order to stimulate the economy. Keynesians believe in the *multiplier effect* whereby every $1 of government expenditure flows through the economy from the worker to the shop to the shopkeeper…Curiously, classic Keynesians do not think that investment from the private sector has the same effect.

But classic Keynesians also believed that governments should sustain fiscal surpluses during upturns. That is not what has happened since 2009, with minor exceptions (of which, Sweden). Instead, since the financial crisis, governments, most notably that of the biggest economy in the world, have continued to return, compulsively, to the cash machine which is the sovereign debt market.

Key economic indicators

In the USA the growth rate for Q2 2018 was just shy of 4 percent and in August 2018 the unemployment rate was recorded at 3.9 percent – the lowest rate since 1970. Modern service driven economies with large pools of mobile labour (gig workers on zero-hours con-

> **"THE COST OF DEBT IS LIKELY TO CONTINUE TO RISE IN 2019, SUGGESTING THAT THE DEFAULT RATE MAY INCREASE. THAT IS BAD NEWS FOR MATURE, INDEBTED COMPANIES."**

tracts etc.) have different characteristics than the manufacturing-based US economics of the 1950s and 1960s, so that a low level of unemployment is not necessarily an indication of economic well-being.

Economists generally believe that, over the long-term, exchange rates do not matter; they just reflect imbalances in capital flows. But, of course, for exporters and importers, exchange rates matter a lot. In the global economy such as it is, within the developed world (Europe, North America Japan, Korea) mutual exchange rates are largely determined not by trade balances but by interest rate differentials. Rising US rates – from near-nothing to something – imply a rising dollar – which is why President Trump is unhappy.

In terms of confidence indices there is currently a marked difference between developed markets (DM) and emerging markets (EM). According to the latest quarterly round of the Global Purchasing Managers' Index for manufacturing, most DM indices display confidence (the exception is Italy), while virtually all the major EM countries expect a downturn.

Growth in world trade is humming along quite nicely at about 4 percent – down from 5 percent last year. All of the major exporting economies have continued to prosper this year. Incidentally, the UK exports 17 percent of its total output as compared with 16 percent for the eurozone as a whole and just 14 percent for Japan. Don't let anyone tell you the UK is not a major trading nation. On the other hand, our Canadian cousins export 25 percent of their GDP (mostly to the USA, of course). The USA exports just 8 percent of its GDP – which is why it can afford to engage in trade wars.

While rising rates will suppress growth in 2019 and inflation will cause concern, I don't see much reason to suppose that there will be a recession in 2019 – although the oil price is the joker in the pack. Readers must have been on retreat in Tutankhamen's tomb if they do not know that the oil price has been rising fairly steadily since February 2016 when crude oil hit a low of $35.94 per barrel[vii]. At the end of September, it was $73.55. As I write, Brent Crude is at $77.70. Morgan Stanley thinks that the oil price will hold up in 2019. The question is whether geopolitical events may intervene to cause it to surge.

Conclusion & action

2018 has been a year of flat markets – though the US market has continued to benefit from the strong performance of the tech giants. Volatility has returned – we have now had several bouts of extreme volatility, of which one in February and one in October. In the credit markets, bond yields are increasing and credit spreads are rising. The cost of debt is likely to continue to rise in 2019, suggesting that the default rate may increase. That is bad news for mature, indebted companies.

What to do? Morgan Stanley has produced an eclectic list of asset classes to avoid. These include cryptocurrencies, European banks, EM equities and bonds, Italian bonds, consumer staples, airlines and base metals. The fund manager still prefers equities to debt, however. It favours pure defensives right now: utilities, staples, telecoms and energy.

We know there will be a market correction sometime – but when? That is the trickiest one to pin down. My answer this November is: *not yet.* Markets follow sentiment around economic fundamentals, perceptions of which are imprecise. Growth is likely to slow next year – but that does not mean that the world will fall into recession – though the build-up of debt globally is worrying. It is more likely that the bull market will be curtailed within two years or so by a conflation of certain critical geopolitical events.

You can see these thunderbolts coming if you carry good binoculars. Next month I'll share with readers the salient geopolitical themes of 2019.

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 Named after the Flemish geographer Gerardus Mercator, 1512-94.
- ii Morgan Stanley Sunday Start, What's next in global macro, 30 September 2018, by Jonathan F Garner.
- iii See: https://www.bbc.co.uk/news/business-39741921
- iv See: https://www.cnbc.com/2018/10/05/ron-paul-us-barreling-towards-a-recession-and-theres-no-escape.html
- v Rolling 90-day correlation between the S&P 500 and the Bloomberg-Barclays Us Aggregate, as reported by JP Morgan.
- vi Source: JP Morgan.
- vii See chart at: https://www.macrotrends.net/1369/crude-oil-price-history-chart

BY DAVID JONES

FORENSIC FOREX

IS GOLD SET TO SHINE AGAIN?

For this month's forex column, I thought we could go back to the world's oldest currency (used as coins in 600 BC, apparently) and take a look at gold. Of course, you could argue that it is more of a commodity these days than a currency, but, as so much of gold's value has to do with factors such as US dollar strength and other economic drivers such as inflation, it seems fair for the precious metal to straddle the currency sector too.

It has been a frustrating – and ultimately profitless – few years for long-term holders of gold. The price, measured in US dollars, peaked just above $1,900 an ounce in September 2011. By November 2015 it had slid as low as $1,050. The chart above shows a break-up through the downtrend early in February 2016. I remember this happening and thought it was important – the first time it had really threatened that trend for a few years. Classically, breaks like this suggest that the existing trend is weakening and the market in question could be on the cusp of a new trend.

Gold Chart – April 2013 to Present

Following this break, the next six months did see the price of gold gain in price, moving from around the $1,200 mark to just shy of $1,380 during July 2016. This was a sizeable move for a major market like gold and did suggest that a new trend was well underway.

"BREAKS LIKE THIS SUGGEST THAT THE EXISTING TREND IS WEAKENING AND THE MARKET IN QUESTION COULD BE ON THE CUSP OF A NEW TREND."


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GOLD
999.9
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The Rally Stalls

But as it turned out, those July highs were going to remain unsurpassed – and at the time of writing that still remains the case. In the second half of 2016 the price slid back below $1,130. During 2017 and for the early part of 2018, once again gold made a valiant effort to put some sort of sustainable recovery together, but, as can be seen from the chart above, the $1,380 barrier proved too much and once again the momentum ran out and the price slid.

There are a couple of factors that have weighed on gold this year. The main one – and gold is not alone in feeling the effects of this – is a resurgence in the US dollar. As mentioned previously in this column, 2017 ended up being the worst year for the dollar in more than a decade. Like other currencies quoted against the dollar, if the dollar goes down, then gold usually goes up. The resurgence of the US dollar from April of this year knocked back the likes of the pound and the euro – and of course the value of gold.

Traditionally, gold is viewed as a safe haven in times of trouble. When stock markets tank, investors have fled to gold as a way of reducing their risk. We have not had much in the way of major market sell-offs in recent years. Apart from the odd short-lived burst of volatility, broadly speaking, stock markets have steadily ground their way higher, delivering excellent returns to investors who have turned their back on the safety of the yellow metal.

Another safe haven use is as a hedge against inflation. Again, gold has been seen as somewhere to park your cash and its value would at least keep pace with the cost of living. But for many years we have been in a low inflation environment, so the compulsion to hedge against this has just not been there.

> **"A WEAK DOLLAR WOULD NORMALLY BE EXPECTED TO LIFT THE PRICE OF GOLD."**

What's Different Now?

Let's first take a look at what the price has been doing. After this year's earlier trip back towards the $1,380 area, the rally stalled as the US dollar came back in favour. This then turned into a full-blown slide, dropping to the $1,160 area by August of this year. Since then there has been a short bounce, but the past couple of months has been pretty dull, with the price of gold trapped in a fairly tight sideways range.

But during October this changed. Gold broke out of its six-month downtrend, looking the most positive it has done for a while – at least from a price-action point of view. Every journey starts with a single step – and breaks of downtrends can often be the first charting sign that sentiment is on the turn.

Let's take a look at the wider backdrop. During October global stock markets experienced sharp falls – at least in relation to the lower volatility that investors have become used to in recent years. This was perhaps a reminder, to those who needed it, that equities were not without their risks. Some of the hardest hit were the technology stocks, such as Facebook and Netflix, both of which have been major drivers behind the wider market strength. It is the second time this year that stock markets have had a short, sharp shock. The last time was in February – and after this, US markets did admittedly go on to set fresh all-time highs before the next stumble. But perhaps the most recent slide will be the catalyst that makes some investors look to reduce risk and increase exposure to the more 'boring' assets such as gold.

The US dollar has had quite a run from April of this year – and maybe that run went a little too far. It is still strong, but, with the broader dollar index gaining not far off 10% in under six months, there is definitely scope for some medium-term dollar weakness here. And a weak dollar would normally be expected to lift the price of gold.

And then there is the inflation angle. The world is not at 'small South American republic' levels of inflation – but the cost of living is definitely on the up after bumping around not far off zero for some time. Plus, the threat of trade wars and tariffs could have further effect here, pushing up the cost of imported goods for the world's major economies. It's early days in the rising inflation cycle, but it's another factor that could play into the hands of the gold bulls, and see the yellow metal once more regain its popularity with a wider investor base.

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

RESET

HOW TO RESTART YOUR LIFE AND GET F.U. MONEY

BY DAVID SAWYER

RESET is a self-published book crafted by PR man David Sawyer, a typical hard-working 45-year-old middle-class professional with a wife and two kids. He has spent the vast majority of his career to date at PR firm Weber Shandwick, winning a number of awards with his team along the way and being awarded a Fellowship of the Chartered Institute of Public Relations for his outstanding contribution to the industry. Sawyer founded his own PR business in 2014 and, as well as being clever, has found time to run a marathon in just 2 hours 40 minutes – some 1 hour 47 minutes faster than my own best effort!

The book is aimed at mid-life, middle-class workers. Specifically, those millions of overworked but well paid middle-aged professionals around the world who either hate or are unhappy in their jobs and have no time for chasing their dreams. No time to focus on what really makes them happy. The book is even aimed at people like me – middle-age starts at 35 apparently!

Sawyer illustrates his typical reader with a profile of his friend "Bren", a laboured but well paid council communications executive who is pushing 50. Already overworked and stretched to the limit, he is offered a chunky pay rise to take on more responsibility and be on call all hours. While this lets him buy a bigger house and have expensive family holidays, he feels trapped in the job and is at the beck and call of a younger, demanding, high-flying boss who he would probably kick in the nadgers given half a chance, if she was man. Forced to check hundreds of emails a day, some on the toilet, some while he should be watching his kids play football, he finally realises he is unhappy and has to do something about it. He seems to me a bit like a modern day Bob Cratchit – but with a good salary.

In RESET, Sawyer offers Bren and his brethren a way out of the middle-class malaise by providing a systematic plan, based on his own experience, to "reset" and restart their lives. And all without the extreme moves of leaving their partners, quitting their job or joining a kibbutz. The ultimate goal of the RESET plan is for readers to become happier at home and work, better at their job and to have a plan in place to eventually become financially independent.

The six main parts of the book kick off by asking what matters to you, or in other words "what makes you happy?" The answer will be different for everyone. But whether it be family, hard work or breaking a world record, we

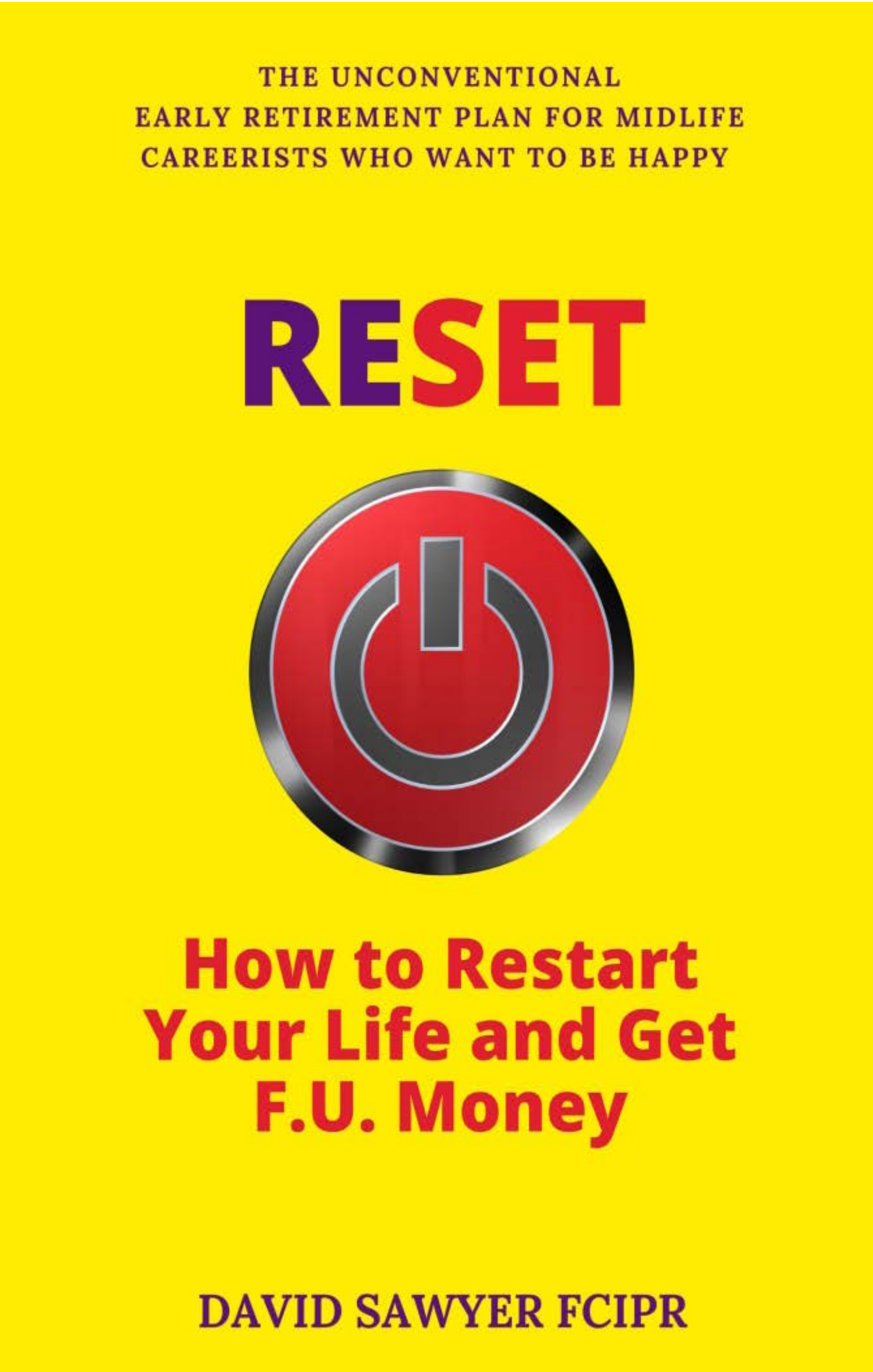
> **"RESET IS ONE OF THE BEST BOOKS I'VE READ THIS YEAR AND IN MY OPINION THE ULTIMATE SELF-HELP/LIFE IMPROVEMENT GUIDE FOR THE TIRED MIDDLE-AGED PROFESSIONAL."**

should all have a meaning and purpose to our lives. Sawyer advocates identifying your purpose in life and making a plan to achieve your goals. Taking a different approach to most self-help books, Part Two then looks at how to "future proof" your career by embracing (but not abusing) digital technology.

Part Three focuses on decluttering your life, removing the physical and digital junk which goes to cloud our minds, to free up time for more important things. Do you really need to subscribe to hundreds of email lists or keep those 20-year-old copies of Private Eye under your bed? If not, then get rid of them.

The term "F.U. money" in the book's sub-title refers to having enough money that you never have to do anything you don't want to for money ever again – e.g. you have enough money to be confident enough to tell the miserable HR boss where to go when they chastise you for being 3 minutes late to work even though you did two hours unpaid overtime the previous night.

This concept is expanded in Part Four, the longest of the book, with Sawyer setting out an easy, practical, stress-free plan for how to become financially independent. This is based on the FIRE concept (Financial Independence Retire Early) and teaches how you can live the lifestyle you want. After working out how much you'll need to live comfortably and what size stash you'll need to get that money every year, Sawyer provides a range of advice on how to invest your money to get to that magic number. At the end of it all you should hopefully be able to retire years earlier than the government wants you to.



Part Five takes a different tack by summarising 11 core principals learned in the previous chapters that Sawyer believes should guide both your work and life. My personal favourite is principal one, "be different", where the author advises, *"never give a monkey's chuff what people think"*. In similar fashion, Part Six follows with a list of 12 Do's and Don'ts. I don't quite agree with the "don't' live in London" advice – it ain't that bad. But I do agree with the instructions to play, laugh, seek adventures and get physical.

Overall, RESET is one of the best books I've read this year and in my opinion the ultimate self-help/life improvement guide for the tired middle-aged professional. Sawyer's chatty and irreverent writing style makes him feel like your mate down the pub and not like one of those annoying American, look at me on a desert island trading Shitcoin with a load of girls and a yacht blah blah blah types. With over 500 references it is very well researched and acts as a handy reference guide once you've given it an initial read. RESET your life today!

About Richard

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

BY TIM PRICE

THE FINAL WORD

THE ONE WAY TO HAPPINESS

"There is only one way to happiness and that is to cease worrying about things which are beyond the power of our will."

– Epictetus.

The investment strategist Ben Hunt recently wrote, in my opinion, one of the best investment essays of 2018. In Things Fall Apart, Ben touches on the political polarisation that has occurred in the US since the last presidential election, though he might just as well have been writing about the increasingly bitter and partisan political landscape in the UK and Europe too:

...If you have a two-party political system with high-peaked bimodal electorate preferences, as the United States began to develop in 2014 and has now fully formed, there are no winning centrist politicians and no stable centrist policies. Instead you have – politically speaking, at least – what Yeats called a *widening gyre*, where a steady stream of extremist candidates, each very attractive to their party base, pull the overall electorate into a greater and greater state of polarisation. In other words, if you enjoyed the choices America had in the 2016 presidential election, you're gonna love 2020.

From there, Ben goes on to analyse the frustration that so many investors must surely be feeling today, after a decade in which US large-cap stocks – i.e. the S&P 500 index – have outperformed just about everything else on the planet:

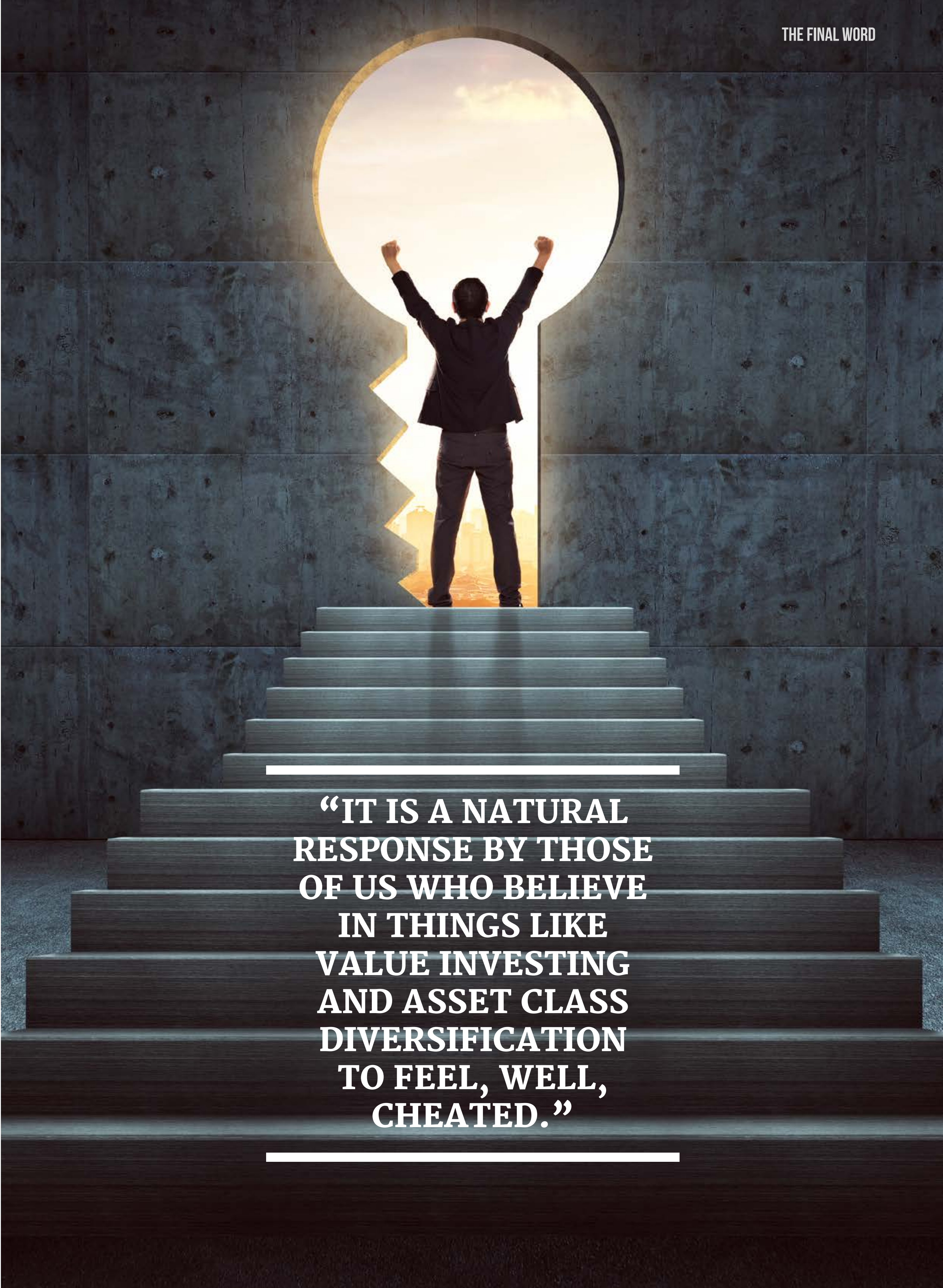
What drives our disappointment? For a *decade* now...

- It is a *fact* that NONE of us have done as well in our individual real-life portfolios as ALL of us have done in aggregate hypothetical indices.
- It is a *fact* that Value has waaay underperformed the S&P 500.
- It is a *fact* that Trend has waaay underperformed the S&P 500.
- It is a *fact* that Quality has waaay underperformed the S&P 500.
- It is a *fact* that Emerging Markets have waaay underperformed the S&P 500.
- It is a *fact* that Real Assets have waaay underperformed the S&P 500.
- It is a *fact* that Hedge Funds have waaay underperformed the S&P 500.
- It is a *fact* that smarts and experience of every sort have waaay underperformed the S&P 500.

And if that weren't enough, here's the kicker that'll get everyone mad at me, because it challenges the central tenet of the Church of Modern Portfolio Theory.

It is a *fact* that diversification has failed us for a decade.

The entire edifice of diversification and Modern Portfolio Theory is built on a simple and powerful idea – that it is *meaningful* to talk about uncorrelated asset classes and factors with positive expected returns. It's built on the belief that all of these 'Things' we call asset classes or factors will work over the long haul, but not all of them will work all of the time or in lockstep with each



"IT IS A NATURAL RESPONSE BY THOSE OF US WHO BELIEVE IN THINGS LIKE VALUE INVESTING AND ASSET CLASS DIVERSIFICATION TO FEEL, WELL, CHEATED."

other, so you're (much) better off owning a mix of these 'Things' rather than just one of these 'Things'.

Put another way, well-diversified portfolios work *great* in a widening gyre.

But our current market equilibrium is the *opposite* of a widening gyre. Where our politics have moved from a roughly single-peaked distribution of electorate preferences to a bimodal distribution, so that there is no effective centre, our markets have moved from a multi-modal distribution of investor preferences to a single-peaked distribution, so that it's all US large-cap stocks all the time...

Ben overstates the case for ironic effect. But his central thesis is sound. When over the course of 10 years just one market trounces every other on the planet, and reaches almost unprecedented valuations (the S&P 500 now trades on a cyclically adjusted price / earnings ratio of 33 times, its second highest level in the last 150 years and only surpassed by the period of the first dotcom bubble), it is a natural response by those of us who believe in things like value investing and asset class diversification to feel, well, cheated.

The former financier and best-selling author Michael Lewis made a similar observation about the perceived failings of value investing when he wrote that:

Graham and Dodd investors [i.e. value investors – the value investors' Bible, *Security Analysis*, was written by Benjamin Graham and David Dodd in 1934] are people who place a very high value on having the last laugh. In exchange for the privilege they have missed out on a lot of laughs in between.

Like most of the things Michael Lewis has ever written, this is funny and also wounding, at least to most value investors.

But what Ben Hunt and Michael Lewis share here is a presumption that we are all trying to beat the market. That presumption doesn't hold for me and I dare say it doesn't necessarily hold for you either.

Many of us are, I suggest, not index-relative, but rather absolute return investors instead.

The purpose and ambition of absolute return investing is not to outperform some arbitrary benchmark – the FTSE 100 index, for example – but, rather, to participate in as much of the upside potential from asset markets when they're rising, and also to preserve capital when they're not. To this end the absolute return risk profile is asymmetrical: pursue meaningful gains, but absolutely limit losses.

Now, I suggest, is probably a good time to be an absolute return investor.

Interest rates have been falling for three and a half decades. Those declining rates have triggered, by and large, colossal rallies in the prices of bonds and stocks worldwide. That's the good news, but it's all in the past.

"NOW, I SUGGEST, IS PROBABLY A GOOD TIME TO BE AN ABSOLUTE RETURN INVESTOR."

Now interest rates are starting to rise, in the US and elsewhere, but the US is the most important market and economy in the world. More to the point, the US Federal Reserve is finally starting to remove some of the extraordinary monetary policy accommodation that it has granted the financial markets since the Global Financial Crisis. Interest rates that were becalmed at zero are now gently moving higher; Quantitative Easing is slowly being rescinded. The implications for financial asset prices are clear. We should not expect them to rise, or at least not to rise at anything like the pace and extent we have all been used to since the trough of the market sell-off that was reached in March 2009.

Such is the 'fundamental' argument.

Economics and politics aren't exactly helping. President Trump seems determined to press on with trade wars that cannot be won by anybody. The UK and the EU are still mired in an ill-spirited debate over the terms of Brexit. The so-called FAANG stocks are starting to display technical weakness, and much of 'Big Tech' now faces regulatory pushback that could meaningfully impact their future growth. Even as I write, the father of the world-wide web, Sir Tim Berners-Lee, has announced the launch of Inrupt, a start-up that plans to decentralise the web and "take back control" from the Internet leviathans that currently act as a data oligopoly. There is a sense of change in the wind, and not necessarily for the better for the market's previous winners.

Per Epictetus, however, there is only so much we can do as individuals to counter these trends.

While I acknowledge some of the painful truth in Michael Lewis' aphorism about value investing, there are also ways of mitigating some of the pain and frustration, that "lack of laughs". One of them is patience. One of them is stoicism. One of them is discipline.

In terms of practical investment advice, within my asset management business, we attempt to draw the sting of whatever adverse future developments may come by allocating to three distinct types of assets:

"THE FINANCIAL WORLD FACES NO SHORTAGE OF PROBLEMS IN THE MONTHS AND YEARS AHEAD."

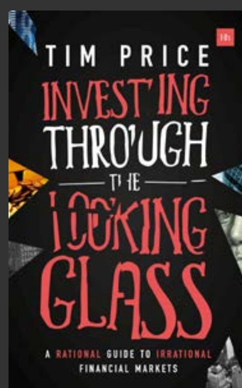
- 'Value' stocks, that is to say shares in decent businesses run by principled, shareholder-friendly management, where those shares are – for whatever reason – being temporarily 'given away' by an irrational market;
- Systematic trend-following funds – i.e. price momentum-based funds that try to 'hitch rides' on price trends, whether higher or lower, across currencies, interest rates, stock indices and hard and soft commodities. These types of funds have little or no correlation to stock and bond markets but have enjoyed good long-term returns and they offer the potential to make outsized gains during periods of market stress;
- Real assets – tangible, non-financial things that when you drop them on your foot, they hurt. We give especial primacy to the monetary metals, gold and silver, because we strongly believe that the future central bank policy response to the accumulated global debt mountain will be highly inflationary.

To put it another way, although Ben Hunt is right that many investors who have pursued a diversified approach to their portfolios probably feel intensely frustrated at the outperformance by a narrow band of US mega-cap stocks, that doesn't mean that asset class diversification has been permanently discredited. Rather, it could just mean that we have lived through an extraordinary period in financial history, and that markets, along with interest rates, may finally be starting to normalise once again.

The financial world faces no shortage of problems in the months and years ahead, and I would put higher rates and a correction in debt markets at the top of the list. There is, however, a nice line by Mark Rylance's KGB officer in the Steven Spielberg movie *Bridge of Spies*. Tom Hanks' American lawyer tells Rylance that he faces the electric chair, and that he doesn't seem alarmed at the prospect. Rylance's character replies stoically, *Would it help?*

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'.



NOVEMBER 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

FRIDAY, 9 NOVEMBER

Event:	Manchester Investor Manchester
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

MONDAY, 12 NOVEMBER

Event:	Women Angel's Of The North Investment Forum
Organiser:	UKBAA / Growth Capital Partners / North Invest
Time:	10:00-16:00
Place:	The Queens Hotel, City Square, Leeds, LS1 1PJ
Link for tickets:	https://www.womenangelsforum.org

WEDNESDSAY, 21 NOVEMBER

Event:	Netwealth evening session with Gerard Lyons
Organiser:	Netwealth
Time:	18:30
Place:	60 Charlotte Street, London, W1T 2NU
Link for tickets:	https://www.netwealth.com/events

MONDAY-THURSDAY, 26-29 NOVEMBER

Event:	Mines and Money
Organiser:	Mines and Money
Time:	09:00-17:00
Place:	Business Design Centre, Islington, London
Link for tickets:	https://london.minesandmoney.com

TUESDAY, 27 NOVEMBER

Event:	5th Mayor of London's Techinvest - Women in Tech
Organiser:	UKBAA and Mayor of London
Time:	16:00-19:30
Place:	Rocketspace, 40 Islington High St, London N1 8EQ
Link for tickets:	http://techinvest.london

FRIDAY, 30 NOVEMBER

Event:	VCT & EIS Investor Forum
Organiser:	Investor Conferences (UK)
Time:	08:00-17:00
Place:	Grange Tower Bridge Hotel, 45 Prescot Street, London E1 8GP
Link for tickets:	https://www.thevctandeisinvestor-forum.com

THURSDAY, 6 DECEMBER

Event:	Capital Cell Investor Pitching Event
Organiser:	Capital Cell and Gieves and Hawkes
Time:	08:00-17:00
Place:	No. 1 Saville Row, London, W1S 3JR
Time:	Please RSVP to donna@capitalcell.net

FRIDAY, 7 DECEMBER

Event:	Prime Advantage Capital
Organiser:	Prime Advantage Capital Partners Breakfast
Time:	08:30
Place:	The Clubhouse, Mayfair, 50 Grosvenor Hill, London, W1K 3QT
Link for tickets:	https://www.eventbrite.co.uk/e/pa-capital-partners-breakfast-tickets-50643775897

MARKETS IN FOCUS

OCTOBER 2018

GLOBAL EQUITIES

Index	Last Month %	YTD%	52-Week Strength
Bovespa	10.2	14.4	
Dow Jones	-5.1	2.7	
FTSE 100	-5.1	-6.7	
IBEX 35	-5.3	-10.8	
Russian TSI	-5.8	-0.8	
S&P/ASX 200	-6.1	-3.7	
DAX Xetra	-6.5	-9.9	
S&P 500	-6.9	2.5	
Euronext 100	-7.1	-3.1	
CAC 40	-7.3	-3.0	
FTSE All-World	-7.6	-4.0	
CSI 300	-8.3	-21.2	
NASDAQ 100	-8.7	10.5	
Nikkei 225	-9.1	-2.3	
Hang Seng	-10.1	-11.5	

COMMODITIES

Commodity	Last Month %	YTD%	52-Week Strength
Sugar (No. 11)	20.9	-3.4	
Coffee	13.5	-2.2	
Natural Gas	9.0	9.8	
Iron Ore	8.9	7.3	
Cocoa	5.7	25.2	
Platinum	2.8	-6.8	
Gold	1.8	-5.7	
Aluminum	0.2	3.7	
Palladium	0.1	1.8	
Cotton	-1.1	5.2	
Silver	-2.8	-14.0	
Copper	-3.7	-17.2	
Bitcoin	-4.9	-56.3	
Crude oil (Brent)	-9.8	8.9	
Crude oil (Light Sweet)	-11.6	5.3	

FOREX

Pair/Cross	Last Month %	YTD%	52-Week Strength
USD/CHF	2.7	2.6	
USD/CAD	2.0	4.1	
EUR/CHF	0.1	-2.4	
GBP/AUD	-0.1	4.2	
EUR/GBP	-0.5	-1.1	
USD/JPY	-0.7	0.3	
AUD/USD	-1.9	-7.7	
GBP/USD	-2.0	-3.8	
EUR/USD	-2.5	-4.8	
EUR/JPY	-3.3	-4.6	

CENTRAL BANKS – RATES & MEETINGS

Central Bank	Key Rate	Next	After
Bank of England (BoE)	0.75%	Dec 20	Feb 07
European Central Bank (ECB)	0.00%	Dec 13	Jan 24
Federal Reserve System (FED)	2.25%	Nov 08	Dec 19
Bank of Japan (BoJ)	-0.10%	Dec 20	Jan 23
Bank of Canada (BoC)	1.75%	Dec 05	Jan 09
Reserve Bank of Australia (RBA)	1.50%	Nov 06	Dec 04
Swiss National Bank (SNB)	1.50%	Dec 13	Mar 21
Banco Central do Brasil (BCB)	6.50%	Dec 12	Nov 08
Central Bank of Russia (CBR)	7.50%	Dec 14	Feb 08
Reserve Bank of India (RBI)	6.50%	Dec 05	Feb 06

FTSE 350 TOP RISERS

Company	Last Month %	YTD%	52-Week Strength
Intu Properties PLC	27.3	-23.0	
Polymetal International PLC	17.9	-20.7	
Telecom plus PLC	17.1	1.3	
NEX Group PLC	14.3	86.2	
Randgold Resources Ltd	12.8	-13.6	

FTSE 350 FALLERS

Company	Last Month %	YTD%	52-Week Strength
Keller Group PLC	-36.2	-32.0	
ConvaTec Group PLC	-30.3	-19.9	
Hastings Group Holdings PLC	-28.6	-37.9	
Superdry PLC	-25.6	-56.4	
Metro Bank PLC	-25.2	-33.1	

FTSE 350 SECTORS RISERS

Sector	Last Month %	YTD%	52-Week Strength
Fixed Line Telecom	6.7	-4.4	
Gas, Water & Multiutilities	2.5	-5.6	
Food Producers	0.3	-12.7	
Pharmaceuticals & Biotech	-0.1	12.4	
Electricity	-0.2	-8.5	

FTSE 350 SECTORS FALLERS

Sector	Last Month %	YTD%	52-Week Strength
Industrial Transportation	-20.5	-20.5	
Leisure Goods	-18.9	44.6	
Automobiles & Parts	-16.5	16.2	
Chemicals	-14.2	2.5	
Aerospace & Defense	-13.7	-2.0	

IA SECTORS RISERS

Sector	Last Month %	YTD%	52-Week Strength
UK Index Linked Gilts	3.3	0.8	
UK Gilts	0.8	-0.8	
UK Direct Property	0.3	3.6	
£ Corporate Bond	0.2	-1.5	
Short Term Money Market	0.0	0.3	

IA SECTORS FALLERS

Sector	Last Month %	YTD%	52-Week Strength
China/Greater China	-11.2	-15.5	
UK Smaller Comp	-10.1	-5.9	
Japanese Smaller Comp	-9.6	-5.0	
European Smaller Comp	-9.4	-7.7	
North American Smaller Comp	-8.9	5.6	