ISSUE 51 – JUNE 2019

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INVESTING IN THE AGE OF POPULISM

PLUS...

BITCOIN
BACK FROM THE DEAD?

SAINSBURY'S
WORTH PUTTING IN YOUR BASKET?

SMALL IS BEAUTIFUL
OUR PICK OF THE SMALL CAP FUNDS

BUBBLES, CRASHES AND PANICS
WHAT CAN WE LEARN FROM THEM?

WELCOME

Dear Reader,

The month of May has been something of a whirlwind – at least as far as UK politics is concerned. The long-awaited resignation speech of Theresa May was delivered just as Nigel Farage's Brexit Party came from nowhere to storm to victory in the European Parliamentary elections.

No doubt the result reflected voters' disillusionment with the lack of progress on Brexit, but it also demonstrated the depth of antipathy towards 'conventional' politicians and the establishment at large. As Victor Hill explains in this month's cover feature (page 10), this populist surge is an important development and one that investors must keep an eye on, especially as it seems to be an international phenomenon.

Meanwhile, Donald Trump has upped the ante in the trade war with China, which hangs over the global markets like the Sword of Damocles. Up until now, the markets have remained relatively sanguine about this spat. But the longer this goes on the more likely it is to develop into something more sinister. You can hear more about this topic in my upcoming podcast with Henderson Far East Income manager Mike Kerley – sign up HERE via Apple Podcasts or Spotify to make sure you never miss an episode.

One last thing I'd like to make readers aware of this month is our upcoming *Master Investor in Focus* event on investing in medicinal cannabis. This is an exciting market that has the potential to transform the quality of life of people suffering from some really nasty illnesses. Up to now, Canada has been leading the way with regard to the regulatory side of things, and although the UK has been slow to reassess its position there are now clear signs that attitudes are shifting.

The event is scheduled for 27 June at 18:00 and will be held at the offices of DAC Beachcroft in central London. We hope to have an exciting line-up of companies and speakers for you in this very promising sector – so act now to reserve your place by clicking HERE.

As always, I wish you all the best of luck in the month ahead.

Best regards,

James Faulkner
Editor

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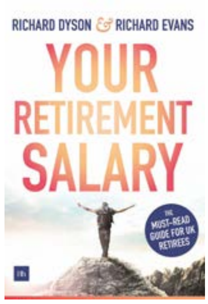

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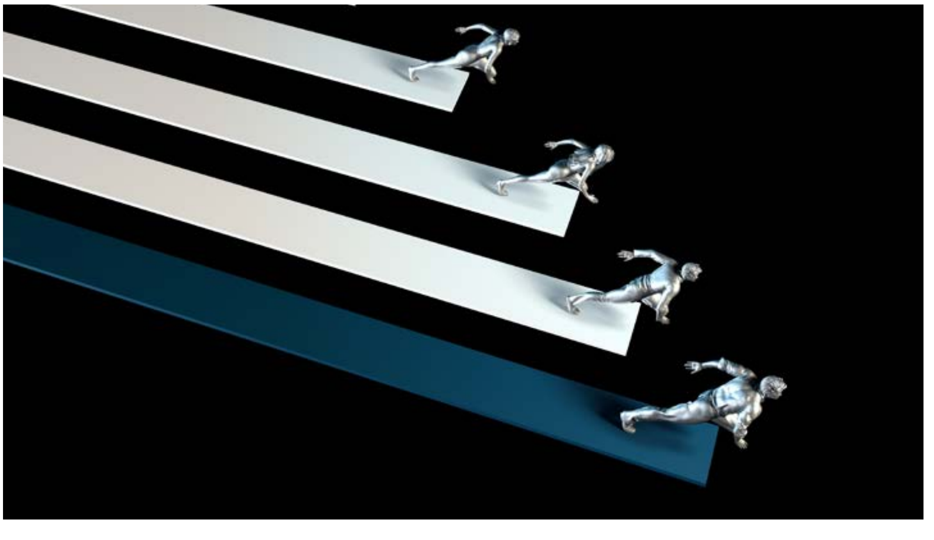

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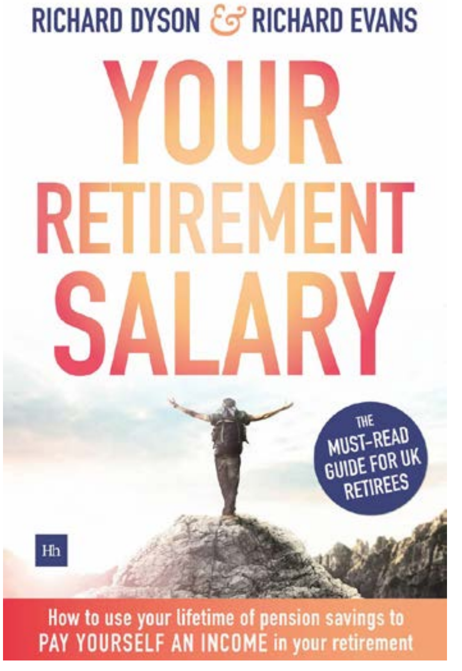

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BY JIM MELLON

MELLON ON THE MARKETS

Inside the mind of the Master Investor: Influential British investor Jim Mellon reveals his latest thoughts on the markets.

I've just been in the US, speaking at the spectacular Mauldin Economics conference where I had the pleasure of listening to George W Bush in conversation with Kyle Bass. The ex-President could give British politicians lessons in self-deprecation, charm, decisiveness and compromise. Lessons much needed.

But, despite all the noise, angst and bitterness, the UK economy, flexible as it is, continues to defy the predictions of the pre-referendum worthies who suggested we would all be ferreting around in rubbish bins by now. Three years of continued economic growth, subdued, but better than our supposedly blessed European major neighbours.

Brexit really doesn't matter much in my view – though it is an awful distraction – and the longer it takes, probably the better as a hard Brexit is probably now well anticipated and prepared for by what is still a very good civil service. The European Parliament will be an interesting place though, with a band of committed dissidents from the UK, Italy, France and Hungary, amongst others livening what is otherwise the dullest parliament in the world.

Jeremy Corbyn *does* matter, however, as Victor Hill has eloquently written in these pages. But I am guessing that the chances of him getting in remain very low. And that's why I am a big buyer of sterling against the dollar (overvalued) and the euro (fragile, with the fracture index rising).

There isn't much value in the world today, but British shares with dividend yields of over 4% make eminent sense, especially with the international spread of business that many UK companies have.

British shares make "eminent sense" at these prices

When gilts and other major economy bonds yield so little, why wouldn't you buy the shares of genuine, blue chip and well-run companies like **BP (LON:BP.), Shell (LON:RDSA), Lloyds (LON:LLOY), HSBC (LON:HSBA), GSK**

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"THERE ISN'T MUCH VALUE IN THE WORLD TODAY, BUT BRITISH SHARES WITH DIVIDEND YIELDS OF OVER 4% MAKE EMINENT SENSE."

(LON:GSK), BAE Systems (LON:BA.), and even, despite or perhaps because of, the recent dividend cut, **Vodafone (LON:VOD)**?

I came into some money recently, and I am doing just that. Lock away and forget. There are funds that can do that for you, at modest cost, good examples being iShares, Fidelity Funds and Netwealth and if you don't want to do the work of selecting individual shares yourself, I would go that route.

In contrast to the UK market, I think the US market is distinctly overvalued, and the rush to the exits by early backers of **Pinterest (NYSE:PINS), Uber (NYSE:UBER), Lyft (NASDAQ:LYFT)** – and lining up on the runway, Airbnb and We (the owner of We Work) – is illustrative that the smart money believes that now is the time to cash in.

"WE ARE CONTINUING TO LOOK AT UK REITS (REAL ESTATE INVESTMENT TRUSTS) AS A SOURCE OF REGULAR DIVIDENDS."

They might just be a little late though. Uber and Lyft are down from their offering prices, and the usual suspects who backed these companies are locked in typically for six months post IPO. **Tesla (NASDAQ:TSLA)** is now showing followers of cults that these are not a one-way street. Even long-term bulls are now turning their backs on the electric car maker. In my opinion (and Tesla was a no. 1 short pick of mine at Master Investor) the best that can happen to this company is that it gets acquired. The cars might be nice, but so were De Loreans!

The fact is, every car manufacturer of note will have electric cars soon, and most know how to produce and deliver automobiles better than Tesla does. Tesla is overpriced, over indebted, and heading for the rocks. I would stay short, at least till $100 per share, at which point **Apple (NASDAQ:AAPL)** might buy them for loose change.

UK property

Regular readers will also know that I have been bearish on UK property for some time, with a few regional exceptions. London has been battered particularly hard, with prices in prime areas back to their pre-2011 levels. With many tower blocks on the market or about to come on the market, there is no screaming reason to get involved in the residential property market (offices remain strong).

But, if you were thinking of buying somewhere in London, what with the pound down and prices at multi-year lows, putting a few low-ball offers in might not be such a bad idea, especially if the property is for less than £2 million, where the Osborne stamp duties become punitive. Those stamp duty rises have proved, as do all usurious tax rises, to be counter-productive and have really dampened activity. Poor estate agents! Meantime, we are continuing to look at UK REITS (real estate investment trusts) as a source of regular dividends, with many selling at significant discounts to NAV.

At time of writing, I am in my house in Spain, where the weather has been uncharacteristically chilly for this time of the year. In fact, we have a fire going, which I think for late May is a first. But in an hour or so, it's back to work for me. I'm off to Oxford University for the whole of the remainder of the week, to be educated by an array of professors in the wonders of molecular biology, along with 12 others, mostly investors in Juvenescence, our longevity company.


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We are dining in hall, and having drinks with the Provost, as well as revisiting the pub where I spent many a happy hour in my long-lost youth. The one thing we are *not* doing is staying in the college; my taste for student accommodation was lost a long time ago, and I can't see it returning any time soon. We have one night off, when some of ours are heading to London's O2 for a concert by Mark Knopfler, of Dire Straits fame. Remember the "money for nothing" song?

Well, as all readers of Master Investor know, there is sadly no such monetary manna available to those who aren't curious, adaptable and apply themselves to the serious business of investing.

Keep some gold, stay cautious, but consider nibbling at those British stocks!

Happy Hunting!

Jim Mellon

About Jim

Jim is an entrepreneur with a flair for identifying emerging global trends enabling him to build a worldwide business empire. He is amongst the top 10% in the "Sunday Times Rich List" (Britain's equivalent to the Forbes list). He is often described as the British Warren Buffett and he predicted the Credit Crunch of 2007-08 in a book entitled *Wake Up! Survive and Prosper in the Coming Economic Turmoil*. Jim followed this with *The Top 10 Investments for the Next 10 Years* (2008) and subsequently *Cracking the Code* (2012), *Fast Forward* (2014) and, most recently, *Juvenescence* (2017). His monthly "Mellon on the Markets" column in Master Investor Magazine has gained him cult status among investors. He holds a master's degree in Politics, Philosophy and Economics from Oxford University. He is on the Board of Trustees of the Buck Institute in California, a trustee of the Biogerontology Institute, and a Fellow of Oriel College, Oxford.

BY VICTOR HILL

COVER FEATURE

THE TRIUMPH OF POPULISM

WHAT IT MEANS FOR INVESTORS

Regardless of the outcome of Britain's private nightmare over Brexit, Europe is likely to become increasingly divided in the near-term. As Victor Hill reveals, this has major implications for investors...

"Populism" is on the march in all advanced democracies. Last month's elections for the European parliament produced a record populist vote across the European Union. In the United States, President Trump is often regarded as a populist who was able to hijack the traditionally conservative Republican Party.

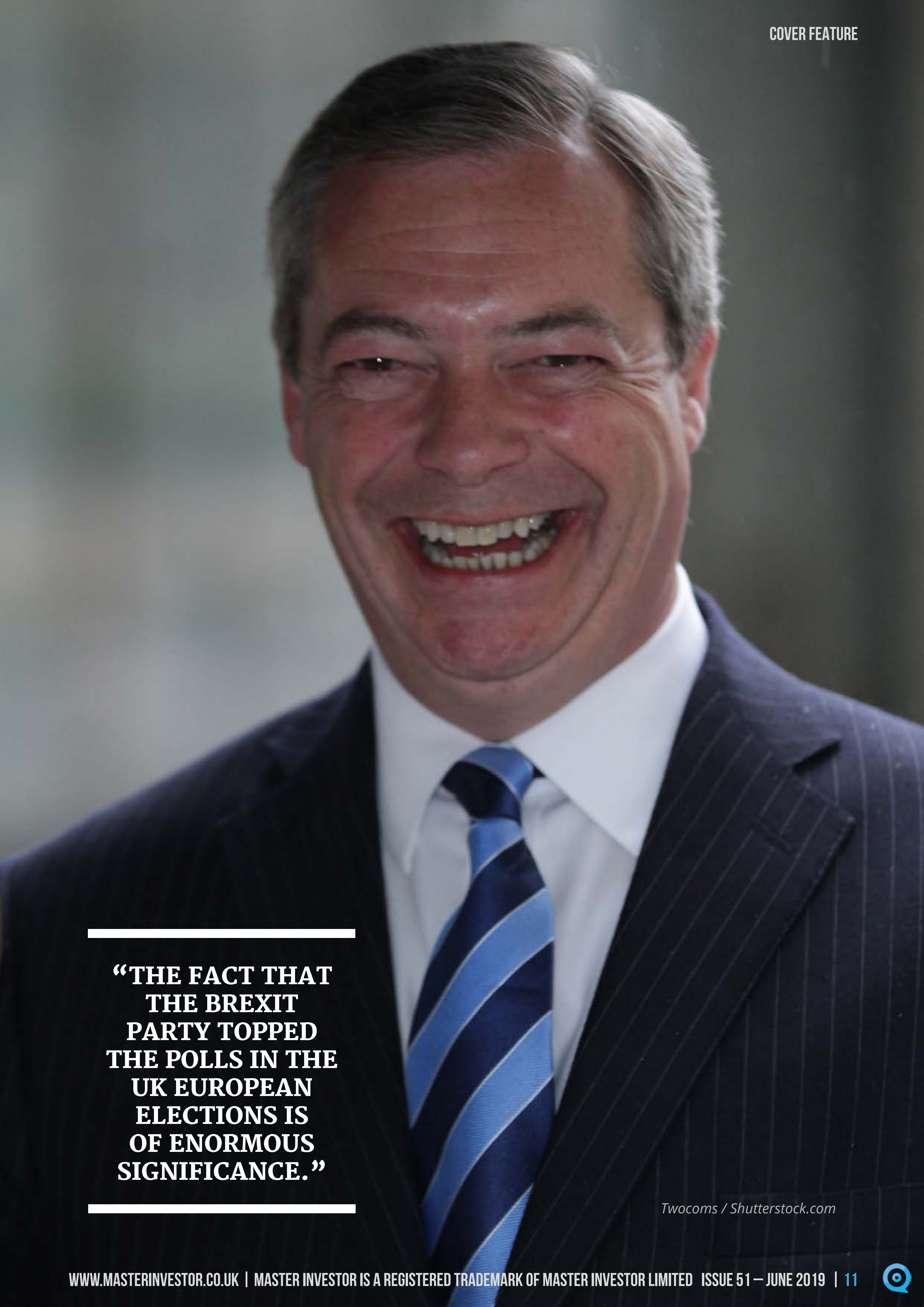
But what is populism and why does it exist? What do populists want? Why is the political establishment so afraid of populism? And what are the economic consequences of the rise of populism? Is this just a protest by the discontented white middle class which will soon fizzle out – or has something very profound happened to the shape of politics in the West? Will anything really change?

I can't answer all those questions definitively here now – but I can offer some ideas about what investors should make of it all. One aspect of populism is a reaction against the perceived austerity imposed by governments after the financial crisis of 2008-09 and the subsequent European sovereign debt crisis (2010-12). A return to higher levels of public spending will drive higher taxes - and higher interest rates too. Investors need to be aware that something is afoot of fundamental importance.

Europe votes

Between 23 and 26 May, 400 million registered voters went to the polls in 28 EU countries to elect 751 MEPs. Not as many voters as in India, which also concluded its general election on 23 May. The turnout was actually above the historic average of the last 40 years (European elections have taken place every five years since 1979).

"A RETURN TO HIGHER LEVELS OF PUBLIC SPENDING WILL DRIVE HIGHER TAXES – AND HIGHER INTEREST RATES TOO. INVESTORS NEED TO BE AWARE THAT SOMETHING IS AFOOT OF FUNDAMENTAL IMPORTANCE."



"THE FACT THAT THE BREXIT PARTY TOPPED THE POLLS IN THE UK EUROPEAN ELECTIONS IS OF ENORMOUS SIGNIFICANCE."

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Members of the European Parliament are responsible for signing off the EU's €145 billion annual budget. They approve international treaties and trade deals entered into by the EU and (technically) appoint EU commissioners and the ECB president. But, in practise, the European Parliament, which sits in both Brussels and Strasbourg, does not initiate legislation as national parliaments do – though the last European parliament voted on more than 700 measures. This opens it up to the accusation that it is just a *rubber stamp* for the European Commission and Council.

Why was this round of European elections so significant? Firstly, the entire Commission and its President will be replaced in November (so its *auf Wiedersehen*, Herr Juncker). So will the President of the ECB (*arrivederci*, Signor Draghi). Moreover, the new budget round will be adversely affected by Brexit (assuming it happens) and President Macron is pushing for fundamental reform of European institutions once the Anglo-Saxons are out. Such reforms will impact key issues such as trade, immigration, single market regulation, energy policy and climate change.

Populist parties are either already included in, or support, 11 governments out of 28 across the EU. In Germany, the two leading centrist parties in the coalition are struggling to maintain support, with Frau Merkel on the way out. This makes the present German government susceptible to pressure from the anti-immigrant populist *Alternative für Deutschland* (AfD), which took 10 percent of the German vote in the European elections – though just half of the Green vote.

In Britain, the elections were seen by many as a second referendum on EU membership (though less than 40 percent of the electorate voted). The day before Britons went to the polls the latest iteration of Mrs May's *cunning plan* was trashed by her own cabinet and the supposition was that her premiership was doomed. With a Tory leadership contest in play on the day of the election, the expected fork in the road was a choice between no-deal (WTO) and no-Brexit (rescind Article 50). This gave voters a stark choice between two courses both devilled by risk. The day after the elections in the UK the Prime Minister resigned – even though the results had not yet been declared.

The Brexit Party topped the polls in the UK with 32 percent of the vote, which secured it 27 out of 72 seats. The Tories gained a historically dreadful 9 percent of the vote with just three seats. UKIP got 4 percent. Given Boris Johnson's popularity amongst the Tory grass roots, a third to a half of the Tory vote would support no-deal. Therefore, only about 40 percent of the UK electorate would support a no-deal or WTO Brexit on 31 October. This is something that the next Prime Minister (who at time of writing is likely to be installed in early July) will have to factor into his or her game plan.

The centrist Europhile parties that have enjoyed a comfortable majority in the European parliament for 40 years are now less dominant. At least 171 MEPs were returned for populist or Eurosceptic parties. The centre-right European People's Party (EPP) grouping will have 173 MEPs (down by 48) and the centre-left Socialists and Democrats (S&D) will have 147 seats (down by 44). The Europhile European Liberals grouping (of which President Macron's Renaissance Party forms part) will have a further 102 seats. The Greens

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"THE CENTRIST EUROPHILE PARTIES THAT HAVE ENJOYED A COMFORTABLE MAJORITY IN THE EUROPEAN PARLIAMENT FOR 40 YEARS ARE NOW LESS DOMINANT."

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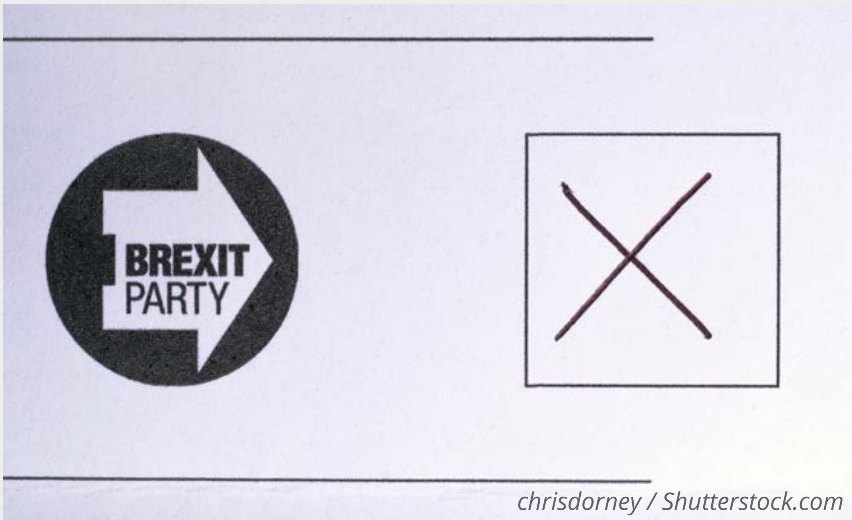
The UK: the Brexit Party triumphs

Nigel Farage explained to the *Sunday Telegraph*[i] before the European elections that he had been inspired to form the party by Italy's Five Star Movement (*Cinque Stelle*), which started as a protest party but which came to power in Rome in May 2018. Mr Farage has been a member of the European Parliament for more than 20 years, so whatever you may think about him as a man he knows a lot about how the EU works. Mr Farage resigned from UKIP, the party he helped to found 26 year ago and which he led for many years, in December 2018. He insists that there is "no comparison" between UKIP and the Brexit Party.

The Brexit Party invites voters to become registered supporters rather than members for a fee of £25. Such supporters will shortly be able to influence the party's policy formation by means of a smartphone app (something I predicted in these pages with reference to the Indian election campaign). The party's candidates were drawn from a wide political spectrum and range from the former Tory minister (and *Strictly* competitor) Anne Widecombe to Claire Fox, an ex-member of the Revolutionary Communist Party.

The fact that the Brexit Party topped the polls in the UK European elections is of enormous significance. It shows that a large number of UK voters support the no-deal (WTO) Brexit at which Mrs May balked back in March. On the morrow of the European elections, Mr Farage suggested that the Brexit Party could contest a UK general election, if one were to take place this year. To do so it would have to develop a full spectrum of policies. This would subject the party to greater scrutiny than the brutally simple message of the campaign: *We want out!* As I write, Mr Farage is demanding a place at the negotiating table…Meanwhile, the bizarre Change UK Party got nowhere – and then began to eat itself…



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advanced across Europe. That means that the Eurosceptic populists will be challenged to slow the integrationist impulses of the centrists and liberals.

We don't believe you

That is the title of Sir John Redwood's new book. I was at the book launch at the House of Commons on 09 May and heard Sir John unpack the major themes. In the book, John Redwood – who is a seasoned economist and political analyst as well as being a politician and former minister with strongly pro-Brexit instincts – explains why populists have been winning elections, and why mainstream "establishment" politicians have responded not with understanding but with haughty disbelief.

Essentially, the Redwood thesis is that ordinary citizens have rumbled the ruling elites. They do not believe that *the good and the great* (as the British establishment used to be called) have their best interests at heart and feel that the liberal elite is oblivious of, for example, the impact of immigration on indigenous working-class communities. The elites, in turn, regard the populists as distasteful bigots – not at all the sort of people they would invite to their dinner parties.

They do so at their peril – because the political terrain has already moved beneath the feet of the ruling classes much in the way that it did in the age of revolutions in the mid-19th century. What is so interesting from my point of view as a macro analyst, is that there is a clear discernible trend here both across Europe and North America. But if the populist phenomenon is surprisingly uniform in the west, the next decade will be one when China is poised to overtake America as the largest economy in the world – and it is likely to unveil its prospectus as a global superpower very soon.

We are therefore at a critical juncture in global political history – indeed, by the time that China overtakes the USA as the largest economy in the world in (my best guess – but don't sue me if I'm wrong) 2032, our political landscape may look very different – and economic policy too. This has huge implications for investors.

Ten drivers of populism

There are many reasons why the traditional political model is being displaced in the UK and other advanced democracies – but we can distil ten essential factors.

Firstly, conventional employment patterns are changing fast. In Britain there are 5.4 million citizens who are either managing their own small businesses as a limited company or who are registered as self-employed. These people are uniquely cognisant of EU regulations that feed through the UK parliament. The prevailing view by small businesses across the EU is that the regulations coming out of Brussels are restrictive and excessive.

Secondly, there is a wide consensus in the UK that London consumes a disproportionate amount of public investment at the expense of the regions.

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London is, for many people – though apparently not immigrants – a symbol of the liberal metropolitan elite that imposes its values on the rest. (Many immigrants can only afford to live in London because they get housing benefit – unlike a lot of London-born people who have had to leave the capital in order to purchase their own homes.) There are analogues to this phenomenon all over Europe. Anyone who has spent time in the Languedoc will know how detested Parisians are in *La France profonde.* Ditto Romans in Calabria.

Third, in the UK there is now a sense of deep frustration, not just about Brexit, but about *how the establishment has handled Brexit.* One often hears people who say it is hardly worth voting anymore since the politicians will just ignore the outcome. That is why a second referendum (the so-called *People's Vote*) might actually be boycotted by large parts of the electorate, thus further undermining the legitimacy of the political system.

Fourth, the membership bases of the traditional two big parties in the UK and elsewhere have fallen sharply – especially that of the Conservatives. In the 1950s the Tories counted on nearly three million fully paid-up members. Currently it has about 165,000 members – up from an all-time low of 124,000 in 2014. As voters become less attached to traditional centrist parties so the chance that they might desert them altogether increases.

Fifth, traditional conservative parties – most notably the UK Conservative

Spain: Vox Speaks

In El Ejido in Andalucía nearly 30 percent of voters supported Vox in Spain's general election on 28 April after years of favouring the *Partido Popular* (PP), Spain's mainstream conservative party. Under its charismatic leader Santiago Abascal, with its party slogan of *Por España*, the party has come from nowhere to being a political force. In 2016 Vox polled just 0.2 percent of the vote but it won more than 10 percent nationally in the general election gaining more than 30 seats in Spain's 350-seat parliament. Analysts attribute three main forces behind the party's rise. The first is a reaction against Catalan separatism. The second is (illegal) immigration – mostly from Africa. The third is corruption. Vox is culturally and socially conservative and aspires to restore the influence of the Catholic Church. Unlike many other European populist parties most of Vox's support appears to come from the middle classes. The PP has already moved to the right in response to Vox's challenge.

Italy: the triumph of Signor Salvini

Matteo Salvini's Lega topped the polls in Italy gaining 24 MEPs. Signor Salvini has been Minister of the Interior in Italy's coalition since its inception in May last year. The coalition is one between the Lega (which is normally described as "right-wing" because it is opposed to further immigration and talks loudly about law-and-order issues) and the quirky Five Star Movement led by Luigi di Maio. The nominal Prime Minister, Signor Conte, a lawyer, effectively forms a triumvirate with these two leaders.

Last year Rome cut a deal with Brussels to cut its fiscal deficit from 2.4 percent of GDP to 2 percent. This calmed the bond markets where spreads between Italian and German government bonds had stretched to over 300 basis points. Italy's debt-to-GDP ratio is pushing 132 percent and rising. Ten percent of Italian banks' assets consist of Italian government debt – so if the state defaults then the banks go too.

Signor Salvini heads the populist European Alliance of People & Nations grouping in the European parliament which aims to reassert national powers. This is an alliance of "patriotic" parties. But few if any of these parties want to follow Britain out of the European Union altogether.

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"ECONOMIST LIAM HALLIGAN BELIEVES THAT THE CURRENCY UNION IS THE SINGLE BIGGEST DANGER TO GLOBAL FINANCIAL STABILITY."

Finland: discontent in the happiest nation on Earth

The Finns Party, a nationalist anti-EU grouping has lit a fire that has spread, politically speaking, across the country's interminable forests. Finland is, so the social scientists tell us, the happiest nation in the world – with a sauna in every home. But resentment against migration (large numbers of refugees have arrived from predominantly Muslim countries) and opposition to the power of Brussels has made a lot of Finns angry. Laura Huhtasaari, deputy chair of the Finns Party told the Daily Telegraph: "Finland and the EU are weak on crime, weak on borders and weak on protecting nation states...I want my country back". The party won 17.5 percent of the vote in the parliamentary election of 14 April, giving them 38 out of 200 seats in the national parliament. The party wants Finland to leave the eurozone and favours a simple trading bloc instead of a federal super state – but it does not favour the country's departure from the EU.

Party – have ceased to be "small c" conservatives. When one of Britain's most distinguished philosophers, Sir Roger Scruton, made some fairly anodyne remarks in April about Islamism and the Chinese he was forced off his (unpaid) position on a government architecture quango. Foremost amongst the lynch mob were Tory MPs waving their street cred. Personally, I'm happy that Britain is no longer an intolerant, socially conservative society; but the trend is that anyone who does not agree with prevailing PC orthodoxy is just driven from public life – without debate. Look at how one of the most prominent feminists of my lifetime, Dr Germaine Greer, has been no-platformed because of her view that male-to-female transsexuals are not women. You would have thought conservatives would at last stand up for free speech – but no, they are part of the right-on PC inquisition.

Sixth, there is still a lot of public concern across Europe about the issue of immigration – and opinion hardens when ordinary people are told by ruling elites that they are *xenophobes*. Actually, there is very little disquiet about intra-EU immigration. I never met anyone during the UK EU referendum campaign who was concerned about French people coming to live in London (where they are the largest ethnic minority). Though, true, many were concerned about large numbers of low-skilled workers coming to the UK from less developed economies in Eastern Europe who undercut the wages of British-born workers. Most of the disquiet concerns the large numbers of overwhelmingly young male immigrants from Africa and the Middle East. Part of this arises from a legitimate fear about social cohesion and security – but it is often dismissed by mainstream politicians as *racism*.

Seventh, globalisation has meant that a lot of traditional working-class jobs have been sent abroad – and this is what President Trump tapped into during his 2016 election campaign. (It's not clear, by the way, how many he will have repatriated by late 2020.)

Eighth: the euro. The single currency has been a disaster for European growth, productivity and employment. Economist Liam Halligan believes that the currency union is the single biggest danger to global financial stability. This is because south Europe has been caught in a deflationary trap while Germany and the Netherlands have

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continued to build up surpluses. The Greek sovereign debt crisis of 2010-12 was contained because the ECB had room to cut rates and to print money. But the maxed-out ECB will not be able to bail out Italy if she totters.

Ninth: austerity. The perception is across Europe that state spending has been cut to the bone. In Greece that is undoubted – one sees boarded up museums and uncollected dustbins everywhere there. In Scotland that is not the case – despite the imprecations of Ms Sturgeon (in fact Scotland enjoys higher state spending per capita than the rest of the UK). But the age of austerity which started after the financial crisis of 2008-09 has certainly made an impact. Look at the way that the UK coalition government cut the police budget in England – with terrible consequences at a time of rising knife-crime. Even well-off people are concerned by this. Again, the Cameron-Osborne pantomime-horse's defence cuts at a time of rising international risks will be regarded as reckless by future generations. It is timely that UK Foreign Secretary Hunt has called for a massive increase in defence expenditure – possibly from two to four percent of GDP (partially financeable by cutting the foreign aid budget). And by the way, spending money on soldiers and defence contractors will have a much better multiplier effect than spending money on destroying agricultural land to build HS2. At the bottom end of society, the benefits system does not seem fit for purpose, with more food banks in operation than ever before (though there are cultural as well as economic reasons for this – many people appear to be unable to cook for themselves).

Any additional state expenditure will have to be financed – and not by additional debt since nearly all European governments are already over-borrowed. One thing is now certain: taxes will have to rise. Any Tory leadership candidate who claims otherwise is ceding a hostage to fortune. The question is where they will fall. It has proven extremely tricky to soak "the rich" (whoever they are – is a headmaster on £100k "rich"?).

Tenth, inequality of income and wealth is broadening almost everywhere – with measurable outcomes in terms of health, well-being and longevity. Of course, there was always economic inequality but what is different now is that these inequalities are more transparent. The rich are getting richer, overall (assisted by the central bankers' addiction to quantitative easing which boosts asset prices – property and stocks) while the poor are flat-lining – though being "poor" in the UK today is not the same as being poor in 1919. There are also huge numbers of homeless people who are cold, hungry and despairing – being "poor" is not one single condition.

Poland: Populists in Power

Poland's ruling Law and Justice Party is famously Eurosceptic and conservative and there has been tension between Brussels and Warsaw since it came to power. However, Poland's pro-EU opposition, the European Coalition, did well in the European parliamentary elections partly due to the impact of a recent documentary called *Just Don't Tell Anyone* about sexual abuse scandals in the Catholic Church. The documentary has been viewed more than 18 million times on YouTube since it was released on 11 May. Just as in Ireland, Poland has been transformed from a highly conservative country in which the Catholic Church was preponderantly influential to a largely liberal and secular one in a matter of 30 years. There was support for a number of small right-wing parties in the elections, however. The ruling Law & Justice Party won out with 42 percent of the vote as against 39 percent for the European Coalition. For many Poles, the alternative to the EU is domination by Russia: therefore there is no appetite for a Polish withdrawal from the EU whatsoever.

Most mainstream commentators assume that populism is "right-wing" – embodied by Hungarian Prime Minister Viktor Orbán who aspires to *illiberal democracy* – by which I understand a democracy that does not tolerate those who wish to destroy it. He is opposed to mass Muslim migration into central Europe and is not ecstatic about the advance of the transgenderism ideology. (He was re-elected in the general election of 26 May – a victory he described as *the triumph of Christian civilisation*.) But, at the same time, many of the populists' most radical ideas are taken from the left. For example, Signor Salvini in Italy is very keen on a *universal basic income* – even if that means higher taxes on the rich.

My advice to investors is that the labels "right-wing" and "left-wing" are almost devoid of meaning these days. You may as well substitute "nasty" and "fluffy" respectively. Sensible, provident folk (who pay virtually all the taxes that keep our society going) need, more than ever, to escape mainstream media (MSM) and its tendentious nomenclature in order to make sense of the world around them.

But watch out. Just as we manage to circumvent MSM and find out the facts ourselves through the judicious use of the internet and social media, the illiberal establishment elite, led by the European Commission and President Macron, desperately want to throttle our access to anything that they regard as "nasty"...More on that soon.

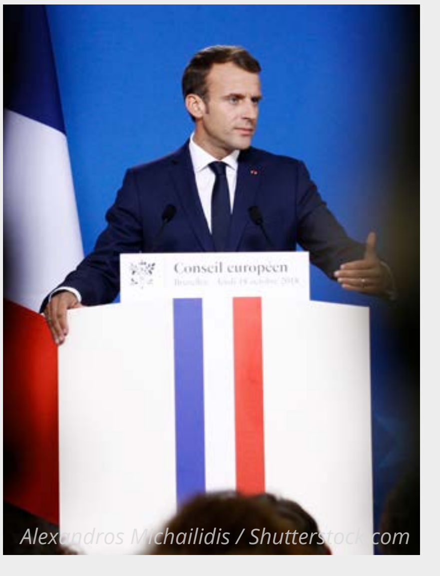
Antonio Gramsci and *cultural hegemony*

I am grateful to James Bartholomew, an ex-Tory who was a Brexit Party candidate in the South East of England region in the European elections for explaining an important phenomenon[ii]. Like the BBC, much of the media, the liberal professions (virtually all teachers) and most of the civil service, many Conservative MPs have adopted a way of thinking that is quite distinct from how most ordinary people think. This is best understood, writes Mr Bartholomew, in terms of Marxist thinking, in particular Antonio Gramsci's concept of *cultural hegemony*.

Much of the establishment believes that all rich people are greedy and therefore morally suspect. Conversely, they believe that the poor are all victims of oppression (by the rich and their agent, the State). They regard the nation state as a relic of a bygone age. While they celebrate diversity, they balk at celebrating what binds us together – *homogeneity* is a dirty word for the mainstream mindset. Anyone from

France: Macron le Vert!

President Macron placed *l'environnement* at the centre of the manifesto of his *République en Marche* rebranded as the *Renaissance* Party. The main rival for the President's party was Marine Le Pen's also rebranded *Rassemblement National.* The President's manifesto included a pledge to outlaw trade deals with countries which have not signed up to the 2015 Paris Climate Accord. Other measures include investing at least €1 billion in developing clean energy, a European Climate Bank by 2024 to channel savings towards the green economy and a carbon tax on all imports into the EU. Monsieur Macron's party was also challenged by the renascent centre-right Republican Party whose leader, Francois-Xavier Bellamy is a socially conservative, though photogenic, Catholic philosopher. In the event, the Republicans took just 8.3 percent of the vote – well behind the Greens who were on 12.7 percent. Madame Le Pen's party topped the poll with just over 24 percent against 22 percent for Renaissance. "This confirms the new divide between nationalists and globalists" Madame Le Pen declared at a victory rally.



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"IF THE TORY PARTY IS TO SURVIVE AT ALL, THE NEXT PM NEEDS TO CULTIVATE A NATION THAT FEELS AT EASE WITHIN ITS OWN SKIN."


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an ethnic minority who lauds their heritage is a local hero; but any white English male who takes pride in the flag of Saint George is a white van-driving bigot. In fact, anyone who immerses themselves in European culture (classic literature, opera, symphonic music – like this writer) is now a suspect racist for idolising dead white males.

It is great that "minorities" should stand tall and proud these days. (I do have a problem with the term "minorities". Am I a member of a minority by virtue of being bald? And who are the majority, anyway?) But to be British, according to this mindset, demands a sense of shame. Apparently, not only were we slavers (actually, we were at the forefront of the abolition of slavery) but we were the first people to pollute the planet (actually, wood-burning has created greater carbon emissions than coal-burning). The default emotion of the ruling establishment is guilt. Guilt nourishes victimhood; which, in turn engenders anger and alienation. It is a gloomy, sad and ultimately negative mindset which damages the collective joy of nationhood which others (the Russians and the Chinese come to mind) extoll.

Mr Bartholomew says that he finds the Brexit Party a space of *hopeful, sunny, interesting, optimistic people*. (Give or take a few loonies, perhaps.) Whether you buy that or not the message is clear. If the Tory Party is to survive at all, the next PM needs to cultivate a nation that feels at ease within its own skin. That will mean taking on the shame-and-guilt mongers.

Three consequences of populism in Europe

What all populist parties have in common (with the possible exception of Mr Farage's Brexit party which has only one policy so far), in addition to tighter control of immigration, is more public spending and the end of austerity. Given the parlous state of government finances across most of Europe, especially in Italy, this cannot be achieved without raising taxes.

So the first outcome will be that there will be upward pressure on state expenditure and therefore taxes. Mr Trump's America has cut taxes, but America befits from unique advantages – it can always print dollars without much fear of inflation because the dollar is the world's surrogate currency. Europe's finances will deteriorate – and at some point the single currency will suffer an almighty crisis. (Yes, Jim Mellon and I have been predicting this for years...But we only have to be right once...). There will also be increased upward pressure on interest rates in Europe going forward.

Second, there will be a slow-down in the pace of European integration. It is quite possible that the next President of the European Commission to be appointed in November (probably a German) will signal this. The EU desperately needs to retrench before it expands further. I suspect that Europhiliac Macronism will retreat as a result of this trend. I can quite foresee that Monsieur Macron will be beaten in 2022 by a more conventional figure from the Republican right of French politics who will garner votes from Madame Le Pen.

Third, open hostility to mass immigration will become more politically acceptable. The UK's generous (£14 billion) foreign aid budget should be directed at projects that alleviate the pressure for young people to emigrate from sub-Saharan Africa, Iraq and Afghanistan. The left will agitate that these economic migrants are in fact *refugees* but the distinction between these two categories is becoming elastic.

"TOM STEVENSON OF FIDELITY INTERNATIONAL BELIEVES THAT A DIVIDED EUROPEAN PARLIAMENT COULD BENEFIT INVESTORS."

How investors should respond

Tom Stevenson of Fidelity International – who was a keynote speaker at this year's Master Investor Show – believes that a divided European Parliament could benefit investors. Europe, he says, will continue to be influenced by events outside Europe as much as within it. The outcome of the trade war between the USA and China is of greater significance. Similarly, the recent fiscal stimulus in China could result in increased consumer spending which would boost Europe's economy.

Currently, company valuations on the European bourses are low – and falling. Fund managers globally have been pulling money out of Europe. European stocks, which include scores of world-class companies, now look cheap (as do British stocks). Political infighting is not necessarily a disaster for corporates as fractious coalitions of politicians tend to leave big business alone. Of course, the advent of a Corbyn government in the UK would be quite a different matter.

In terms of European equities there are some very persuasive stories out there for those who are prepared to do their homework. On the other hand, expect more bad news in the European automotive and banking sectors. Overall, the headwinds are blowing against Europe as political and financial risks increase. Regardless of the outcome of Britain's private nightmare over Brexit, Europe is likely to become increasingly divided in the near-term.

It is highly paradoxical that a European election – which, by rights, should never have taken place in the UK at all – has concentrated minds as never before.

USA: The Trump take-over

John Redwood's take is that, in the USA, which is a country the political institutions of which have held together longer than any other (except the UK – a debatable point) populism triumphed because Donald Trump pulled off a kind of reverse take-over of the Republican Party. The Republican establishment, epitomised by the Bush family clan, opposed him vigorously – and still do. They regarded him as an outsider – a mantle he adopted to his own advantage. Before he went into politics Mr Trump was, if anything, a (New York) Democrat – a successful businessman who went to all the right charity balls. What turned him was the fatalistic attitude of the American elite to the decline of the American working class in the "states between" who lost out from uncontrolled immigration and globalisation. Personally, I regard Mr Trump as an old-fashioned conservative with a traditionally liberal economic agenda. American socialism is growing: but I am currently gauging the probability of Mr Trump's re-election in 2020 at over 70 percent.

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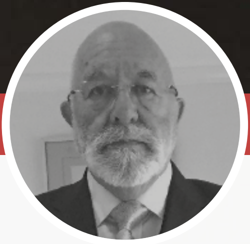
About Victor

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 Sunday, 12 May 2019.
ii See: Six weeks' old and the Brexit Party has already ousted a Prime Minister, by James Bartholomew, The Sunday Telegraph, 26 May 2019.



BY MARK WATSON-MITCHELL

PORTFOLIO INTELLIGENCE

MARKET BUBBLES, CRASHES, PANICS AND CRISES

WHAT DO WE LEARN FROM THEM?

Awareness of previous market events helps investors avoid the worst excesses. Mark Watson-Mitchell takes us on a whirlwind tour of history...

The strong urge to make a quick buck always counters sage warnings. It is different this time – but is it?

Market bubbles are built upon financial desire and excessive greed. Crashes are then built upon excessive fear. So too are panics – that you cannot get out before your profits implode. Crises are the result of a mixture of all of these and the aftermath.

I have taken a look at what history has thrown up during a host of market bubbles, crashes, panics and crises – can we learn anything from what happened in the past?

Tulip Mania

In the 1590s, tulips were introduced to the Dutch. Coming from Turkey, the new exotic and beautifully coloured flowers became much sought after, with prices shooting up as they became 'must have' adornments for houses.

After a few years the tulip bulbs contracted 'mosaic', which was a harmless virus; however, it created flames of colour in the tulips, the patterns of which made the flowers even more unique. What the Dutch did not know at the time was that after a growth period of nine years or so a tulip will

> "OVER THE YEARS OF 1634 TO 1637, PRICES STARTED TO REACH RIDICULOUS HEIGHTS, WITH SUGGESTIONS THAT EVEN 5,000 GILDERS BOUGHT JUST ONE TULIP BULB. THAT WAS A FORTUNE, THE PRICE OF A HOUSE AND MANY TIMES A YEAR'S SALARY."


-0.025
-7.576%
-0.007

"SARCASM OR MOCKERY ABOUT JOHN LAW AND HIS VARIOUS SCHEMES CREATED THE ISLAND OF MAD-HEAD, DISCOVERED BY ONE MR LAW-RENS. IT WAS INHABITED BY A NATION OF 'SHAREHOLDERS' AND WAS AMIDST A SEA OF CERTIFICATES."

become striped or speckled because of that disease. The people were amazed at the changing flowers and that made them even more in demand.

Accordingly, the price of tulips rose even higher. With everyone now more than keen to deal in tulip bulbs, the speculation was rife as values appeared to have no limits. Personal savings were put at risk as one and all joined in the frenzy. Over the years of 1634 to 1637, prices started to reach ridiculous heights, with suggestions that even 5,000 gilders bought just one tulip bulb. That was a fortune, the price of a house and many times a year's salary.

As prices rose some speculators started to 'flip' their contracts to buy bulbs and made big profits in the process. But that encouraged so many more to play that market, which was obviously only going one way – up. However, at the massively inflated prices the 'dealers' started to sell hard, and the big fall was in process. By the end, the value of a tulip bulb crashed down to equal the cost of an onion. A Dutch Depression followed the dawning of reality.

The South Sea Bubble and The Mississippi Company

In the early 1700s the British Empire was growing fast and it brought prosperity to many of its citizens. Money was flowing easily and always looking for a new home.

The East India Company, which had just 499 investors, was a veritable money machine and its dividends were legend. So, in 1716 when the South Sea Company was 'floated' it gained an enormous following. South Sea had given the UK Government a promise to pay £10m for the 'rights' to all the trade in the South Seas. The investing public deemed this opportunity to be where their money should be invested – and they piled into the many issues and re-issues of South Sea Company stock.

About the same time over in France, John Law came up with the idea of switching the monetary system from silver and gold over to a paper currency system. When he floated his Mississippi Company, to exploit the French colonies, it too gained massive investor attention. At one time, it is said, the company's stock was worth more than 80 times the value of all the gold and silver in France.

The investing public believed that the Brits could do no wrong – whether in the Americas, France or wherever. And a plethora of public issues hit the markets to soak up the ensuing investment frenzy. By the summer of 1720, deciding that the value of their own holdings in the South Sea Company were out of reality, its management started to sell off their stakes.

Thereafter, a wave of selling turned into a panic and the values of the majority of the recent issues started to crash. Similarly, Mississippi Company stock fell, and it eventually went out of business.

Sarcasm or mockery about John Law and his various schemes created the island of Mad-head, discovered by one Mr Law-rens. It was inhabited by a nation of 'shareholders' and was amidst a sea of certificates.

The Bengal Bubble of 1769

Following the conquest in 1757 of Bengal by Robert Clive, the valuation of The East India Company rose significantly between the years of 1757 and 1769. Just before the Bengal Famine in 1770, the shares were peaking at £284 each. Together with recognition of various corporate management actions and its growing predatory nature, this brought about several attacks on the East India Company and led to the collapse of the Bengal textile industry.

Within a short period of time the company's shares had fallen back to £122, before a number of 'bailouts' of the company eventually led to the Crown taking control.

The Credit Crisis of 1772

As the price of the East India Company shares continued to rise, Alexander Fordyce, a banker, was shorting the stock heavily. He eventually covered his position whilst it was still rising, which lost him some £300,000.

Unable to meet his debts he decamped to France, but the resultant collapse of his bank in turn led to other banks falling. Dependence upon credit by banks then led to public doubt of the banking system – with an ensuing credit crisis as confidence waned.

Around twenty banking houses either went bankrupt or refused to meet debt repayments, causing a financial meltdown.

The Poyais Panic of 1823

Following the Napoleonic Wars, Britain's financial system was extremely profitable as money was pumped into all parts of its economy. Not only did that bring about strong elements of prosperity but it also engendered several speculative ventures.

A stock market boom led to propositions of all sorts for the investing public, especially for interests across the oceans. Latin America was a particularly fashionable area for investors, as confidence in the region grew after several states gained independence from Spain. Government bond issues for Colombia, Peru and Chile whetted investor appetites, as such interest was then created for Latin American mining companies.

This investment bubble suited Gregor MacGregor, who was seeking investment in his scheme to colonise an area of the Mosquito coast called Poyais. Poyais was described as 'one of the most healthy and beautiful spots in the world' in a 350-page guidebook. The territory was also 'fertile with considerable gold and silver reserves, possessing the elegant capital of St Joseph, with its wide boulevards, bank, cathedral and opera house.'

MacGregor raised £200,000 by issuing Poyais 30-year bonds carrying a 3% interest rate. He also sold plots of land to settlers, with 100 acres costing £11. One ship with 70 settlers aboard departed from London in September 1822, the next with 200 left Leith in January 1823.

However, the land of Poyais was a total lie fabricated by MacGregor. By the time that some of his bond instalments came due, the Latin American political instability had taken over the marketplace. The bond bubble burst in Spring 1823.

The Railway Bubble of 1846

The Industrial Revolution in the early 1800s enticed many companies to seek investors to support their growing companies. It crossed all aspects of UK business.

By the mid-1840s new businesses were collecting fresh funding, especially the railway companies. And the investors were enthusiastically joining in the frenzy that was circling, what many now call the first and possibly the biggest technology bubble.

Anyone, it seemed, could form a new railway company and get it funded. It

> **"BY 1846 THE RAILROAD STOCK INDEX PEAKED AS INTEREST RATES STARTED TO BE RAISED AND INVESTORS BEGAN TO REALISE THAT SOME OF THE SCHEMES IN WHICH THEY HAD INVESTED WERE NOT ONLY UNVIABLE BUT WERE IN FACT FRAUDS."**

led to several thousands of miles of track being laid across the country, a lot of which was of little real use. Railway companies sprang up like weeds, their shares were traded up to dizzying heights. Some new companies eager to get investors into their equity actually offered their stock at 10% down, with the other 90% to be paid when the companies called up the balance.

The speculation reached a fever point just as a number of the new companies were discovered to be fraudulent. By 1846 the Railroad Stock Index peaked as interest rates started to be raised and investors began to realise that some of the schemes in which they had invested were not only unviable but were in fact frauds.

Prices later fell and many companies went out of business as a result.

The L'Union Generale – 1882

What seemed like an unending stock market boom in France saw share prices rise strongly in the late 1870s.

However, the worst crisis in the French economy followed the collapse of L'Union Generale in January 1882. The bank's shares had risen from 500 francs in 1879 to as high as 3,000 francs before its demise. A failure to repay its debts combined with falsified public reports did not help

The market crash in 1882 saw some 25% of brokers close to failure, including seven that went bankrupt.

The Encilhamento Bubble of the Mid-1890s

The industrial innovations surrounding rail transport, gas lighting and steamships in Brazil during the 19th century created major investment opportunities.

The Brazilian Government helped to back an abundance of capital as an encouragement. Economic incentives fuelled increased inflation, as well as unbridled speculation, all of which engendered several scam public offerings and ill-advised takeovers.

'Saddling up' or 'encilhamento' was a horse-racing term which also described the very speculative 'get rich quick' schemes. The bubble created by the Government's easy credit quickly got out of hand and was succeeded by the inevitable market crash.

The Florida Real Estate Bubble

The boom of the Roaring Twenties helped to make many US citizens extremely wealthy. Their money was quickly invested in a fast-developing area that had previously been deserted – the Florida Coast. Offering sunshine and lovely beaches it quickly caught on as being the 'new destination'.

Real estate prices rapidly escalated and a fully-fledged boom was under way. Land started to change hands at multiples of the original purchase value. Everyone knew that prices only went up and that land was the best investment you could have.

Speculators, having chased values higher, then realised that a profit is not a profit until it's in your pocket. They started to sell. The panic followed as sellers quickly outnumbered the buyers of Florida property. A hurricane in 1926 did not help values to recover

at all and the slump continued for another couple of years or so.

The Wall Street Crash

The boom that followed the First World War had made everyone realise that dealing on the stock market was a guaranteed way of getting rich. Life savings were pumped into a multitude of stocks, in what was the no-risk world of finance.

Manipulated prices by brokers, bankers and even company owners threw petrol on the flames of a market already ablaze. The herd mentality drove prices higher as one and all jumped aboard the money-making machine. And better still, the banks and brokerage houses were lending money to buy stocks on margin.

However, inevitably, three very Black days occurred in late October 1929, panic selling hit the US market. Prices fell steeply despite several well-heeled financiers wading into the market buying as much stock as they could in an effort to hold it all up. But to no positive end. Margins were called and investors failed to meet their commitments. Banks and brokerage houses also buckled under the financial strains that occurred, many of them failing in the process.

The crash led to the Great Depression, which lasted well into the next decade.

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"IT TOOK ANOTHER 13 YEARS FOR THE UK MARKET TO RECOVER TO ITS PREVIOUS BEST LEVELS."

The UK Market Crash of 1973-74

From January 1973 until December 1974, what became known as 'the worst bear market in history' hit global markets. Bretton Woods, the 'Nixon Shock', the US dollar devaluation and then the October 1973 Oil Crisis all combined to drive markets lower. World economies had slowed and fallen back into deficit.

In the UK, a period of recession saw prices fall dramatically, whilst the secondary banking sector's implosion did not help, as the Bank of England started to bail out lenders. It took another 13 years for the UK market to recover to its previous best levels.

Souk Al-Manakh

The Al-Manakh market was Kuwait's unofficial stock market. Housed in an air-conditioned parking garage that had previously been a camel-trading venue, the market specialised in highly speculative and unregulated non-Kuwaiti companies.

The massive oil revenues in the 1970s saw many local families amass fortunes. Those fortunes were used to play in the Kuwait official market. But a small crash there in 1977 led to Government controls tempering that market.

Substantial funds then flowed into the alternate market – the Souk Al-Manakh. Shares were purchased using post-dated cheques, thereby creating a major expansion of credit. It took just one punter 'bouncing' his payment, in 1982, to bring that market to its knees. The Kuwait Ministry of Finance ordered all dubious cheques to be turned in for clearance, as it shut down the market.

The total extent of this crash was shown when the value of the worthless cheques, from 6,000 investors, totalled some $94bn. It shook the Kuwait economy and its entire financial sector.

Black Monday

Program trading and illiquidity helped to cause a mega meltdown of the US stock market in October 1987. That followed years of increasing prices and valuations, often from companies that over-embellished their balance sheets and activities. That was when investors started to notice the number of increasing market investigations that were underway.

The fall in the Dow Jones was over 500 points at one stage in just one day, causing $30bn in losses. It was the largest one-day percentage drop in history, at some 22.6%. And here in the UK our market fell in tandem. Prices were slashed across the board, causing even further drops as panic set in and the market suffered a vicious decline.

The Dot.Com Crash

The 1990s saw the dawning across the world of the Internet generation. This new technology wave was something very special – and it presaged a period of incredible growth from 1994 until early 2000. Investors were increasingly anxious to get into the equity of any company involved in some way in the Internet, even if it just had ".com" after its corporate name.

Venture capital was incredibly easy to raise. The Nasdaq Index rose 400% in the same time, with price-earnings ratios reaching an incredible 200 times. Major floats like Yahoo, Lycos, Netscape and Excite came to market, raising billions of dollars in the process and going to significant premiums.

The 'New Economy' and its constituents enjoyed a substantial ride – negative earnings and sky-high valuations were the norm for these new players. Sense did not come into the equation because everyone was going to become a dot.com millionaire.

Wrong!

The global dot.com bubble popped in early 2000, and the slide lasted for the next couple of years. Too many new issues, overpriced companies, any form of realism having gone out of the window, combined with the wise few taking profits – the crash was inevitable.

The Nasdaq fell from 5,000 to almost 1,000 by 2002, with the US economy being thrown into recession in the process.

The Sub-Prime Housing Bubble

As a result of an overall easing of credit and lower interest rates, the value of property, especially housing, rose impressively. The higher prices fuelled real estate speculation backed by the easy money. House values soared and mortgages were almost given away to one and all, with little consideration of ability to meet repayments.

The banks and building societies were aware of this massive growth and they started to securitise their positions by bundling together parcels of sub-prime property mortgages. The major investment banks then commenced trading in those packages. Buying and selling between themselves and then passing them off to their luckless clients. The sub-prime areas were almost shanty towns full of new 'owners' who had no incomes, certainly insufficient to pay their mortgages.

Collapse was due, both in property prices and the other asset markets.

The late summer of 2008 climaxed with the bankruptcy of Lehman Brothers in September. Credit markets had been tightening over that summer, but after the banks' failure the resultant freeze brought about the global financial crash.

If it was not for central governments adopting policies of quantitative easing, a multitude of banking names would have disappeared entirely. Equity markets during this whole period fell significantly, more than halving in just months.

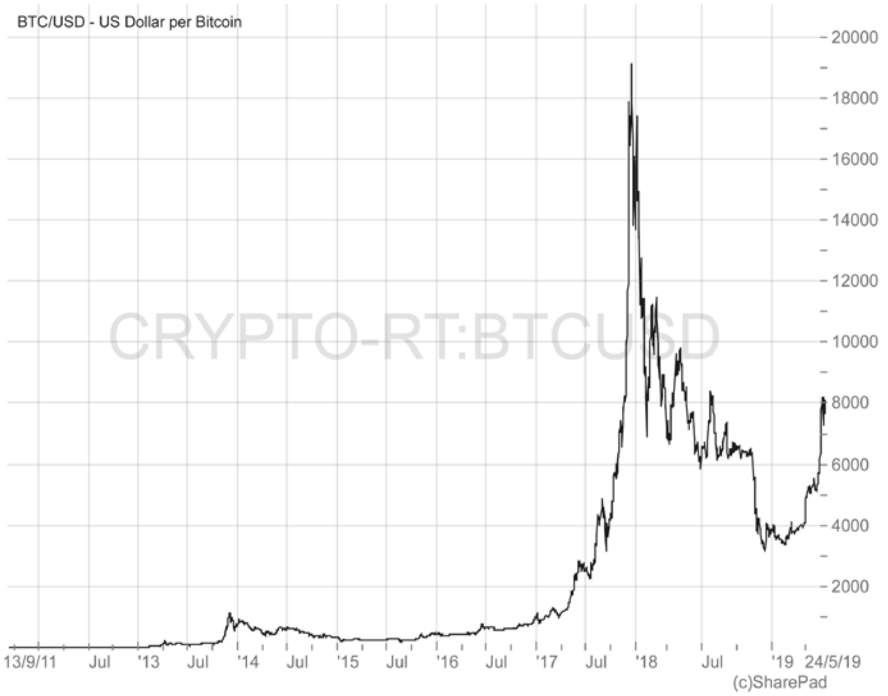
"IS THIS A BUBBLE? I WILL NOT COMMENT BUT INSTEAD STAND BACK AND WATCH BLOCKCHAIN AFICIONADOS GETTING EXCITED."

Bitcoin

From less than a dollar to almost $20,000, the price of Bitcoin exploded in the couple of years to the end of 2017. Everyone, it seemed, was talking bitcoin, playing the bitcoin market, and making a fortune in the process.

The blockchain currency has global attraction and is a subject upon which I will not opine without total knowledge – there are others far better than I to do that. However, I do see a lot of media comment about hackers breaking into and ripping off bitcoin 'wallets', about banks of bitcoin being raided and pilfered. Also, such an international and faceless currency attracts illegal use, particularly in the dealing of drugs.

Prices recently fell to around $2,000 before rising again to circa $8,000 currently.



Is this a bubble? I will not comment but instead stand back and watch blockchain aficionados getting excited. Even reticent investment bankers and institutional fund managers across the world are participating – but I am refraining.

What are the lessons to be learned?

The stages of markets need to be studied. So often, mania and greed outweigh common sense.

As he lost a fortune in the railway debacle, Charles Mackay commented that investors 'go mad in herds and only recover their senses one by one'. John Templeton, the legendary US investor observed that 'bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria'. That is borne out by practically all of my previous examples.

Investors may think that they have the golden touch, that they are guaranteed to make profits, but nothing is that definite in life. Sir Isaac Newton, when he made and then lost his profits in the South Sea Bubble, reflected that he could 'calculate the motions of the heavenly bodies, but not the madness of people'.

Looking at the cycle of market emotions gives us a very good clue as to how it all works. It includes the following, in order: optimism, excitement, thrill, euphoria, anxiety, denial, fear, desperation, panic, capitulation, despondency, depression, hope, then relief, leading to optimism – the cycle persists.

Somewhere in the world, at any one time, there is a new bubble underway, whether it is stocks, property, fine wines, motors or even market indices – the game is spotting, playing quickly and getting out too early.

It has been so often proved that 'a profit is not a profit until it is in your pocket' – that 'you never go broke taking a profit' even if you miss the big rise after you have sold. Awareness of previous market events helps investors avoid the worst excesses.

But remember to always leave something in it for the next man!

About Mark

Director of SQC Research and Author of mw-m.com.

Mark, who has over fifty-five years' experience in the UK stock market, established SQC Research in 1993. He previously worked as a dealer for four stockbroking firms and an investment fund management business. Prior to SQC Research, which provides investment information and comment on smaller quoted companies, he published financial and investment magazines and newsletters.

BY RICHARD GILL, CFA

FROM ACORNS TO OAK TREES

TOP TECH TIPS

Small cap guru Richard Gill, CFA, takes a look at three small cap technology companies which he believes could go on to deliver strong returns for investors over the coming years.

A basic definition of technology is, *"the practical application of scientific knowledge"*. This is a broad description and can cover anything from telecoms, computing, robotics, genetics and many more complex sectors. But even something as simple as a spoon can be considered to be technology. For example, we know from materials science that substances such as steel, plastic or wood, when fashioned into a shallow oval shape and handle, can make tools which are ideal for using in the preparation and consumption of food.

So while pretty much every company on the stock market is involved in technology in some way, this month I am focussing on those UK listed companies which operate in the more narrowly defined Software & Computer Services and Technology Hardware & Equipment areas of the wider tech industry.

As many investors know, technology companies can deliver outstanding returns. This is especially so in the US markets, where several tech titans now command valuations of pushing $1 trillion. At the top of the scale, those who took part in the **Amazon (NASDAQ:AMZN)** IPO in 1997 and have held on since then are currently standing on capital gains of over 120,000%! **Facebook (NASDAQ:FB)** shares are up by a more modest but still likeable 384% since its listing in May 2012, and looking back a bit further **Apple (NASDAQ:AAPL)** shares are up by 46,000% since its IPO in 1980. Of course, being one of the most exciting areas of the market, tech stocks are also prone to bubbles – **Microsoft (NASDAQ:MSFT)**, for example, took almost 17 years to get back to its dotcom bubble peak.

Here in the UK, the market for technology companies is far smaller than in the US. The largest tech stock on the FTSE 100, valued at a piddling £8.2 billion, is enterprise software business **Sage Group (LON:SGE)**. However, there has been a considerable number of success stories, especially amongst small cap techies, in recent years. Since the beginning of 2009, **GB Group (LON:GBG)** has seen its shares soar by almost 3,000% as clients have flocked to its identity data products, boosted by some shrewd acquisitions. Investors in **Craneware (LON:CRW)** have seen gains of 1,360% over the same period as the firm expanded strongly in the US health software market. And while having fallen sharply since last

"TECHNOLOGY COMPANIES CAN DELIVER OUTSTANDING RETURNS."

September, former small cap darling **Accesso Technology (LON:ACSO)** is still 2,060% up over ten years.

This month, I take a look at another three small cap technology companies which I believe could go on to deliver strong returns for investors over the coming years.

MTI WIRELESS EDGE

Within the value segment of small cap technology stocks is Israel based **MTI Wireless Edge (LON:MWE)**. The business was founded in 1972 as an antenna technology provider for commercial and military markets. It joined AIM in 2006 and since then has made two major acquisitions to expand its operations. The most recent of these was completed last August and saw the business merge with its majority shareholder, MTI Computers & Software Services.

As of today the business has grown into a $35 million revenue technology group focused on providing comprehensive communication and radio frequency products and services across multiple sectors through three core segments.

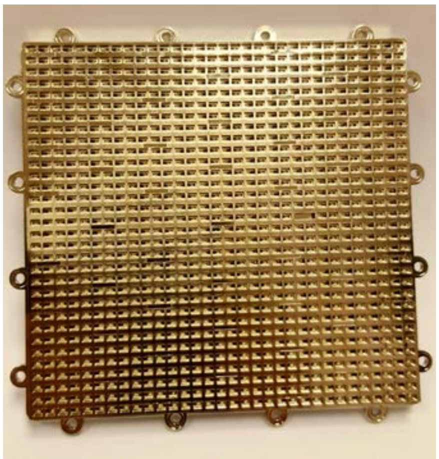
In the Antenna division, MTI is a world leader in the design, development and production of a range of high quality and cost-effective antenna solutions. MTI supplies antennas for both military and commercial markets. Military applications include a range of broadband, tactical and specialised communication antennas, antenna systems and DF arrays installed on numerous airborne, ground and naval, including submarine, platforms worldwide. In commercial, MTI supplies directional and omni-directional antennas for outdoor and indoor deployments, including smart antennas for WiMAX, Broadband access, public safety, RFID, base stations and terminals for the utility market.

The second major division is Water Control & Management Division where via subsidiary Mottech Water Solutions MTI provides high-end remote control solutions for water and irrigation applications based on Motorola's IRRInet state-of-the-art control, monitoring and communication technologies. As Motorola's global prime-distributor Mottech serves its customers worldwide through its international subsidiaries and a global network of local distributors and representatives. Activities are focused in the market segments of agriculture, water distribution, municipal and commercial landscape as well as wastewater and storm-water reuse.

Finally, via subsidiary, MTI Summit Electronics Ltd., MTI offers consulting, representation and marketing services to foreign companies in the field of RF and Microwave solutions and applications including engineering services in the field of aerostat systems and the ongoing operation of Platform subsystems, SIGINT, RADAR, communication and observation systems.

Transmitting good news

MTI has been a consistent performer throughout its history, with 2018 seeing a surge in the numbers following the completion of the merger with MTI Computers & Software Services. Revenues increased by 35% to $35.5 million in the 12 months to December, although assuming the merger was in effect in 2017 growth was a more modest 2%. Nevertheless, net profits rose by a decent 16% to $2.33 million on a merged basis. The balance sheet is notably strong, with net cash standing at $4.4 million at the period end.



60 GHz Directional (CPE) Antenna

To date, 2019 has also been a successful year, with MTI releasing a string of positive announcements over the past five months. These have included a number of contract wins including a $1 million deal for the development and manufacturing of military antennas and a $3 million plus agreement for Mottech in China, the largest individual order ever received by MTI. Results for the three months to March 2019 also confirmed that growth has continued this year, with revenues up by 16% at $9.1 million and pre-tax profits more than doubling to $0.56 million.

High frequency trading

MTI shares have had a good run over the past few years, rising from just over 5p in 2012 to peak at 37.5p in summer 2017. Since then, however, they have slipped back to just 23.5p and are looking incredibly cheap at current levels.

"MTI IS ONE OF THE HIGHEST YIELDING TECHNOLOGY STOCKS ON THE WHOLE OF THE LONDON STOCK EXCHANGE."

At current exchange rates, the shares now trade on a historic price to earnings multiple of 11 times. With analysts at Allenby Capital looking for earnings to rise to almost 3p next year, the multiple falls to just 7.9 times – very cheap for a growing technology stock.

Another major attraction here is the dividend, with last year's payment of 1.5c (1.19p) equating to a historic yield of just over 5%. Should the company pay out c. 1.54p for this year as Allenby is expecting, then the yield rises to a generous 6.55%. According to my data sources that means MTI is one of the highest yielding technology stocks on the whole of the London Stock Exchange.

Providing further backing to the investment case, net assets of $21.44 million (£17 million) cover 83% of the current market cap. Investors may be put off by the shares having a limited free float, with the founding Borovitz family having a 35% stake. However, there are some well-known small cap institutional investors on board, including Miton Asset Management and Herald Investment Management. What's more, a modest share buy-back programme up to a maximum of £150,000 is currently in progress with a view to increasing liquidity.

AMINO TECHNOLOGIES

Media and entertainment technology company **Amino Technologies (LON:AMO)** was for a long time a small cap darling, with the shares having risen eightfold between the end of 2009 and October last year. However, things came crashing down following a very badly received profits warning which has resulted in the company having undertaken a strategic review and restructuring of the business model. With the shares now trading at c. 40% of their peak worth, the market's over-reaction does seem to present an opportunity for patient investors.

Since its formation in 1997, Amino has been at the forefront of the transition of TV from traditional broadcast technologies, such as one-way cable and satellite, to IP / Cloud TV. The company is a provider of hardware, software and related services for TV set-top boxes, such as those used by cable TV operators and telco companies wanting to offer value added services to their customers. Revenues are derived from the sale of set-top box devices which include a perpetual licence for the software operating system and from software and services sold independently of any devices.

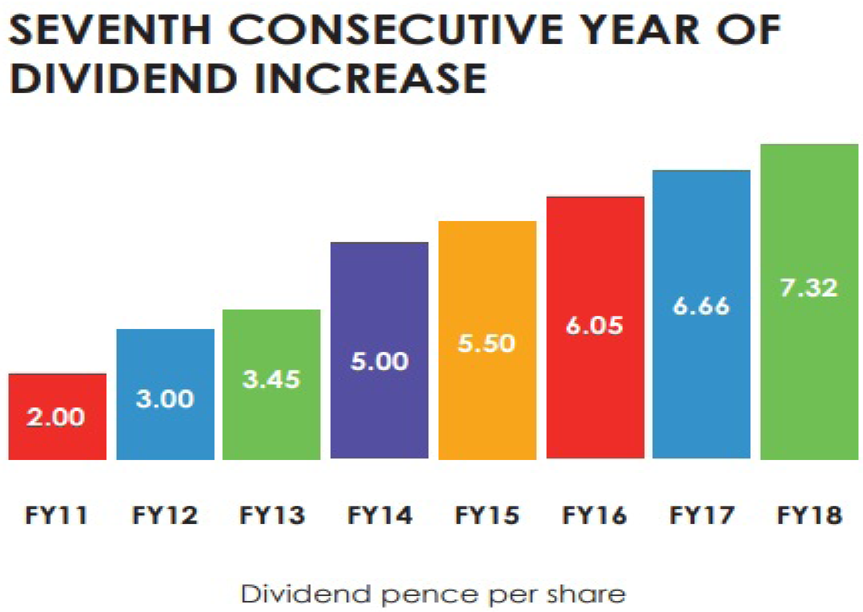
Bottom box

The main story of recent months has been the aftermath of the October 2018 profits warning. At the time Amino guided that 2018 adjusted pre-tax profits would be c. $11.5 million, well below expectations and down on 2017's figure of $15.2 million. This came after an intensification of external macroeconomic headwinds resulted in lower than anticipated orders and higher than expected component price increases in the second half of the year.

Final results for 2018, which were in line with the revised guidance, provided more details on the firm's reaction to events and guidance on its future direction. Notably, actions to deliver annualised overhead savings of $4.4 million were made since October, and a further $5 million are expected to come from a company-wide transformation programme. With just over $32 million of operating expenses in 2018 the combined savings add up to a significant amount.

The transformation programme, expected to have been completed by this April, will also see a move to focus on higher margin software and services and value-add hardware, to support a more resilient business model with improved operating margins and recurring revenues. Amino also plans to exit from low margin, commoditised hardware activities and as a result revenues for 2019 are expected to fall by c. 20% and adjusted operating profits by 10%.

Another crucial point is that the company intends to accelerate software and services growth through a focused M&A strategy. Amino certainly has plenty of cash to go about an acquisition strategy, with net cash at the end of November 2018 standing at $20.3 million. Also crucial for the future investment case, the dividend for 2018 was increased by 10% to 7.32p, in line with a previous commitment and the seventh year of such increases. Amino has also committed to maintain this dividend level for at least the next two financial years.



Over the top valuation?

The current price of 85p represents a c. five-year low for Amino, with the business now capitalised at just £62 million. On last year's earnings, that puts the shares on a multiple of 7.4 times adjusted earnings. As per the recent guidance and business model shift, broker FinnCap is looking for earnings to fall over the coming years before recovering to around last year's levels in 2021. That valuation looks cheap – albeit perhaps justified given the current uncertainty – and provides plenty of room for recovery should the firm go on to meet expectations.

Should the dividend be maintained as promised, then the yield for the next two years should be at least 8.6%. While this looks to be in yield trap territory, forecast earnings for the next two years should provide adequate coverage, with the large cash backing providing further comfort. Also, Amino is notably cash generative, with the net inflow from operations last year being $14.2 million, 72% higher than reported pre-tax profits.

Analysts at FinnCap recently reiterated a target price of 185p for the shares, justified by the "extraordinary" free cash flow and dividend yield. That implies upside of 118% from current levels. So as a recovery play, boosted by the high probability of a decent income, Amino Technologies has its attractions.

LOOPUP GROUP

Technology companies can famously attract huge earnings-based valuation multiples, especially in the early stages of their development, as investors look towards the future and have high expectations for growth. One such company currently attracting a high rating, but seeing levels of growth to justify it, is remote meetings company, **LoopUp Group (LON:LOOP)**.

Joining AIM in August 2016 and raising £8.5 million at 100p per share, LoopUp provides its clients with a premium remote meetings and conference call solution. The SaaS (Software as a Service) product, also called LoopUp, is built to give business professionals a better and more productive experience compared to basic dial-in conferencing. The product has been designed to address common frustrations associated with conference calls, such as forgotten access codes and background noise, and has a range of features designed to increase reliability, productivity and security for business users. To date over 2,000 companies across the world have used LoopUp's services, including blue-chip names such as Travelex, Planet Hollywood, National Geographic and Clifford Chance.

In June 2018 the company expanded its operations significantly by completing the reverse takeover of MeetingZone Group, a UK-based conferencing services provider, for a total consideration of £61.4 million. MeetingZone sells its own standalone audio conferencing services, resells Cisco's WebEx and Spark collaboration services, and also offers a value-added audio services product for Microsoft Skype for Business. The deal brought with it c. 6,000 global customers and a consistent track record of growth, with the business posting revenues of £22.5 million and adjusted EBITDA of £5 million in 2017.

> **"THIS IS A STRONGLY CASH GENERATIVE BUSINESS."**

More than meeting expectations

LoopUp came to market with an impressive track record and this has continued during its life as a public company. Results for the year to December 2018, the first since the reverse takeover, showed revenues ahead by 96% at £34.2 million and adjusted earnings up by 111% at 9.3p per share, well ahead of market expectations.

MeetingZone was said to have been fully integrated, with annualised cost synergies materially above the £3 million expected at the time of acquisition. As well as seeing the benefits of the deal, the firm continued to see strong organic demand for the LoopUp product during the period from its target market of mid-large enterprises and professional services firms. Multiple new accounts were won over the year and since the period end a material contract renewal was closed with law firm Clifford Chance, worth £2.34 million over three years.

The company ended the year with cash of £5.6 million but net debt was £10.6 million after further borrowings were taken on to finance the MeetingZone deal. However, this is a strongly cash generative business, with the net inflow from operations being £5.3 million, in contrast to reported pre-tax profits of £0.39 million, largely due to the adding back of non-cash amortisation and depreciation charges.

Get in the LOOP

LoopUp investors have done well since IPO, with the shares having more than trebled to the current price of 322.5p. On an earnings basis that values the business on a historic multiple of 35 times. But with good levels of organic growth being seen, combined with a full year contribution from MeetingZone in 2019, LoopUp is a company which looks set to carry on growing strongly in the short/medium term.

The market consensus is for around 60% earnings growth in 2020, which would put the shares on a PEG (price-to-earnings growth) ratio of 0.3 times. With a PEG of 1 generally considered to be fair value for growth companies then the shares arguably still have a long way to go.

Analysts at the house broker Numis have a chunky 600p target price on the shares, almost double current levels. They believe that the levels of growth being seen mean that earnings-based metrics are sub-optimal at this stage in the company's development, instead setting the target on a multiple of 7 times forecast sales.

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 2018.

PARTNER CONTENT

BY JOB CURTIS

HOW WE ACHIEVED 52 YEARS OF DIVIDEND GROWTH

City of London Investment Trust manager Job Curtis explains how he uses revenue reserves to smooth dividend payments over time.

"REVENUE RESERVES ARE THE MEANS BY WHICH INVESTMENT TRUSTS CAN CONTINUE TO GROW THEIR DIVIDENDS EVEN WHEN DIVIDENDS ACROSS THE STOCK MARKET ARE FALLING."

IR Stone / Shutterstock.com

There is no question that we find ourselves in uncertain times. It is during periods of uncertainty that the investment trust structure has distinct merits. That's because investment trusts, which are listed companies in their own right, can store future income away for a rainy day – a unique function of investment trusts called revenue reserves.

Revenue reserves are the means by which investment trusts can continue to grow their dividends even when dividends across the stock market are falling, typically during economic downturns. Investment trusts do not have to distribute all of their income in each financial year. They are allowed to hold back up to 15% of their annual income. For example, in a good year for investment income, an investment trust might hold back 5% of its income, while distributing the other 95% in dividends to its shareholders. The 5% that is held back will be added to the revenue reserve. Over the years, the revenue reserve can build up to a substantial sum if the investment trust is able to make further retentions.

In contrast, during an economic recession, there will be dividend cuts. If during these times an investment trust's income from its portfolio declines, it is still possible to grow its dividend by drawing down from the revenue reserve. Obviously, revenue reserves are finite and so using the revenue reserves to sustain dividend growth can only take place for a limited number of years. The revenue reserve of an investment trust is revealed each year in its annual report and accounts. The largest revenue reserves tend to be found in old investment trusts which have accumulated them over many years.

City of London's use of revenue reserves

I have now managed City of London Investment Trust for more than 27 years and we have grown our dividend in each of those years. We have had to use revenue reserves in seven different years to increase the dividend. Our financial year ends on 30th June and I can well remember how difficult it was for world equity markets over the twelve months to 30th June 2002. During those 12 months, City of London's earnings per share (including all its investment income) fell by 11.0% to 7.48p and yet we were still able to increase the dividend per share by 5.9%

to 7.94p. The difference between 7.94p and 7.48p, or 0.46p, was paid from the revenue reserve.

The following year (to 30th June 2003), earnings per share recovered by 5.2% to 7.87p but it was still not enough to cover the dividend per share, which we increased by 1.6% to 8.07p using the revenue reserve. The next year (to 30th June 2004,) earnings per share grew by 4.7% to 8.24p but again failed to cover the dividend per share, which grew by 3.2% to 8.33p. It was after three years of using revenue reserves, in the 12 months to 30th June 2005, that the dividend per share of 8.62p (up by 3.5%) was covered by earnings per share of 8.88p (up by 7.8%) and revenue reserves were once again added to.

In City of London's portfolio, I aim to be invested in companies that can consistently grow their profits and dividends through the cycle. However, during economic downturns, there are bound to be companies that disappoint. Open Ended Investment Companies (OEICs) have to distribute 100% of their income each year and are not permitted to have a revenue reserve. I would have not been able to achieve 27 years of annual dividend increases if I had been managing an OEIC.

City of London's annual dividend stood at 4.56p in 1991, the year when I was appointed its Fund Manager. The quarterly dividend is now 4.75p and the investment trust's Board of Directors has announced that it intends to pay an annual dividend of 18.60p for the year to 30th June 2019.

About Job Curtis

Job Curtis is Director of Global Equity Income at Janus Henderson Investors, a position he has held since 2006. He has been Portfolio Manager of the City of London Investment Trust since 1991 and is also co-manager of the Global Equity Income and Global Dividend & Income strategies. Job joined Henderson in 1992 following Henderson's acquisition of Touche Remnant, where he had served as a unit trust and investment trust manager since 1987. Prior to this, he was an assistant fund manager at Cornhill Insurance from 1985 to 1987 and a graduate trainee at Grieveson Grant stockbrokers from 1983 to 1985. Job holds an MA in philosophy, politics and economics from Oxford University. He is an associate member of the Society of Investment Professionals (ASIP) and has 36 years of financial industry experience.

Henderson Global Investors merged with Janus Capital Group in May 2017.

BY FILIPE R. COSTA

THE MACRO INVESTOR

SMALL IS BEAUTIFUL

A SMALL CAPS STRATEGY TO REAP LONG-TERM BENEFITS

Investing in small caps can be very rewarding over the long term. Filipe R. Costa looks at some of the most effective ways to get exposure to this exciting market.

One of the most puzzling effects observed in financial markets is the size premium, which refers to the incremental return investors can expect to get by investing in smaller capitalisation companies instead of blue chips. Thus, digging deeper in the market and looking for the less known companies – those trading more infrequently, carrying lower liquidity levels and often ignored by analysts – may actually pay off over time.

For some time now, both academics and practitioners have been studying the size effect: academics in order to explain the sources of risk, practitioners to reap alpha benefits. But the size effect (or size premium, as it is often referred to) has also been challenged on many fronts. It has been shown to vary over time – in particular it appears to have weakened after its discovery in the 1980s. Some evidence shows that it is concentrated in micro capitalisation stocks. It has even been reported that if the month of January is excluded from a return series, the size premium disappears. At the regional level, many studies point to the size premium being strong in the US and weak in international and emerging markets.

Despite conflicting views about the size premium, it's reasonable to suppose that there is a premium on offer from investing in a relatively unknown company instead of a blue-chip company that's followed by 100 analysts and owned by hundreds of funds. The art of investing is the art of deviating from the average – for good. The alternative is to follow the market and get average returns. So, to the extent that smaller caps carry a more uncertain future and are therefore riskier, it's reasonable to say that they also carry a higher expected return. Because investors usually care about both risk and return, the trick here is to reduce this extra risk as much as possible. One of the simplest and most effective ways of achieving such a goal is by extending the investment horizon.

"INVESTING IN SMALL CAPS IS A GREAT WAY OF REAPING ADDITIONAL RETURNS OVER TIME."

"WHEN WE CALCULATE RISK AS A MEASURE OF FAILURE TO ATTAIN OBJECTIVES OVER LONGER TIME PERIODS, WE OBSERVE THAT SMALLER CAPS MAY BE A LOT LESS RISKY THAN FIRST THOUGHT."

Smaller capitalisation stocks appear riskier if we look at standard deviation and beta measures, usually built from daily or monthly returns. But when we calculate risk as a measure of failure to attain objectives over longer time periods, we observe that smaller caps may be a lot less risky than first thought. Such an observation is in line with what David Dreman claims regarding stocks and bonds. In *Contrarian Investment Strategies: The Psychological Edge,* Dreman shows that over long time periods stocks aren't in fact risky while bonds are (when risk is seen as a failure to achieve an appreciation in one's capital).

Investing in small caps is a great way of reaping additional returns over time. Nevertheless, building a portfolio of small caps is no easy task. While identifying small caps just involves ranking stocks by market cap from lowest to highest and selecting the top spots, an investor would still need a significant number of stocks to build a diversified portfolio. Besides, recent research has shown that the size effect may work better when combined with additional factors like quality – that is, after eliminating junk stocks from the list. Still, it's possible to build a portfolio from scratch while taking care of these issues, as I show bellow.

The best and most effective way of taking a position in the small cap world is through an investment fund or ETF. Some are actively managed while others just track small cap indices. Nevertheless, don't expect a pure small cap portfolio, because these funds are unable to purchase the smallest capitalisations due to their own restrictions and lack of sufficient liquidity. I take a look at a few ETFs below, pointing out their strengths and weaknesses.

The theory behind small caps

In an efficient market, higher expected return should come with higher risk. Thus, the reason for the extra return generated by small caps should be the extra risk incurred. Small caps are often less liquid and less well covered by analysts. Their finances can be opaque and are often less exposed to public scrutiny, which increases the risk of investing. At the same time, institutional investors are often unable to access this market in full, possibly because they are prohibited from investing more than a fraction of their funds in a single company or owning more than a percentage of a company's outstanding stock. Moreover, from the standpoint of a typical fund with billions under management, a stock with a market cap of $100m isn't particularly interesting. There is also the issue of liquidity to take into account.

Due to all these restrictions, the opportunities open to investors are far greater in small caps than in blue chips. Notwithstanding this, smaller companies are inherently risky in nature. Investors receive extra compensation for taking on the higher volatility and higher risk of bankruptcy that is usually present with small caps, as evidenced in the Ibbotson study shown below.

Additional risks

While the reasons to invest in small caps may be appealing, investors should never take the risks lightly. In addition to the fact that small caps are by nature more volatile and more prone to bankruptcy, the size factor is highly cyclical. In general, factors (investment themes) like size, momentum, value, volatility and quality are heavily influenced by market condi-

U.S. EQUITY MARKET PERFORMANCE BY MARKET CAPITALISATION

1926-2006

Market Capitalisation	Annualised Return	Standard Deviation
1st decile (largest 10%)	9.6%	19.1%
2nd decile	11.0%	21.7%
3rd decile	11.3%	23.5%
4th decile	11.3%	25.8%
5th decile	11.7%	26.6%
6th decile	11.8%	27.7%
7th decile	11.7%	29.8%
8th decile	11.9%	33.3%
9th decile	12.1%	36.3%
10th decile (smallest 10%)	14.0%	45.2%

Source: Ibbotson Associates

"SMALL CAPS ARE OFTEN LESS LIQUID AND LESS WELL COVERED BY ANALYSTS."

tions and may experience prolonged periods of underperformance (for more on this, please check Master Investor Magazine December 2018 Issue 45 p. 22-29).

The size factor is usually positively correlated with the business cycle. When the economy is growing, broad investor sentiment is positive and so are the profit estimates for smaller, growth companies. At this time, smaller companies tend to rise faster than the rest of the market, and at times the share price can overreach itself, particularly after prolonged periods of optimism. The reverse occurs when economic conditions start to deteriorate, as investors become less optimistic and cut their profit estimates, which often leads to large price declines experienced by small caps.

The above means that a portfolio of small caps is exposed to severe drawdowns. In order to mitigate losses during harsher economic conditions, action must be taken, either through reducing portfolio exposure to small caps in general or by filtering out lower quality companies, and/or by extending the investment horizon.

Building a customised (*and riskier*) UK portfolio

The simplest way to get exposure to small caps (or the size factor) is through selecting the companies from a list of stocks. We could just rank LSE stocks by market capitalisation, from lowest to highest and select a number of top spots. While simple, I believe that such a strategy isn't that great. I would prefer to pick up a specialised investment fund or ETF. I suggest a few, some of which carry really low fees, below.

Still, for the sake of building a customised UK portfolio from smaller capital-

> **"THE BEST AND MOST EFFECTIVE WAY OF TAKING A POSITION IN THE SMALL CAP WORLD IS THROUGH AN INVESTMENT FUND OR ETF."**

isations, I've shortlisted 12 small cap stocks based on a few additional filters that start with a list of LSE stocks and end with a modified size rank. As I explained above, the size factor alone is risky and largely exposed to the business cycle, so I added a few filters to help eliminate the junk from the final list. On the one hand, I want to capture the best quality stocks possible. But, on the other, I'm mindful that I want a list filled with small caps and not value or quality stocks.

The procedure I use follows these steps:

1. **Select the universe of stocks:** LSE stocks.
2. **Market capitalisation filter:** Exclude stocks with market capitalisation above £750m.
3. **Volume filter:** Exclude stocks with an average daily trading volume of less than 50,000 for the last 25 days.
4. **Turnover filter:** Exclude stocks with an annualised turnover growth below 10% for the past 5 years.
5. **ROCE filter:** Exclude stocks with a negative return on capital employed (ROCE) 5-year average.
6. **ROCE rank:** Rank stocks from highest to lowest based on their return on capital employed 5-year average.
7. **Debt to EV rank:** Rank stocks from lowest to highest based on their ratio of debt to enterprise value.
8. **Free cash conversion rank:** Rank stocks from highest to lowest based on their ratio of free cash flow per share to earnings per share.
9. **Market capitalisation rank:** Rank stocks from lowest to highest by market capitalisation.
10. **Final rank:** Take the average rank from the above four ranks and rank this number from lowest to highest to get the final picture.
11. **Stock selection:** Select the top rankings as desired, whilst avoiding concentrations of more than 2-3 stocks from each industry.

I opted for a selection of 12 stocks in a compromise between diversification and transaction costs. The idea is to hold this portfolio for many years. A few tweaks and revisions may be conducted every six months or so though.

Using ETFs to get exposure to small caps

The alternative – and simplest – option to get a tilt towards small caps is through investing in ETFs. These instruments are widely available, have good liquidity, don't carry counterparty risk,

TOP 12 FTSE SMALL CAPS

Ticker	Stock	Industry	Market Cap (£m)	ROCE (5y)	Debt to EV	Free Cash Conversion
QTX	Quartix Holdings PLC	Technology	128.5	36.9	0.0	102.5
SOM	Somero Enterprises Inc	Industrials	205.6	49.7	0.0	96.9
MAB1	Mortgage Advice Bureau Holdings Ltd	Financials	303.2	73.6	0.0	115.0
TPFG	Property Franchise Group (The) PLC	Financials	45.6	24.5	3.7	97.1
NUM	Numis Corporation PLC	Financials	285.0	22.6	0.0	126.7
ULS	ULS Technology PLC	Consumer Services	40.3	34.3	10.8	98.1
W7L	Warpaint London PLC	Consumer Goods	76.0	34.6	3.6	69.6
TAP	Taptica Ltd	Consumer Services	181.6	26.4	7.3	134.0
D4T4	D4t4 Solutions PLC	Technology	92.0	17.8	0.9	80.4
TRCS	Tracsis PLC	Technology	195.6	17.0	0.2	103.2
TUNE	Focusrite PLC	Consumer Goods	305.7	34.0	0.0	72.3
SDI	Scientific Digital Imaging PLC	Health Care	51.2	9.3	2.7	153.7
	Median (from full list of selected stocks)		***222.3***	***11.2***	***10.8***	***60.6***

Source: Sharescope, Own Calculations

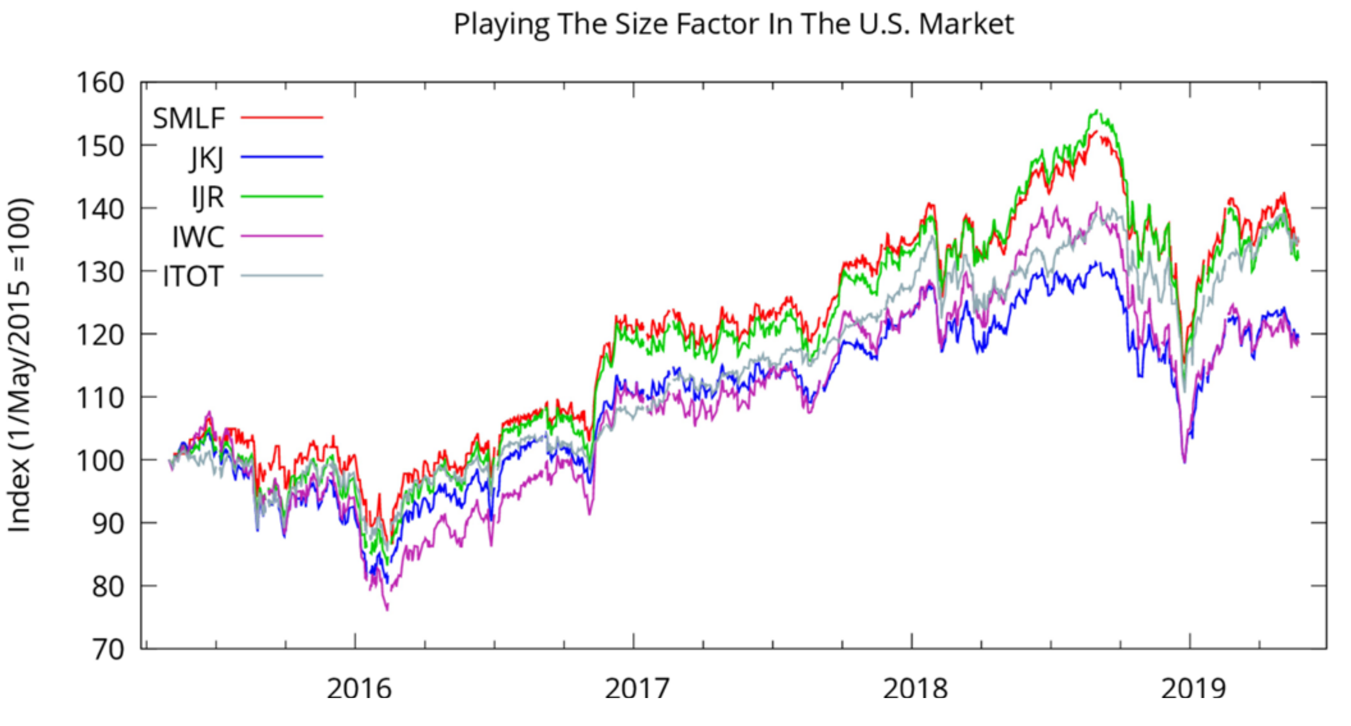
and are usually well diversified. Here I review a few of the biggest.

- **iShares Core S&P Small-Cap ETF (NYSEARCA:IJR)**
  This ETF tracks the S&P Small Cap 600 index, which represents 3% of the US securities market. Due to its expense ratio of just 0.07% and its high liquidity, IJR is one of the most attractive funds, particularly for an investor wishing to add funds regularly to his portfolio. IJR is exposed to several sectors of the economy and currently trades on a price-to-earnings ratio of 18.5 and on a price-to-book ratio of 1.85, which are both below the numbers for the broader market.

- **iShares Micro-Cap ETF (NYSEARCA:IWC)**
  Investors seeking exposure to the smallest part of the US market may fulfil that goal by purchasing shares in this ETF. It targets companies with capitalisations between \$30m and \$699m. Because of its characteristics, IWC has a high beta and higher standard deviation than the market and it's exposed to large drawdowns under stress periods, which should be weighed carefully by investors. Additionally, IWC is highly tilted towards the health care and financial sectors (more than 50% of total funds). Even so, this ETF is a good option for long-term investors looking for a real small cap fund. Expense costs are on the high side, coming in at 0.60%.

- **iShares Morningstar Small-Cap ETF (NYSEARCA:JKJ)**
  The iShares Morningstar Small-Cap ETF is an alternative to the IJR ETF. It tracks a different small cap index and comes with higher expenses (0.25%) than the IJR. But, in my view, there's no reason to prefer this ETF over the above option, as it has produced inferior risk-adjusted returns.

- **iShares Edge MSCI Multi-factor USA Small-Cap ETF (NYSEARCA:SMLF)**
  This ETF is built from the MSCI USA Small Cap index but in a way to in-



PERFORMANCE STATISTICS FOR SMALL CAPS ETFS

Analysis for the period May 2015 – May 2019

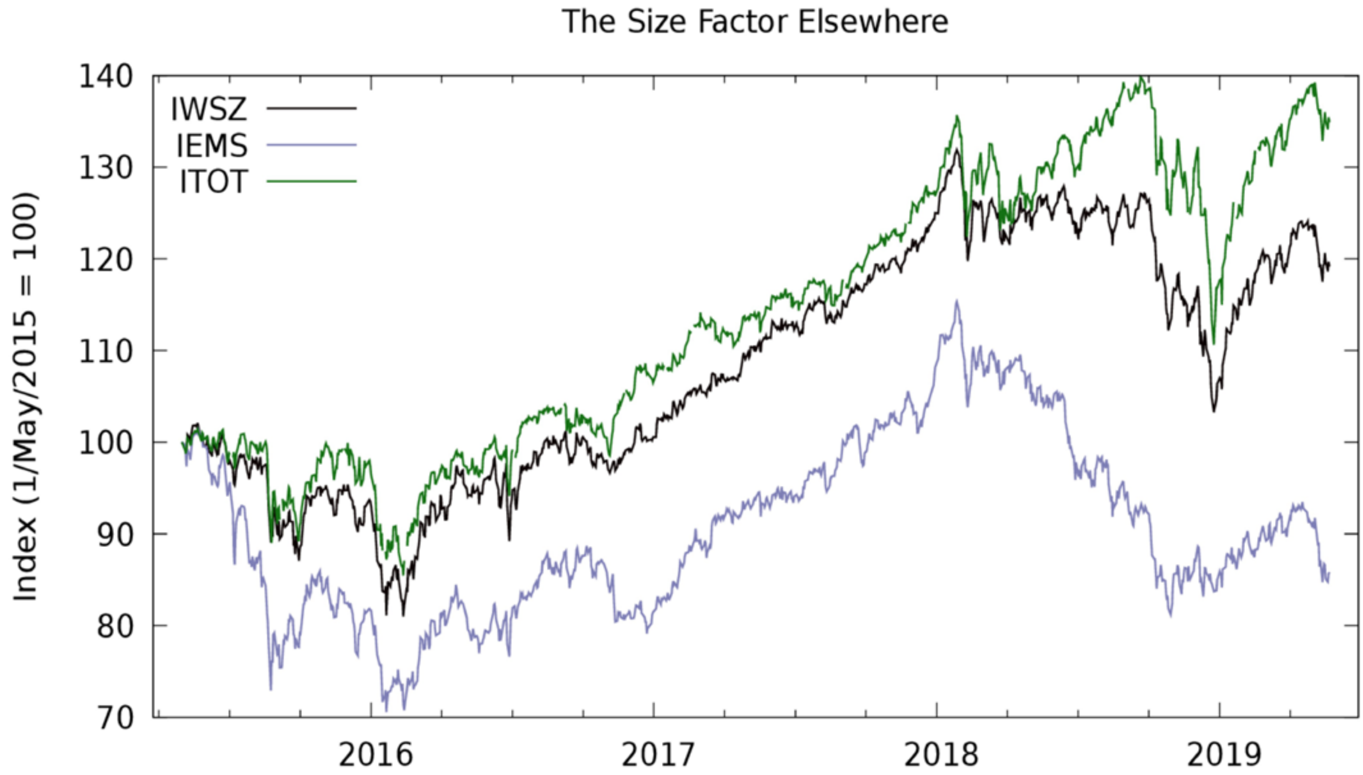
Ticker	Asset	CAGR	Stdev	Beta	Max. Drawdown	Sharpe Ratio	US Mkt Correlation
IJR	iShares Core S&P Small-Cap ETF	10.06%	16.18%	1.15	-22.64%	0.62	0.87
IWC	iShares Micro-Cap ETF	6.45%	17.37%	1.15	-24.65%	0.40	0.81
JKJ	iShares Morningstar Small-Cap ETF	7.35%	15.28%	1.12	-19.96%	0.48	0.89
SMLF	iShares Edge MSCI Multifactor USA Small-Cap ETF	10.35%	15.28%	1.08	-19.64%	0.66	0.86

Source: Portfolio Visualizer

crease the exposure of the fund to four factors: quality, value, momentum, and size. The key idea is to create a portfolio of small caps that has greater exposure to other factors as well. In my view this is one of the best options for investors because, as I mentioned above, recent research has shown that the size effect is more powerful when associated with other factors. The expense ratio comes at 0.30%, which is reasonable for this kind of smart beta ETF. Its performance has been the best of the above four for the last four years. It shows the best risk-adjusted returns, as reflected in its higher Sharpe ratio.

- **iShares Edge MSCI World Size Factor UCITS ETF (LON:IWSZ)**
  The iShares Edge MSCI World Size Factor ETF provides exposure to global smaller capitalisation companies within the MSCI World investment universe. The IWSZ is well diversified, as it holds 903 securities from 13 different countries. The expense ratio comes at 0.30%. This is a good option for those looking to get international exposure to small caps.

- **iShares MSCI EM Small Cap UCITS ETF (LON:IEMS)**
  Some people report that the small cap effect is greater in emerging markets. One explanation that has been advanced is that foreign investors going into emerging markets tend to bid up the larger companies because they are most liquid, the best covered, the most transparent and the ones that appear in the key regional indices. In consequence, as the argument goes, the large caps become more highly priced relative to smaller stocks in these markets. But this contrasts with other research that reports the size premium as being greater in the US markets, and poor in emerging markets. As I point out above, quality may interfere with size. In this particular case, the opacity of the market increases significantly when we go down the market cap scale, which may result in deficient investor protection and limited returns. From an individual investor perspective, the best way to get exposure to this market is through an ETF.



The iShares MSCI EM Small Cap ETF is a good choice. Its top holdings are from Taiwan, South Korea, India and China (collectively more than 50% of total holdings). Unfortunately, the expense ratio comes in at 0.74%, which is on the high side.

Small is beautiful – sometimes

Investing in small cap companies can indeed be very rewarding. Several limitations faced by institutional investors and a lack of analyst interest leave many smaller companies less well covered (if covered at all), giving rise to some good investment opportunities. But we should always remember that just as institutional investors don't bid up the price of small caps as much as they do with larger caps, this lack of institutional interest can also result in liquidity problems and a rapid sell-off when sentiment sours. Any potential price disconnect works in both directions and may expose investors to the risk of buying at extremely high prices, only to see their investments decimated in a bear market. Therefore, the best way to mitigate the risks is to extend the investment horizon to 10 or more years, build a well-diversified portfolio, buy at reasonable prices, and try to discard as much junk from the portfolio as possible.

About Filipe

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

BY DAVID JONES

CHART NAVIGATOR

ALL YOU NEED TO KNOW ABOUT CHARTING

So many traders try to bet against the trend and get burned. In this piece, charts guru David Jones explains why it's important to put yourself on the right side of sentiment.

Apologies for the somewhat click-bait nature for this month's charting piece. But as far as I am concerned, it's not stretching the truth *too* much and it is incredibly relevant to the sort of markets we have experienced so far this year – it's happening across many asset classes. It is of course the principle of trading or investing with the trend. There are a host of other tools that you can apply when charting markets – but in my view they pale into insignificance next to the concept of actually putting yourself on the right side of sentiment.

Why is the trend so important?

Perhaps a more accurate way of posing this question would be – *why are most charting and technical indicators actually not that useful?* I've worked in the financial and trading business for about twenty years and I have seen a definite trend (pardon the pun) in that time. There has been a marked increase in the number of people who come into this expecting to get rich quick, with a minimal amount of effort. If only they can get the correct settings for their triple-smoothed exponential Moving Average Convergence Divergence indicator, the future will be full of gold Lamborghinis.

I think this reliance on the black-magic elements of market analysis is also fuelled by the technical advancements we have seen over the past ten years. Nowadays even the most basic of charting packages will have a whole slew of customisable indicators – pretty coloured lines that can be added to your chosen market. But the trend is the most important – and to build that argument let's start with Exhibit A, the broader US stock market index the S&P500.

I think it is pretty clear that there is a trend in that market. It is up – this chart covers the period to the end of April 2019. I can also guarantee you something else. The majority of people trying to short-term trade this market over the last four months will have been "short" i.e. trying to call a top. And missing out on huge chunks of a market that just kept on trending higher. You can try it for yourself. Just pick a market that has a clear up- or down-trend over a decent period of time, have a look with your broker if they provide this sort of sentiment

"THE TREND REVERSAL – WHEN A TREND BREAKS – CAN BE A USEFUL SIGNAL FOR HIGHLIGHTING THE OPPORTUNITY OF A NEW MOVE STARTING IN THE OPPOSITE DIRECTION."

S&P500 year to April

Gold price August 2018 to date

data (many do), and I would be very surprised if the majority of open positions from clients would be in the direction of that trend.

I think this is the main problem with the vast array of technical indicators – they take people away from looking at what is actually going on in the market. If the pound is in freefall due to the lack of ability of the government to actually make a decision on anything, it does not matter how oversold your RSI is, chances are it will carry on falling. Until it stops. So why not wait for it to actually stop before trying to buy in?

Let's strip this back to the basics and look at how we identify a trend.

Gold has been in a steady uptrend since August of last year, but I think it is fair to say this only became clear in mid-November. Remember – when spotting trends, we actually need the market to have at least been moving in one direction for a little bit of time. This is what we had with gold. By November – three months after the 2018 low – there had been a succession of higher highs and lows as the price started to carve out the first tentative steps of an uptrend.

It is at this point that you can start drawing in a trend line. The text-book approach to trend lines is this: in an uptrend the line sits beneath the lows; and in a downtrend it is on top of the highs. I think it is a perfectly good tool for spotting and reinforcing the discipline of sticking with the trend. The assumption is that it is the third touch of the trendline – the first arrow above – that confirms this as a valid trend. That's the first true buy signal. After that, any weakness back to that trend line is expected to hold above the line – until it doesn't. What is interesting is that at the time of writing the gold price is back on that trend support, so it is time for a bounce – or otherwise a potential trend reversal in the weeks ahead for gold.

Of course, trends do not go on forever – that would make life too easy. But the trend reversal – when a trend breaks – can be a useful signal for highlighting the opportunity of a new move starting in the opposite direction.

"ACTUALLY PAYING ATTENTION TO THE TREND, AND NOT A BUNCH OF OTHER SQUIGGLY INDICATOR LINES, ON YOUR CHARTS IS IN MY OPINION THE MOST IMPORTANT THING A TRADER OR INVESTOR CAN DO WHEN IT COMES TO CHARTING."

US crude oil downtrend October 2018 to January 2019

Oil experienced a significant slide in the last quarter of 2018. It went from above $75 a barrel in October to below $43 by the end of December. You can see from the trend line in the chart above that this did a great job of stopping any significant recoveries on the way down. But this changed in early January – the trend line broke for the first time. Usually, after a break like this, there is some to-and-fro as the bulls and bears battle it out – but it wasn't the case in oil. The price did not really look back after this break and by the latter part of April, a barrel of oil was worth $66 – a recovery of more than 50% from that December low.

The usual caveats need to apply here – this approach does not work all the time. Trend lines break, only for the previous trend to resume at a slightly more gradual pace. But as a reminder, in my all-too-long experience, the single most prominent mistake made by investors and traders alike is to sell when a market is going up and buy when a market is going down. Actually paying attention to the trend, and not a bunch of other squiggly indicator lines, on your charts is in my opinion the most important thing a trader or investor can do when it comes to charting.

Chart of the Month

It makes sense to stick with the theme of trends for this month's chart and I thought the past year has been an interesting one for **Barclays (LON:BARC)**.

Barclays April 2018 to date

Back in May 2018 the share price of Barclays started to slide. It was trading at 215p back then but had dropped as low as 145p by December. You can see that again in this chart the trend-line did a reasonable job of stopping any of the rallies on the way down. These turned out to be just corrections against the trend until the Barclays share price slipped lower again.

But all of this changed in February of this year. The price had recovered and managed to break out of the trend line, suggesting that perhaps this slide was finally ending. I do not think it is quite as clear cut as that just yet – we have seen the price move out of that trend but so far it has struggled to find much in the way of positive momentum.

Given that the low in December was 145p, I think that that is really the key level to watch to see whether this downtrend is truly over – or is it just having an extended pause before it resumes? If the price breaks 145p, then for me any suggestion of a recovery in the short-term is off, and the risk is for another leg lower to get underway. For this trend to really end, the strength needs to start coming back in for Barclays ahead of that old December low.

The more conservative trader could take this a step further. Even though that downtrend has broken, which is a positive, there is not much in the way of a new trend. A break through the recent high of 170p would be one sign that Barclays is starting an actual recovery after that long slide.

"GOING IN THE DIRECTION OF THE TREND TILTS A MAJOR PORTION OF THE ODDS IN OUR FAVOUR."

Herein lies the problem with charting. It is always very easy in hindsight to look at a chart – such as the oil one above – and see where the trend has changed, and then mentally calculate all the money we could have made. In the real world, things are a little more difficult. But, just to hammer the point home, given that most people will try to bet against a trend (with predictable results for their investing and trading profits), going in the direction of the trend tilts a major portion of the odds in our favour.

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 NICK SUDBURY

FUNDS & TRUSTS IN FOCUS

THE BEST SMALL CAP FUNDS AND INVESTMENT TRUSTS

It's a very exciting time to invest in smaller companies, and Nick Sudbury has picked out some of the funds and trusts that can give investors ready-made exposure.

Small cap stocks are one of the most fertile areas for fund managers to operate in. These sorts of companies don't attract as much attention from the analysts as their larger brethren, which means that there's plenty of hidden gems to uncover for those who are willing and able to do the research.

Adrian Lowcock, Head of Personal Investing at Willis Owen, says that it is a very exciting time for smaller companies, as modern technology enables them to more easily access a larger market without the huge amounts of capital investment that were previously required.

"Valuations of smaller companies are not expensive either, although I

"SMALLER COMPANIES CAN BE VERY VOLATILE IN THE SHORT TERM, AND EVEN OVER A ONE- OR TWO-YEAR TIMEFRAME THEY CAN EXPERIENCE SHARP UPS AND DOWNS, BUT THE LONGER-TERM PERFORMANCE SPEAKS FOR ITSELF."

"OVER THE LAST 25 YEARS, THE IA UK SMALLER COMPANIES FUNDS SECTOR HAS GENERATED AN AVERAGE CUMULATIVE RETURN OF 1,004%, WHICH IS WELL AHEAD OF THE 474% PRODUCED BY THE MULTI-CAP UK ALL COMPANIES FUNDS."

do think it is misleading to look at average valuations of small caps, as it is the individual companies that matter."

The sector was hit hard in the fourth quarter of last year as investors adopted a risk-off approach. When markets are under pressure it is the perceived riskier and less liquid investments like small cap stocks that tend to be the most vulnerable, although there has been a strong recovery in the first part of 2019.

Smaller companies can be very volatile in the short term, and even over a one- or two-year timeframe they can experience sharp ups and downs, but the longer-term performance speaks for itself.

Over the last 25 years, the IA UK Smaller Companies funds sector has generated an average cumulative return of 1,004%, which is well ahead of the 474% produced by the multi-cap UK All Companies funds. The same difference can also be seen with Japanese, European and US funds.

Room to grow

Darius McDermott, MD of FundCalibre, says that smaller companies tend to do better than larger companies over the long term. "This is because they have more room to grow. It is easier for a company with a market capitalisation of £200m to double than one of £50 billion. Also, larger companies tend to grow via merger and acquisition, rather than organically like some smaller companies."

Whilst interest rates stay low and global growth remains muted, investors are likely to opt for companies that can grow faster than the economy as a whole, such as the small caps. Because of the volatility, the safest way to invest is by drip feeding money in on monthly basis, as this naturally evens out the fluctuations in the market.

Patrick Connolly, a Chartered Financial Planner at Chase de Vere Independent Financial Advisers, says that investing in smaller companies is most suitable for higher risk investors who want the potential of better returns and are willing to accept greater levels of volatility and potentially big short-term losses in order to achieve this.

"Over the longer-term, small companies, which are often dynamic firms, should outperform larger companies that might be at the consolidation stage of their development."

The problem is that UK domestic stocks still have the overhanging uncertainty of Brexit and this is a bigger concern for smaller companies, which are likely to earn more of their revenue in the UK, and could be badly affected by any weakness in the British economy.

"Those looking to invest in smaller companies should be assuming a time horizon of at least five years and, over this period, with valuations looking attractive and with Brexit issues hopefully having been long resolved, smaller companies could be positioned to perform very well," notes Connolly.

Open-ended funds

His preferred option is the £894m **Liontrust UK Smaller Companies** fund, which he describes as a top-quality fund with a strong investment team that focuses on factors such as high recurring income, distribution networks and intangible assets such as brand and culture.

The managers, Anthony Cross and Julian Fosh, have built a concentrated 66-stock portfolio of which 72% by value is listed on AIM. It is quite expensive with an ongoing charges figure of 1.4%, but this is more than made up for by the excellent performance, as since inception in 1998 it has returned almost twice the sector average with a gain of more than 1,100%.

Global exposure

The majority of smaller companies funds invest in a single region, which means that you would have to hold several of them to get a full international exposure, whereas the **Aberdeen Standard Investments Global Smaller Companies** fund would be sufficient in itself. This £1.3bn vehicle has a concentrated 54-stock portfolio that is divided between the US, UK, Japan, Europe, China and elsewhere. Over the last 5 years it has generated a cumulative return of 80.8% compared to the global sector average of 60.5%.

"THE CLOSED-ENDED STRUCTURE IS WELL SUITED TO THIS RELATIVELY ILLIQUID ASSET CLASS AND ALLOWS THE FUND MANAGERS TO BACK THEIR VIEWS WITHOUT HAVING TO WORRY ABOUT THE TRADING LIQUIDITY OF THE UNDERLYING STOCKS."

Lowcock also likes it because it provides investors with access to a differentiated process that concentrates on the importance of the intangible assets of a company.

"This typically leads to a bias towards the less capital-intensive people businesses, such as support services, technology, and media. The size of each holding is influenced by the riskiness of the investment, with the managers paying relatively little attention to the benchmark."

McDermott prefers the £49.5m **LF Tellworth UK Smaller Companies** fund despite the fact that it was only launched last November. He says that it is a pure smaller companies fund run by two very experienced and highly regarded managers, Paul Marriage and John Warren.

"They have an outstanding long-term track record investing in smaller companies and this fund is very similar to portfolios they have run before at Cazenove and Schroders. We have high hopes that they can repeat their past success with this new venture."

Looking at their holdings, the median market cap is £263m, which is much smaller than many of the other funds operating in the sector. This is where they see the best opportunities ahead of some kind of resolution of the Brexit process.

Investment trusts

The analysts at Numis say that over the long term, the UK Smaller Company investment trusts have built up a good track record relative to their open-ended counterparts. This reflects the fact that the closed-ended structure is well suited to this relatively illiquid asset class and allows the fund managers to back their views without having to worry about the trading liquidity of the underlying stocks.

Data from Winterflood Securities reveals that there are 13 UK small cap investment trusts, with the sector trading on a weighted average discount to NAV of 7.8%. The largest are **Aberforth Smaller Companies (LON:ASL)** (£1.15bn), **BlackRock Smaller Companies (LON:BRSC)** (£679m), **Henderson Smaller Companies (LON:HSL)** (£669m), and **Standard Life UK Smaller Companies (LON:SLS)** (£492m).

There are also three UK micro-cap trusts including **Miton UK Micro-Cap (LON:MINI)** and **R&M UK Micro-Cap (LON:RMMC)**, as well as six Global Smaller Companies trusts, the largest of which is **Smithson (LON:SSON)**, which was launched last October.

Most of the investment trusts operating in the sector have a growth at a reasonable price (GARP) investment style, whereas Aberforth Smaller Companies and the income focused mandates have a value bias. The other main option is Standard Life UK Smaller Companies, which has a high growth methodology.

Last year was a tough one for the sector with the NSCI ex Investment Companies Index falling 15.3%, although all the UK smaller companies trusts managed to outperform it in terms of their share price total returns, helped by a narrowing of the discounts. The asset class has recovered strongly since then, along with the rest of the market, with the index up 8.7% in the first quarter of 2019.

Core holding

Numis regard Henderson Smaller Companies as an attractive core holding for those who want exposure to small cap stocks. Neil Hermon, the manager, focuses on companies with good growth prospects, sound financial characteristics, and strong management that are trading at a valuation level that does not reflect these strengths.

He has established a strong long-term track record, with NAV total returns of 15.7% per annum since he took over in late 2002 (versus 12.3% p.a. for the NSCI ex Investment Companies Index). The fund also benefits from low fees, with an ongoing charges figure of just 0.41% plus a performance incentive. It is currently trading on a 9% discount and yielding 2.4%.

Herman has put together a well-diversified portfolio consisting of 105 different holdings, with the largest position, Bellway, accounting for 3.2% of the assets. The manager tends to focus on the larger more liquid stocks in his investible universe, and is willing to hold onto the winners, hence the reason that 57% of the portfolio is currently in FTSE 250 mid-cap stocks, with the remainder split between FTSE Small Cap (16%) and AIM (24%).

The largest fund in the sector, Aberforth Smaller Companies, has suffered in recent years due to the fact that its value investment style has been out of favour. This makes the performance look dull relative to the sector average, even over 10 years, although it has still managed to significantly outperform since its inception in 1991. The shares are trading on a 9% discount and yielding 3%.

Other trusts

If you would prefer a higher weighting to shares listed on AIM, you might want to consider BlackRock Smaller Companies, which can invest up to half of the fund in these stocks. Mike Prentis, the manager, has established a strong track record via his quality growth bias, characterised by strong balance sheets and proven management teams. He has put together a diversified portfolio of 133 stocks, with the fund generating a 10-year share price total return of 623%. Prentis has recently announced his retirement and will be replaced by his co-manager, Roland Arnold, who has worked with him for the last 14 years.

Winterflood's favoured fund in this area is Standard Life UK Smaller Companies, which has been managed by Harry Nimmo since September 2003. Nimmo is one of the most highly regarded managers in the sector and has considerably outperformed his peer group and index over the last 10 years by focusing on quality growth stocks.

The manager invests in strong business franchises that have the potential for considerable earnings growth. He has put together one of the more concentrated portfolios in the peer group with just 54 stocks, of which the top 10 account for 33% of the assets. These include the likes of Dechra Pharmaceuticals, Fevertree Drinks and Gamma Communications.

If you are looking for something a bit different, McDermott suggests the £494m Baillie Gifford Shin Nippon Trust (LON:BGS), which is unusual as it invests

"NUMIS REGARD HENDERSON SMALLER COMPANIES AS AN ATTRACTIVE CORE HOLDING FOR THOSE WHO WANT EXPOSURE TO SMALL CAP STOCKS."

FUND OF THE MONTH

The £1,289m **Merian (formerly Old Mutual) UK Smaller Companies** fund has one of the best investment teams in the sector, and they have produced a strong and consistent performance over many years.

"It is one of the bigger funds operating in this area, which means that the managers invest in larger companies than some of their competitors. Their focus is on investing in good quality businesses and this has enabled them to benefit from IPOs, which has helped to drive the performance in recent times," explains Patrick Connolly of Chase de Vere.

Dan Nickols, who has been running the fund since 2004, has put together a 93-stock portfolio that is currently weighted in favour of industrials and financials. Over the last five years it has returned 62% versus a sector average of 41.3%.

In order to be included, companies must first demonstrate one or more of the following characteristics: the ability to grow earnings faster than the market average for an extended period of time; the scope to generate a positive surprise; or the potential to be re-rated relative to the market.

Adrian Lowcock of Willis Owen says that a pragmatic approach is taken to valuation, with various ratios and timescales used depending upon the situation. "This flexible approach allows growth, value and recovery companies to be held, although the portfolio has tended to show a growth bias."

Fund Facts

Name:	Merian UK Smaller Companies
Type:	OEIC
Sector:	UK Smaller Companies
Total Assets:	£1.3bn
Launch Date:	February 2001
Current Yield:	0.59%
Ongoing Charges:	1.03%
Website:	www.merian.com

in Japanese smaller companies. Over the last 10 years it has returned 817%.

"Shin Nippon means 'new Japan' and this trust focuses on emerging or disrupted sectors, where the manager sees innovative growth opportunities. The team are prepared to bide their time while these companies reach their full potential," he says.

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 JOHN KINGHAM

DIVIDEND HUNTER

IS SAINSBURY'S WORTH ITS HEAVILY DISCOUNTED PRICE?

With Sainsbury's shares trading at their lowest in 25 years, and with a 5.2% dividend yield on offer, John Kingham investigates whether they are worthy of investors' attention.

Poor old Sainsbury's. Its share price is currently lower than at any time over the last 25 years and as I type, it appears to be in freefall. But how can this be? Surely Sainsbury's is a defensive dividend payer with a long record of unbroken dividend payments and a core supermarket business which is about as dependable as they come?

Well, perhaps not. The big UK supermarkets have had problems ever since the financial crisis made consumers far more cost conscious than they were before. The market effectively fell into the laps of Aldi and Lidl, and Sainsbury's has been playing catch up ever since.

To build greater economies of scale it proposed a merger with ASDA in 2018, but that was recently blocked by the Competition and Markets Authority. Sainsbury's shares are now about 40% below where they were last summer. As a dividend-focused value investor, that sort of decline sparks my interest, so I thought I'd take a closer look at whether Sainsbury's is finally good value or not.

Has Sainsbury's grown its dividend consistently?

At 210p per share, Sainsbury's 5.2% dividend yield is attractive, but if that dividend goes down rather than up, then shareholders will be disappointed rather than pleased. What we want to see, of course, is a dividend which goes up over time, enough to grow the income ahead of inflation and to give us a satisfactory total return (10% per year from income and growth is my ballpark target).

Sainsbury's has a long history of dividend payments, but has it consistently grown that dividend in recent years?

The answer is no. Sainsbury's has cut its dividend on several occasions and the 2019 full-year dividend of 11p is below where it was in 1993. This lack of performance stands in

"SAINSBURY'S HAS CUT ITS DIVIDEND ON SEVERAL OCCASIONS AND THE 2019 FULL-YEAR DIVIDEND OF 11P IS BELOW WHERE IT WAS IN 1993."

John David Photography / Shutterstock.com

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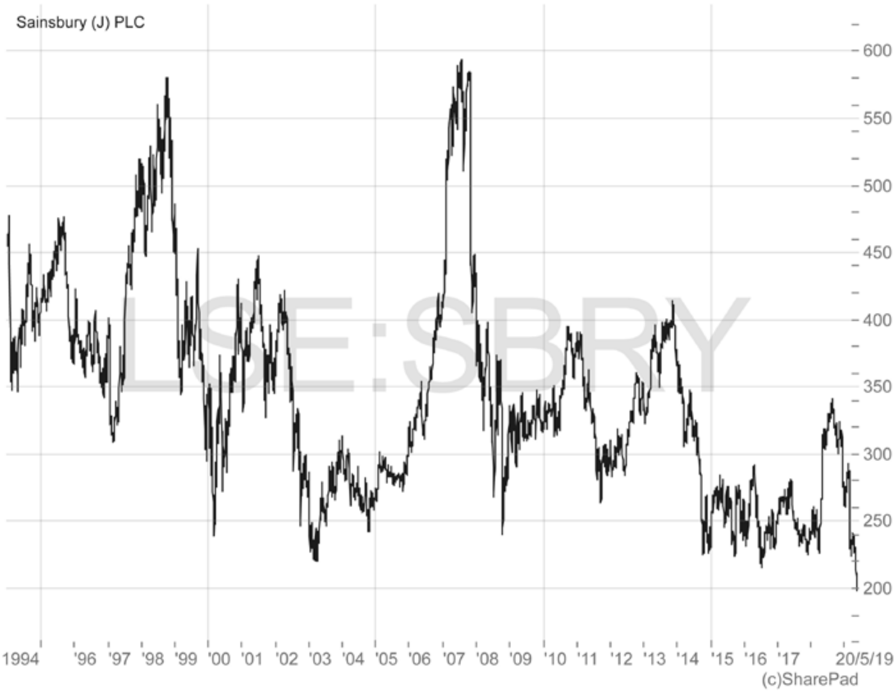

stark contrast to the company's record of 23% annualised growth over the 20 years to 1992.

Back then, Sainsbury's and Tesco had little serious competition as they plastered towns and cities up and down the UK with huge supermarkets, the likes of which had never been seen before. It was the golden age of the supermarket giants.

Unfortunately for them, things are very different now. Every city and town has about as many supermarkets as it can profitably support, and it seems that every supermarket niche (from big to small and cheap to expensive) has already been filled to overflowing. In this sort of mature market, above average growth is hard to come by unless you can offer something radically different.

This market maturity began to show up in the company's results around the turn of the millennium. After 1999 the dividend stalled at 14.3p for a few years while management invested heavily in new distribution centres and other infrastructure. After that the dividend started to creep up again, but in hindsight that was a mistake. In 2005 the dividend was cut from 15.7p to 7.8p and the annual report of that year asked: "what will it take to make Sainsbury's great again?"

We may still be waiting for an answer to that question. After the 2005 dividend cut, the dividend was raised progressively for a few years only to be cut repeatedly, until finally settling at a low of 10.2p in 2017.

This most recent dividend cut was largely caused by the aggressive discount prices of Aldi and Lidl, but the true cause has long remained the same: Sainsbury's is a major player in a mature market, so growing by expanding the market or expanding market share is virtually impossible unless you offer something radically different (like the incredibly low prices of Aldi and Lidl), and Sainsbury's does not.

So that's the up and down story of Sainsbury's dividend. Of course, there's much more to a company than just its dividend, so let's have a look at the company's recent results in a broader context.

Has Sainsbury's grown anything consistently?

Let's start with two major sources of funds which the company can try to extract a profit from: revenues and capital.

Starting with revenues, these are paid into the company by customers and profits are what's left over after all expenses are paid – so if revenues don't grow over the long term, profits can't grow over the long term either.

In 2010, Sainsbury's revenues were just shy of £20 billion, or 1,066p per share. In 2019 revenues per share were 1,175p, so they'd grown, but not by much. In fact, the growth rate of revenues per share for the last ten years is less than 1% per year, so Sainsbury's isn't growing its revenues fast enough to keep up with inflation.

Let's turn to capital. These are funds raised from shareholders and debtholders which are typically used to buy assets such as stores, distribution centres and the equipment that fills them. The combination of shareholder and debtholder capital is known as capital employed.

In 2010, shareholder capital (i.e. shareholder equity) stood at £5 billion and the company had total borrowings of £2.4 billion. So capital employed was £7.4 billion, or 395p per share. In 2019, Sainsbury's capital employed per share

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Kristi Blokhin / Shutterstock.com

had grown to 411p, an increase of just 4% over ten years.

So it seems that even if we look beyond dividends and measure growth across revenues and capital employed, which are the sources of cash from which profits ultimately flow, Sainsbury's has basically not grown at all in ten years. This doesn't necessarily mean it's a bad company, but it does suggest (as I've already said) that it's operating in a highly competitive and mature market.

Does Sainsbury's have any competitive advantages?

Capitalism is all about competition. If a company operates in a competitive market but doesn't have any competitive advantages, other companies will come along and take its profits.

For truly uncompetitive businesses the result is bankruptcy, administration or some other form of total failure. For middlingly competitive companies the result is profits which are, at the very least, driven down to the point where returns on shareholder equity are no better than the average returns of the market. In the UK, that means something in the region of seven to ten percent.

Sainsbury's ten-year average return on equity is 7%, so by that measure it appears to be about as competitive as the average UK company. That's not bad, but it's not great either. However, a company's return on equity can be boosted by taking on lots of debt. The borrowed funds can be used to invest in stores, distribution centres and so on. As long as those assets generate returns greater than the interest on the debt, the remainder goes back to shareholders in the form of boosted returns on equity.

But taking on lots of debt to boost returns on shareholder equity is a very risky strategy. That's why I prefer to look at net returns on capital employed, because it takes all borrowings into account.

If we take Sainsbury's average borrowings of £2.4 billion into account, its net return on total capital employed (rather than just equity) falls to a very meagre 5.2%. This suggests that Sainsbury's has no meaningful competitive advantages, and it therefore has to battle with other supermarkets primarily on price and location. As a general rule, competing on a price-first basis is usually a very bad idea, unless your whole business is designed from the ground up with that in mind (which Sainsbury's isn't).

As well as weak returns on capital employed, Sainsbury's also has low returns on sales. Its net profit margins over the last ten years have averaged an incredibly weak 1.9%, which really is exceptionally low. This combination of thin profit margins and weak returns on capital are both signs of a company that is in a very weak competitive position.

"SAINSBURY'S HAS BASICALLY NOT GROWN AT ALL IN TEN YEARS."

One common consequence of weak returns on capital is that the company in question has to borrow lots of money to fund any necessary capital investments, such as upgrading stores, distribution centres, etc. This is because profits are too low to cover these necessary expenses, and so debt is the only remaining source of funds.

Are Sainsbury's debts too high?

Today, Sainsbury's has total borrowings of £1.7 billion. It generated net profits over the last ten years averaging £440 million, so the ratio of debt to ten-year average profits is currently 3.8. This is quite high in my experience, although not excessively high for a defensive sector company such as a supermarket.

Debts are also heading in the right direction – i.e. down. Last year Sains-

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"IT'S NO WONDER THAT SAINSBURY'S MANAGEMENT ARE SO KEEN TO AGGRESSIVELY REDUCE ITS DEBTS OVER THE NEXT FEW YEARS."

photocritical / Shutterstock.com

bury's debts stood at £2.2 billion, giving the company a debt to average profits ratio of 4.9. That's dangerously close to five, which is the point at which I'd call a company's debts excessive.

Fortunately, the company's current management agree. Debt reduction is now a high-profile priority and the recent 2019 results announced a new plan to reduce net debt by £600 million over the next three years.

So debts aren't a major problem; but what about defined benefit pension liabilities? These have been instrumental in some catastrophic corporate collapses in recent years, so they're well worth looking at.

Is Sainsbury's pension liability dangerously large?

Sainsbury's has a total defined benefit pension liability of just over £10 billion, which is over 20-times the company's £440 million average net profits. That's a lot and it's way above my preferred pension ceiling of ten-times average profits.

Thankfully, the company's pension scheme only has a relatively small £260 million deficit. However, just a year ago the deficit was £850 million, which is effectively a form of debt. If the deficit returned to that level (which is not an unlikely scenario) then Sainsbury's debts, including the deficit, would be almost six-times its average profits, which is an uncomfortably high debt burden for a company with no clear competitive advantages.

Given that context, it's no wonder that Sainsbury's management are so keen to aggressively reduce its debts over the next few years.

Is Sainsbury's investible?

In general, I try to invest in above average companies because they're more likely to prosper over my preferred five- to ten-year holding period. Mediocre companies are, on the other hand, far more likely to suffer at the hands of competitors and disappoint shareholders over that sort of multi-year period. So what do we have with Sainsbury's?

We have a company that has no sustained track record of dividend growth over the last 25 years or so. We have a company that has very weak profitability and therefore is unlikely to have any meaningful competitive advantages. We have a company that has used significant amounts of debt in the past to boost shareholder returns, but which has at least seen the folly of that approach and is trying to repair its balance sheet. We have a company with an extremely large pension liability where there is real potential for a dangerously large deficit.

This is not the sort of background I like to see before investing in a company. In many ways it reminds me of several other high profile, major UK companies that have floundered in recent years.

> **"MY CONCERN IS THAT TESCO OR AMAZON OR ALDI WILL SUCK AWAY SAINSBURY'S CUSTOMERS, LEAVING THE COMPANY ON A LONG DOWNWARD SLOPE FROM MEDIOCRITY TO IRRELEVANCE."**

Marks & Spencer is one example. It's a giant of the high street, but one which is very much into the mature phase of its life. It hasn't grown consistently for years, it has weak profitability and non-trivial debts. Or look at Centrica, the company behind British Gas. It's also very mature and was once a monopoly supplier, but it now has no sustained growth, no significant competitive advantages and an enormous mountain of debt.

This is why I advise people to be wary of the idea that you should "invest in what you know". If you invest in what you *really* know very well, perhaps focusing on and analysing insurance companies if you work in the insurance industry, then yes, that makes sense. But if you invest in companies like Sainsbury's just because you've heard of them and used their services, I think that's a very bad idea, regardless of how attractive their dividend yield.

What price would I pay for Sainsbury's?

As you've probably guessed, I'm not a massive fan of Sainsbury's as an investment. It has no sustained track record of success (in recent decades at least) and no obvious competitive advantages, so my concern is that Tesco or Amazon or Aldi will suck away Sainsbury's customers, leaving the company on a long downward slope from mediocrity to irrelevance.

Of course, its future might not be that bad and Sainsbury's could well limp along, going nowhere for another twenty years. But that's not exactly what most dividend investors are after. And while the company could turn things around and perform exceptionally well, I don't think that's the most likely outcome.

So I'm not looking to invest in Sainsbury's. But if I were, what price would I pay? Well, assuming I was happy to ignore its weak profitability, lack of growth and enormous pension liabilities (which I'm not), the price would have to be significantly lower than it is today.

Given the company's lack of sustained growth, the dividend would have to make up virtually all of my expected return. In other words, I would want the dividend yield to be above 7% before I'd even think about investing. That would require a price of no more than 157p, so I think a target buy price of below 150p is reasonable for a long-term income investor, but only if you're willing to ignore the company's various problems.

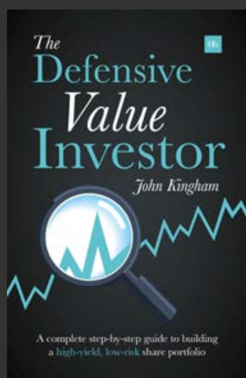
Willy Barton / Shutterstock.com

About John

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

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

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



BY DAVID JONES

FORENSIC FOREX

BITCOIN IS BACK FROM THE DEAD

The recovery we have seen over the past couple of months makes Bitcoin an interesting market to watch once more, argues David Jones.

Hands up who remembers the last few months of 2017? The Dow Jones index was relentlessly hitting fresh all-time highs; the UK had more than a year to negotiate an easy, seamless exit from the EU; and suddenly everyone was an expert on the blockchain and cryptocurrencies. The price of Bitcoin – and other cryptos – started going parabolic in the last few months of 2018, and social media was full of converts rejoicing at the free money that the great market gods were bestowing on them after they had cannily invested into the future of money.

Bitcoin 2018 chart

Make no mistake, 2017 was an incredible year for cryptocurrencies. Bitcoin started the year a little under $1,000 per coin – and was worth more than $19,000 by 18 December. But it was the last few months of the year where crypto-mania seemed to grab the world's attention: in that three-month run to 18 December, the dollar value of Bitcoin increased more than five-fold. Looking back, it did feel as if every day there was a significant news release around cryptos and the blockchain. Whether it was the imminent launch of official futures contracts or exchange traded funds; various companies changing their name to incorporate the world "blockchain"; or companies launching their own version of crypto currencies. Eastman Kodak is one that sticks in my mind – the traditional photography business announced it was launching KODAKCoin in early 2018 – with predictable results.


BITCOIN DIGITAL DECENTRALIZED

Eastman Kodak 2018

Down to Earth with a bump

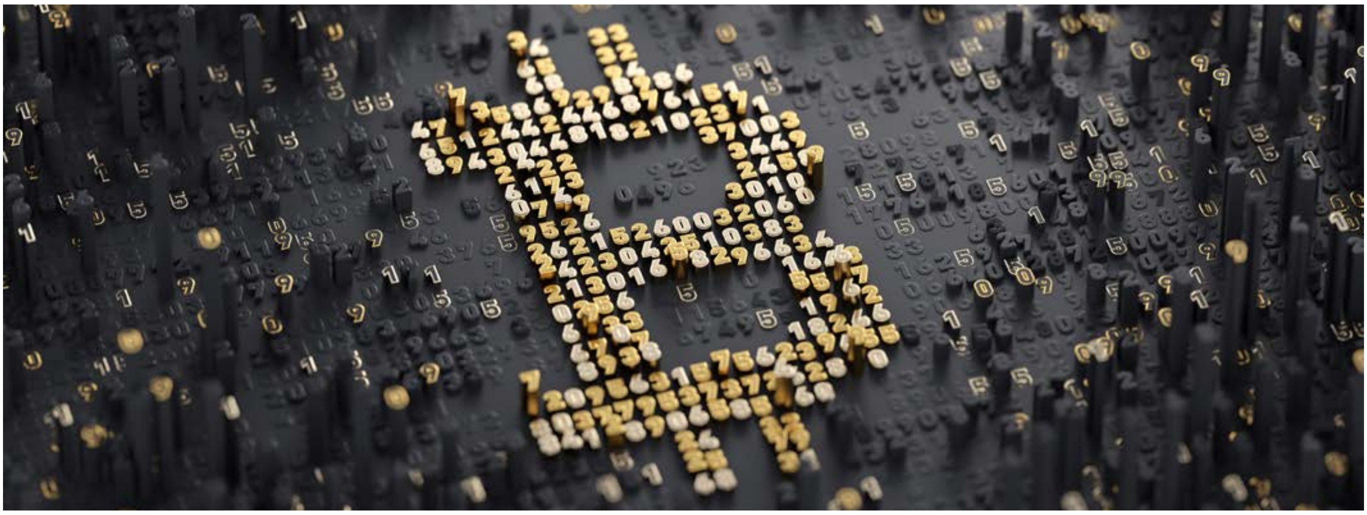
I wonder if you can spot the point when the company made the announcement. The share price jumped fourfold in a couple of days – and then, of course, gave it all back over the next few months. It was very reminiscent of the technology boom from the late 1990s where bolting ".com" onto your business name often resulted in an instant boost for the share price.

As with the dotcom bubble, nothing goes up forever as the faithful "crypto-holders" learnt to their cost in 2018. December 2017 marked the top, and by December 2019 one Bitcoin was only worth slightly more than $3,000. A lot of interest had simply evaporated and those looking for easy money ended up getting their fingers burnt.

That's enough of a catch up with the history of the last couple of years. Bitcoin has got interesting again and – I can only whisper this – perhaps we will see a continued and more orderly recovery in the months ahead. There have been plenty of false dawns for the price of Bitcoin and other alternative currencies such as Ethereum and Ripple. These were characterised by short, sharp bounces – only to turn lower again as old holders were glad to offload at break-even – or at least, less of a loss. It was the usual example of a "dead-cat bounce" that you see in plenty of other markets. But the moves in recent months have been more sustainable.

The move that started in early April blasted through some previous real problem areas. Investors and traders had become used to rallies just running out of steam – but not this time. I've talked a lot about the "breakout" approach in the past. When a market breaks a previous peak – somewhere where sellers had come in before and pushed the price down – it can be a sign of sentiment shifting. We have had that in spades in Bitcoin (and other cryptos) over the past couple of months. By the middle of April, the price had doubled from that breakout level. Once again, the crazy world of cryptocurrency was on fire!

What is interesting to me is where this has stopped. In July last year, the price peaked around the $8,500 mark, and this proved to be a significant top



"I FULLY EXPECT TO SEE MORE NORMAL 'BACK AND FORTH' TRADING NOW THESE MARKETS HAVE COME BACK TO LIFE."

Bitcoin: July 2018 to present

at the start of a slide that saw it halve in value. Despite this surge in Bitcoin since April, plenty of people will still be nursing large losses on their holdings – and I think it is these old trapped buyers who are the ones to watch.

Why "trapped buyers" hold the key

Those of us familiar with more traditional investing can probably recall the feeling in the pit of our stomach when a share price has a sharp fall. There can be a lot of kicking ourselves and wishing we had got out earlier. Then the market rebounds and it can often be tempting to cash out of the investment for near enough break-even.

I wonder if this is what will dictate the price movement in cryptocurrencies in the month to come. This strong surge may be too much to resist for people who have seen their investment lose 50% or more. In the second half of May, the high from September did a very good job of capping the rally and stopping any further progress. After that, the next major hurdle is the $10,000 level. I fully expect to see more normal "back and forth" trading now these markets have come back to life.

What is encouraging for further recovery is the fact that, despite the odd sell-off on the way up, buyers have been willing to step back in and pick up Bitcoin on weakness. This does suggest – for now at least – that the recovery is proving more sustainable than all of the other failed moves over the past 12 months. The only problem with trading it – and for me, it is a big problem – is the volatility. It is a market that can move 25% in a couple of days so it can be incredibly difficult to apply any sort of sensible risk management in the face of that.

Famous last words: I think the easy money days of 2017 will not be coming back anytime soon, but the recovery we have seen over the past couple of months makes Bitcoin an interesting market to watch once more.

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 ANDREW LATTO

QUALITY INVESTOR

BLUE WHALE'S TOP TEN

Backed by Peter Hargreaves of Hargreaves Lansdown fame, the Blue Whale Growth Fund is a top-performing fund that focuses on high-quality conviction plays. Andrew Latto looks at the portfolio in more detail.

The Blue Whale Growth Fund was launched on 11 September 2017 and has returned 34.3% to April 2019. This puts it in fourth place out of 286 funds in the IA Global Sector. The fund's top ten positions merit a closer look.

At the end of April 2019, the Blue Whale Growth fund owned 30 stocks and aims to hold between 25-35 stocks. The ten largest positions make up 46.7% of the portfolio and are not listed in size order.

Blue Whale recently published the investment case for its ten largest holdings. The fund manager stated that:

> *They represent our highest conviction picks within the portfolio and offer, we believe, a significant upside to the current share price."*

Companies may, though, have become large positions due to recent share price momentum. This could make them relatively expensive and may result in the manager reducing its exposure.

Blue Whale's top ten

The market capitalisation of Blue Whale's top ten positions ranges from US$5.4 billion to US$981 billion. Eight are listed in the United States, one is listed in the UK and one is listed in Europe.

Five of the positions have been held since the fund's inception in September 2017 – Adidas, PayPal, Adobe,

Blue Whale top ten (most recently added first)

Company	Share price	Market cap	Listing	Founded
Anysys Inc	$187	$16bn	Nasdaq	1970
Smith & Nephew	£16.3	$16bn	LSE	1856
Veeva Systems	$142	$21bn	NYSE	2007
Wyndham Hotels	$55.4	$5.4bn	NYSE	1981
Salesforce	$155	$120bn	NYSE	1999
Microsoft	$128	$981bn	Nasdaq	1975
Alphabet*	$1,162	$809bn	Nasdaq	1998
Adobe	$280	$137bn	Nasdaq	1982
PayPal	$113	$132bn	Nasdaq	1998
Adidas	€256	$56bn	Frankfurt	1949

Source: Blue Whale, SharePad, share prices at close on 17 May 2019;
**Blue Whale owns the GOOGL class of shares, which have voting rights.*

"IMPROVING MARGINS ARE AN INDICATOR THAT A COMPANY IS ABLE TO HOLD OFF THE COMPETITION."

Colin Burdett / Shutterstock.com

Alphabet and Microsoft. The other five were added between March and November 2018.

The youngest company in the portfolio, **Veeva Systems (NYSE:VEEV)**, was founded in 2007. The oldest company in the portfolio, **Smith & Nephew (LON:SN.)**, was founded in 1856. The average age of the ten companies is 46 years.

Blue Whale's beauties

Blue Whale Capital states that:

> *"In picking our top 10, we employ what we internally call 'The Beautiful Companies Concept'. That is picking those companies which fulfil several important criteria that we believe makes them 'beautiful'."*

Companies that Blue Whale invests in must have 1) the ability to grow and improve profitability over the long term and 2) no structural or imminent cyclical issues.

The manager expects its holdings "to receive favourable revisions of medium-term consensus growth and profitability expectations." Improving margins are an indicator that a company is able to hold off the competition.

Nine of Blue Whale's ten largest positions are expected to see margins improve by 2021 – including four by over 10% (i.e. 1,000 basis points). Alphabet is the exception with margins expected to decline from 24.5% in 2018 to 22% in 2021.

Top ten share prices and forecast valuation ratios

Company	Added	Shares since*	Free cash-flow yield %		P/E 2020
			2020	2021	
Anysys Inc	Nov-18	20%	3.3	4.1	28X
Smith & Nephew	Aug-18	20%	4.6	5	19X
Veeva	June-18	70%	2	2.3	63X
Wyndham	June-18	-10%	7.1	1.2	15.4X
Salesforce	March-18	21%	3.4	4.2	45X
Alphabet	Sept-17	25%	4.2	4.9	21X
Adidas	Sept-17	29%	3.6	4	23X
Microsoft**	Sept-17	71%	4.1	4.6	25X
Adobe	Sept-17	81%	3.9	4.5	29X
PayPal	Sept-17	79%	3.4	4.5	32X

*Source: SharePad, Blue Whale; *change on mid-month price for date added; **Microsoft year-end June; share prices at close 17 May 2019.*

"THE FUND INVESTS IN BUSINESSES THAT IT BELIEVES REPRESENT 'THE BEST COMPANY COMPETING IN ITS RESPECTIVE FIELD'."

Top ten valuations

The Blue Whale Growth Fund will be driven by the performance of its top ten holdings. All but one company has increased in price since being first added to the Blue Whale portfolio.

Eight of the top ten positions are forecast to have a free cash flow yield of at least 4% in 2021 (share prices on close 17 May 2019). Seven of the top ten positions are forecast to have a P/E ratio below 30X in 2020.

The "leaders in their field"

The fund invests in businesses that it believes represent "the best company competing in its respective field." Blue Whale states that: "we believe in investing only in the best."

There are no companies in the portfolio that directly compete against each other. It is clearly the case that **Alphabet (NASDAQ:GOOGL)**, **Microsoft (NASDAQ:MSFT)**, **Adobe (NASDAQ:ADBE)** and **PayPal (NASDAQ:PYPL)** are market leaders.

It is less clear if **Adidas (ETR:ADS)** is better than its rival Nike or if **Wyndham Hotels & Resorts (NYSE:WH)** is better than InterContinental Hotels. Smith & Nephew, meanwhile, competes with Stryker and Johnson & Johnson.

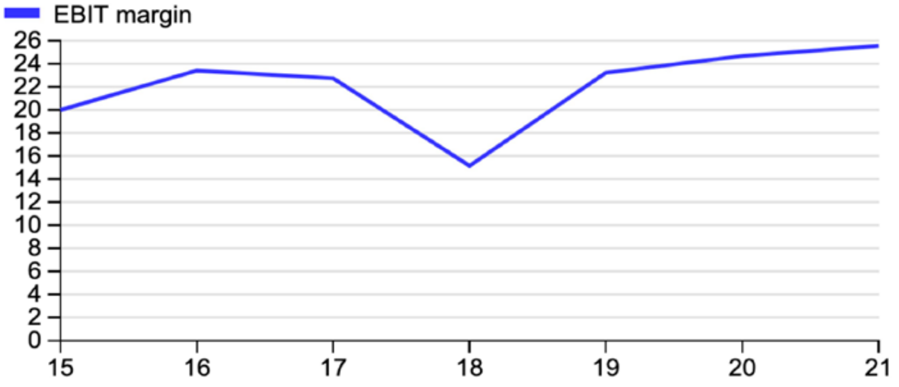
The following stocks are considered in order of the P/E forecasts for 2020 – least expensive first.

Blue Whale's top ten – margin progress

Company	Net cash/ (Net debt)	EBIT margin		Change (basis points)
		Last Annual	Forecast 2021	
Anysys Inc	$777.4m	37%	44%	700
Smith & Nephew	(£1.1bn)	20%	24%	400
Veeva Systems	$551m	26%	36.4%	1,040
Wyndham Hotels	($1.8bn)	15%	25.5%	1,050
Salesforce	($507m)	4.5%	21%	1,650
Microsoft*	($64bn)	31.7%	35%	330
Alphabet	$12.7bn	24.5%	22%	-250
Adobe	($2.5bn)	32.5%	43.4%	1,090
PayPal	$5.6bn	18%	24%	600
Adidas	$863m	11.2%	12.3%	110

*Source: SharePad; *Microsoft has a June year-end*

Wyndham's margins are forecast to improve



Source: SharePad

Wyndham Hotels & Resorts (NYSE:WH) – hotel franchising

Wyndham Hotels & Resorts became a top ten position in March 2019 and is the smallest company in the portfolio. The company was spun-off from Wyndham Worldwide on 18 May 2018 and started trading at $65 per share.

Wyndham Hotels & Resorts describes itself as "the largest hotel franchise company in the world." The group has an asset-light business model with its portfolio of brands licensed to hotel owners.

Wyndham's focus is on the mid-market and budget hotel segment, which is less economically cyclical than the upmarket segment. Most Wyndham franchisees only own one hotel and the typical agreement lasts for 10-20 years.

Revenue in the eight years to 2018 increased at an annualized pace of 2.7% – i.e. a 23.7% increase. Underlying revenue in Q1 2019 was up 4.4% and the company is confident that underlying revenue growth will approach 3.5% in the full year.

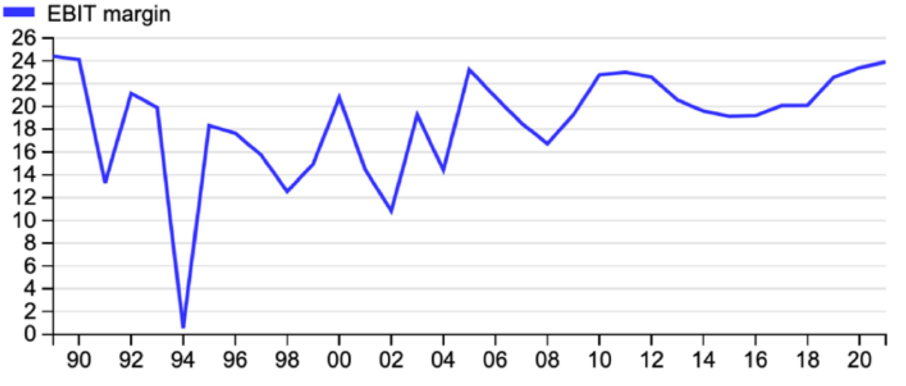
Smith & Nephew (LON:SN.) – Medical devices

Smith & Nephew is a member of the FTSE 100 and became a top ten position in January 2019. The group has historically delivered a "lacklustre performance" but this appears to be changing.

Blue Whale highlights the appointment of Namal Nawana as CEO in May 2018. His efforts to transform the group offer scope for "improved organic growth, operating profit margin expansion and improved returns from acquisitions."

Smith & Nephew is a profitable business, with a 20% EBIT profit margin; it just needs to deliver top-line growth. Ageing demographics, emerging market expansion and new product launches all drive increasing demand for health care.

Smith & Nephew's EBIT margin – forecast to hit 24% in 2021



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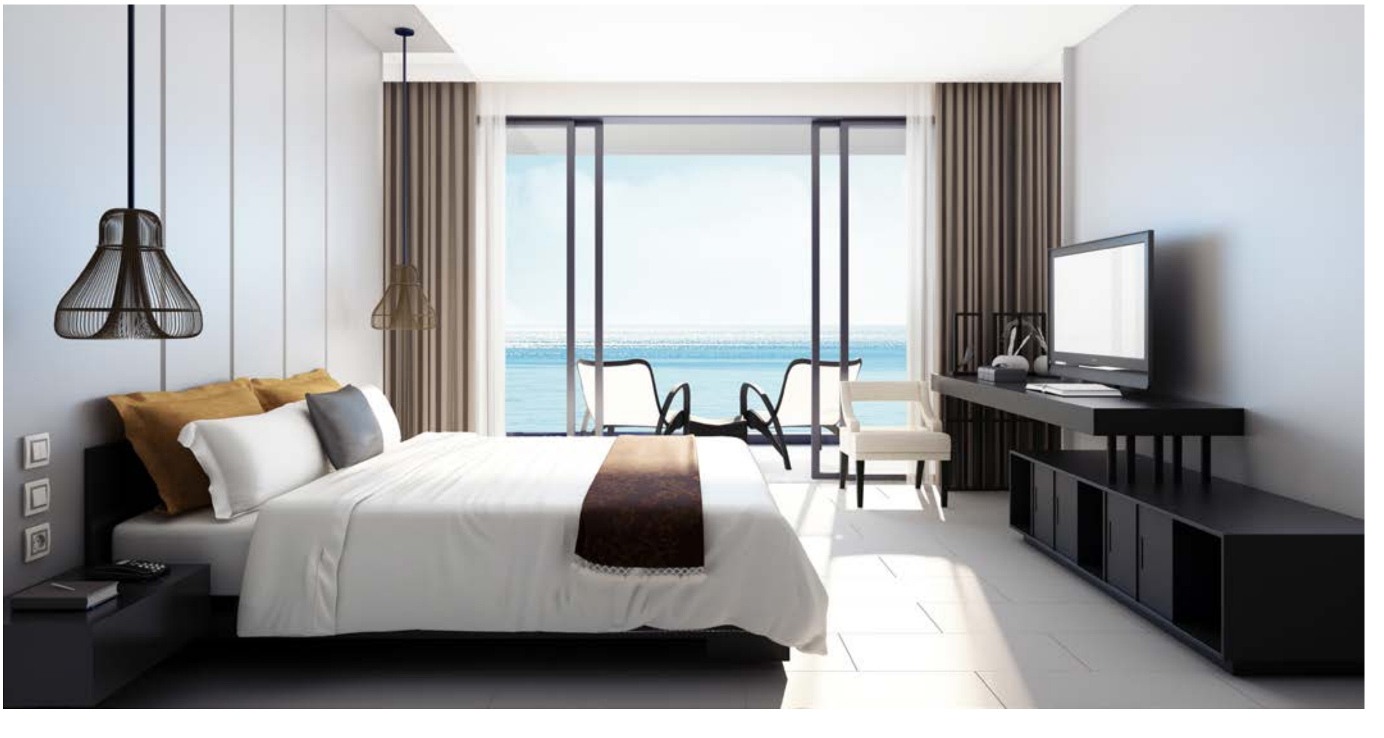
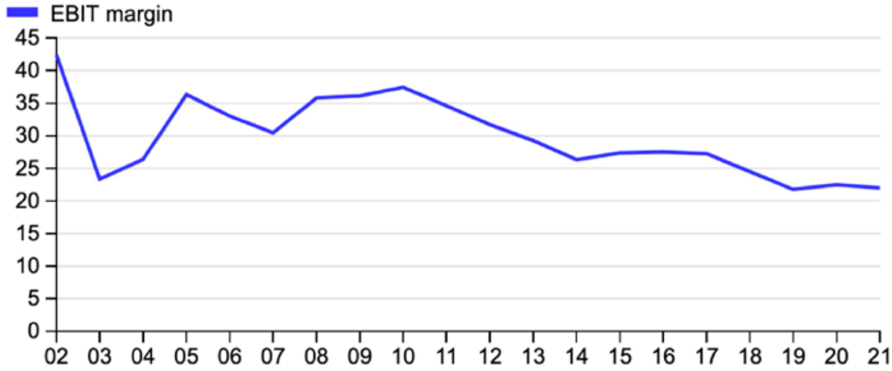


Alphabet's margins have been declining



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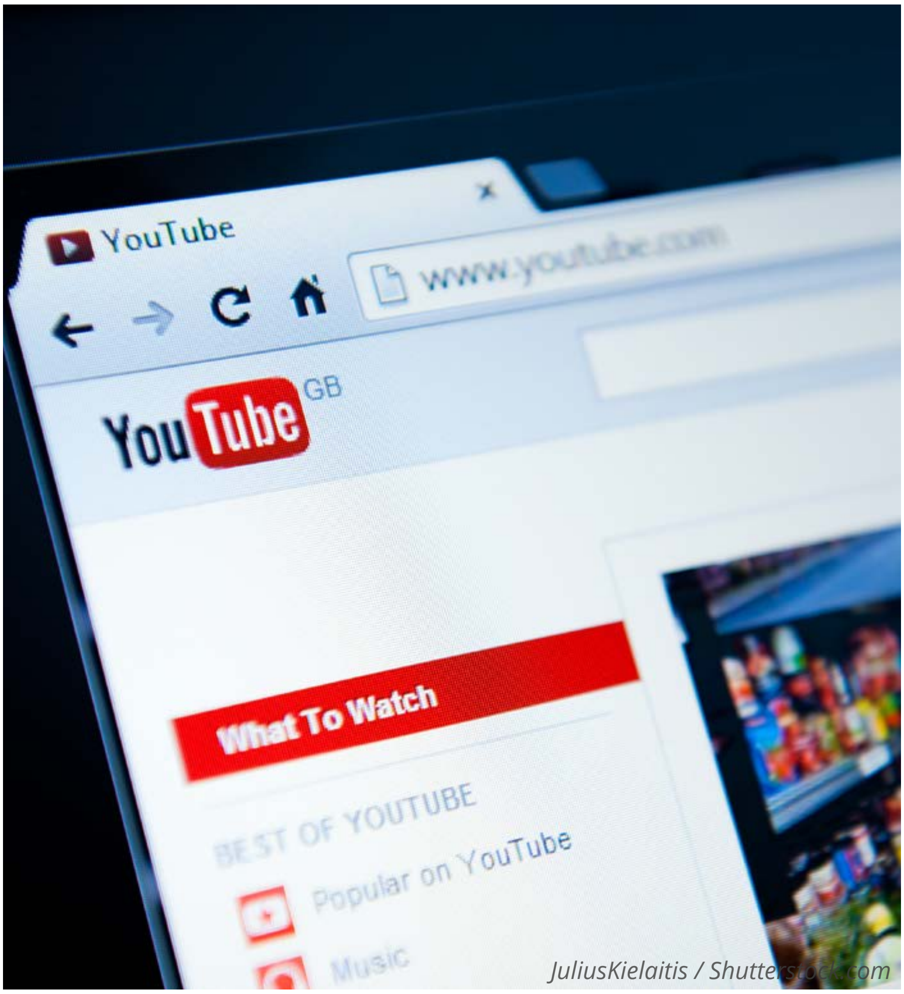

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Alphabet (NASDAQ:GOOGL) – search engine and other bets

Alphabet's 17% annual revenue growth in the first quarter of 2019 was weaker than forecast. Two possible drivers include weak advertising demand and increasing competition from Amazon.

Amazon is charging companies to appear at the top of its search results, which potentially means less advertising money to be spent on Google. Consumers are also increasingly bypassing Google and searching for products on Amazon.

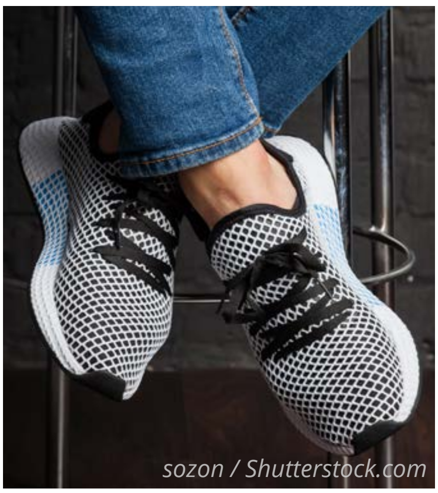
Alphabet is more than just Google search with key brands that include Google Maps, Gmail, YouTube, Android, Chrome and the Google Assistant. YouTube may be a key opportunity with 1 billion hours of content watched on the platform per day.

Blue Whale states that: "we believe investors continue to underestimate the growth of the digital advertising market. Many of the world's largest brands are moving spending from TV advertising."

Adidas (ETR:ADS) – Sportswear

Sportswear group Adidas has "enjoyed a renaissance" since CEO Kasper Rorsted took the helm in 2016. Sales have increased by 48% since 2016 and the operating profit margin has improved from 8.6% in 2016 to 11.2% in 2018.

Rorsted has invested in direct-to-consumer sales while bolstering the brand's position in "trend-setting" cit-



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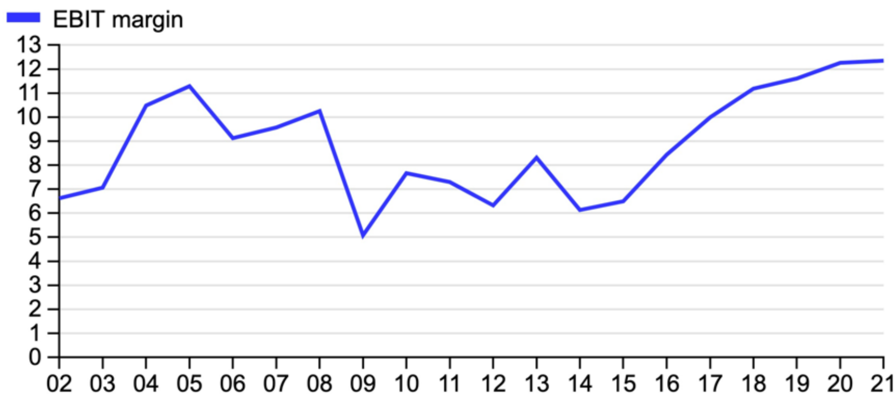
Adidas' margins rebound



Source: SharePad

ies. This has helped Adidas to improve its market position and increase profitability in the key North American market.

The group is also performing well in China and benefiting from the global trend towards casual sports wear. Blue Whale states that: "the potential for Adidas to continue delivering such strong performance is underestimated by the market."

Microsoft (NASDAQ:MSFT) – enterprise software

Microsoft is the software group that rivals fear. Its Windows operating system for PCs has allowed it to remain steadfast in enterprise software. Other key products include Office, server operating systems and developer tools.

> **"MICROSOFT IS THE SOFTWARE GROUP THAT RIVALS FEAR."**

CEO Satya Nadella took the helm in 2014 and has "reinvigorated" Microsoft by overhauling the culture and making the software more "open." A shift towards the cloud has improved the group's earnings quality and provided a growth opportunity.

Microsoft's margins have been stable

Source: SharePad

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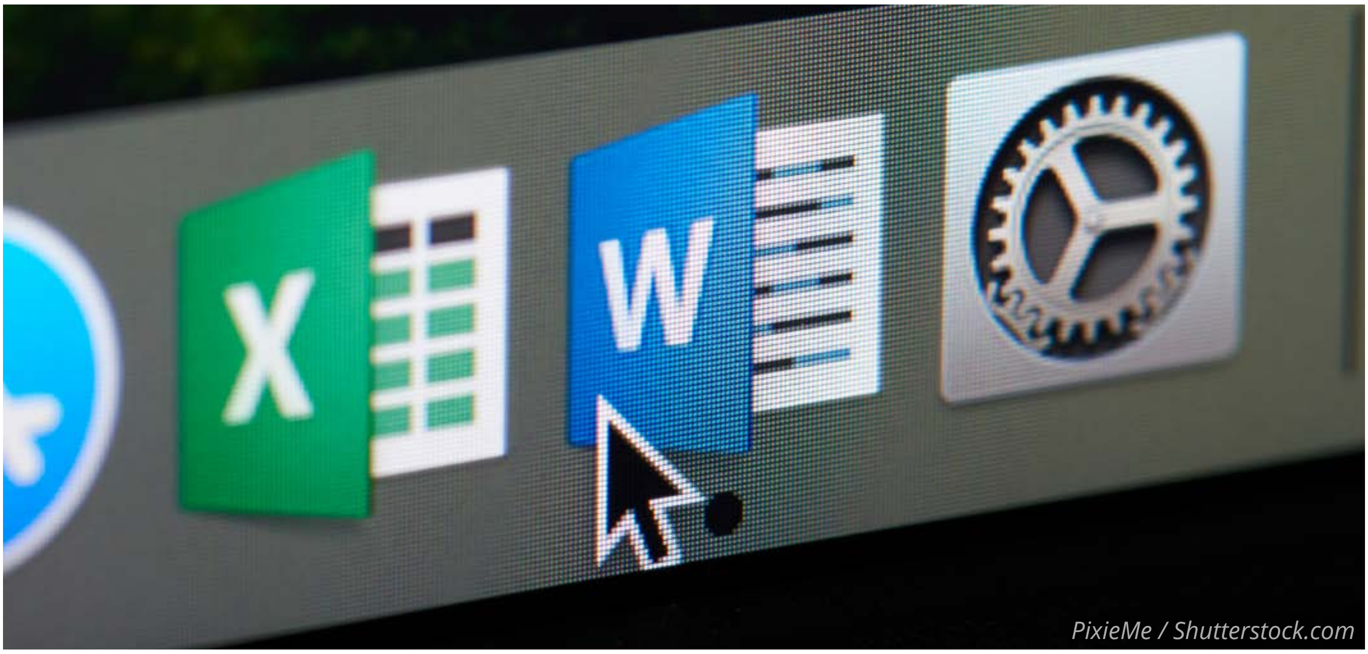

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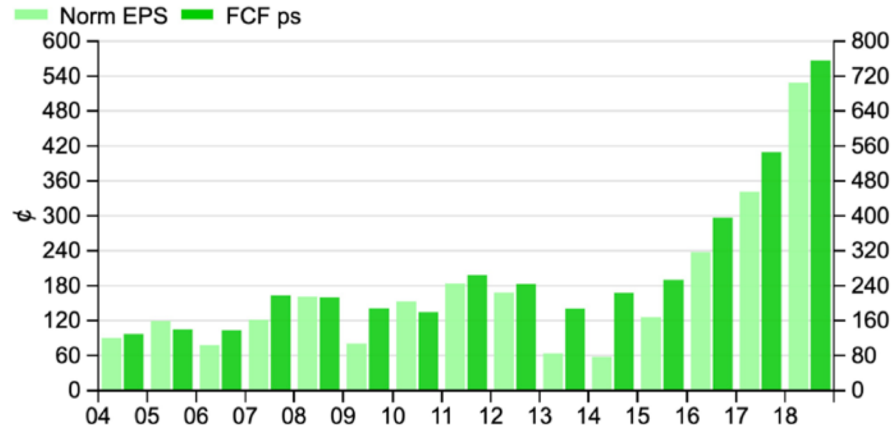
Adobe's margin picks up

Source: SharePad

Adobe's earnings per share take off



Source: SharePad

Sharaf Maksumov / Shutterstock.com

Ansys' margins have been on a tear

Source: SharePad

Adobe (NASDAQ:ADBE) – digital content creation software

Adobe has over half the market for digital content creation software. Its products are used to create videos, websites, magazines and images. They are a must have for web developers, graphic designers and photo editors.

> **"THE GROUP'S EBIT MARGIN IS EXPECTED TO HIT 43.5% IN 2021 – A MULTI-DECADE HIGH."**

Adobe has moved towards a subscription model, which has reduced piracy and helped unlock global growth opportunities. The group's EBIT margin is expected to hit 43.5% in 2021 – a multi-decade high.

Blue Whale states that: "We believe Adobe will be a major beneficiary of continued explosive growth...as ever-richer digital content is consumed across devices."

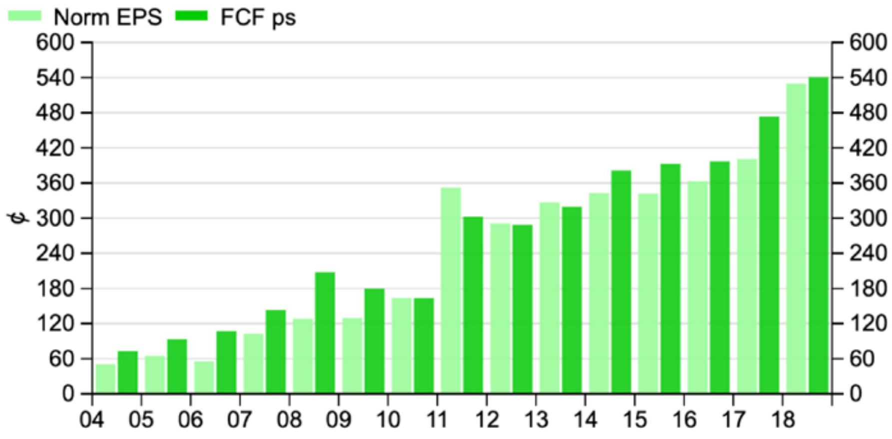
Ansys (NASDAQ:ANSS) – simulation software

Ansys describes itself as the global leader in engineering simulation. Its software predicts "how product designs will behave in real-world environments." This helps to save its customers – large industrial groups – time and money.

Increasing product complexity and new manufacturing techniques both underpin demand for Ansys' products. Recently appointed CEO Ajei Gopal has launched a number of growth initiatives.

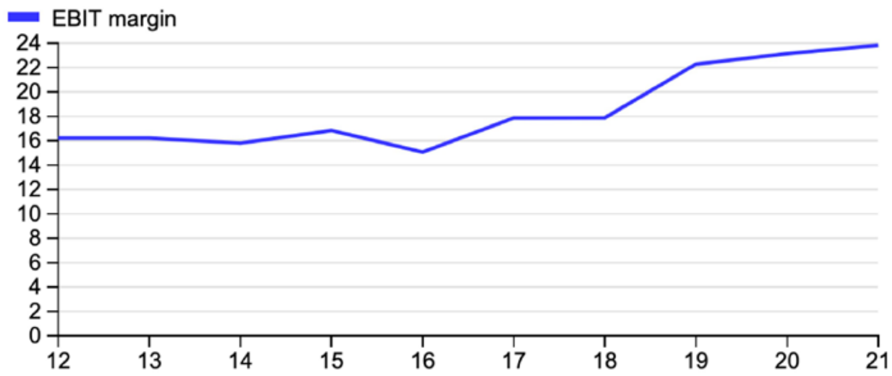
Organic revenue has increased 9% a year over the past seven years and margins have continued to improve. Blue Whale states that: "We are optimistic about an acceleration in Ansys' growth rate."

Ansys – Revenue growth with margin expansion drives earnings



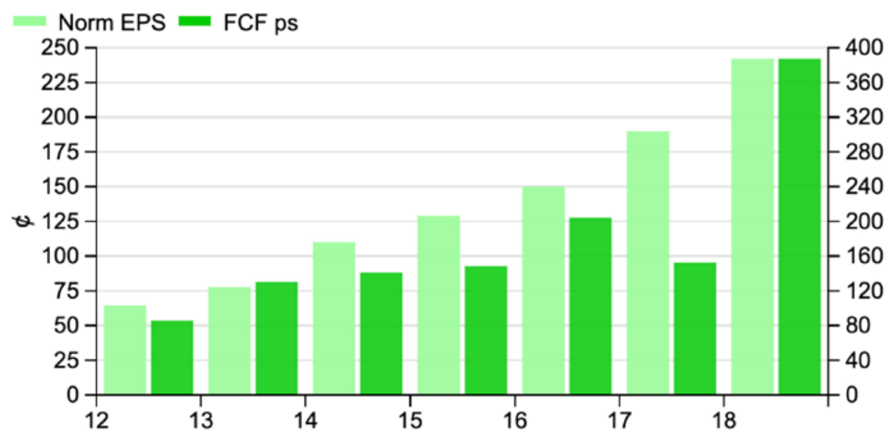
Source: SharePad

PayPal's margins are moving up



Source: SharePad

PayPal's EPS growth



Source: SharePad

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Paypal (NASDAQ:PYPL) – online payments

PayPal is the trusted brand when it comes to paying online – an area where trust is key. The company was the first mover in allowing consumers to pay online without having to fill in their card details.

Payment network effects have underpinned PayPal's growth and enabled it to keep the competition at bay. The more consumers that use PayPal the greater incentive there is for websites to offer the service and vice-versa.

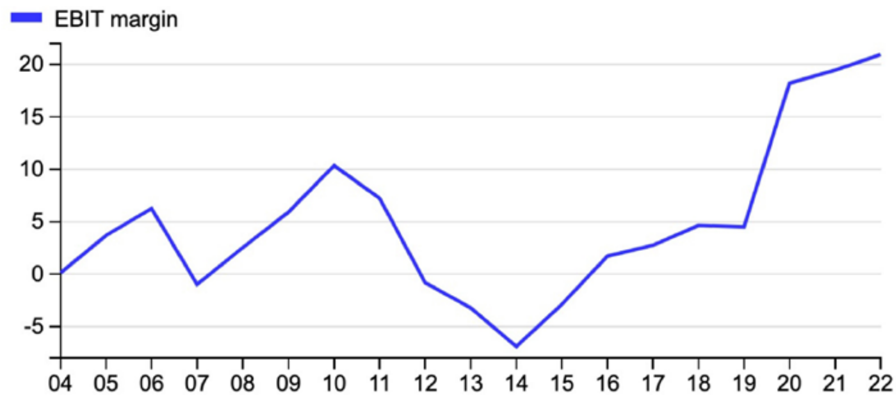
Salesforce (NYSE:CRM) – Customer relationship software

Salesforce's main focus is customer relationship management software. The company pioneered cloud-based CRM software in 1999 and 150,000 companies currently use its products.

T-Mobile CEO Jon Legere has stated that: "Salesforce connects us to...customers faster than ever before." Schneider Eclectic CMO Chris Leong has stated that: "Salesforce has completely transformed the way we manage our customer base."

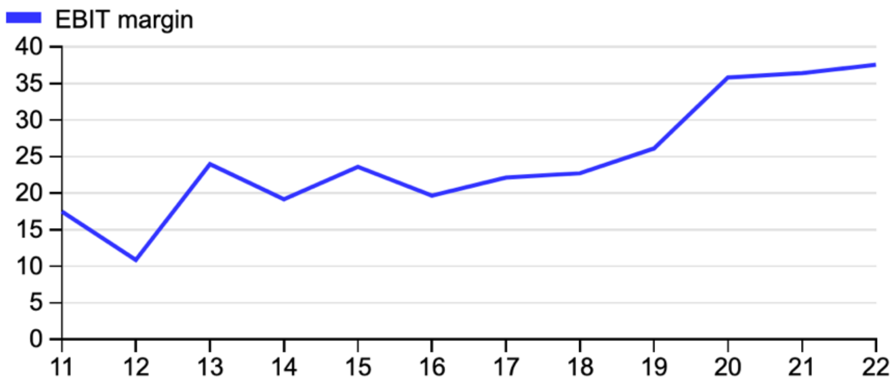
"THE GROUP HAS A 70% MARKET SHARE IN PHARMACEUTICAL CRM SOFTWARE AND HAS SCOPE TO EXPAND IN OTHER NICHES OF THE LIFE SCIENCES INDUSTRY."

Salesforce's margins are set to take off



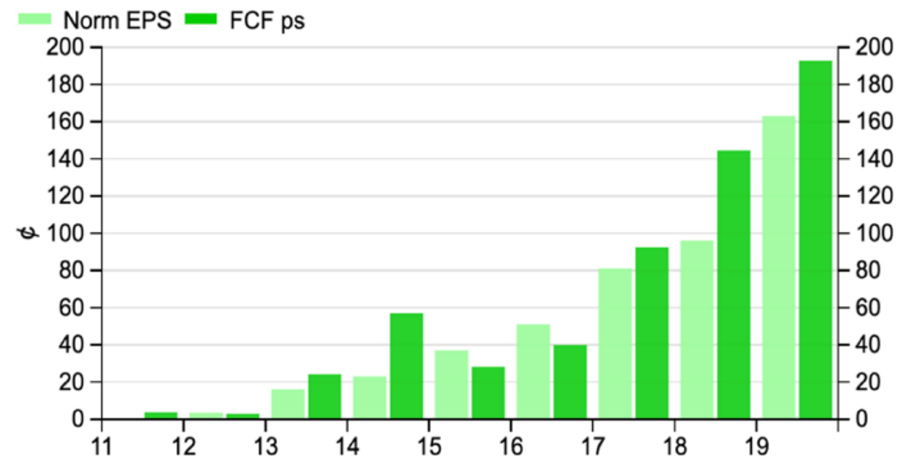
Source: SharePad

Margins approaching 40%



Source: SharePad

Veeva's earnings take-off



Source: SharePad

Veeva (NYSE:VEEV) – software for the life sciences industry

Veeva is the largest software vendor to the life sciences industry and was founded by current CEO Peter Gassner in 2007. Blue chip clients include GlaxoSmithKline, Pfizer, Syngenta and Coloplast.

The group has a 70% market share in pharmaceutical CRM software and has scope to expand in other niches of the life sciences industry. Veeva will also consider expansion in similar industries such as chemicals and cosmetics.

Summary

The top ten companies in the Blue Whale Growth Fund appear to be well placed. They are in growing markets and enjoy strong competitive positions. Nine of the ten are expected to see margins improve over the next couple of years.

The combination of revenue growth and margin strength will result in strong earnings growth. This will deliver strong share price momentum as long as current valuations are not excessive.

About Andrew

Andrew Latto, CFA, is an independent analyst and the founder of www.fundhunter.co. Fund Hunter's mission is to identify the best investment funds. The Fund Hunter model portfolio has meaningfully outperformed the All-Share index since inception. Andrew previously worked for an investment management company and a research company. He also contributes to www.cube.investments.

BY ROBERT STEPHENS, CFA

STOCKS IN FOCUS

UNILEVER

A QUALITY STOCK WITH A WINNING FORMULA

With innovation and sustainability at the core of its strategy, Robert Stephens, CFA, argues that Unilever has a winning formula that could continue to drive strong returns.

The performance of Unilever's share price over the last decade has been exceptional. It has recorded an annualised capital gain of 12.5% during the period, while the FTSE 100's annual growth rate has been 5.5%.

The company has benefited from its increasing exposure to the emerging world. Rising wages and increasing wealth in major economies such as China and India have propelled the company's top and bottom lines higher at a rapid rate. Under an increasingly innovative strategy led by Paul Polman, the company has been able to expand its presence in developing economies. This has helped to offset challenging growth conditions in more established regions.

While 2019 has seen a change in CEO, with Polman retiring after a decade in charge, the company's strategy is likely to experience an evolution as opposed to a revolution. It will continue to focus on adapting to changing customer tastes, with an increasing focus on sustainability being a key part of its growth plans. It will also aim to innovate at a faster pace, while shifting its portfolio towards direct-to-consumer (DTC) capabilities that could strengthen customer loyalty.

"THE COMPANY'S SUSTAINABLE LIVING BRANDS ARE OUTPERFORMING ITS OTHER BRANDS."

Although the stock's valuation is not particularly attractive relative to the wider FTSE 100, its track record of consistent growth and strategy to maintain a strong position among fast-growing markets could lead to further gains. As a result, its growth story remains highly appealing in my opinion.

Sustainable Living drives outperformance

A key area for Unilever over the next decade will be adapting its brands to rapidly-changing consumer tastes. While in previous years the performance of a product and the satisfaction which it provided to a customer may have been sufficient to induce brand loyalty, customers are likely to demand much more than this from their favourite brands in future.

In order to achieve this goal, the company is seeking to introduce a clear purpose behind each of its brands. Examples of this include cleaning product Domestos' purpose to improve sanitation for millions of people who do not have access to a toilet, as well as ice cream

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"TIME TO MARKET WITH NEW INNOVATIONS TO MEET LOCAL TRENDS IS NOW 40%-50% FASTER THAN IT WAS A COUPLE OF YEARS AGO."

product Ben & Jerry's seeking to build movements surrounding important issues such as climate change and refugee crises.

Although each brand having a purpose may lead to cynicism among some consumers, the company's Sustainable Living brands are outperforming its other brands. Its Sustainable Living brands are those that are furthest ahead in terms of delivering a purpose, with them growing 46% faster than the rest of the business in 2018. In doing so, they delivered 70% of the company's growth, which suggests that having a sustainable focus is resonating with customers, and will continue to do so in the long run.

Revised strategy has innovation at its core

One challenge facing a company such as Unilever, which has 400 household brands that include 12 brands with an annual turnover in excess of €1 billion, is the speed at which it operates. All too often, larger companies are slow to innovate and adapt to changing consumer trends, with smaller and more dynamic peers sometimes being first-to-market with new products and innovations.

Unilever is seeking to address this potential threat through its Connected for Growth (C4G) programme. It aims to increase speed and agility, as well as focusing on boosting the entrepreneurial spirit within the business. As a consequence of the C4G strategy, time to market with new innovations to meet local trends is now 40%-50% faster than it was a couple of years ago. This should help the business to shift its portfolio to faster-growing segments, with it having launched 19 new brands in the 2018 financial year. As a faster business that can quickly innovate, it may strengthen its competitive advantage in crowded markets in particular.

Alongside this, a focus on embracing the DTC channel could lead to improved margins and greater customer loyalty. With consumers now bypassing retailers in some markets such as men's grooming/shaving, Unilever is investing heavily in its digital operations. It is working with leading global technology companies to build a strong data analytics infrastructure to support further growth.

Being able to connect directly with consumers will enable it to tailor its marketing to a greater degree, as well as to provide increasingly personalised offers, and may even strengthen its margins versus selling to retailers. With e-commerce sales growing by 47% in 2018, it could be a key growth area for the business in the long run.

Emerging market growth remains strong

As highlighted, Unilever's growth story over the last decade has been largely focused on its success in emerging markets. With over 58% of its sales being generated in developing economies, the company has embraced the

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emerging market growth opportunities that have been, and still are, on offer.

For example, in the most recent quarter the company's emerging market underlying sales growth was 5%. This helped to offset weaker underlying sales growth in developed markets, which grew by just 0.3%.

The outlook for emerging markets remains very positive. In China, for instance, the retail sector is forecast to record an annual compound growth rate of over 10% between 2019 and 2024. Although the country has experienced an uncertain period in recent years, its transition from being a capital expenditure-led economy to a consumer-focused economy is unlikely to be frictionless. However, as wage

growth is expected to remain high, demand for Unilever's variety of goods is likely to increase and could make the business increasingly focused on fast-growing emerging markets.

Possible threats

The recent change in CEO at the company could be considered a risk factor by some investors. Paul Polman did a great job during his ten years as CEO in improving the company's performance from both a business and investment perspective. While a new CEO will inevitably have differing views on a number of key areas, the change to a new CEO is likely to be a smooth transition. This is because Alan Jope, the new CEO of Unilever, was previously in charge of its biggest division; Beauty & Personal Care. He is likely to maintain the company's focus on sustainability and innovation, rather than seek to make wholesale changes to its strategy.

Another possible threat facing the business is the prospect of a full-scale global trade war. At the time of writing, tariffs on all exports from China to the US are being mooted. Should an increasingly protectionist world economy emerge, global consumer goods companies such as Unilever could suffer to a significant extent. In the short run, negative news flow in this area could hold back the company's share price performance to some degree.

Since the stock has a P/E ratio of 20, some investors may view its valuation as being too high to merit investment. Although the prospect of a major upward rerating may be more limited today than it was when the stock was trading on a lower P/E ratio a number of years ago, the bottom-line growth prospects for the business mean that it could produce continued share price growth. Given its consistent track record of growth, as well as its wide range of products that are exposed to not only fast-growing economies but also to a wide range of regions across the world, it could justify a premium valuation. Therefore, while not a cheap share compared to the wider FTSE 100, Unilever could offer good value for money relative to its peer group.

Outlook: further growth ahead

Unilever's growth strategy has the potential to catalyse its sales and profitability over the long term. Its ability to innovate at a faster pace than many of its global consumer goods rivals could allow it to adapt more quickly to changing consumer tastes. It may also mean that it reacts quicker to local changes in consumer behaviour, which could strengthen its competitive position across a number of regions.

Consumer tastes are likely to evolve further, with consideration for the environment and sustainability likely to take on a more important role in their decision-making. The company's decision to focus on the purpose of its brands may allow it to become increasingly aligned with consumer tastes, and ensure that its products remain relevant beyond the short term.

"THE DTC CHANNEL COULD BE A STRONG GROWTH AREA FOR THE BUSINESS."

The DTC channel could be a strong growth area for the business. It provides not only the opportunity to expand margins through the omission of retailers from the sales process, but to also offer greater personalisation to consumers that could lead to increased customer loyalty.

While there are threats to the emerging market growth story, such as the potential for a full-scale trade war between the US and China, forecasts for growth in demand within the consumer goods segment across the developing world mean that the company could gain a tailwind from its focus on emerging markets.

While a new CEO and a relatively high valuation could also suggest its decade-long surge may be at risk in future, Unilever's strategy and its growth potential indicate that it has investment appeal. Therefore, while it has comprehensively outperformed the FTSE 100 over the last decade, further capital growth could be ahead.

David Tonelson / Shutterstock.com

About Robert

Robert Stephens, CFA, is an Equity Analyst who runs his own research company. He has been investing for over 15 years and owns a wide range of shares. Notable influences on his investment style include Warren Buffett, Ben Graham and Jim Slater. Robert has written for a variety of publications including The Daily Telegraph, What Investment and Citywire.

BY RICHARD GILL, CFA

BOOK REVIEW

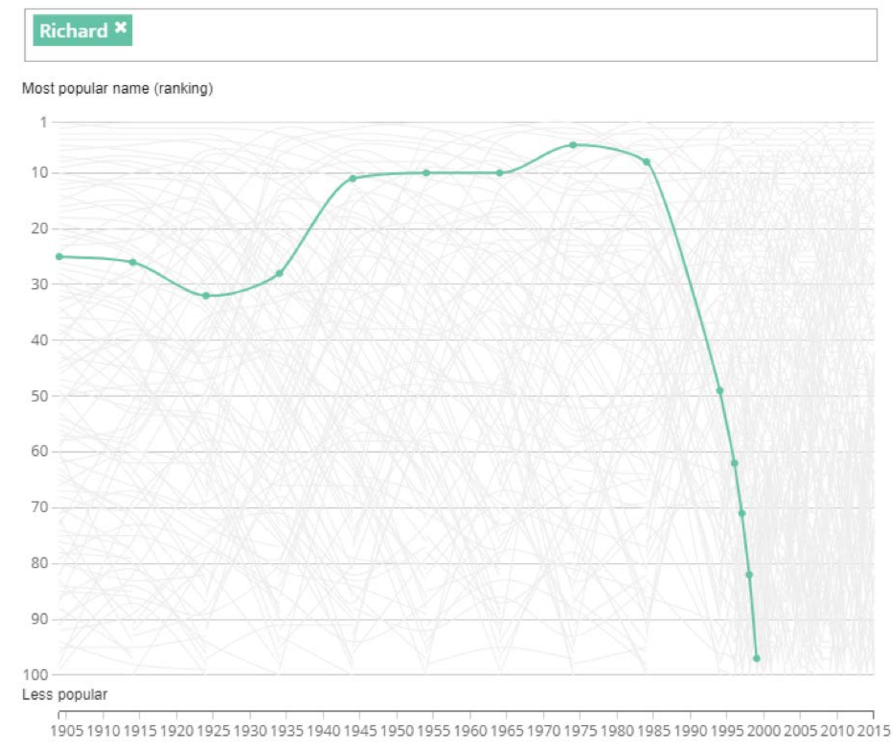
YOUR RETIREMENT SALARY

HOW TO USE YOUR LIFETIME OF PENSION SAVINGS TO PAY YOURSELF AN INCOME IN RETIREMENT

BY RICHARD DYSON & RICHARD EVANS

Richard Gill, CFA, reviews *Your Retirement Salary*, a book that's essential reading for those looking to make the most of their pension pot in retirement.

Reading the headline of this review, you might think *that's an awful lot of Richards.* But it is (or was) an awfully popular name. In my year of birth, 1982, it was in the top 10 of baby boys' names in the UK and 27th in the US. However, since then, as the chart below from the Office of National Statistics shows, there has been a massive decline in the number of Dicks.

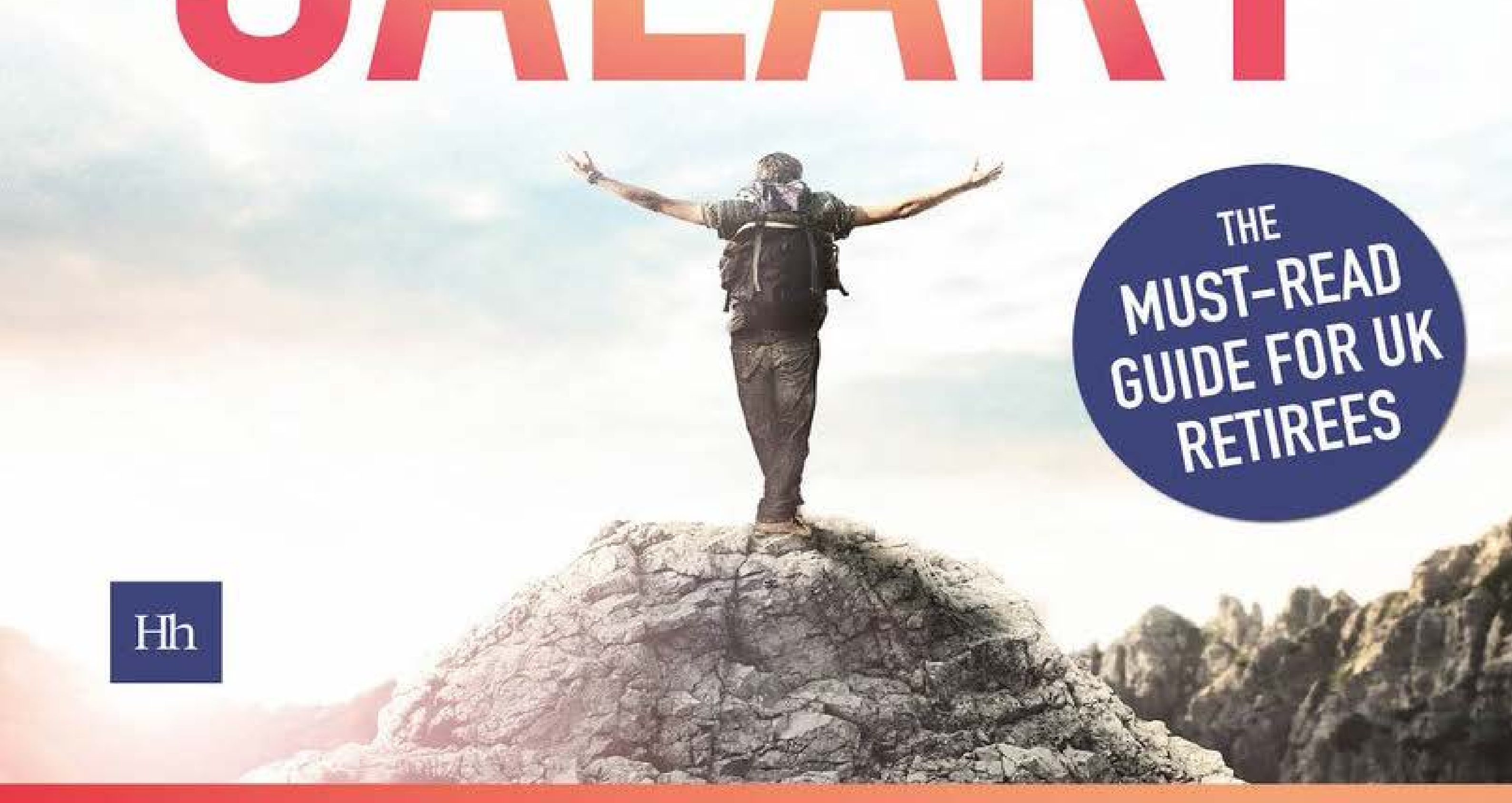


Source: ONS

While Richards have not rocketed over the past 36 years, many factors more important to humanity as a whole have. For example, according to the excellent website HumanProgress.org, since 1982 infant survival rates have soared by 66% in the UK, income per person has risen by 86%, years

RICHARD DYSON & RICHARD EVANS

YOUR RETIREMENT SALARY



THE MUST-READ GUIDE FOR UK RETIREES

Hh

How to use your lifetime of pension savings to PAY YOURSELF AN INCOME in your retirement

> **"LIFE EXPECTANCY AT BIRTH IN ENGLAND REACHED 79.6 YEARS FOR MALES AND 83.2 YEARS FOR FEMALES IN 2017."**

of schooling are up by 56% and food supply per person is up by a tasty 10%. Perhaps more important in an investment context, life expectancy rates have also risen strongly.

According to the most recent data from the ONS, life expectancy at birth in England reached 79.6 years for males and 83.2 years for females in 2017. That's up from around 71 for males in 1982 and 77 for females. Looking back even further, a new-born boy was expected to live to just over 40 in 1841, with a baby girl expected to live to just over 42.

This longevity lengthening has of course had implications for pensions and in particular, retirement age. For much of the 20th and into the early 21st century, the age at which you could claim your state pension was 65 for men and 60 for women. But both sexes' state pension ages are currently in the process of increasing to 66 by next year, with the government looking to increase this further to 67 between 2026 and 2028 as the Treasury seeks to combat rising costs.

Prime your pension

For those who are coming up to retirement age, and have spent the past few decades saving for it, Harriman House's new offering, *Your Retirement Salary*, is essential reading for learning how to make the most of your pension pot. Written by Richards Dyson and Evans, the book equips readers with everything they need to know to turn their pension savings into an income that will last throughout the rest of their lives. The authors are both personal finance experts with decades of experience in the markets. Evans is perhaps best known for editing the Daily Telegraph's Questor share tipping column and Dyson for creating the Telegraph's widely followed Questor Income Portfolio.

Unlike many books on the subject, *Your Retirement Salary* isn't about building up a pension pot. Instead it focuses on what to do with the money you have accumulated once you're ready to say goodbye to the world of work. It comes a few years after the UK pension rules saw some sweeping changes (in 2015), following which anyone over the age of 55 has the freedom to use their pension cash as they wish. But with a range of complex tax and related issues surrounding this, the book comes as an apposite guide to making the most of your cash and minimising tax along the way.

The book is divided into three parts of several chapters each, with Part One preparing retirees for the process of investing their pension money. It begins by explaining the basics of pensions, including exactly what a pension is. The current market background, which is seeing a move away from generous defined benefit schemes to more uncertain defined contribution programmes, is also discussed. We then get a review of the major changes made by George Osborne in 2015 and advice on how to combine all your pension pots into one to save on time and admin costs.

Part Two goes on to advise readers on how to be their own pension manager. Chapter three discusses the importance of making sure your money lasts as long as you do, working out how much you might need every year in retirement and trying to estimate how long you might live for. Then we move on to some practical examples of how to build an income portfolio, securing a flow of funds sufficient to meet your expected spending. Three portfolios are suggested, one high income, one which aims to pay a modest income but maintains the value of its assets and a compromise portfolio which stands between the two.

Finally, while the certainty of death might be a few years away, tax is still pretty much inevitable in your retirement. Chapter seven covers what you need to know about matters including income tax, lump sums, the lifetime allowance and more lofty concepts such as the money purchase annual allowance. The ugly subject of death is covered in the next chapter, looking at what happens to your pension after you pop your clogs and providing some ideas about inheritance planning.

Up until this point, the book mainly covers private savings, but chapter nine covers the state pension and what you might expect to get from the government to boost your own income. Part Three also contains some ideas on how to get additional income in your retirement, mainly from property assets in the form of buy to let and equity release.

Enjoy the golden years

Your Retirement Salary is an indispensable guide for anyone who is approaching retirement and wants to make the best of the funds they have available. While I am a few decades away from the statutory retirement age, I still found it useful, with the book providing a range of tips and tactics to employ so you can make the most of your days in the sun.

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 2018.

BY TIM PRICE

THE FINAL WORD

HOW TO BEAT THE PROFESSIONALS

Fund manager Tim Price explains the surprisingly powerful advantages private investors have over the institutions when it comes to managing money and generating a return.

"To succeed in today's overcrowded environment, investors need an edge, an advantage over the competition, to help them allocate their scarce time. Since almost everyone has access to complete and accurate databases, powerful computers, and well-trained analytical talent, these resources provide less and less of a competitive edge; they are necessary but not sufficient. You cannot have an edge doing what everyone else is doing; to add value you must stand apart from the crowd. And when you do, you benefit from watching the competition at work."

— Seth Klarman.

The history of science is not confined to revelatory insights about the world. It is also a history of bold and sometimes reckless experimentation. On the morning of Sunday February 4th, 1912, for example, an Austrian tailor, Franz Reichelt, climbed to the first floor of the Eiffel Tower, 360 steps up. He climbed onto a table, checked the direction and speed of the wind, and then stepped out into the void.

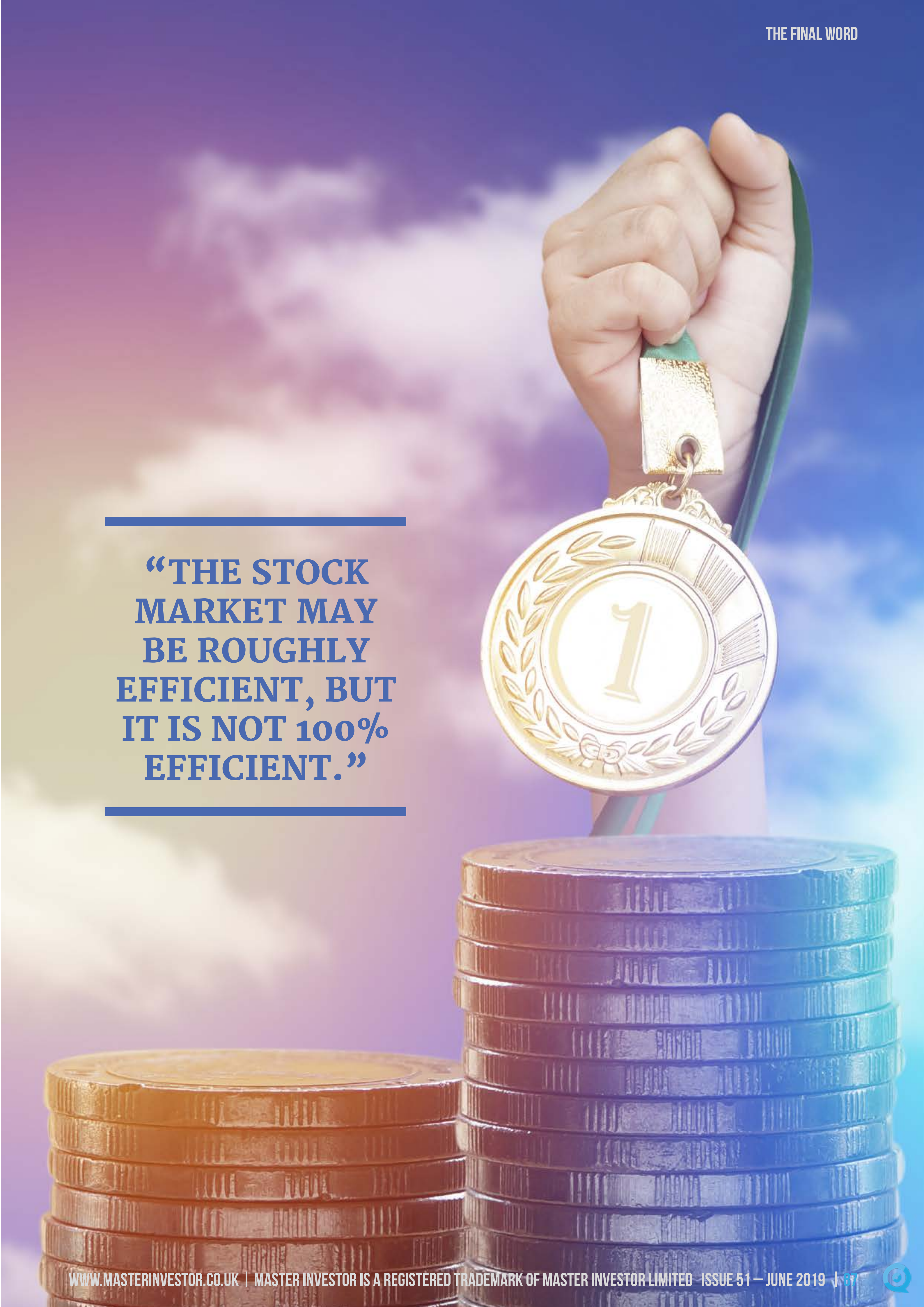
Reichelt was wearing a prototype parachute, made from a combination of waterproof fabric and silk. Large silk sheets connected his arms to his ankles. A silk hood stood above his head. He fell for four seconds, accelerating as he fell, until he hit the ground at sixty miles an hour. He was killed instantly. The impact left a dent in the frozen Parisian soil six inches deep.

They had tried to warn him. Gaston Hervieu, who had conducted a successful parachute trial with a 160-pound test dummy a year beforehand, warned that there were technical reasons why Reichelt's parachute would not work. Modern parachutes use 700 square feet of material and should be deployed only above 250 feet. Reichelt's parachute used less than 350 square feet of material, and he deployed at only 187 feet. He had neither sufficient surface area of fabric nor enough altitude to make a successful jump. Experts at the Aéro-Club de France had also warned him:

> *The surface of your device is too small. You will break your neck.*

The laws of science are immutable. There are no shortcuts.

Unfortunately for most economists and many fund managers, economics and modern portfolio theory are not science, and they do not obey the laws of nature. 'Finance world', for want of a better phrase, is an entirely man-made construct. Its laws, such as the efficient market hypothesis, hold sway only in the minds of its believers.



"THE STOCK MARKET MAY BE ROUGHLY EFFICIENT, BUT IT IS NOT 100% EFFICIENT."

"IF YOU'RE PLAYING A GAME AGAINST FINANCIAL PROFESSIONALS, WHICH IS WHAT INVESTING ULTIMATELY AMOUNTS TO, IT'S A HUGE ADVANTAGE FOR YOU TO BE ABLE TO PLAY BY DIFFERENT RULES."

The efficient market hypothesis, or EMH, is still taught at business schools. EMH states that it is impossible to beat the market because the efficiency of the market causes all share prices, at all times, to incorporate and reflect all known market information.

The stock market may be roughly efficient, but it is not 100% efficient.

There is a great deal of difference between being roughly right and 100% right. Just as there is a great deal of difference between jumping off the Eiffel Tower with 700 square feet of parachute and jumping off with less than 350 square feet of parachute.

Between them, EMH and its intellectual cousin, the Capital Asset Pricing Model (CAPM), continue to account for squadrons of fund managers falling ingloriously out of the sky into an early grave.

CAPM describes the risk and expected return of an asset in a diversified portfolio. More details are unnecessary – largely because the theory is nonsense – but suffice to say that between them, EMH and CAPM require an awful lot of "assumptions" for these theories to "work".

Among those assumptions:

1) All investors are seeking to maximize returns;

2) All investors are 100% rational and risk-averse;

3) All investors are 100% diversified across a broad range of investments;

4) All investors have an equal relationship with prices that they cannot influence;

5) All investors can lend and borrow without limit at the same interest rate;

6) There is no such thing as transactions costs or tax;

7) All assets are 100% liquid and perfectly divisible;

8) All investors have identical expectations;

9) All investors have access to infinite amounts of information simultaneously.

Probably the best refutation of EMH lies in Warren Buffett's 1984 introduction to Ben Graham's 'The Intelligent Investor' – a book Buffett himself describes as the best book on investment ever written. (I agree.) You can read this famous piece, on what he called "the Superinvestors of Graham and Doddsville", here.

Another solid refutation of EMH lies in the performance of Buffett's investment holding company, Berkshire Hathaway, during his management. Between 1965 and 2015, the company's shares returned, on average, 20.8% per annum to shareholders. If you were fortunate enough to have bought Berkshire Hathaway stock back in 1965 and have held on to it since then, that equates to an overall return of over 1.5 million %. Such an astronomical return is not just a refute, it's a rebuke, of EMH.

Buffett's colleague Charlie Munger makes the following observation:

> *Efficient market theory is a wonderful economic doctrine that had a long vogue in spite of the experience of Berkshire Hathaway. In fact, one of the economists who won – he shared a Nobel Prize – and as he looked at Berkshire Hathaway year after year, which people would throw in his face as saying maybe the market isn't quite as efficient as you think, he said, "Well, it's a two-sigma event."*
>
> *And then he said we were a three-sigma event. And then he said we were a four-sigma event. And he finally got up to six sigmas – better to add a sigma than change a theory, just because the evidence comes in differently. [Laughter]*
>
> *And, of course, when this share of a Nobel Prize went into money management himself, he sank like a stone.*

(The Greek letter sigma is used as a measure of standard deviation – of how much some series of events vary around the average. For a certain type of statistical distribution, for example, one third of events will be more than one 'sigma' from the average, only 5 percent will be more than two 'sigmas' away and only 0.3% more than three 'sigmas' away. All you really need to know is that when economists start using Greek letters, they are resorting to pretentious theoretical nonsense.)

Warren Buffett knows that the market isn't 100 percent efficient. He has publicly stated that if it were, he'd be a bum on the street corner with a tin cup. If you're playing a game against financial professionals, which is what investing ultimately amounts to, it's a huge advantage for you to be able to play by different rules. Here are some of the rules that bind institutional fund managers into highly restrictive investment constraints.

Size hurts

The more assets under management that a fund manager controls, the less likely he is to outperform versus his peers. Buffett, himself no slouch at deploying large amounts of capital, has publicly acknowledged this. As he writes in his Superinvestors piece above ("Size is the anchor of performance"):

> *The fate of Fidelity's Magellan Fund is a good example of how that anchor weighs managers down. When the highly successful Peter Lynch left Magellan in May 1990 after 13 years with the group, the fund had grown to $13 billion in assets. By the time Morris Smith had left in July 1992, the fund was up to $20 billion.*
>
> *On Jeffrey Vinik's departure in June 1996, assets were up to $50 billion. By the end of the century, Magellan assets had grown to over $100 billion (the fund was closed to new investors in September 1997 and peaked at almost $110 billion in August 2000), only to see them fall back to $52 billion on manager Robert Stansky's departure in 2005, through a combination of investment losses and investor outflows.*

Fund structure hurts

That Warren Buffett chose to use the listed business Berkshire Hathaway as his primary investment vehicle is no accident.

Firstly, it meant he could deploy the cash pool or 'float' of his reinsurance business to make investments long before he would need to pay out on any insurance policies that the business underwrote. In other words, he had effectively free access to other people's money and he could invest it unconstrainedly. Secondly, since he wasn't managing the capital of unit-holders in a mutual fund, he didn't have to worry about investors redeeming their funds.

Berkshire Hathaway's public listing means that he has what's known as "permanent capital". Shareholders are free to sell their shares, if they wish, but such share sales have no impact on Berkshire's investment portfolio whatsoever.

Let's explore the difference a bit more. Share sales have no impact on Berkshire's investment portfolio. But it's a different story for a mutual fund manager. The unit-holders of a publicly held mutual fund can seriously impact the fund manager's performance if they choose to redeem their units when markets are falling.

"AS A PRIVATE INVESTOR, YOU CAN BUY WHAT YOU WANT."

Such redemptions force the fund manager to sell his investments when he least wants to. They also oblige him to make most of his portfolio "liquid" – i.e. it can be easily sold in order to pay out redeeming unit-holders.

Benchmarking hurts

Most institutional fund managers are obligated to match and ideally outperform some kind of investment benchmark.

If they're managing a portfolio of US domestic blue-chip stocks and large cap companies, then the benchmark will likely be an index like the Standard and Poor's 500 stock index. Those 500 US businesses that are worth more than any others in the market. If they're managing a portfolio of global stocks, then their benchmark is likely to be something like the MSCI World Equity Index.

But the composition of the index matters a lot. 60% of the MSCI World Index is currently allocated to the US. This means that any global equity manager effectively has to have 60% of his or her portfolio dedicated to the US, irrespective of whether there is any inherent value in that market or not. This sort of indiscriminate madness is just one reason to be wary of passive exchange-traded funds and index-trackers.

Smaller is often better

As a private investor, you can buy what you want. Even if you buy a concentrated position within your own portfolio – lots of one particular kind of stock, for example – you're not going to move the market against you while you establish that position. Fund managers have that problem day in, day out. But you don't have to limit yourself to the largest stocks in your benchmark – because you don't have a benchmark.

Nobody is trying to pick you off... or profit from your trading habits. You can operate under the radar, if you will. Large cap domestic stocks, small cap foreign stocks, mid cap emerging market stocks – you can buy literally anything you want. Institutional fund managers simply don't have that flexibility. They have to buy from a comparatively small, fixed template of stocks, and they constantly have to worry about managing the liquidity profile of that portfolio.

Perhaps the single biggest opportunity set available to the private investor – one that is 'out of bounds' for most institutional managers — is the world of small cap companies. Those are listed businesses with a market value of, say, between $300 million and $2 billion. Small cap companies can make decisions more quickly than their larger competitors. Being nimble, they can take advantage of market opportunities more quickly than large conglomerates with top-heavy executive boards and bureaucratic management committees. Being small, they can double in size more quickly than large companies.

Career risk

If I could only use one phrase to sum up why fund managers so often fail to meet their investors' expectations, it would be this one. A typical fund manager has little or no 'skin in the game' – it's not like he's managing his own money, so he's more likely to want to hug that benchmark until it squeaks.

From 2003 to 2006, for example, the chief investment officer of T. Rowe Price (no relation) amassed ownership of equity in the management company worth over $75 million. His total personal investment in T. Rowe Price's mutual funds amounted, apparently, to $1 million. Whatever the quality of the cooking at this fund business, there was precious little eating going on, by this manager, at least.

And in the words of the British economist John Maynard Keynes, for professional fund managers, it's essentially better to fail conventionally – clinging to that benchmark – than to succeed unconventionally – by actively choosing to steer away from that benchmark, potentially losing one's job in the process.

Career risk accounts for why fund managers focus only on market relative performance, and almost never on the generation of absolute returns. But you cannot take relative performance to the bank.

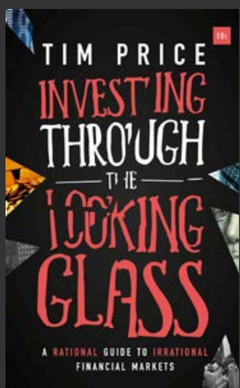
Many fund managers never even see the end investor. That role is intermediated by his own sales force, or by a third-party financial advisor. So it's no surprise that an economic agent feels less compelled to deliver than a true principal.

As a private investor, the size of your portfolio is no constraint to performance whatsoever. And because it's your money, you're more likely to want to manage it well. You can take the time to investigate opportunities that aren't available to institutional fund managers. And you have the luxury of time to allow those investments to bear fruit.

These are ingredients for a win. Apple Inc used to run an ad campaign for one of their products that gets the point across nicely: *think different.*

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'.



JUNE 2019

INVESTOR EVENTS DIARY

EVERY WEDNESDAY

Event:	SR Live webinar
Organiser:	SyndicateRoom
Time:	12:30
Place:	Webinar
Tickets:	www.syndicateroom.com/events/sr-live

WEDNESDAY, 5 JUNE

Event:	Funders & Founders; Networking Reception
Organiser:	Business Funding Club
Time:	18:00 – 20:30
Place:	Wework Chancery Lane (Fox Court)
Tickets:	www.businessfundingshow.com/events/funders-founders-networking-reception-2

TUESDAY, 11 JUNE

Event:	Netwealth Investor Evening
Organiser:	Netwealth
Time:	18:00 onwards
Place:	60 Charlotte Street, London W1T 2NU
Tickets:	www.netwealth.com/events

WEDNESDAY, 12 JUNE

Event:	Mayor of London's Techinvest Event focusing on GovTech
Organiser:	UKBAA
Time:	17:00-20:00
Place:	The Chamber, City Hall, The Queen's Walk, London SE1 2AA
Tickets or sponsorship:	www.ukbaa.org.uk/events/mayor-of-londons-techinvest-event-focusing-on-govtech

WEDNESDAY, 12 JUNE

Event:	Funding for Innovation – Unleash a box of opportunities
Organiser:	Business Funding Club / GovGrant
Time:	17:30-21:00
Place:	Newable London Office, 140 Aldersgate St, Barbican
Tickets:	www.businessfundingshow.com/events/funding-for-innovation-unleash-a-box-of-opportunities

WEDNESDAY, 26 JUNE

Event:	Small Cap Awards 2019
Organiser:	Small Cap Network
Time:	18:00-23:00
Place:	The Montcalm Hotel, Marble Arch W1H 7TN
Tickets or sponsor-ship:	Email amanda@masterinvestor.co.uk to register interest

WEDNESDAY, 26 JUNE

Event:	Women in Finance Awards 2019
Organiser:	Bonhill plc
Time:	19:00-00:00
Place:	The Grosvenor, London
Tickets or sponsor-ship:	https://www.womeninfinance.co.uk/london/the-awards

THURSDAY, 27 JUNE

Event:	Master Investor in focus: Investing in Medicinal Cannabis
Organiser:	Master Investor
Time:	18:00-21:30
Place:	DAC Beachcroft, One Minster Court, Mincing Lane, London EC3R 7AA
Tickets:	50% discount using code: MIF06 https://micannabis.eventbrite.co.uk

TUESDAY, 2 JULY

Event:	UKBAA Angel Investment Awards and Gala Dinner 2019
Organiser:	UKBAA
Time:	19:00-23:00
Place:	Illuminate at the Science Museum, London
Tickets or sponsor-ship:	http://awards.ukbaa.org.uk

MONDAY, 29 JULY

Event:	Master Investor Sheffield meetup
Organiser:	Master Investor
Time:	18:00-21:00
Place:	Jaywing, Albert Works, Sidney Street, Sheffield S1 4RG
Tickets:	50% discount using code: MIF07 https://misheffield.eventbrite.co.uk

FRIDAY, 25 OCTOBER

Event:	London Investor Show
Organiser:	UK Investor Events
Time:	09:30-17:00
Place:	Novotel London West, 1 Shortlands, London W6 8DR
Tickets:	https://www.eventbrite.co.uk/e/london-investor-show-2019-tickets-53471905910

WEEK COMMENCING 11 NOVEMBER

Event:	Longevity Week
Organiser:	Master Investor and Longevity Forum
Place:	Various London locations
Tickets:	Email info@masterinvestor.co.uk to register interest

SATURDAY, 28 MARCH 2020

Event:	Master Investor Show
Organiser:	Master Investor
Time:	09:30-17:00
Place:	Business Design Centre, 52 Upper St, London N1 0QH
Tickets:	https://masterinvestorshow.eventbrite.co.uk

MARKETS IN FOCUS

MAY 2019

GLOBAL EQUITIES

Index	Last Month %	YTD%	52-Week Strength
Russian TSI	3.3	20.4	
Bovespa	1.2	10.9	
S&P/ASX 200	1.1	13.3	
Swiss Market	-2.5	13.0	
FTSE 100	-3.5	6.4	
DAX Xetra	-5.0	11.1	
Euronext 100	-5.9	11.5	
FTSE All-World	-6.2	7.9	
S&P 500	-6.6	9.8	
Dow Jones	-6.7	6.4	
CAC 40	-6.8	10.1	
CSI 300	-7.2	20.6	
Nikkei 225	-7.5	2.9	
NASDAQ 100	-8.4	12.6	
Hang Seng	-9.4	4.1	

COMMODITIES

Commodity	Last Month %	YTD%	52-Week Strength
Bitcoin	66.0	138.0	
Coffee	9.9	0.5	
Iron Ore	5.3	38.5	
Cocoa	2.9	0.5	
Gold	0.6	0.6	
Palladium	-0.6	14.0	
Palm Oil	-0.9	-2.1	
Natural Gas	-1.2	-14.0	
Silver	-3.2	-6.9	
Sugar (No. 11)	-4.7	-2.2	
Copper	-8.5	1.0	
Cotton	-9.7	-4.0	
Platinum	-10.9	-0.9	
Crude oil (Light Sweet)	-10.9	23.5	
Crude oil (Brent)	-11.6	16.5	

FOREX

Pair/Cross	Last Month %	YTD%	52-Week Strength
EUR/GBP	3.0	-1.5	
USD/CAD	1.2	-0.4	
EUR/USD	-0.2	-2.4	
AUD/USD	-1.5	-1.6	
GBP/AUD	-1.6	0.6	
USD/CHF	-1.9	1.6	
EUR/CHF	-2.0	-0.5	
USD/JPY	-2.8	-1.3	
EUR/JPY	-3.0	-3.6	
GBP/USD	-3.1	-0.9	

CENTRAL BANKS – RATES & MEETINGS

Central Bank	Key Rate	Next	After
Bank of England (BoE)	0.75%	Jun 20	Aug 01
European Central Bank (ECB)	0.00%	Jun 06	Jul 25
Federal Reserve System (FED)	2.50%	Jun 19	Jul 31
Bank of Japan (BoJ)	-0.10%	Jun 20	Jul 30
Bank of Canada (BoC)	1.75%	Jul 10	Sep 04
Reserve Bank of Australia (RBA)	1.50%	Jun 05	Jul 03
Swiss National Bank (SNB)	-0.75%	Jun 13	Sep 19
Banco Central do Brasil (BCB)	6.50%	Jun 19	Jul 31
Central Bank of Russia (CBR)	7.75%	Jun 14	Jul 26
Reserve Bank of India (RBI)	6.00%	Jun 06	Aug 07

FTSE 350 TOP RISERS

Company	Last Month %	YTD%	52-Week Strength
Greggs PLC	21.0	71.7	
Indivior PLC	19.7	-59.3	
Plus500 Ltd	19.7	-53.9	
Sophos Group PLC	16.8	10.2	
Galliford Try PLC	15.3	0.3	

FTSE 350 FALLERS

Company	Last Month %	YTD%	52-Week Strength
Thomas Cook Group PLC	-35.2	-43.8	
Just Group PLC	-29.8	-47.8	
Saga PLC	-27.7	-58.9	
AA PLC	-26.5	-27.3	
Kier Group PLC	-25.9	-31.8	

FTSE 350 SECTORS RISERS

Sector	Last Month %	YTD%	52-Week Strength
Leisure Goods	7.4	46.8	
Health Care Equip & Serv	5.4	7.8	
Beverages	2.8	18.6	
Software & Computer Services	2.7	29.9	
Personal Goods	1.0	14.7	

FTSE 350 SECTORS FALLERS

Sector	Last Month %	YTD%	52-Week Strength
Fixed Line Telecom	-14.2	-17.0	
Oil Equipment, Serv & Dist	-14.0	-16.8	
Automobiles & Parts	-12.8	-15.4	
Tobacco	-11.2	1.9	
Industrial Transportation	-10.0	-0.7	

IA SECTORS RISERS

Sector	Last Month %	YTD%	52-Week Strength
UK Index Linked Gilts	5.0	9.2	
UK Gilts	2.7	4.8	
Global Bonds	2.0	4.2	
Global Emerging Markets Bond	1.9	5.3	
£ Corporate Bond	0.5	4.7	

IA SECTORS FALLERS

Sector	Last Month %	YTD%	52-Week Strength
China/Greater China	-7.8	8.9	
Technology and Telecom	-5.1	15.5	
Asia Pacific Excluding Japan	-3.9	7.4	
Global Emerging Markets	-3.8	6.6	
UK Equity Income	-3.2	8.8