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AUTOMOTIVE ARMAGEDDON

WHICH AUTO MANUFACTURERS WILL PICK UP THE PIECES?

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RESTAURANT FRANCHISING

GRAB A SLICE OF SOME TASTY RETURNS

WELCOME

Dear Reader,

Something happened last month that struck fear into the heart of the financial world. That something was the inversion of the yield curve, an event which has presaged every US recession since the 1950s. So what is an inverted yield curve and does it mean it's time for investors to run for the hills?

A yield-curve inversion takes place when the spread between long- and short-dated government bonds – in this case US Treasury bonds – turns negative, ie near-term Treasury bonds yield more than their long-term counterparts. There is a lot of debate surrounding the topic, but the most commonly held belief is that a yield-curve inversion happens as a result of investors flocking to the safety of long-term bonds in anticipation of weaker economic growth and market volatility.

Clearly, the recent reversal of interest-rate policy by the Fed and Donald Trump's ongoing trade war against China are significant factors in the inversion, and markets are highly sensitive to any further deterioration in sentiment. That said, and despite its past reliability as an indicator, a yield-curve inversion is no guarantee that a recession is imminent.

Even if a recession is around the corner, investors probably need not panic just yet. Historically speaking, recessions have started on average 15 months after the inversion of the 2-year/10-year spread occurred, and markets rally by an average of 15% after the inversion. There are even those who argue that an inversion is no longer a reliable indicator due to the Fed's interference in the bond markets post 2009.

Last month, I had an interesting conversation with a fund manager who reminded me that many people are still investing with one eye in the rear-view mirror. What he meant by this is that our experience of the 2008-09 financial crisis has left us acutely sensitive to the signs of any potential downturn and has left this bull market to climb a particularly steep 'wall of worry'. Indeed, many people were put off investing for life by the financial crisis – and look what has happened to the stock market post 2009!

My point is that there is always a reason not to invest. The trick, as Nick Train (for the record: not the fund manager referred to above) puts it, is to invest anyway. I have no idea whether this latest 'alarm bell' will prove prescient. But what I do know is that in investing it often pays to avoid the 'noise' and concentrate on the things you *can* control.

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

Best regards,

James Faulkner
Editor

CONTACTS

ADVERTISING
amanda@masterinvestor.co.uk

EDITORIAL ENQURIES
james.faulkner@masterinvestor.co.uk

FOLLOW US

Master Investor Ltd.
Unit 2, The IO Centre
Salbrook Industrial Estate
Salbrook Road
Salfords
Redhill RH1 5GJ
United Kingdom

EDITORIAL
Editorial Director James Faulkner
Sub Editor Fiona Nicolson
Creative Director Alexandra Mueller

EDITORIAL CONTRIBUTORS
Filipe R. Costa
Richard Gill, CFA
Victor Hill
David Jones
John Kingham
Andrew Latto
Jim Mellon
Tim Price
Jamie Ross
Robert Stephens, CFA
Nick Sudbury
Mark Watson-Mitchell

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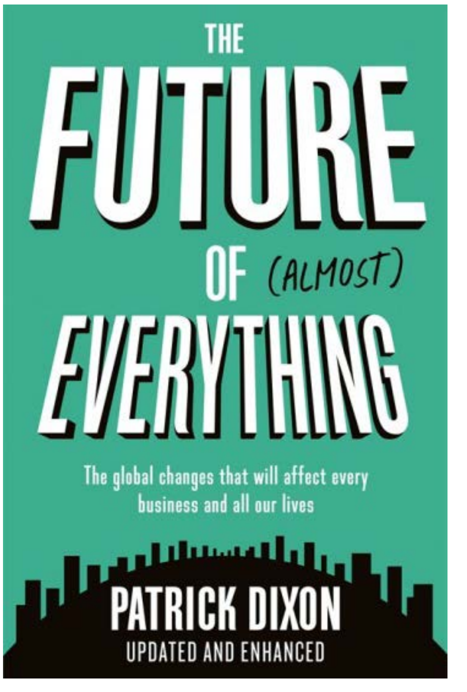


THE
FUTURE
OF (ALMOST)
EVERYTHING
The global changes that will affect every business and all our lives
PATRICK DIXON
UPDATED AND ENHANCED

BY JIM MELLON

MELLON ON THE MARKETS

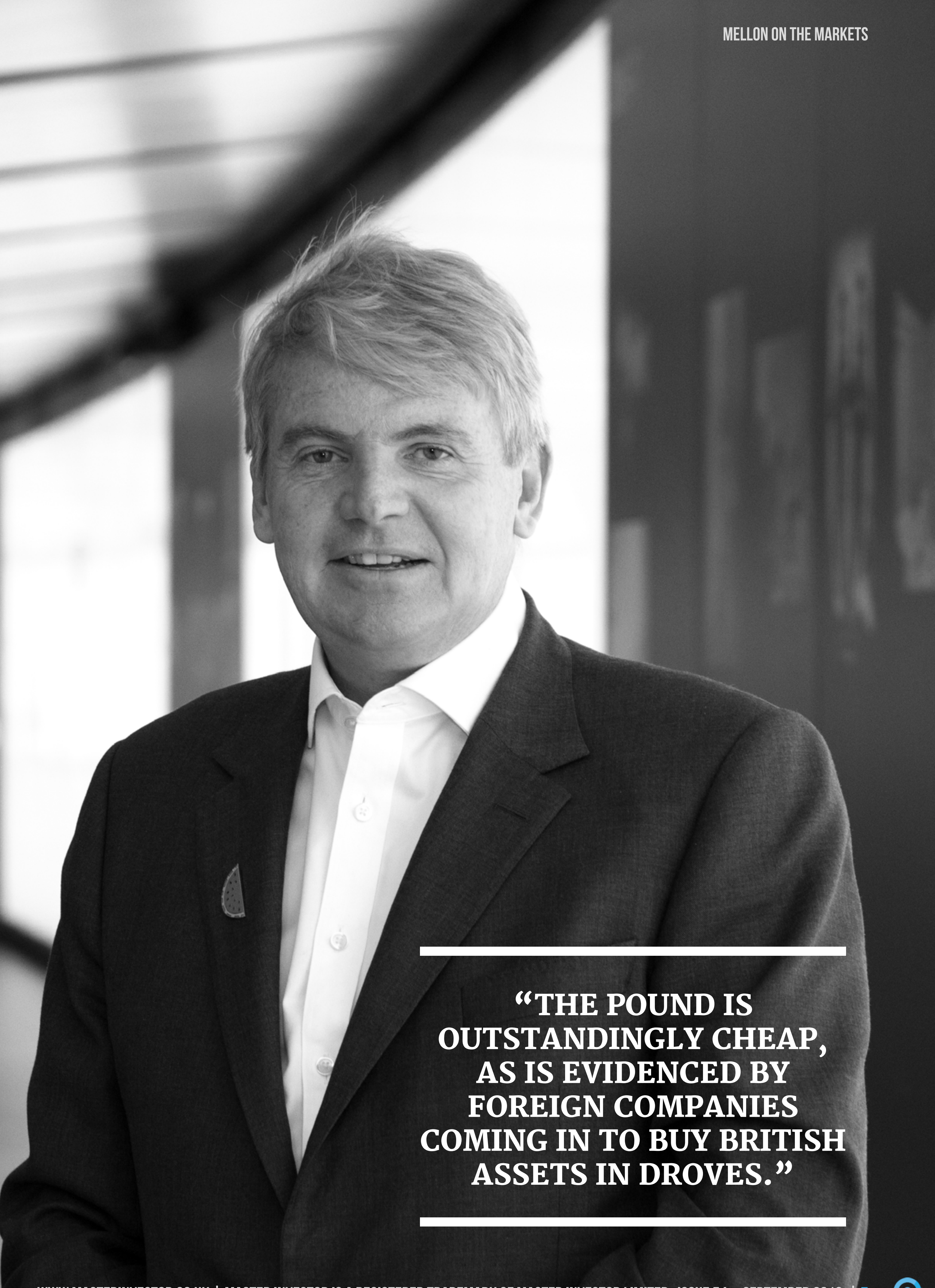
Inside the mind of the Master Investor: Influential British investor Jim Mellon reveals his latest thoughts on the markets.

My last few missives have focused on precious metals, which have, rather like a reluctant cobra in a basket, begun to do their portfolio duty. Silver has caught up a bit with gold; by all means trade in and out of them, but don't liquidate them entirely as these are going much higher.

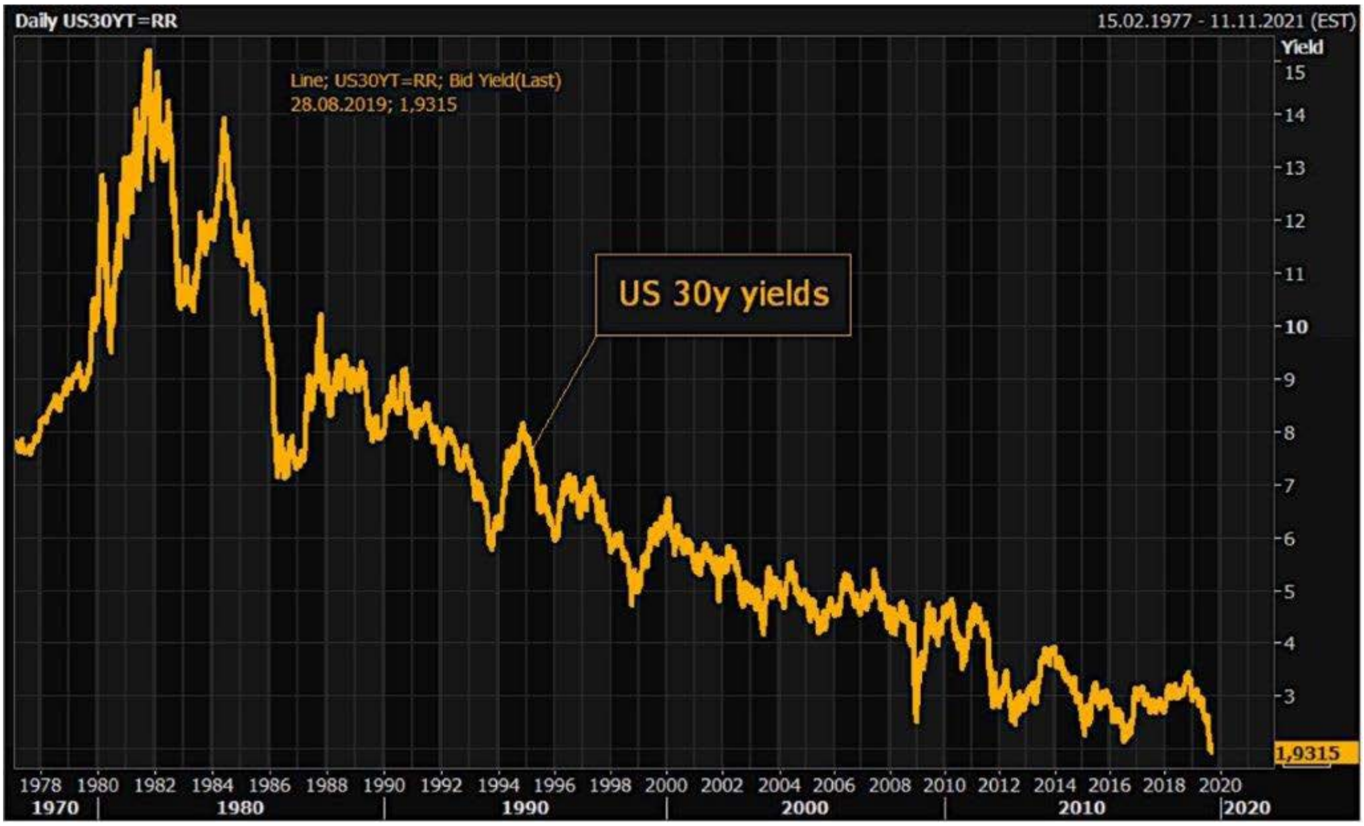
In terms of shares and gold miners, **Sandfire (ASX:SFR)**, with a yield approaching 5% and a low price-earnings ratio (PE), based in Australia, and seemingly well run, has gone onto my buy list. I have added to **Condor Gold (LON:CNR)**, listed in London, and of which I am a director and now largest shareholder. I have also been buying **Dart (ASX:DTM)**, in Australia, and **Kefi (LON:KEFI)** in London, both of them highly speculative. Silver is harder, but old standbys **Fresnillo (LON:FRES)** and **Hochschild (LON:HOC)** are OK to tuck away, in my opinion.

I think gold will hit new highs this calendar year, possibly close to $2,000 an ounce, and silver should breach $24 an ounce, a third up from the current level.

The reasons for buying gold etc are self-evident: this world is full of potential flashpoints, not least the US and China's Twitter-inflamed trade war. The list of other fracture points is longer than normal. Then we have the fact that global net debt has trebled since the financial crisis;



"THE POUND IS OUTSTANDINGLY CHEAP, AS IS EVIDENCED BY FOREIGN COMPANIES COMING IN TO BUY BRITISH ASSETS IN DROVES."



world economic growth is notably slowing, particularly in the mess that is Europe; and the lack of yield on precious metals is now irrelevant, as the lack of yield on bonds gets more and more crazy.

Although I am not a fan of jumping into the US market at this time, it is incredible that for the first time in decades the yield on US 30-year Treasury bonds is lower than the yield on the S&P.

We are in a weird period and the prescription for that is gold and silver. Gold has already made new highs in pounds, Australian dollar and euro terms. It's only a matter of time before the same applies to gold in US dollars.

Speaking of the US dollar, in a debt-laden world short of dollars (think Argentina and Venezuela as examples), it is not surprising that the dollar has been relatively strong. It is also the case that US interest rates, while tumbling (see chart) are generally higher than elsewhere, and this is a pull factor for the dollar.

Don't be tempted to jump on this bandwagon. A few months ago, I sold a bunch of euros and put the money in dollars. I now think that – wait for it – the British pound is a buy. This might be premature, what with dire predictions around a 'no deal' Brexit and Jeremy Corbyn advocating mass civil disobedience in the UK – but

the time to buy anything is when the newsflow is overwhelmingly bad. (Not always, but in this case yes.)

The pound is outstandingly cheap, as is evidenced by foreign companies coming in to buy British assets in droves (Cobham and Greene King most recently), and those with a strong constitution should dive in now − both against the euro and the USD.

Also, British shares are cheap on an international basis, and I strongly advocate a smattering of UK blue chips in any portfolio. My picks include **Vodafone (LON:VOD), Tesco (LON:TSCO), BP (LON:BP.)** and **Lloyd's (LON:LLOY)**, all of which are terrific yielders and generally unlikely to disappoint in terms of maintaining their dividends.

In terms of trying to get ahead of another acquirer of British assets, I would suggest buying **Marston's (LON:MARS)**, a large owner of British pubs, with a good yield and **New River REIT (LON:NRR)**. It has a huge yield (13%), which may be unsustainable but looks

> **"I AM DUE TO HAND IN THE SECOND EDITION OF *JUVENESCENCE* QUITE SOON, AND I AM ALSO WRITING ANOTHER BOOK (SUBJECT TO BE REVEALED TOWARDS THE END OF THE YEAR)."**

uber cheap to me. New River has a balanced portfolio of reasonable retail properties and pubs, and the retail properties have the capacity to produce housing units on adjacent land.

About a third of all government debt globally is now negative yielding and anyone with an ounce of sanity must see that this is crazy and unsustainable. What will burst the bubble, I don't know, but burst it will. Maybe Italy, where the 10-year bonds have gone to a ridiculous 1.2% yield might be the catalyst. Those who think Signor Salvini is going to go quiet now that he is not in government will end up with big losses.

Back to the day job... We just closed our Series B for Juvenescence, raising another $100m to advance the cause of keeping us all alive for longer and in a healthier condition.

I am heading back on the road next week, first (probably) to San Francisco for the Good Food Conference and Juvenescence. (San Francisco is a place where I no longer have a flat, due to falling out of love with what used to be a glorious city, but now looks like something out of the Hunger Games.) Then it's over to Hong Kong for the massive CLSA conference, where I am speaking on things Juvenescent (hopefully without too much in the way of trouble outside), then quickly thereafter to the Middle East and Australia. En route to San Francisco, I am stopping in Miami to see my friend John Mauldin, whose newsletter is a must-read for investors.

I'm hoping that I can catch up on my writing while in the air – I am due to hand in the second edition of *Juvenescence* quite soon, and I am also writing another book (subject to be revealed towards the end of the year).

While in Edinburgh last week, a couple of chums and I had a guided tour of the new aircraft carrier, Prince of Wales, which is about to start sea trials. It's a magnificent ship, truly impressive and a proud example of British engineering. It's costing £3 billion and worth every penny.

Now, I think the British government should follow the example of Austria (and, less gloriously, Argentina) and issue 100-year 'century' bonds, raise £200 billion or thereabouts and build a lot more stuff. Interest rates are derisory; there must be some projects which can exceed them in terms of return, and now is the time before aforesaid bubble bursts. Be brave, be decisive!

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.

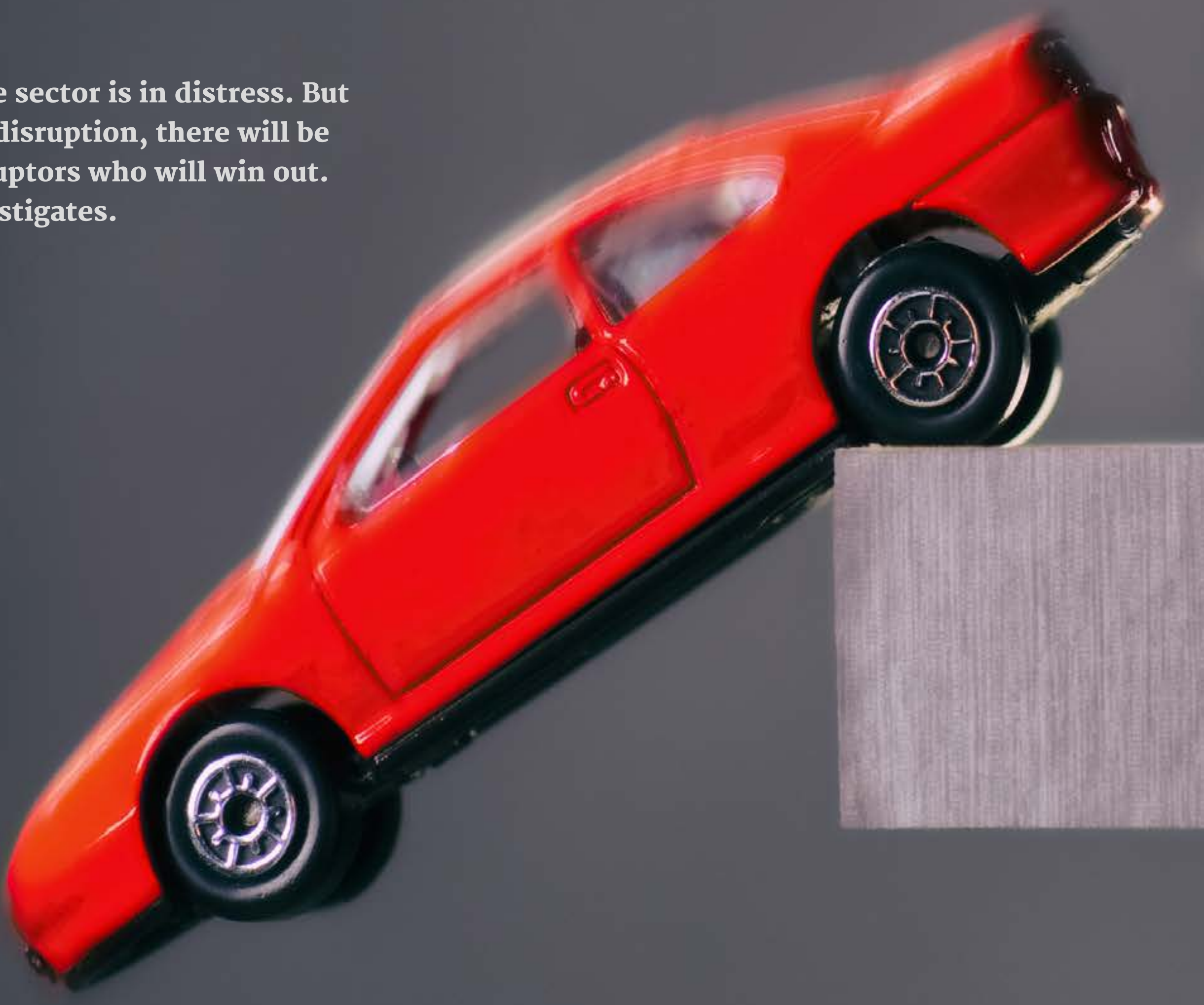
BY VICTOR HILL

COVER FEATURE

AUTOMOTIVE ARMAGEDDON

CRUNCH TIME BRINGS OPPORTUNITY

The automotive sector is in distress. But where there is disruption, there will be successful disruptors who will win out. Victor Hill investigates.



The global automotive sector is facing unprecedented disruption. It is still one of the world's greatest industries, with 87 million unit sales per year. But car ownership is going out of fashion – at least with the young who are disciples of the sharing economy and summon rides through their smartphones. Diesel is a synonym for toxic. The day of the gas guzzler is clearly dead, with Britain and other advanced countries now committed to going carbon neutral by 2050 (just 21 years away). Self-driving electric cars are just around the corner (or so we are constantly told) – but what will they look like and who will buy them?

In short, one of the world's largest manufacturing industries of the last 125 years faces both changes in demand and massive changes in technology at the same time. This has led to falling output (not helped by a slowdown by global growth); falling margins; and sluggish share prices for the 20 or so top volume automotive manufacturers worldwide.

The response of the industry has been threefold. First, a number of big names have announced plant closures as they cut back production. Second, there is a wave of consolidation underway as volume players seek increased economies of scale. Third, the market leaders are stepping up the transition to electric vehicles (though not fast enough).

For investors, this is a distressed sector with apparently not much upside in the near-term future. But where there is disruption, there will be successful disruptors who will win out. How can investors sniff out the medium-term winners?

The eternal defensive strategy: merge and consolidate

Before he died last year, the chief executive of Fiat Chrysler, Sergio Marchionne, warned that excessive competition was killing the global automotive industry. He proposed that manufacturers needed to join forces. Carmakers are having to invest huge sums in R&D as emissions controls and tighter regulations bite. He argued that almost half the cost of developing a new model was accounted for by the development of products and technologies of which the purchaser is not even aware, such as engine components and in-car software.

Signor Marchionne identified two possible solutions. First, carmakers could reduce their product range; second they could join forces to share R&D costs and generate greater economies of scale. Carmakers need an output of about 10 million cars a year now to break even – and only **Toyota (TYO:7203)**, **Volkswagen (RTE:VOW)** and Renault-Nissan are at that level. He reckoned that the global automotive industry was spending $2 billion a week on R&D – and that most of this was duplicated.

It now seems that Signor Marchionne's call for the industry to consolidate has been heard. A wave of alliances, cross-holdings, joint ventures, partnerships, mergers and buy-ins is now sweeping the sector.

VW and **Ford (NYSE:F)** had already announced plans to team up in the US to produce vans. In July they announced a bolder collaboration. Ford will use VW's modular electric toolkit (MET) to develop at least one new electric model. The MET is a kind of chassis with a battery onto which a car body and interior can be placed. VW has spent billions on developing the MET (sometimes irreverently called a skateboard) and now plans to recoup some of those costs by selling the technology to other carmakers. In this way the automotive industry is becoming like the smartphone industry: a basically similar chip and operating system supports numerous designs with different functionality.

Jaguar Land Rover (JLR, owned by India's **Tata Motors (BOM:500570)**) and **Peugeot SA (ETA:UG)**, which is owned 13.7 percent by the French state, are also thought to have had talks about a possible tie-up. Against this backdrop, in late May, it was revealed that **Fiat Chrysler (NYSE:FCAU)** had proposed a merger with French carmaker **Renault (EPA:RNO)** in a deal worth $33 billion to create the world's third-largest automotive giant behind VW and Toyota. By the terms of the proposal, each party would own 50 percent of the new entity which would have combined unit sales of 8.7 million vehicles a year and revenues of nearly $170 billion. Renault announced that it would study Fiat's "friendly proposal" with interest.

The logic of the deal was that Renault could shore up Fiat's loss-making European business while Fiat could offer Renault a foothold in the North American market where it has some strong brands such as Jeep. Between the two, Renault has the edge in terms of electrification – but, together, the two giants could achieve huge economies of scale

> **"IT NOW SEEMS THAT SIGNOR MARCHIONNE'S CALL FOR THE INDUSTRY TO CONSOLIDATE HAS BEEN HEARD. A WAVE OF ALLIANCES, CROSS-HOLDINGS, JOINT VENTURES, PARTNERSHIPS, MERGERS AND BUY-INS IS NOW SWEEPING THE SECTOR."**

"CHINESE PASSENGER CAR SALES FELL BY 6.7 PERCENT IN 2018 TO 22.7 MILLION UNITS (OUT OF 87 MILLION GLOBALLY) AND GOLDMAN SACHS IS PREDICTING AN EVEN BIGGER DECLINE FOR 2019."

in manufacturing electric cars. The timing of the proposal came as a parting of the ways between Renault and **Nissan (TYO:7201)** seemed quite likely.

Initially, all the governments involved – France, Italy, America and Japan – appeared to be onside and there seemed to be few regulatory issues to resolve. But within two weeks the proposed deal collapsed. Fiat Chrysler withdrew its offer, claiming that the French government (which has a controlling stake in Renault) had required the support of Nissan. The real issue was that the French government wanted guarantees that there would be no job cuts in France. More bluntly, Fiat said in a press statement that "political conditions do not currently exist in France to carry out such an arrangement". The Agnelli family still has a 29 percent stake in Fiat Chrysler.

Chinese carmakers have also asserted themselves. **Geely (HKG:0175)**, run by billionaire Li Shufu, bought Volvo from Ford for $1.8 billion in 2010. (That was just a quarter of Volvo's value when Ford took it over a decade earlier for $6.5 billion). Since Geely took control, Volvo's output has almost doubled. It has even launched a luxury electric brand, Polestar. Geely has also acquired LEVC (which makes, amongst other models, London's black cabs), and Lotus (for $1.5 billion).

Geely also has a 9.7 percent stake in **Daimler AG (ETR:DAI)** which it bought for $9 billion. Chinese automotive giant BAIC (HKG:1958) has a five percent stake in Daimler. This gives both players huge intellectual capital in terms of how to design, style and build state-of-the-art motor cars.

Not all marriages in the automotive sector are happy ones. Chrysler partnered with Daimler in 1998 but that arrangement came to an end in 2007 on account of fundamentally different corporate cultures. The Nissan-Renault tie-up also may be coming to an end partly, but not only, due to Japanese resentment at the French partner's dominance. Reportedly, the Fiat Chrysler tie-up is also under strain.

Some of the most radical innovation in an industry sometimes occurs when a market stagnates. Demand for new cars grew in Europe by just 0.5 percent last year despite benign economic conditions. The recent downturn in manufacturing output in Europe (the German economy contracted by 0.1 percent in Q2) has been largely driven by a dramatic slowdown in car production, which is only partially caused by the fall in demand from China. Chinese passenger car sales fell by 6.7 percent in 2018 to 22.7 million units (out of 87 million globally) and Goldman Sachs is predicting an even bigger decline for 2019.

The Chinese car market – comprising over one quarter of the global market − is critical for all of Europe's volume automotive manufacturers which have ruled the roost for so long, secure behind huge barriers to entry.

Powering up

Electrification is great news for power generators and distributors. Using the Octopus Energy's Go EV tariff, drivers of electric cars pay a reduced rate of 5 pence per kilowatt hour if they charge overnight. That means that a full charge of a Tesla Model S costs around £4. Ovo EV offers the 'Everywhere' bundle which includes a free home charger or membership of one of the main charging networks. Users can even sell unused electricity back to the grid. **EDF's (EPA:EDF)** GoElectric tariff offers cheaper tariffs between 9pm and 7am. **E.ON's (ETR:EOAN)** Fix & Drive tariff comes with a £500 grant for a home charger.

Other electricity suppliers offering tailored packages for electric-car drivers include **Scottish and Southern Energy (LON:SSE)**, Bulb Energy and Shell Energy. All these electricity suppliers are committed to making the transition to electric vehicles easier. At a Downing Street summit in May it was proposed that every new home in the UK should be required to have a charging point for electric cars. That is likely to be enacted in law shortly.

Meanwhile, the power outages across parts of England on 9 August have raised the question of whether National Grid (LON:NG) has the power-generating capacity at its disposal to charge millions of new electric cars. (Incredibly, two power plants were taken out by one lightning strike). According to one study, electric cars could double peak demand from current levels in 10 years' time. A huge investment may have to be made in new generating capacity that is used only part of the time.

Electrification accelerates

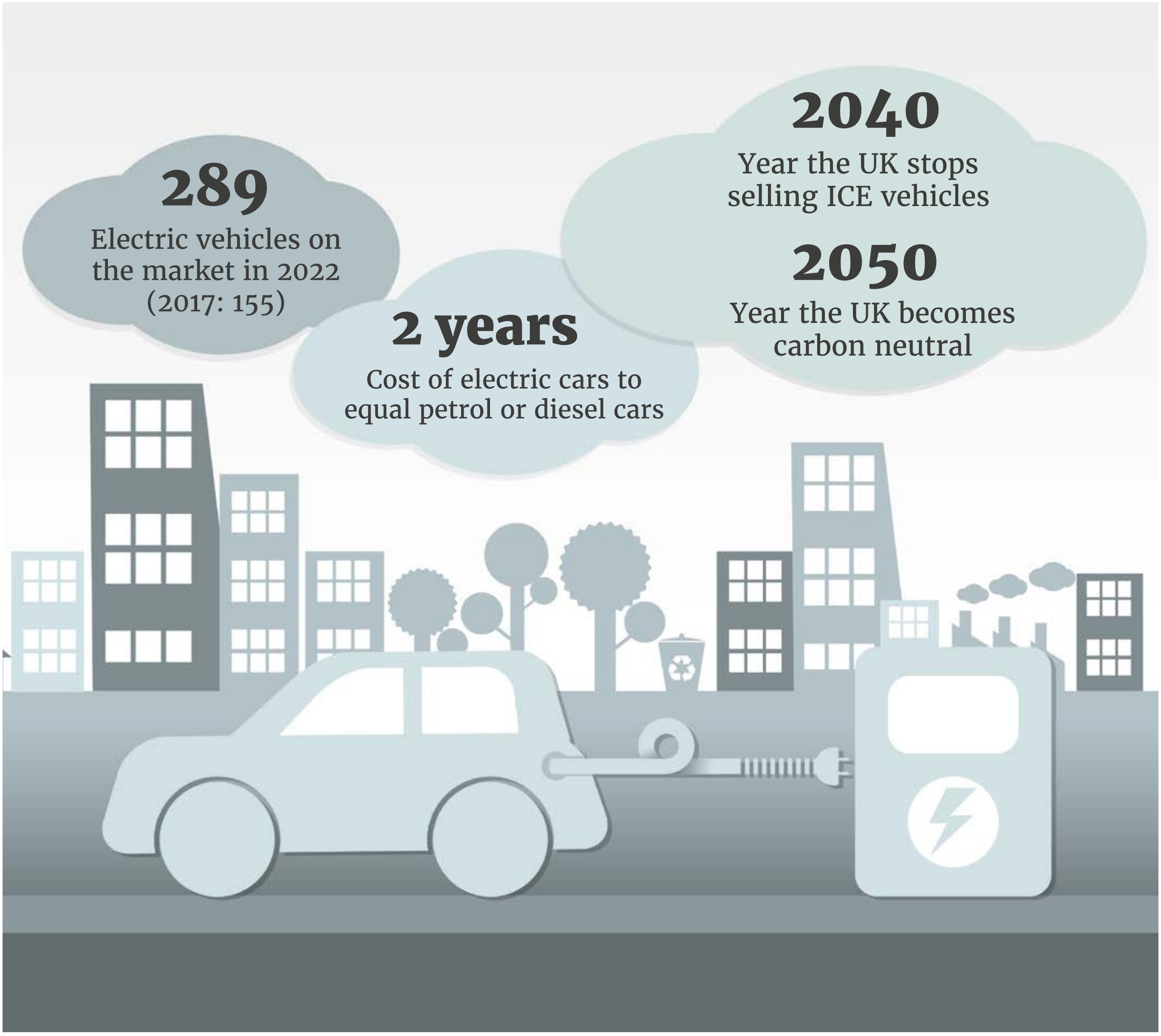
One of Theresa May's last acts as prime minister was to commit the UK to becoming carbon neutral by 2050. This means in practice that CO2 emissions should be brought down to a level that could be entirely offset by carbon capture and storage (CCS) technology. Cars are currently one of the major causes of CO2 emissions thanks to the fossil-fuel-powered internal combustion engine (ICE). The UK government had already set a target of 2040 after which date no further ICE-powered vehicles will be sold: by then all vehicles on the road will be electric. France has also set a 2040 target for electrification – though India has been even more ambitious with a target of 2030 (whether that is achievable is another matter).

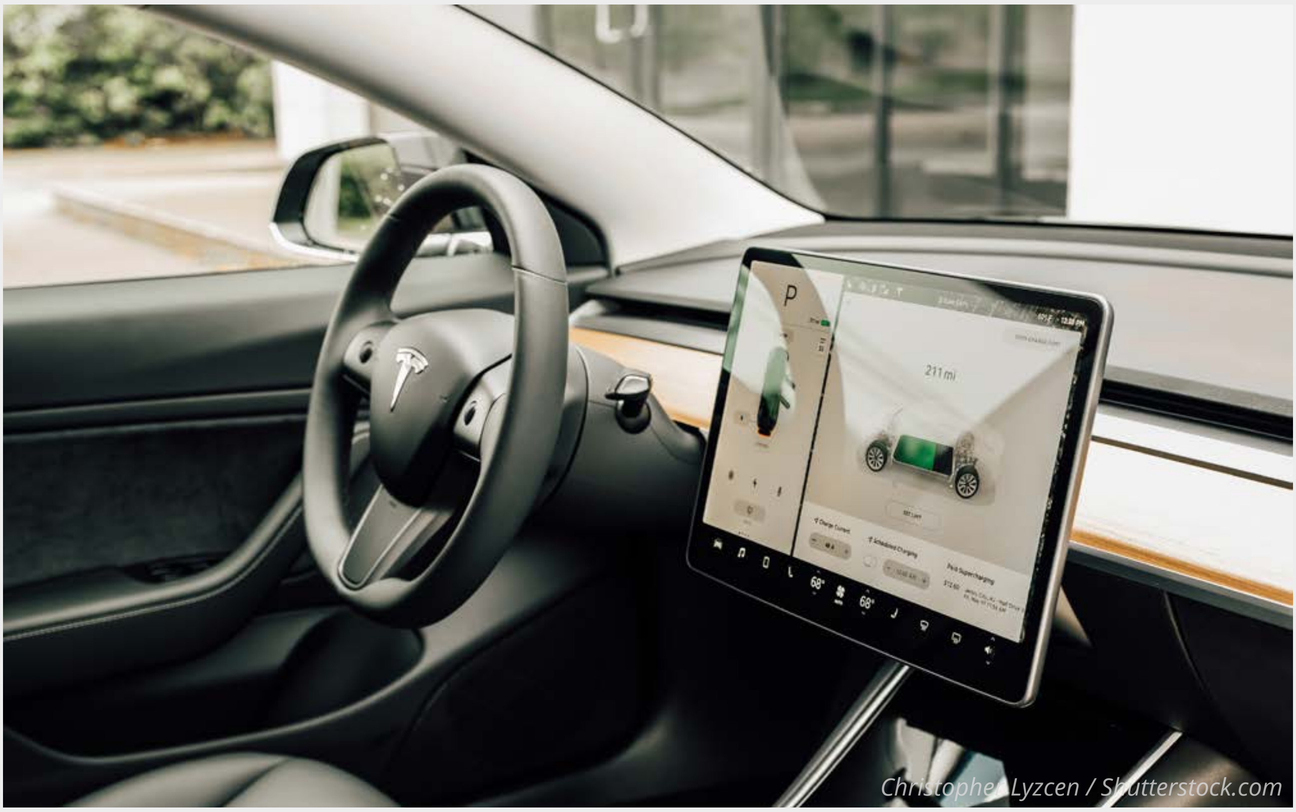
Few doubt that electric vehicles are the industry's future though it is still unclear whether lithium battery or hydrogen fuel-cell technology will finally win out. According to Bloomberg NEF, the number of electric-vehicle models on the market will rise from 155 in 2017 to an estimated 289 in 2022, after which date it predicts that sales of internal combustion engine-powered vehicles will go into terminal decline ahead of being outlawed. Yet most established automotive leaders are still some way from offering a full range of electric-powered vehicles.

The key drivers of increasing ownership of electric cars are threefold. First, the range of electric vehicles must be far enough to make middle-distance journeys viable without a recharge. Second, there must be a sufficient network of widely and easily available charge points. Thirdly, electric cars should not be appreciably more expensive than their CO2 spouting equivalents.

Well, the range of electric cars is lengthening fast with improved battery technology. The number of charge points in the UK is increasing exponentially. **Tesla (NASDAQ:TSLA)** has pioneered a network of free-to-use charging points. And, according to Deloitte, the cost of owning an electric car could be equivalent to owning a petrol or diesel car within two years.

Battery-powered electric cars will be cheaper to run than petrol or diesel-powered cars. Not only will the charging costs be less than the equivalent cost of fuel, but they will require less maintenance and fewer spare parts than conventional cars. That is because they are mechanically simpler – there is less that can go wrong. That is good news for drivers, but it means that the lucrative after-market in spares and repairs will dry up. That is bad news for businesses like Unipart.





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Tesla fights back

Tesla (NASDAQ:TSLA) turned in excellent earnings numbers for Q4 2018 thanks to strong sales of its Model 3, its first mass-market car. (The Model 3 does seem to have some reliability issues, but in July Tesla cut the price of the Model 3 in the UK to £37,340 (including VAT and the plug-in car grant)). Yet the Q1 2019 results were awful – the company lost $702, partly on account of delays in deliveries. On the plus side, Tesla has managed to slash costs over the last 12 months, closing many of its showrooms and reducing its workforce by 16 percent.

Reports started to circulate in late spring that Tesla was facing a cash crunch, given a $10 billion debt pile with $566 of repayments due in November. Most analysts think the company will have to raise new capital in the order of $2.5 billion – despite Mr Musk's earlier protestations that that would not be necessary. The yield on Tesla's 2025 bonds stands at around the 8.0 percent mark at time of writing (it has a 5.3 percent coupon).

Founder and CEO Elon Musk has declared that Tesla "is light years ahead of everyone else" in the field of self-driving cars because it has accumulated more data from its autopilot function equipped on all its models. Tesla fans in Europe have called on the EU to repeal restrictive rules on the use of the system. In April Mr Musk said that his company would have one million self-driving cars on the road in 2020.

Tesla's shares at time of writing in late August are trading at $226 – well up from a low point of $179 on 31 May. Some analysts regard Mr Musk's attitude to corporate governance as a drag on the share price; fund manager Baillie Gifford, which has a 7.5 percent stake in Tesla worth $3 billion, suggested this month that Mr Musk was "not irreplaceable as chief executive".

"THE MARKETS HAVE ASSIGNED POOR VALUATIONS TO GERMANY'S THREE MAJOR CAR MANUFACTURERS WHILE ASSIGNING OPTIMISTIC VALUATIONS ON MORE SPECULATIVE STOCKS SUCH AS TESLA."

Diesel: the end

European car makers are facing the challenge of tighter regulations limiting the use of diesel engines and the move away from the internal combustion engine towards electric-powered vehicles. The shadow over the future of diesel was lengthened by the emissions scandals afflicting both VW and Daimler AG (which manufactures under the Mercedes brand). In 2015 the VW Group admitted that it had equipped up to 11 million vehicles worldwide with devices that allowed them to cheat emissions-control tests. While both those firms are investing heavily in electrification, it is taking longer for them to roll out a full range of electric vehicles than expected.

Daimler announced in late June that it is expecting further liabilities in connection with its complicity in faking diesel emissions from its vehicles one day after the German government ordered the recall of 600,000 diesel-powered Mercedes cars.

Since April this year, the latest diesel cars in London's Ultra Low Emissions Zone (ULEZ), which covers central London) are subject to a charge of £12.50 per day – and older ones are banned altogether. From 25 October 2021, the ULEZ will be expanded to include the inner London area bounded by the North and South Circular Roads (that is most of Greater London).

Electric cars are still more expensive than their petrol or diesel-powered equivalents. The Model S costs around £75,000 to buy new in the UK – around the same price point as Range Rover Evoque. But the all-electric Hyundai Ioniq comes in at just £20,000.

There is already a move away from hybrid cars towards battery-powered cars. This is partly a function of the subsidy regime. In October last year the UK government scrapped the £2,500 grant available for plug-in hybrids while lowering the maximum available for battery-powered cars from £4,500 to £3,500.

Recently Ford invested $500 million in electric car start-up Rivian, a maker of electric 'adventure vehicles'. This followed Apple's investment of $700 million in Rivian earlier this year.

Stock-market performance

The markets have assigned poor valuations to Germany's three major car manufacturers while assigning optimistic valuations on more speculative stocks such as Tesla (despite the efforts of the short-sellers). All of the European volume manufacturers have huge fixed costs and enormous pension-fund deficits. That is not likely to change in the near future.

If uncertainty around Brexit is inhibiting new investment in the automotive sector in the UK, something similar is unfolding in America. The United States-Mexico-Canada (USMCA) agreement to update NAFTA was signed off on 30 November last year but has not yet been ratified. American unions are lukewarm about the deal and the new Democrat-controlled House of Representatives has concerns about the enforcement of workers' rights in Mexico.

European car producers with production facilities in the US are better placed to ride out President Trump's threat of higher tariffs on imported cars. At the Detroit Auto Show in January, VW announced plans to upgrade its plant in Chattanooga, Tennessee, where it will build its first electric-vehicle facility in the US. The $800 million investment is expected to create another 1,000 jobs. The first electric vehicle is expected to roll off the Chattanooga production line in 2022.

Driverless cars

The other aspect of the automotive revolution – the advent of driverless cars – requires that they invest in a whole range of related technologies, of which artificial intelligence (AI) is just one.

What is holding back the arrival of driverless cars is the issue of safety. Last year a pedestrian was killed by a driverless Uber taxi in Arizona. Uber

Changes in consumer behaviour

Millennials seem to be less inclined to buy cars than their parents. Car ownership by under-35s in the US is plummeting. Fewer British millennials are even bothering to pass their driving test. That may be partly a function of lifestyle: they generally live in cities with good public transport and they are also more conscious of the environmental impact of motoring. Cars do not seem to be such a status symbol amongst the young.

Anecdotally, many consumers have decided to postpone the replacement of their petrol-powered cars because they anticipate that in two-three years the price of electric cars will have come down substantially. This is a classic example of deferred purchase – which implies falling demand. We shall probably come under increasing social pressure to go electric as time goes by. People who still drive gas-guzzlers will be regarded as antisocial long before 2040.

Because cars are generally better engineered these days (thanks to better design and production technology) most decent cars will be perfectly serviceable for 10 years or more. My hunch is that people will tend to change their car less often as time goes by. What is clear is that car ownership – electric-powered and self-driving, or not – is likely to decline in coming years. That suggests that there is overcapacity in the global automotive industry.

The rise of the sharing economy means that many people, not least in the US, are hiring cars as and when they need one rather than buying one outright. **Uber (NASDAQ:UBER)** and **Lyft (NASDAQ:LYFT)** are now ubiquitous. Significantly, Toyota recently invested a reported $500 million in Uber and GM invested an equivalent figure in Lyft. Presumably, they see these ride-hailing apps as hugely important future purchasers of their products.

Car-rental companies are doing reasonably well – a sector dominated by the "big three", that is Hertz, **Avis (NASDAQ:CAR)** and **Europcar (EPA:EUCAR)**. But even they are under threat from the rise of peer-to-peer car-hire apps such as **Turo**. Turo is a San Francisco-based unicorn which enables car owners to generate revenues from their cars by renting them out on a daily basis to people in need of transport. In 2017, according to Turo, four million users had registered to use the service and 170,000 privately owned cars were available for rental in 5,500 locations across the USA, Canada, the UK and Germany. The service is especially popular with tourists but users need to be pre-approved before they can summon a hire car.

has even constructed a fake city where it is testing driverless vehicles using dummies and robots rather than human pedestrians.

Interestingly, one of the most difficult manoeuvres to robotise is a turn into the flow of oncoming traffic. Robots, it seems, are either too timid to find a gap at all or are daredevils who cause collisions. Another problem is teaching machines how to interpret human behaviour. Someone reading a newspaper at a bus stop is much less likely to step into the road that a pedestrian looking right and left. But getting the machine to understand that simple thing requires a very high level of AI.

The organisation set up by the UK Department of Transport (DOT) to help develop driverless cars is called Zenic. Addison Lee (a privately owned courier company) and Oxbotica (a privately owned software company) have been trialling self-driving vehicles on British roads under licence from the DOT in the London Borough of Greenwich.

Chinese tech giant Huawei (nominally owned by its employees) says it will launch self-driving cars as early as 2021 in collaboration with Audi (part of the VW Group), Toyota and others. JLR has signed a contract to supply 20,000 I-Pace electric Jaguars to Waymo's operation in Detroit where they will be used to test the Google subsidiary's self-driving technology. Similarly, Volvo is supplying Uber with vehicles that are destined to become self-driving taxis. Ford has also invested $1 billion into the autonomous vehicle specialist Argo AI. Meanwhile, **BMW (ETR:BMW)** is working with China's **Tencent (HKG:0700)** and **Baidu (NASDAQ:BIDU)** on driverless cars.

That all sounds very exciting but no one seems to know when we shall be able to purchase a self-driving vehicle and command it to take us home. Tech titans like **Apple (NASDAQ:AAPL)** and **Alphabet/ Google (NASDAQ:GOOGL)** (in the form of its subsidiary Waymo) are software companies and will never manufacture cars. The volume automotive players still don't know whether there will ever be significant popular demand for driverless cars. The initial market at least will be with the ride-hailing apps and other champions of the sharing economy.

Luxury car brands: Ferrari versus Aston Martin

One bright spot in a declining market might be niche luxury automobile brands. But it is a mixed picture.

Italy's **Ferrari (BIT:RACE)** has an unrivalled brand image and is in the process of increasing production. Last year it produced 8,500 units but in the first six months of this year it delivered 5,281 cars. Germany's **Porsche (ETR:PAH)**, in contrast, produces 250,000 units in six classes. Ferrari will never rival Porsche in production volume but there is huge potential to scale its operation.

In early August Ferrari reported 2019 H1 revenues of €1.9 billion, up 11 percent on the previous year. Net profit for the half year was €36 million, a rise of 18 percent. This robust performance was driven by keen sales of the Portofino – an entry-level grand tourer. The average selling price of a Ferrari car was €287,000.

Ferrari was spun off from FIAT (**Fiat Chrysler (BIT:FCA)**) in January 2016 but the brand goes back to 1940. Ferrari can command high margins and is profitable. Miton European Opportunities Fund regards it as a long-term holding.

Why then has the Warwickshire, UK-based **Aston Martin Lagonda (LON:AML)** – another iconic luxury brand – fared so badly of late? Its shares plunged by another 12 percent in late July after the sports car-maker posted a £78.8 million loss, blaming a "worsening trading environment" and "continued macroeconomic uncertainty". The company revealed that the selling price of its cars had fallen from £167,000 last year to £145,000. The company slashed its sales forecast for this year by 1,000 units – it is likely to manufacture only 6,300 cars this year. Its target is to raise that to 14,000. But is that realistic?

The brand has its keen adherents but has been unable to achieve sufficient economies of scale. Since the firm's IPO in October 2018 at nearly £19 per share (much derided by some analysts) the share price has fallen to £4.45 at time of writing – a disastrous investment for those who have held the shares. Aston's chief executive, Andy Palmer, has been criticised by commentators. Analysts at Canaccord believe that the company will have to raise new capital given its 700 million in debt pile. Leading shareholders include a number of Kuwaiti funds and the Italian private equity firm Investindustrial.

The key point about luxury brands is that they are price insensitive (their purchasers gain status from the fact that they are expensive). Also, they tend to be less sensitive to an economic slowdown (the rich, unlike the rest, continue to spend). That is all very well. But unless they pursue electrification they will just become collectors' items for use at private race tracks. Though, at this rate, Aston Martin is likely to disappear well before 2040.

"INVESTORS SHOULD FAVOUR CAR PRODUCERS THAT HAVE INVESTED IN BATTERY TECHNOLOGY AND BATTERY PRODUCTION."

Action

The global automotive industry faces systemic disruption. Demand for new cars is falling as the global economy slows down; people are delaying new purchases in anticipation of electrification and driverless technology; and lifestyle factors cool demand thanks to the sharing economy. The traditional barriers to entry which have protected established volume producers are falling. Evidence for this is that a successful manufacturer of vacuum cleaners and hand dryers (Dyson, private) is currently building a factory which will produce electric cars in Singapore for the East Asian market.

The disruption of the global automotive market could not have come at a worse time for Germany and France. In both countries, car production accounts for a significant proportion of total manufacturing. (Car production accounts for four percent of German GDP but just 0.8 percent of UK GDP). The French automotive industry has been particularly skewed towards diesel since diesel was actually favoured by the tax regime until recently. (Diesel is still cheaper than petrol in France – while the opposite is true in the UK).

In order to profit from the great automotive Armageddon, investors need to cast their nets wider towards the players who will offer a full range of electric vehicles soon – and their principal suppliers. There are a few guidelines we can apply.

First, sales of battery-powered cars are rising rapidly while those of hybrid engines are already in decline. This is partly due to a change in subsidy regimes. Volume manufacturers that have hedged their bets with hybrid engine models have missed the boat. Investors should favour car producers that have invested in battery technology and battery production. One such is Tesla, which, despite the shortcomings of its management, has consistently blazed a trail in technology and design. Tesla's full potential has still to be unlocked.

Second, volume carmakers which are already supplying the sharing economy are likely to establish a competitive advantage. JLR's deal with Waymo and Volvo's deal with Uber are significant. It's worth noting that JLR's parent company, Tata Motors, is well placed to supply India's leading hail-and-ride operation, Ola, which is growing rapidly.

Thirdly, volume car producers which have a lead in electrification technology, and who are able to supply such technology to their peers will build up a competitive advantage as they begin to set industry standards. Volkswagen stands out with its MET – even though I am not sanguine about Germany in general right now and VW's involvement in the emissions scandal will continue to generate liabilities.

The short-term outlook for the automotive sector is poor − though there could be buying opportunities as share prices are bid down excessively. In the medium term, we should expect more consolidation in the sector as the tipping point nears where sales of electric vehicles surpass those of petrol and diesel-powered cars. That moment could be much closer that we think – perhaps as soon as 2025. Investors will have to keep their eye on this ball.

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.

BY MARK WATSON-MITCHELL

PORTFOLIO INTELLIGENCE

FROM JONATHAN'S COFFEE HOUSE TO THE LSE

Mark Watson-Mitchell looks at the growth of the alternative UK stock markets, including JP Jenkins and NEX.

The London Stock Exchange is one of the world's oldest stock exchanges. It can trace its history back to the Royal Exchange, which was based on the Antwerp Bourse, and set up by Thomas Gresham and Sir Richard Clough way back in 1571.

The Great Fire of London destroyed Gresham's building, leaving the brokers doing business elsewhere in the City of London. When it was rebuilt in 1669, the Royal Exchange realised that stockbrokers were a rude bunch of characters and they were banned.

Over the following 100 years or so, the scene of brokers' dealings switched to other places around the City of London, such as Jonathan's Coffee House.

In 1773, together with about 150 brokers, Jonathan formed a club and set up a much more formal 'stock exchange'.

A veritable force in world markets

Over the years, the London Stock Exchange established itself and has subsequently become a veritable force in world markets. Its rules and regulations, much like English law, have been respected and copied all over the world.

Thousands of companies have come to its market and raised capital for further investment in their businesses or let the market establish a buying and selling price for their shares, which enabled holders to dispose of their positions.

Compliance with the rules and regulations, however, became increasingly strict and exceedingly well defined.

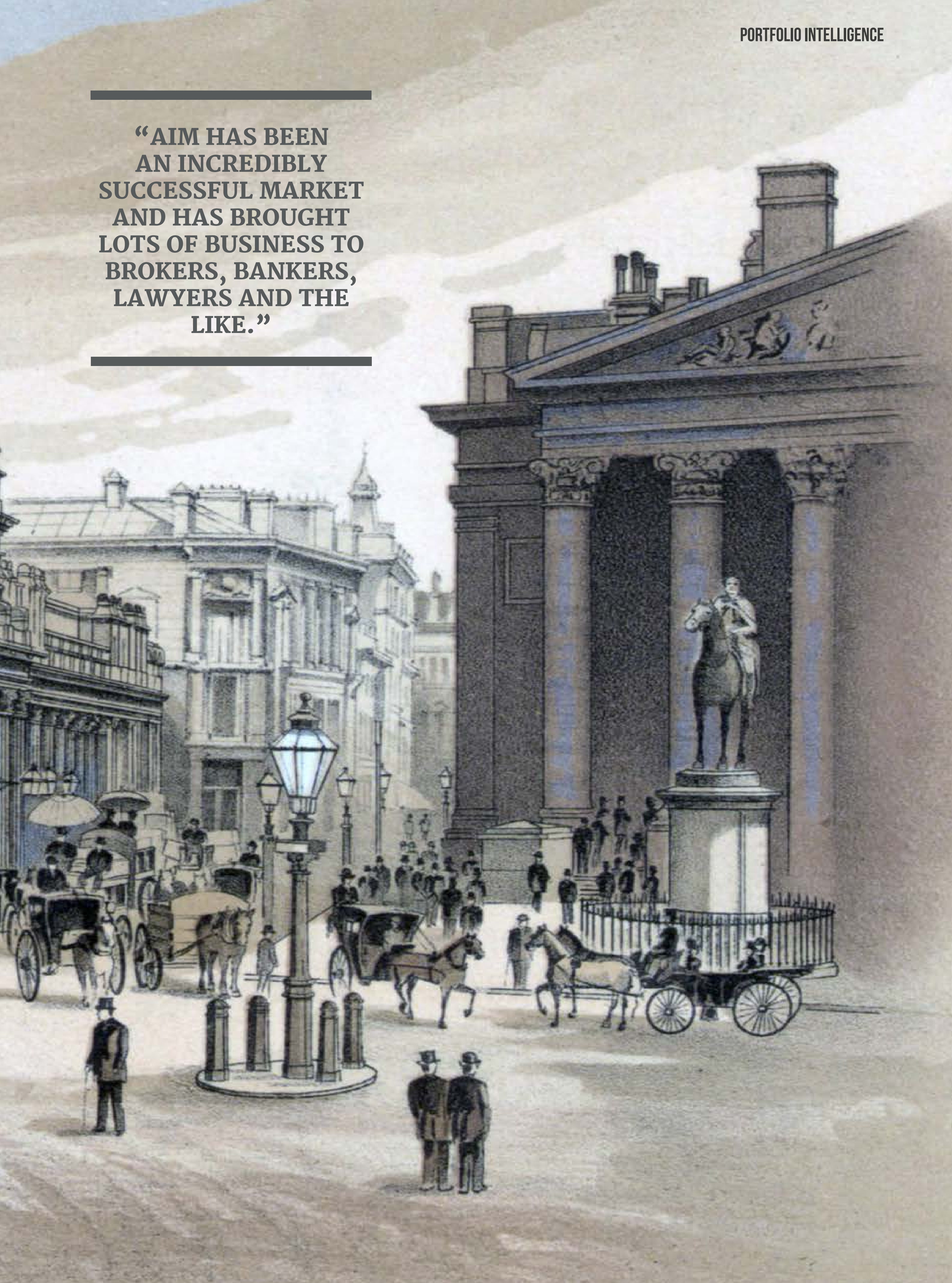
The old market 'floor'

Not all the companies seeking to raise fresh monies were prepared to adhere to the narrow confines of the LSE rulebook. However, they needed markets for the shares of their companies for various reasons, whether for funding or disposal or simply to use as a gauge of value by which to offer their shares to take over another company's capital.

Way back in 1963, when I first went on to the floor of the old Stock Exchange, we used to have stockjobbers calling prices from their books and price boards positioned around the Exchange.

At one end of the market a number of jobbers dealt in mining companies; at another end there were those who dealt with investment trusts; other pitches listed building, property, banks, industrials etc.

"AIM HAS BEEN AN INCREDIBLY SUCCESSFUL MARKET AND HAS BROUGHT LOTS OF BUSINESS TO BROKERS, BANKERS, LAWYERS AND THE LIKE."



> **"THE USM WAS IDEAL FOR ENABLING BROKERS AND INVESTORS TO PARTICIPATE IN THE GROWTH OF COMPANIES TOO SMALL TO QUALIFY FOR A FULL LISTING ON THE STOCK EXCHANGE."**

The 'quick and the dead' and 'matched bargains'

In the section where my broking company had its direct lines to the dealing room, there was one jobber who made markets in entertainment, holiday camps and betting businesses.

That jobber was Sid Jenkins. He also made a 'matched' market in the shares of companies that were not quoted on the Stock Exchange but had good businesses and lots of shareholders. The latter needed a market to help identify the value of their 'unquoted' stocks.

They were what we used to call the 'quick and the dead' – and included local breweries; greyhound-racing stadiums; cemeteries and crematoria; undertakers; football clubs; and local department stores.

The Stock Exchange allowed such dealings on a buyer matched to a seller basis under Rule 163 in its rulebook.

The birth of The Unlisted Securities Market

Over the years, the younger and growth-oriented businesses started to use the market for raising capital, which in due course spawned the Unlisted Securities Market (USM) in 1980. The USM was ideal for enabling brokers and investors to participate in the growth of companies too small to qualify for a full listing on the Stock Exchange.

To gain a full listing for a company, it needed to have at least three years of trading history and be prepared to 'float' at least 25% of its equity. For this new market, companies did not need to show a full three years of history and were expected to offer not less than 10% of their shares to the investing public.

A number of the companies which previously dealt under Rule 163, switched to the USM because of its more relaxed structure.

The Over-the-Counter market

At the same time, a very much less regulated market was growing outside the City – the 'over-the-counter' market, which was operated by licensed dealers in securities. Unfortunately, that led to several ill-based companies being dealt in by even less reputable dealers.

163 becomes 535

Back on the market, the Stock Exchange altered its rulings and what was previously traded under Rule 163 switched to trading under Rule 535 status.

USM becomes AIM

The USM had a few hiccups along the way. The Stock Exchange closed it in June 1995 and introduced the Alternative Investment Market (AIM), with very much the same ruling strictures.

AIM has been an incredibly successful market and has brought lots of business to brokers, bankers, lawyers and the like. It too has been up and down and had several near misses, but it motors onwards.

JP Jenkins and OFEX

In the early 1990s, Sid Jenkins' son John and one of his dealer colleagues set up JP Jenkins as an alternative platform for unquoted companies who did not want to or could not afford to pay for the costs of a listing on the USM.

When the USM became AIM in 1995, the JP Jenkins company established the OFEX Market to offer a 'lighter touch alternative' to AIM. It became a very successful market structure and at one stage had several hundred companies quoted through its system.

OFEX becomes PLUS becomes NEX

Unfortunately, OFEX failed to secure some required funding in late 2004 and collapsed. It was subsequently subsumed and resurrected as PLUS Markets.

But the financial crisis of 2008 started to rot away its foundations and it made a massive £8m loss that year. The next year was worse, with a £10m loss. Its demise was predicted in May 2012, but a bid from ICAP saved the day.

That market, which is now known as NEX Exchange, was recently acquired by **Aquis Exchange (LON:AQX)**, in a £2.7m deal. NEX Exchange classes itself as the UK-based stock market for growth enterprises. It is one of only four equities-focused Recognised Investment Exchanges in the UK. It works with 51 registered brokers, seven market makers and has 89 companies currently listed on its two markets, with a combined market capitalisation of approximately £1.9bn.

JP Jenkins and Peterhouse

The JP Jenkins name was acquired by Peterhouse Corporate Finance in April 2013. Today it operates as a trading platform for unlisted companies, enabling prospective investors and existing shareholders to trade in their shares.

It provides a trading facility in companies that may have de-listed from the LSE, AIM, NEX Exchange Growth Market or companies that have raised finance through crowdfunding and EIS schemes.

Listed below are just a few of the companies using the JP Jenkins platform.

Alpha Prospects
Symbol: APHP | Price: 2.50p
An investment company in both unquoted and quoted, fast-growing companies and those with strong recovery prospects.

Camper & Nicholsons Marinas
Symbol: CNMI | Price: 8.5p
A top-tier marina management business for the last 40 years, providing services to clients from over 25 countries worldwide.

Dyson Group
Symbol: DYS | Price: 7p
Research, development, manufacture and sale of technical ceramics products for the steel, glass and other industries.

InterQuest Group
Symbol: ITQ | Price: 13p
A specialist technology recruitment business for analytics, networks, information security, change management, digital and information-technology sectors.

Millwall Holdings
Symbol: MCR | Price: 175p
Millwall Football Club operations and related activities.

NCI Vehicle Rescue
Symbol: NCI | Price: 40p
A UK-based insurance broker, focused on car, home, pet and personal-lines insurance products. It also operates an online vehicle breakdown recovery service.

Rangers International
Symbol: RFC | Price: 18p
The holding company for Glasgow-based Rangers Football Club, one of the world's most successful clubs.

Richoux Group
Symbol: RIC | Price: 1p
Operates 15 restaurants under four different brand names: Friendly Phil's Diners, Richoux, Villagio and The Broadwick.

Viscount Mining Corporation
Symbol: VML | Price: 0.23p
This company is a project generator and explorer; it has a portfolio of gold and silver properties in Colorado and Nevada.

Tony Baggett / Shutterstock.com

The NEX Exchange Growth Market

This is a market for earlier stage, entrepreneurial companies seeking access to growth capital. Its regulatory framework is specifically designed to meet the needs of smaller companies.

The exchange states that its admission criteria and ongoing obligations are as simple as possible to allow management to focus on running the business and generating returns for shareholders, while still protecting investors.

Listed below are just a few of its 89 constituents.

Adnams
NEX: ADB | Price: £93.50
Based in Southwold, on the Suffolk coast, this company is a brewer, distiller, pub owner and retailer. Brewing for over 140 years, it produces a range of award-winning cask and bottled beers, which are now available in pubs and supermarkets nationwide.

Ananda Developments
NEX: ANA | Price: 0.29p
This company is focused on the medicinal, therapeutic and wellness cannabis sectors and currently has three key areas of endeavour. It has an interest in Israel Cannabis, a global leader in medicinal cannabis research as well as a 15% shareholding in Liberty Herbal Technologies, which is developing a technology for the dry vaping of medicinal cannabis. Indirectly it also owns 50% of the DJT Group which is pursuing a licence to grow THC cannabis in the United Kingdom.

Coinsilium
NEX: COIN | Price: 3.6p
Since 2014, this company has been investing in seed-stage, blockchain-technology ventures, helping founders through the key stages of growth. It describes itself as a venture builder, investor and advisor, supporting early-stage blockchain-technology companies and the digital-token economy. In 2015 it was the first ever IPO of a blockchain company. It harnesses its experience and wide-ranging network to invest in some of the world's leading blockchain projects.

Daniel Thwaites
NEX: THW | Price: 120p
This award-winning craft brewery, pub, hotel and leisure company was founded in 1807. Based in Lancashire, it has a portfolio of 250 tenanted pubs. Across the country, it also has a fast-growing managed inns business, with accompanying lodges and spas. The focus of its business is on providing customers with 'big hospitality' in outstanding properties situated in great locations.

Eight Capital Partners
NEX: ECP | Price: 0.025p
Based in London, this company provides equity, debt and equity-related investment capital to companies seeking capital for growth and development; consolidation or acquisition; or pre-IPO financing. It has specific interest in the technology, media and telecoms and the financial-services sectors.

European Lithium
NEX: EUR | Price: 0.073p
This mining exploration and development company is focusing on its Wolfsberg Lithium Project in Austria. The wholly owned mine is located in Carinthia, 270km south of Vienna. It aims to be the first local lithium supplier into an integrated European battery supply chain for electric-vehicle makers.

Hydro Hotel
NEX: HYDP | Price: 725p
Dating way back to 1895, this company states that from its elevated setting, the four-star-rated Hydro Hotel boasts one of the best hotel panoramic and sea views in Eastbourne and East Sussex. It offers an array of function rooms, large lounges and 82 bedrooms, the majority of which have been refurbished since 2016. It has over 420 shareholders.

Lombard Capital
NEX: LCAP | Price: 2.75p
Based in Bedford, this company is an investor in pre-IPO companies and companies on AIM and NEX. It is also now focused on the unique opportunity of producing secure bond investments where the instrument is fully secured by reinsurance or by tangible assets. Strong progress is being made towards this target.

National Milk Records
NEX: NMRP | Price: 127.5p
As part of the integrated UK dairy supply chain, this company guarantees milk quality and supply. Every day, it receives a sample of milk from every dairy farm, for testing. It also tests half of the individual dairy cows in the country every month. The company works 24 hours a day for 365 days a year.

Netalogue
NEX: NTLP | Price: 3.75p
This company offers a leading business-to-business ecommerce software platform for building enterprise-class website solutions for manufacturers, distributors and wholesalers. It includes sophisticated online catalogues, online stores, buyer self-service and complimentary mobile ecommerce app functionality.

Newbury Racecourse
NEX: NYR | Price: 755p
For just 29 days every year, this racecourse company stages top-class flat and jump horse racing. It also creates income from promoting exhibitions, conferences and outdoor events on its premises. Of potentially greater interest is a joint-venture agreement with David Wilson Homes to redevelop the racecourse and construct 1,500 new homes.

NQ Minerals
NEX: NQMI | Price: 3.5p
Based in Australia, this is a gold and base metal exploration and development company, which is looking to move into near-term revenue generating production. Its Hellyer Mine in Tasmania, acquired earlier this year, contains over $1bn of gold, silver, zinc and lead in situ and is believed to have significant existing infrastructure. The company plans to fast-track its mine into production within 12 months, thereby hoping to generate both cash flow and profitability. The company also has two other metal projects.

Sativa Investments
NEX: SATI | Price: 6p
As an investment vehicle, this company looks to take advantage of the highly fashionable and rapidly growing medicinal-cannabis market. It seeks returns from investing in well-placed opportunities, concentrating on the areas of research, development, production, testing and compliance, pharmacology, commercialisation and the sale and marketing of medicinal cannabis.

Shepherd Neame
NEX: SHEP | Price: £10.10
Founded in Kent in 1698, Britain's oldest brewer is a family business, brewing widely acclaimed premium ales including 'Bishops Finger', 'Whitstable Bay Pale Ale' and 'Spitfire'. From its brewery in Faversham, it also brews internationally renowned lagers such as 'Samuel Adams Boston Lager'. All of its beers are sold through various channels across the South East of England and nationally. The company also has a growing presence in international markets.

The Barkby Group
NEX: BARK | Price: 4.75p
Focused on Gloucestershire, Oxfordshire and West Sussex, this company is a boutique hospitality group offering premium gastropubs, inns and function spaces. It owns five gastropubs and 42 hotel rooms in total. Its intentions are to build up to around 10 sites over the next five years. The group also owns the recently acquired Centurian Automotive company, which sells quality, used cars.

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

TAKE ANOTHER LOOK AT THE DISCOUNT TO BOOK

Richard Gill, CFA, takes a closer look at three small caps trading at less than their net asset value.

Valuing shares can often be more of an art than a science. But a relatively simple way – and one which has been shown by academic research to pick winners – is by comparing the price of a company on the stock market to the value of its net assets (or equity shareholders' funds). In other words, investors should look at the price-to-book value ratio (aka the P/B ratio).

If I offered you an opportunity to buy a £10 note for less than its face value, you'd probably think it was either a scam or too good to be true. But that is exactly the chance you have when company shares are trading at a discount to their book value. Well, at least in theory.

If the P/B ratio is less than one, meaning that net assets are higher than the market cap, then you effectively have the chance to buy something for less than its worth. Say for example, Big Bucks plc has £100 million of net assets on its balance sheet but the market cap is only £50 million; this means you can effectively buy a tenner for the price of a fiver.

Word to the wise

As I said, this is a simple method of valuing shares and when using it investors should keep several matters in mind. First, remember that there are a number of accounting tricks available for valuing assets at more than they could be realised for. Inventories, for example, may be given a price higher than their readily realisable value, and debtors, especially long-lived ones, might never pay their bills. That's why investors prefer solid, tangible assets like property and cash – assets whose value are more easily determined.

> **"INVESTORS PREFER SOLID, TANGIBLE ASSETS LIKE PROPERTY AND CASH – ASSETS WHOSE VALUE ARE MORE EASILY DETERMINED."**

Another key point is that the P/B ratio includes all the intangible assets on a company's balance sheet, ie things such as goodwill paid for acquisitions, brands and intellectual property. Theoretically, these could be worth nothing, so the more prudent investor would strip these out of the calculation and look for companies which trade at a discount to tangible assets only.

A related matter is that the P/B ratio is a more relevant valuation metric for companies in certain industries. These include the likes of financials, property and investment trusts – sectors which tend to have high levels of tangible assets and are typically valued by investors in relation to these. Such companies tend to trade close to their net asset values (NAVs), with a P/B ratio of close to one, so if they are selling at a discount, they could prove to be a good buy in the longterm. Take banking for example. In London, HSBC is current trading at a price to NAV of 0.8 times, with RBS at 0.5, Barclays at 0.4 and Lloyds at 0.7.

In contrast, software and technology aren't good sectors to apply the P/B ratio to, as companies in these sectors typically create value from their employees, intellectual property and know-how. As a result, these businesses tend to have high P/B ratios. Some UK-based examples here include property website Rightmove, which is on a P/B multiple of 377 times, online car-sales marketplace Auto Trader on 84 times and, in the US, Netflix on 25 times.

Of course, like any financial ratio, price-to-book value should not be looked at in isolation. In particular, a company's wider financial statements should always be looked at to filter out any poorly performing or financially distressed businesses, many of which can trade on low P/B ratios as a result of their troubled situation.

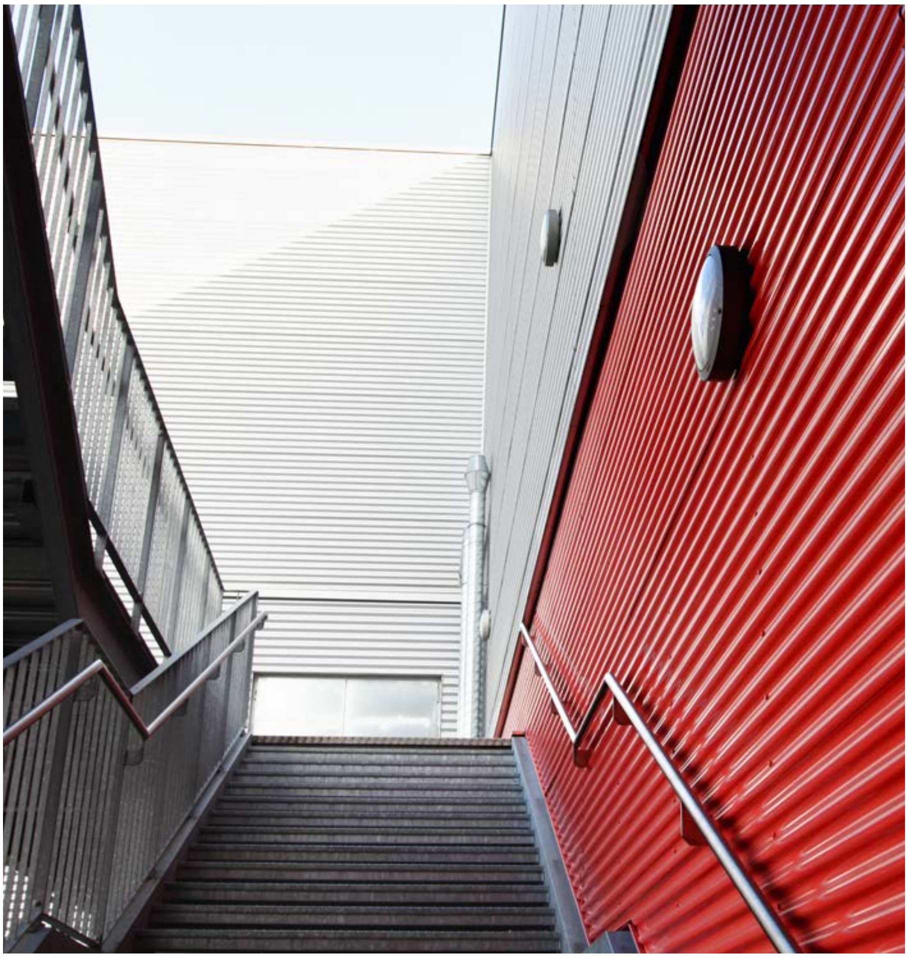
Having done my monthly sift through the data, here are three small-cap companies which are currently trading at a discount to their last reported NAV and look worthy of considering for your portfolio.

"LIKE ANY FINANCIAL RATIO, PRICE-TO-BOOK VALUE SHOULD NOT BE LOOKED AT IN ISOLATION."

J SMART & CO CONTRACTORS

In August every year, hundreds of thousands of visitors and thousands of comedians and other artists head to Edinburgh for the annual Fringe Festival. While having launched the careers of many performers, the Fringe Festival has been criticised in recent times for the huge costs associated with involvement in the event, not least property rents. An estimated 10,000 AirBnB properties in the city now rake in rental income from the huge seasonal spike in demand for accommodation.

One other company making money from property in the Scottish capital is FTSE Fledgling-listed **J Smart & Co. Contractors (SMJ)**. The family-run business was founded in 1947 to carry out a range of building and civil-engineering works. Today it has a wider presence in central Scotland and carries out construction work on developments including public works, shopping centres, offices, factories, warehouses and private housing, as well as for local authorities and registered social landlords.



Another strand to the business, and key to the investment case, is its property investment portfolio. This includes a range of commercial and industrial developments which are retained for rental income and capital appreciation. The current portfolio totals more than around one million square feet and includes a variety of small and large industrial units, retail sites, office developments, serviced offices and other development sites.

SMART

Subtle Scots

J Smart is one of those businesses which is very quiet on the news front, only really providing the interim and full-year numbers as well as standard regulatory announcements. Looking through the historic annual reports, the construction business doesn't look particularly attractive as a standalone unit to me, as it has not made an operating profit since 2011. Indeed, one loss-making subsidiary, Concrete Products (Kirkcaldy), was shut down last year. However, the company's investment activities look a lot more appealing.

This is where the value is in my opinion, with the investment portfolio bringing in £6.35 million of rental income and service charges in the year to July 2018 and £3.73 million after direct property costs. At group level, net profits for the year were up by 30% at £4.85 million after a £2.86 million net surplus was booked in on the revaluation of investment properties. The business has been profitable every year since 2013, with 2012 seeing a modest £0.53 million loss after a £4 million revaluation deficit.

The balance sheet is where investors should go to see the value on offer here. As at the most recently reported date of 31 January 2019, the largest asset was investment properties which were in the books at a total of £69.6 million. Other major items included £11.8 million of inventories and £22.25 million of cash. At the bottom line, net assets were £96.2 million. However, there is a key point in the results which investors should take notice of. In line with many companies in the sector, J Smart does not have its investment properties revalued at the interim stage of its financial year. Had it done so the company believes, *"... there would have been an uplift in the valuation, which would have had a material effect on the headline figures."*

"THE BALANCE SHEET IS WHERE INVESTORS SHOULD GO TO SEE THE VALUE ON OFFER."

Smart choice?

With a current market cap of £49.5 million, J Smart trades on a P/B ratio of just 0.51 times, which is pretty much like getting a tenner for the price of a fiver. Remember too that the property portfolio was likely worth more at the half-year stage, which means that the discount is probably even deeper. There are income attractions here too, with last year's total dividend payment of 3.16p equating to a yield of 2.76% at the current share price of 114.5p.

So, is this an incredible opportunity to buy the shares or does no-one really want them? The main caveat here is that, aside from the property industry being cyclical, the company is majority-owned by directors David and John Smart who have a combined stake of around 57%. Nevertheless, it seems that they have identified the huge discount to NAV, with the company currently undertaking a moderate share buy-back programme.

For investors who want to enjoy a modest income while patiently waiting for value to be realised, J Smart is a long-term buy and hold.

1PM

One company which I have written about many times over the years is alternative-finance provider **1PM (OPM)**, which provides finance to a range of UK businesses across the areas of asset, vehicle, loan and invoice finance. The business model sees 1PM bringing in money from a range of sources, including block discount facilities, secured loans from high-net-worth individuals and from its own balance sheet, then lending it out to SME customers at a higher rate.

1PM has been a rapidly expanding business for several years now, especially so following the appointment of Ian Smith as chief executive in February 2016, with growth being driven by a number of complementary acquisitions, along with organic expansion. In the 2018 financial year (to May) revenues were a record £30 million, with net profits of £6.4 million. These contrast with the 2012 figures, which showed revenues of just £2.31 million and net profits of £0.35 million. The headline strategic aim is to increase the lending portfolio to £350 million by the 2023 financial year, up from around £134 million this May.

Dinner time

The most notable event of recent times was the company's full-year 2019 trading statement. It reported that unaudited figures show revenues for the period up by 6% at £31.8 million, and profit before tax and exceptionals up 4% at £8.2 million. Earnings however are expected to be up by a more modest 2% to 6.6p per share after new shares were issued to satisfy acquisition earn-outs. Encouragingly, over 50% of revenues for the current year are already secured as unearned income, providing a good degree of visibility. More notable for this article, net assets were said to be in excess of £53 million at the period end, up from £51 million at the interim stage.

While there were no nasty surprises in the announcement, shares in 1PM plunged by around 25% following the news. In my view, investors did not take kindly to comments that the current financial year is expected to be one of investment and consolidation, with future benefits being derived from these actions in ensuing years. With the market having been used to consistently strong growth, it responded accordingly.

Only Profits Matter

In my view, the recent price plunge provides an excellent opportunity.

“THE SHARES TRADE ON A HISTORIC MULTIPLE OF JUST FOUR TIMES.”

With a current market cap of just £23.2 million, the shares trade at a whopping 56% discount to the reported £53 million of net assets as at 31 May 2019. These assets mainly consist of loans due from customers and accrued interest income. Even if we strip out the £27.85 million of goodwill on the balance sheet as at 30 November 2018, the shares still trade at a discount to tangible NAV of around 8%.

1PM also looks cheap according to other valuation metrics. With earnings of 6.6p per share expected for 2019, the shares trade on a historic multiple of just four times. This looks very cheap for a business which has grown profits 18-fold since 2012 and is looking to more than double its lending portfolio over the next three years. What's more, in July last year the company confirmed details of an enhanced progressive dividend policy under which the final dividend of 0.65p for 2018 will be increased by 30% for the following three financial years. That implies a payout of 0.84p for 2019 and a reasonable yield of 3.17% at the current share price of 26.5p.

While credit risk is a concern, along with the ongoing ability to borrow funds at attractive rates, 1PM looks like a buy for the long term.

NORTHGATE

Finally, a somewhat overlooked FTSE Small Cap constituent is the vehicle-hire outfit **Northgate (NTG)**, which began operations in 1981.

NORTHGATE
DRIVING BUSINESS FORWARD

The business is one of Europe's biggest light commercial vehicle-hire companies, operating a fleet of over 100,000 vehicles in the UK, Spain and Ireland.

The core business is the hire of light commercial vehicles, such as vans and cars, to businesses on a flexible or minimum-term basis. This is an attractive alternative to buying vehicles outright, as customers can avoid the high initial capital outlay involved with vehicle ownership; it brings cost certainty; and clients can quickly and easily change vehicles according to their needs.

As well as making money from the hire of vehicles, Northgate also has an active vehicles-sales business segment and provides a number of complementary services in the wider B2B vehicle-rental sector such as fleet and accident management solutions. In the last financial year, just under two thirds of revenues came from the UK and Ireland, with the remainder coming from Spain.

Van-tastic numbers

Strong and solid is a good way to describe Northgate's results for the year to April 2019, with revenues up by 10% at £517.6 million and pre-tax profits surging by 14.5% to £60.4 million. The results were driven by a strong showing from the UK and Ireland operations, with Spain seeing good vehicle-hire growth but a fall in vehicle-sales proceeds. As a result of the performance, the total dividend for the year was increased by a modest 3.4% to 18.3p per share.

As with all the companies in this analysis, the balance sheet is where the most interesting reading can be found. Northgate's standout asset is £0.9 billion worth of vehicles for hire, added to another £69 million of other property plant and equipment. So, the balance sheet is backed by a significant amount of hard assets, with the intangibles being an almost insignificant £15 million. Northgate is heavily financed by borrowings however, with net debt at the period end of £437 million. The crucial net-asset figure was £563.6 million.

Fleeting chance to buy?

Northgate shares haven't had a great year so far, with the current price of 336p down from a recent peak of 565p in March 2017. At that price, the discount to NAV is 17% and the historic earnings multiple is a lowly 8.7 times. The yield on last year's dividend payout is an attractive 5.4%, with the payment policy being progressive.

There are some clear concerns here, as Northgate has high capex costs from replacing its fleet, and interest payments on debt are quite large. However, they were covered a comfortable five times by operating profits last year. With operations in the EU, Northgate has also identified some Brexit-associated risks, in particular potential disruption to the supply of new vehicles and vehicle components imported into the UK from the EU, including additional import costs. However, on the whole it expects these to be short term in nature.

Analysts at Peel Hunt have a 450p target on the stock, which implies upside of 34% from the current price. Ahead of a planned Q1 trading update on 23 September, I believe that investors should get on board.

"STRONG AND SOLID IS A GOOD WAY TO DESCRIBE NORTHGATE'S RESULTS."

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 BEN LOFTHOUSE OF HENDERSON INTERNATIONAL INCOME TRUST

BEWARE THE DISRUPTIVE REGULATORS

Regulations can often be positive for industry incumbents, but investors need to be wary of regulator change, explains Ben Lofthouse of Henderson International Income Trust.

Highly regulated industries, like financial services, telecoms and utilities, can often contain companies with attractive dividend yields. Bureaucratic and often complex, regulations are the unseen forces that can protect or disrupt a company's profitability – and ultimately the dividend it pays to shareholders.

In many cases, regulations are a barrier to entry for outsiders and a competitive advantage for incumbents. So, for income-seeking investors, it makes sense to gain a healthy exposure to companies operating in industries with tough or complex regulations, where it is harder for new entrants to take market share. Global portfolios are best placed to access regulated industries, in our view, as they provide flexibility to diversify regulatory risk across both sectors and countries.

Regulations with disruptive consequences

Investors need to be prudent, as regulations are constantly evolving. Often with new governments and shifting sociopolitical sentiment, regulations can change and quickly become troublesome to the incumbent market leader(s). You only need to look at one of the UK's largest energy providers, **Centrica (LON:CNA)**, to see the disruptive potential of regulatory change. As well as encouraging new competition over the past five years, the UK energy regulator, Ofgem, introduced a new energy price cap at the beginning of 2019, which has seen the company's share price slide as investors anticipate pressure on future revenue.

Unlike Centrica, investors can mitigate some of these risks by diversifying their exposure to different regulatory environments within the same sector. So that might mean you own shares in gas companies in the US, Europe and Asia, as well as a UK provider, in order to maintain exposure to the sector without being too exposed to the whims of a single supervisor.

At **Henderson International Income Trust (LON:HINT)**, we have a global (ex. UK) mandate to deliver a growing dividend for our shareholders, as well as grow shareholders' capital. That means we are looking for companies that pay an attractive dividend or have strong potential to grow their dividends in the medium term. The portfolio does invest in regulated companies, but focuses on diversifying the exposures by country to avoid too much exposure to one regulatory environment.


REGULATIONS

Roughly 10% of the HINT portfolio is invested in telecom companies (telcos). The varied approaches to telco regulation between countries and regions means the returns profiles of companies within the sector can differ markedly. One of the major discrepancies here is the way in which companies are permitted to access and distribute network coverage.

Tricky telcos

Telcos rely on radio waves called 'spectrum' to provide wireless services to customers. Spectrum at key frequencies is scarce and is allocated via auctions. These auctions can be competitive and costly, with telcos aiming to recoup the investment over time by selling mobile services. In the US, telcos buy perpetual rights to spectrum, while European telcos purchase the rights for a set time period, after which they must bid to renew their licences.

The difference between European and US spectrum regulations means that US companies have more time to recover the costs and more certainty around their return on investment. In Europe, competition is often encouraged with auctions being employed as a mechanism to introduce new mobile operators into the market.

More recently, the regulatory environment in some European countries has shifted focus from encouraging competition to supporting investment. In France, for example, the regulator provided an extension of some existing spectrum licences on the condition that the telcos invest to provide service across the country, including rural areas. This serves to benefit the telcos, government and consumers by accelerating the pace of network investment at a lower overall cost.

The Trust holds a position in **Orange (EPA:ORA)**, France's largest network operator, which we see as positioned to benefit from the more supportive regulatory environment, as well as the French supervisor's openness to market consolidation. This could drive a more stable competitive environment, supporting higher returns and providing greater capital flexibility to invest in next-generation networks. Orange is also a multinational operator, which means it is exposed to different regulators, thus mitigating the risks associated with operating under a single regulator.

In other countries we have taken profits and decided to exit the market entirely because the pendulum is beginning to swing the other way. In Japan, the regulator is encouraging new competition and pricing pressure, which we feel is unsupportive for dividend growth. The Canadian regulator, on the other hand, has been more consistent, and the three-player market has supported rational competition and gradual pricing growth over the years.

Generally speaking, the telecom sector is cash generative and provides attractive dividend yields; we continue to focus on investing in companies that are exposed to a regulatory framework that allows companies to balance cash flow generation and investment.

“REGULATIONS CAN CHANGE AND QUICKLY BECOME TROUBLESOME TO THE INCUMBENT MARKET LEADER(S).”

Financials' difficult decade

The largest weighting by sector in the HINT portfolio is financials, which includes retail banks, insurers, asset managers and investment banks. This is perhaps the most regulated sector of all, but since the global financial crisis (GFC) of 2007-08, regulators have moved at different speeds and with different areas of focus, giving rise to vastly different operating conditions around the world.

For example, financial institutions on either side of the Atlantic are operating in widely different regulatory environments. For the past two years or so, US regulators have been relaxing some of the more stringent rules introduced around capital reserves post-GFC, affording companies more flexibility on the balance sheet. In Europe, on the other hand, the pace of reform has been much slower, and companies are still adapting to complex regulations and their new supranational supervisors, including the European Banking Authority (EBA) and insurance and pensions supervisor EIOPA.

As a result, European financial institutions, including British-based firms, have endured a difficult decade of regulatory reform and tough economic conditions. Some companies, however, have invested well and adapted, putting them in a strong position as the dust settles after the regulatory upheaval in the aftermath of the GFC. One such company we feel has managed this is France-based multinational insurer **Axa (EPA:CS)**.

With its European life-insurance business under immense pressure, owing to strict capital-intensive rules and ultra-low interest rates, the group has diversified its business mix through a number of takeovers and acquisitions. Last year, the group completed the full takeover of Bermuda-based XL Catlin (formerly XL Group), a property and casualty insurer with large operations in the US; and more recently it acquired a smaller and relatively new underwriter called Vindati, which specialises in US marine cargo.

We believe these deals put Axa in a stronger position to overcome the economic and regulatory hurdles it faces in Europe right now, providing a desirable exposure to US financial regulation and high-growth business areas within the insurance industry.

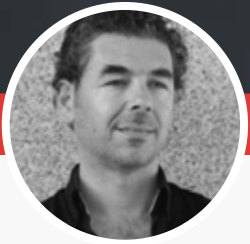
In summary, there is little to gain from owning shares in different companies that have the same regulator; it is far more prudent to find overseas firms with supportive regulators. That's exactly what we have been doing at HINT. With a mandate to deliver a growing income for our shareholders without investing in the UK, we look for companies operating in cash-generative industries with supportive regulation, which should provide a very healthy diversifier for investors with exposure to UK domestic stocks.

"WE LOOK FOR COMPANIES OPERATING IN CASH-GENERATIVE INDUSTRIES WITH SUPPORTIVE REGULATION."

About Ben Lofthouse

Ben Lofthouse is Head of Global Equity Income at Janus Henderson Investors, a position he has held since 2018. Prior to this, Ben was a director and has been part of the Global Equity Income Team since joining Henderson in 2004. He has managed Henderson International Income Trust since its launch in 2011. Prior to Henderson, Ben worked as an accountant at PricewaterhouseCoopers, where he started his career in 1998. Ben graduated with a BA degree (Hons) in business economics from Exeter University. He is an associate of the Institute of Chartered Accountants in England and Wales (CA) and holds the Chartered Financial Analyst designation. He has 21 years of financial industry experience.

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



BY FILIPE R. COSTA

THE MACRO INVESTOR

HOW TO BUILD A QUALITY PORTFOLIO FOR RISING VOLATILITY

In the light of a widely anticipated economic slowdown, Filipe R. Costa explains how quality factors can be used to manage an effective portfolio.

Is the 10-year market rally coming to an end? Do central banks around the world have the necessary tools to avoid a recession? At a time of rising volatility, investors must take action. But that doesn't necessarily mean replacing bonds with stocks. Investors may instead increase exposure to quality.

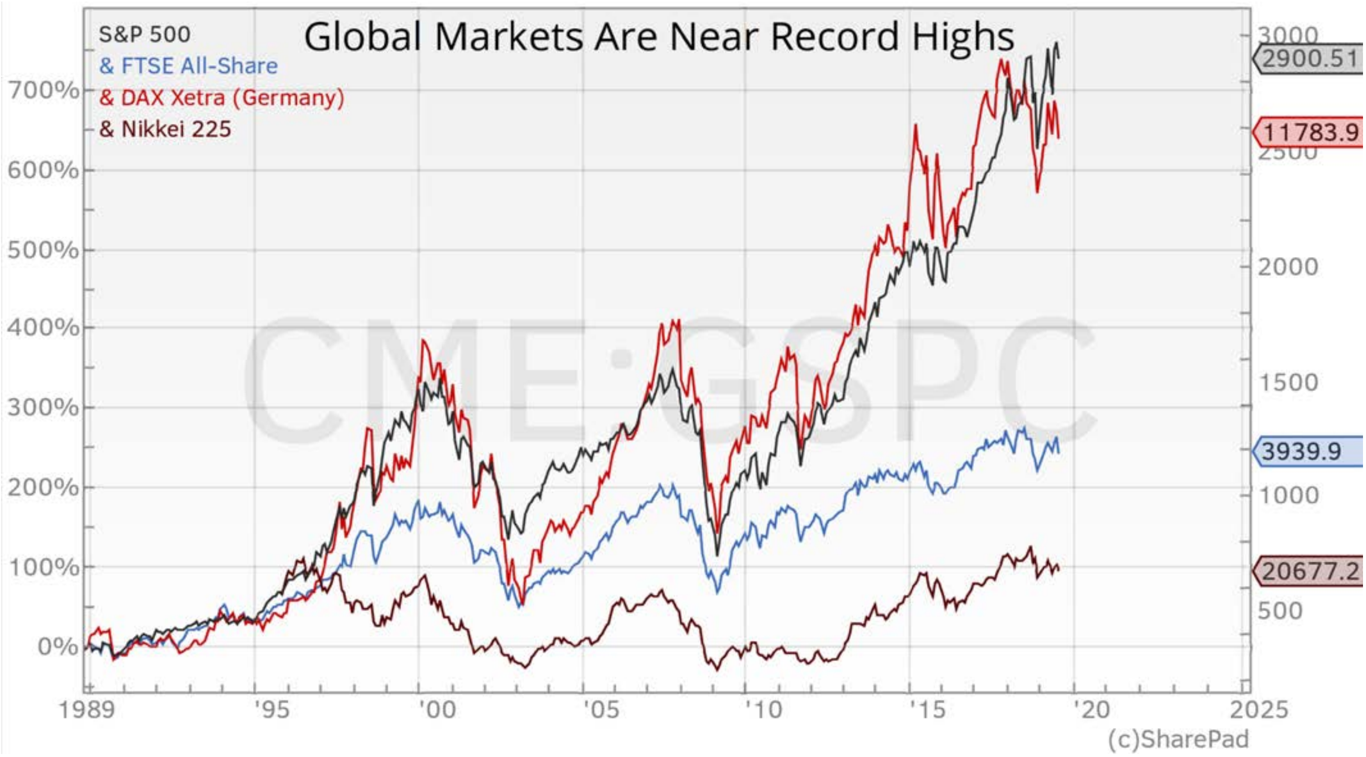
The boom of the US equity market following the aftermath of the 2007-2009 financial crisis has been spectacular both in magnitude and duration. In 10 and a half years, the S&P 500 rose by 325%, rewarding investors with a compounded rate of 14.8% per year. The global economy recovered well and the US economy, in particular, experienced expansion, along with subdued inflation and record low unemployment. However, there are now signs which give cause for concern. For instance, the latest GDP figures point to contraction in Germany and the UK, and slowing growth in the US. This comes at a time when central bankers have limited conventional policy tools, with interest rates currently at 2.25%. Against this backdrop, questions are being asked as to the best way to manage an effective portfolio.

Should investors reduce exposure to equities while increasing exposure to bonds? The conventional view, in terms of portfolio management, is that it's best to group assets into classes according to their risk-return characteristics. Bonds do well in recessions; equities do well in a positive economic environment. Thus, increasing bond exposure should improve returns and/or reduce risk when the economy is moving from boom to bust. However, with interest rates so low at the moment, it's hard to foresee further decreases in bond yields and therefore the upside potential for bonds seems limited.

"FOR INSTANCE, THE LATEST GDP FIGURES POINT TO CONTRACTION IN GERMANY AND THE UK, AND SLOWING GROWTH IN THE US."

What about investing in specific factors that do well in uncertain times? An unconventional approach to portfolio management is to divide assets according to different factors, ie characteristics, that are associated with higher returns. All we have to do is to identify the prevailing factors for volatile times and then, using accounting ratios, match them quantitatively.


Total
Other
Utilities
Travel



The investment case

In my view, it's not time to write off the equity market, but we need to be cautious, because there are hints of tougher times ahead. When the economy cools and sentiment turns from neutral to negative, turnover and profit estimates are slashed and equity prices decrease, with some stocks more exposed than others. Positive sentiment usually boosts the smaller, harder-to-value stocks, more than established companies. When sentiment is high, investors are attracted to stocks that show unstable cash flows and profits, high leverage and high growth potential. However, when sentiment changes, and money becomes more valuable, investors look for safety, offered by stable cash flows and profits, moderate leverage levels and reasonable growth prospects.

Profitability and quality are the key traits to look for in stocks at a time of rising volatility. The next step would be to match quality and profitability against accounting ratios that can proxy them. This is something an individual investor can do, with the help of a good stock screener.

To help individual investors build their own portfolios, I will now go through the process of selecting stocks on the basis of quality/profitability. For the 'lazy' investor, there's an alternative way to get exposure to that factor, ie through exchange-traded funds (ETFs) that select investments based on certain rules (smart beta approach).

Equities can be broken down into five key factors

Market beta is the key factor for explaining asset returns. It expresses the degree to which an asset tends to move within the broad market. An asset with a higher market beta is a kind of leveraged market bet and it therefore comes with higher expected return and risk. The other key factors are size, value, momentum and quality/profitability.

The size factor captures the compensation for bearing the additional risk of investing in less-known, smaller companies; value captures the tendency for relatively cheap assets to outperform relatively expensive ones; and the momentum factor captures the reward for buying the best-performing assets while selling the worst-performing ones.

The profitability factor captures the outperformance of profitable firms that are less susceptible to negative macroeconomic conditions. In selecting these companies, investors earn a premium above the market return, which is particularly in demand at times of recessions and high volatility. In fact, quality is an extension of the profitability factor; it encompasses profitability as well as other characteristics that high-quality companies have, such as low profit volatility; high profit margins; high asset turnover; low financial and operating leverage; and low stock-specific risk.

TABLE 1: THE FIVE FACTORS THAT EXPLAIN STOCK RETURNS (1927-2015)

	Market Beta	Size	Value	Momentum	Quality
Average Annual Premium (%)	8.3	3.3	4.8	9.6	**3.8**
1-Year Odds of Outperformance (%)	66	59	63	73	**65**
3-Year Odds of Outperformance (%)	76	66	72	86	**75**
5-Year Odds of Outperformance (%)	82	70	78	91	**80**
10-Year Odds of Outperformance (%)	90	77	86	97	**89**
20-Year Odds of Outperformance (%)	96	86	94	100	**96**

Source: "Your Complete Guide To Factor-Based Investing" (2016)

"IT'S NOT TIME TO WRITE OFF THE EQUITY MARKET, BUT WE NEED TO BE CAUTIOUS, BECAUSE THERE ARE HINTS OF TOUGHER TIMES AHEAD."

The proxies for the quality factor

The big question about the quality factor is: *how can we build the quality factor quantitatively?*

We need to find a few simple accounting ratios that serve as proxies for quality. There is extensive academic literature on the accounting ratios to use; however, a key characteristics of the factors I mention above is their robustness to various measures. That means that, no matter the proxy used to target quality (provided it is reasonably related to that factor), the quality premium should be present. In a football game, a goal will always be a goal, no matter where you're watching it from.

For the sake of capturing quality traits from a list of equities, I use the following proxies:

1. **Return on Capital Employed (ROCE)** – ROCE measures profits before interest and taxes (EBIT), which I believe is the best measure of profits. Capital employed is also a better measure than assets or equity, because it measures the amount of capital from all sources. ROCE is more precise than return on assets (ROA) and return on equity (ROE). I use trailing 12-month figures here.
2. **Cash Return on Capital Employed (CROCI)** – Good companies should have a consistent ability to earn high profits on the money invested, as measured by ROCE. However, some companies have difficulty in converting those profits into cash. Good companies should be able to produce lots of surplus free cash flow. CROCI is calculated by dividing free cash flow by capital employed. This ratio gives an idea of how good the company is at converting profit into cash and it's much more difficult to 'massage' cash than profits. Similar to ROCE, I use trailing 12-month figures.
3. **Debt-to-enterprise value** – As leverage tends to be a problem during hard times, we prefer to focus on companies with sound balance sheets that can overcome bad times without taking on too much debt. The lower the debt-to -enterprise value the better. Similar to ROCE and CROCI, I use trailing 12-month figures here.
4. **Interest cover** – Good companies should pay interest obligations with ease, which means being more than able to pay interest expenses. Quality companies have ratios of three, four or even more. This helps to assure investors that if the business cycle turns unfavourable, the company will still be able to pay interest without external financing or shareholders' dilution. Trailing 12-month figures are again used here.
5. **EBIT growth volatility** – Quality companies typically make consistent profits over time. It's not about showing large profit growth rates but rather low growth volatility. Highly volatile profits are usually associated with nascent companies and with pro-cyclical businesses. To measure growth volatility, I compute the standard deviations of the last five annual EBIT per share growth rates.

We have five ways to proxy for quality. What we now need is to rank them effectively. Some investors/ academics prefer to select stocks separately; others prefer to build an overall ranking. I prefer the latter option.

Let's start by attributing a rating for each stock and for each proxy (the higher the rating, the better the quality factor). Each stock will therefore have five ratings, one for each quality factor. We sum up these ratings to obtain an overall, global rating for each stock, and then rank them, from high to low, by the overall rating. We may then decide to buy say the top 10 or top 20 ranked stocks, or perhaps buy the top-ranked stocks and sell the bottom stocks.

After collecting the data for the five ratios mentioned above for both a list of UK stocks and a list of US stocks, I obtained a shortlist of 414 UK stocks and 1,544 US stocks. Tables 2 to 5 show the top and bottom selections for the UK and the US market (based on the calculated global ratings).

TABLE 2 – UK QUALITY FACTOR – TOP RANKINGS

Rank	Company	ROCE	CROCI	Debt-to-EV	Interest Cover	EBIT Volatility
1	Rightmove PLC	381.7	320.3	0.3	822.0	6.8
2	James Halstead PLC	30.6	27.5	1.8	110.1	2.0
3	Hays PLC	27.6	17.8	4.1	52.1	3.0
4	Howden Joinery Group PLC	25.9	16.3	0.2	620.5	12.4
5	Moneysupermarket.com Group PLC	52.4	44.7	1.3	78.2	14.8
6	Barr (AG) PLC	18.4	14.6	1.9	75.7	1.7
7	PageGroup PLC	24.8	15.0	9.2	124.2	2.5
8	Dunelm Group PLC	21.8	22.3	5.2	70.9	8.3
9	Churchill China PLC	22.2	11.4	3.3	279.7	4.9
10	London Security PLC	17.8	12.9	3.5	439.0	7.1

Source: Sharescope, Own calculations

TABLE 3 – UK QUALITY FACTOR – BOTTOM RANKINGS

Rank	Company	ROCE	CROCI	Debt-to-EV	Interest Cover	EBIT Volatility
414	London & Associated Properties PLC	3.9	-7.5	82.7	1.3	178.4
413	Zambeef Products PLC	1.2	-0.5	74.3	0.6	271.5
412	Gulf Marine Services PLC	3.4	0.9	111.7	0.9	157.8
411	Caffyns PLC	0.9	4.1	76.8	0.2	168.3
410	Sutton Harbour Group PLC	3.6	-1.9	47.2	2.7	771.5
409	Renewi PLC	6.3	-0.8	80.8	3.0	86.6
408	Nostrum Oil & Gas PLC	5.7	1.9	119.5	3.0	78.1
407	Synnovia PLC	1.4	-0.9	40.5	0.4	55.2
406	Centrica PLC	3.9	3.4	57.3	1.8	81.1
405	Tongaat Hulett Ltd	4.2	-0.8	488.7	1.3	25.9

Source: Sharescope, Own calculations

TABLE 4 – US QUALITY FACTOR – TOP RANKINGS

Rank	Company	ROCE	CROCI	Debt-to-EV	Interest Cover	EBIT Volatility
1	Paychex Inc	43.0	35.6	5.0	322.2	2.4
2	Automatic Data Processing Inc	35.7	24.0	2.7	97.7	2.2
3	TJX Cos Inc	34.1	18.7	3.6	769.4	2.1
4	Rollins Inc	28.1	24.5	5.4	240.5	3.9
5	Nike Inc	29.2	29.3	4.0	97.4	7.6
6	Jack Henry & Associates Inc	23.4	13.8	0.3	927.3	3.4
7	Mastercard Inc	64.2	42.3	2.8	47.2	9.8
8	Colgate-Palmolive Co	38.8	28.7	9.7	23.7	3.4
9	Fastenal Co	34.1	15.1	4.1	73.7	6.5
10	Mettler Toledo International Inc	36.6	22.8	7.3	20.1	3.4

Source: Sharescope, Own calculations

TABLE 5 – US QUALITY FACTOR – BOTTOM RANKINGS

Rank	Company	ROCE	CROCI	Debt-to-EV	Interest Cover	EBIT Volatility
1544	FTD Cos Inc	381.7	320.3	0.3	822.0	74.2
1543	Hertz Rental Car Holding Co Inc	30.6	27.5	1.8	110.1	127.9
1542	Pennsylvania Real Estate Investment Tru	27.6	17.8	4.1	52.1	83.7
1541	Preferred Apartment Communities Inc	25.9	16.3	0.2	620.5	56.7
1540	Stratus Properties Inc	52.4	44.7	1.3	78.2	67.0
1539	CSI Compressco LP	18.4	14.6	1.9	75.7	205.8
1538	NN Inc	24.8	15.0	9.2	124.2	74.0
1537	Ascent Capital Group Inc	21.8	22.3	5.2	70.9	61.7
1536	CalAmp Corp	22.2	11.4	3.3	279.7	16906.6
1535	Brookdale Senior Living Inc	17.8	12.9	3.5	439.0	86.1

Source: Sharescope, Own calculations

The top UK stocks for the quality factor include **Rightmove (LON:RMV), James Halstead (LON:JHD), Hays (LON:HAS), Howden Joinery Group (LON:HWDN)** and **Moneysupermarket.com Group (LON:MONY)**. These top companies don't rank high on every proxy, but they rank high overall. The bottom-placed stocks include **London & Associated Poperties (LON:LAS), Zambeef Products (LON:ZAM), Gulf Marine Services (LON:GMS), Caffyns (LON:CFYN)** and **Sutton Harbour Group (LON:SUH)**.

The US list includes **Paychex (NASDAQ:PAYX), Automatic Data Processing (NASDAQ:ADP), TJX (NYSE:TJX), Rollins (NYSE:ROL)** and **Nike (NYSE:NKE)** at the top spots, and **FTD (NASDAQ:FTD), Hertz Rental Car (NYSE:HTZ), Pennsylvania Real Estate (NYSE:PEI), Preferred Apartment Communities (NYSE:APTS)** and **Stratus (NASDAQ:STRS)** at the bottom.

Factor investing usually consists of buying the top decile or deciles and selling those at the bottom. This strategy has the advantage of being market neutral. Unfortunately, from the point of view of an individual investor, this is often difficult to achieve and manage, because sometimes it is not even possible to short stocks, as the strategy may create additional risks, making it undesirable. Nevertheless, buying the top stocks from the list and building a long-only strategy can still provide exposure to the quality factor.

In terms of the exact number of stocks to buy, there's no clear answer. I would say that 10 would be the absolute minimum to get exposure to the factor and enjoy some diversification. A better number would be something between 20 and 30, but that's only doable if investors are able to spread their capital without incurring additional transaction costs. Such portfolios may be rebalanced semi-annually.

The **easy** option

- **Vanguard US Quality Factor ETF (BATS:VFQY)** – The ETF uses a rules-based quantitative model to evaluate US stocks. It's diversified across market sectors, industry groups and different market capitalisations. The fund manages $22.2 million in assets, spread over 666 stocks. The expense ratio is 0.13%.
- **iShares Edge MSCI World Quality Factor ETF (LON:IWQU)** – The fund seeks to track performance of an index composed of a subset of MSCI World stocks with a focus on strong and stable earnings. The fund manages $1,559 million in assets, spread over 300 world stocks. Its expense ratio is a bit high at 0.30%.
- **iShares Edge MSCI USA Quality Factor ETF (BATS:QUAL)** – The fund gives exposure to large-and mid-cap US stocks with a focus on high ROE, stable earnings growth and low financial leverage. The fund's total assets are $11,056 million and it is spread over 125 assets. Expense fees are reasonable at 0.15%.
- **iShares Edge MSCI Intl Quality Factor ETF (NYSEARCA:IQLT)** – This fund complements QUAL, extending coverage from the US to global markets. It manages $807 million in assets and comes with an expense ratio of 0.20%.

There are other options available, for different markets and from different providers.

"PROFITABILITY AND QUALITY ARE THE KEY TRAITS TO LOOK FOR IN STOCKS AT A TIME OF RISING VOLATILITY."

"AT A TIME WHEN ECONOMIC GROWTH IS SLOWING AND TRADITIONAL MONETARY-POLICY TOOLS ARE RUNNING OUT OF STEAM, IT'S WORTH CONSIDERING A MORE CONSERVATIVE PORTFOLIO."

Final remarks

At a time when economic growth is slowing and traditional monetary-policy tools are running out of steam, it's worth considering a more conservative portfolio. However, despite what many people may think, being more conservative doesn't mean increasing exposure to bonds and reducing exposure to stocks. The stock/bond proportion can be kept unchanged by increasing exposure to a factor that protects for downturns – the quality factor. Any individual investor can tilt their portfolio to the quality factor on their own with the help of a few accounting ratios and a good stock screener. For the investor who is looking for a shortcut, there are still a few good ways to gain exposure to the quality factor, in the form of ETFs.

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.


masterinvestor
RESEARCH • ANALYSE • INVEST
INVESTING IN THE AGE OF LONGEVITY
13 November 2019
Science Gallery, London
We are on the verge of a lifespan revolution. In the next 30 years, life expectancy is going to rise to between 110 and 120.
How can we as investors prosper in this new era of longevity?
Tap into the advancing technologies that will increase human life and health span.
» Witness the latest ageing related discoveries
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Get 50% off your ticket(s) using code: MIF09
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BY DAVID JONES

IS FINANCIAL ARMAGEDDON JUST AROUND THE CORNER?

The inversion of the yield curve – a reliable predictor of imminent recession – has put the financial world in a flap. Is this a cause for concern? David Jones takes a closer look.

The financial media loves a bit of drama and hyperbole. At the time of writing, the headline-grabber of the day is the inversion of the yield curve and worries about a recession just around the corner. This month, I would like to take a look at this in more detail, with a particular focus on whether this means major reversals across the board in financial markets – or whether everyone just needs to calm down a little.

What is the bond yield-curve inversion?

In layman's terms, the interest rate on 10-year US government bonds has dropped below the rate on the two-year (shorter) bonds. The punchline for this somewhat dry fact is a little more attention-grabbing – historically this has happened ahead of seven previous recessions.

To put it into context, if you look at savings accounts, you will probably notice that they typically pay more for locking your money up over the longer term than if you decide to have an instant-access account. The clear implication here is that a longer lock-up implies more risk. But what we are seeing in financial markets is that the situation has actually reversed. It is a rare event, but it does happen. Shorter-term interest rates are higher than longer term, suggesting investors are somewhat 'spooked' by what lies immediately ahead for markets. Add in the fact that historically this inversion has occurred ahead of every US recession since 1955, and it is maybe not *too* surprising that we saw steep falls in the likes of the Dow during August.

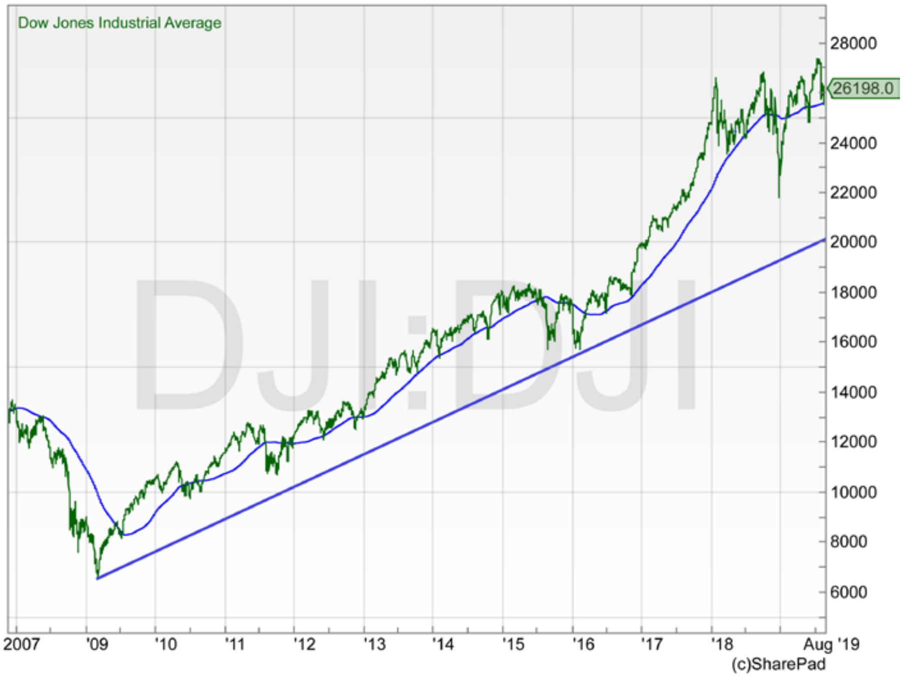
"HISTORICALLY THIS INVERSION HAS OCCURRED AHEAD OF EVERY US RECESSION SINCE 1955."

Bad news sells papers – or perhaps more appropriately in the modern world, it garners clicks. And the 100 percent predictive record of this event is a hard one to argue with. But even when economies have had a downturn, it has typically taken around 18 months to materialise after this inversion occurs. Nevertheless, forewarned is forearmed, so it seems a good time to catch up with some of the major markets and see if they could be at significant turning points.

It is more than 10 years since this US stock-market index set its financial crisis low. That came in just below the 6,500 mark in March 2009 and since then the popular benchmark has risen more than four-fold. This July saw it hit fresh all-time highs once more – which is normally seen as a demonstration of strength in a market. But there was also plenty of volatility during August, with the Dow dropping back by more than 7% by the middle of the month.

However, looking at the long-term trend and the 200-day moving average, there does not appear to be an awful lot to be too concerned about just yet. It could be argued that a 10-year plus bull market is

US Dow Jones Index



"THE MORE AGGRESSIVE INVESTOR WOULD SEE THIS AS JUST ANOTHER OPPORTUNITY TO BUY INTO WEAKNESS."

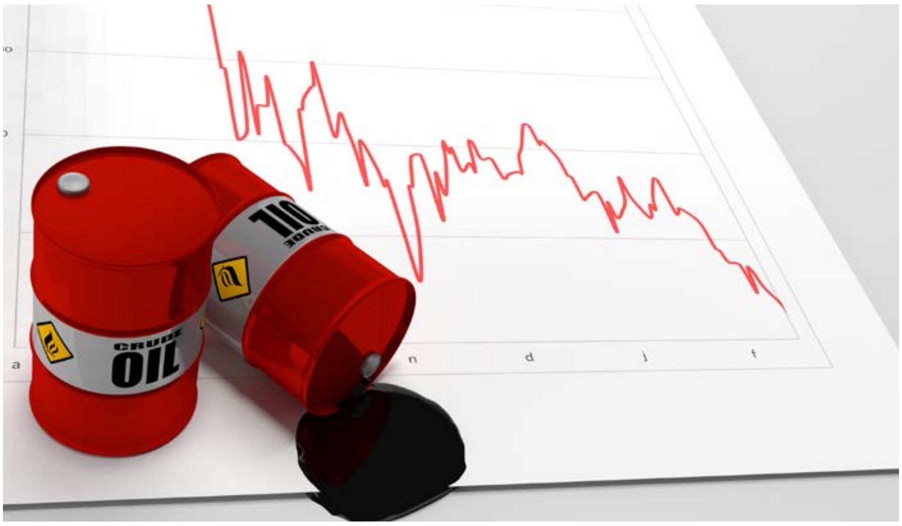
UK FTSE All-Share

admittedly somewhat 'long in the tooth' by historical standards, but it is still a long way away from that major trend line which comes in around the 20,000 mark. US stocks have experienced plenty of bouts of volatility in recent years, only to bounce back higher once more. For now at least, there does appear to be the appetite to continue to be a buyer on dips, with major weakness seen as an opportunity rather than a threat.

It is a similar, if not quite as bullish picture for the UK's broad market index, the FTSE All-Share. Momentum has flagged here: it has been more than a year since this index set fresh all-time highs − although like the Dow Jones it is still above that trendline that dates back more than a decade. August saw the All-Share dip below the 200-day moving average, the first time we have seen a sustained move below this indicator since the last quarter of 2018. The more aggressive investor would see this as just another opportunity to buy into weakness. I would also be inclined to take that view − for me, only if those late 2018 lows in the 3,600 area start to get breached does it look like it is time to worry about that longer uptrend finally changing.

If there is one commodity that is more vulnerable than most to concerns about the prospects for economic growth, then oil is surely that market. If it seems as if the global economy is about to 'catch a cold', oil traders are very quick to hit the sell button. If retail spending levels drop, then factories slow down and less goods are transported – with an obvious knock-on effect in demand for fuel. Bearing all this in mind, it is not surprising that the many mentions in August of a coming recession saw the oil price drop more than 10% in fairly short order.

Oil has always been a volatile commodity. From late December 2018, it had bounced back by more than 40% as April 2019 drew to a close. Admittedly, it has lost a lot of positive momentum since then but for now at least seems well-supported ahead of the $50 a barrel area. I think it will be a long time before it is trading back at the heady heights of $85 seen in 2018 – but as with other markets at the moment, buyers seem happy to step in on sudden drops.



Brent crude oil

Gold

And finally, gold. If financial-news services like a crisis, then 'gold bugs' positively love them! I have written about gold already this year as it had been in a recovery since the 2018 lows. But talks of trade wars and inverting bonds have boosted the price in recent months. From June till mid-August, gold rose by more than 15% as investors sought a relatively safe destination in the face of all these potential threats.

As a committed trend follower, I am still bullish on the price of gold medium term. But I do just wonder if maybe in recent months the price has got a little ahead of itself, helped along by all this gloomy talk and a slightly weak US dollar. Gold has hit six-year highs and could definitely stand a 'healthy correction' of a few percent from its current elevated levels.

Should investors be worried?

Back to that inverted yield curve. Clearly a lot of investors are concerned, otherwise it would not be inverted. It has undeniably predicted economic slowdowns with great accuracy – and stock markets in particular have been rising for a long time. But there has been a lag in the past between this signal occurring and economies suffering. For now at least, I think there could well be a little more fuel left in the tank when it comes to the upside for global stock markets.

Chart of the Month

iShares S&P 500 (CSPX)

I thought we would stick with the overall theme this month and take a look at a broad market asset – the London-listed iShares S&P500 tracker.

I always think this is an interesting exchange traded fund – and something I have made various purchases of over the years. Put simply, it tracks the US S&P500 index – a much preferred index by many when compared to the Dow Jones, as it has a wider mix of stocks (although the performance in reality does not differ that greatly). This S&P tracker is quoted in US dollars so as a UK investor you do have the currency risk – although that has been working in our favour recently with the pound dropping versus the dollar.

I have picked up on a closer trend in the chart, from the 2016 lows. That is currently coming in around the $250 mark and there is also good support ahead of $230, the lows from December 2018. For the investor that wants to fly in the face of the fear around the inverted bond yield, then this asset is clearly an interesting one to easily get wider exposure to the broader US market performance, without having to drill down into the detail of looking into individual US-listed stocks.

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 AND TRUSTS IN FOCUS

THE BEST PROPERTY INVESTMENT TRUSTS

REITs offer the prospect of capital growth and a secure and rising income. Nick Sudbury looks at some of the best ways to gain exposure to these trusts.

Real estate investment trusts (REITs) offer the prospect of capital growth, and a secure and rising income. Many of these funds have delivered strong returns in the last few years, but have weakened in the run up to Brexit, and offer some attractive buying opportunities for those willing to accept the short-term volatility.

It is likely that investor sentiment will be further tested ahead of the 31 October Brexit deadline. With an increasing chance of a 'no deal' exit, there is a real possibility that discounts across the sector will widen, as was the case after the EU referendum. If the pessimism is overdone, this could generate the chance to pick up these vehicles at knock-down prices.

The most commonly used benchmark in this area is the MSCI Property Monthly Index, which shows that UK commercial property returned 1.14% in the first six months of the year. This represents a considerable slowdown from the 7.5% achieved in 2018, with capital values now having fallen for eight consecutive months, mainly due to the weakness in the retail sector.

Interestingly, it is the income that has been the key driver, accounting for around 60% of the total returns from property over the last decade. In the first six months of 2019, it contributed a further 2.6%, more than offsetting the fall in capital values.

Most of the underlying subsectors have moved into negative capital growth, with the exception of the industrial sector, although there are still plenty of assets in each area that will increase in value.

The investment-company analysts at Investec Securities are cautious on the retail-property sector given the headwinds it is facing, as illustrated by the large number of company voluntary arrangements in recent months. They believe that funds with a higher exposure to the industrial and office sectors should fare better in the current environment.

Valuation is, of course, key, and the £1.4bn **BMO Commercial Property Trust (LON:BCPT)** is a good example. It is heavily invested in the retail sector with a

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portfolio weighting of 34%, but this is already reflected in the wider-than-normal discount of 18%, which offers considerable value. The shares are yielding an attractive 5.4%, with equal monthly distributions.

REITS

There is a wide range of choice if you want to invest in this area. The analysts at Winterflood split the sector into two main subsets: investment trusts providing a broad exposure to UK commercial-property assets and those that concentrate on more specialist parts of the market.

The former consists of 14 funds that are trading on a wider-than-normal average discount to net asset value (NAV) of 7.6%, and yielding an average of 5.7%. Of these the largest is the **UK Commercial Property REIT (LON:UKCM)**, with total assets of £1.4bn.

There are a further 13 investment trusts in the specialist subsector that cover everything from student property, to healthcare, social housing and logistics. The largest is **Tritax Big Box (LON:BBOX)**, with total assets of £2.7bn.

Investment trusts are the ideal vehicle for investing in 'bricks and mortar', because the fund managers will never be forced into selling these illiquid assets to finance client redemptions. Many of the open-ended funds operating in this area ran into severe difficulties in the wake of the EU referendum as sentiment deteriorated, and we have seen recently how much of a problem liquidity can pose from the travails of Neil Woodford.

One other point to be aware of is the gearing. Borrowing to invest in additional assets can provide a real boost to returns when markets are rising, but can be detrimental if asset values fall. The levels of debt vary enormously between the different property investment trusts, with some having no gearing at all and others having in excess of 50%, which has a major bearing on their risk-return profile.

Top picks

The analysts at Winterflood recommend the £2.7bn **Tritax Big Box (LON:BBOX)**, which invests in large logistics facilities in the UK. It has performed well since it was launched in December 2013, with an annualised NAV total return of 13%; this is well ahead of its nine percent yearly target.

Winterflood expects there to be strong demand for the sort of 'big

box' assets that the fund invests in, which, in combination with the significant element of inflation linkage and fixed uplifts, should continue to provide scope for further rental growth. This is supported by the high weighted-average, unexpired lease term.

Tritax shares have generated a NAV total return of 36% in the last three years, but the recent interim results

"INVESTEC SECURITIES HAS A BUY RECOMMENDATION ON SCHRODER REAL ESTATE (LON:SREI) BECAUSE OF ITS SECTORIAL POSITIONING AND THE FACT THAT THE SHARES ARE AVAILABLE ON A 16% DISCOUNT."

were disappointing. The shares are available on a discount of two percent and offer a prospective yield of just under five percent that is fully covered by earnings.

Winterflood also recommends the £1.6bn **TR Property Investment Trust (LON:TRY)**, which is unusual in that it mainly invests in property company shares rather than the actual bricks and mortar. Winterflood also likes the fact that it benefits from an experienced and well-resourced management team that has a strong, long-term performance record.

Investing in property shares enables the fund to be more diversified and makes it easier to change the portfolio to take advantage of the best opportunities. At the end of June, it held around 60 different securities that provided exposure to UK and European property markets and there was also a 7.9% investment in bricks and mortar.

TR Property has returned 92% over the last five years and is yielding three percent with the shares trading on a two percent discount. The ongoing charges are a reasonable 0.69% and the net gearing is a modest 13%.

A different type of exposure

Numis recommends **LXI REIT (LON:LXI)**, which raised £175m when it floated in October 2018. The money has been invested in a portfolio of secure, long-dated and inflation-linked leases with the aim of generating an NAV total return of eight percent per annum.

LXI recently raised a further £200m that has been used to acquire a diversified portfolio containing new Lidl stores, a BUPA care home and a Premier Inn that offer a combined net initial yield of 5.74%. The fund's assets are all let and have a weighted-average unexpired lease term to the first break of contract of 22 years, with 97% of the rental income benefiting from index-linked or fixed uplift reviews.

Numis says that the manager buys well, crystallises profits and recycles the capital quickly, driving attractive returns ahead of its eight percent per annum target. This is reflected in its 14% premium to NAV, although even at this level the shares still offer a prospective yield of 4.5%.

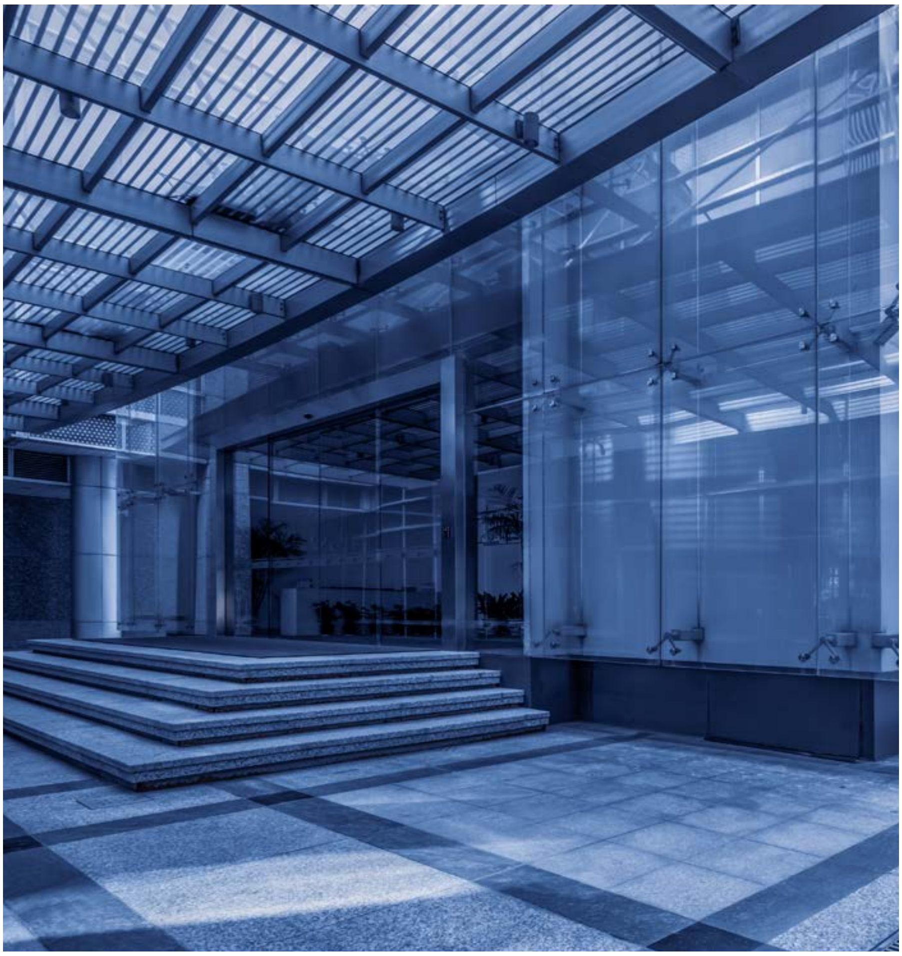
Investec Securities has a buy recommendation on **Schroder Real Estate (LON:SREI)** because of its sectorial positioning and the fact that the shares are available on a 16% discount. The company has a 36% allocation to offices, with 32.7% in industrials and 24.5% in retail, with the balance invested in other areas.

At the end of June, the underlying portfolio comprised 43 properties valued at £461.1m, with a rent roll of £26.8m per annum. The net initial yield is 5.4% and the average unexpired lease term, assuming all tenants vacate at the earliest opportunity, is 6.1 years. SREI's shares are yielding 4.6%, with the dividends fully covered by earnings.

Profiting from structural trends

Ben Yearsley, a director at Shore Financial Planning, recommends the £289m **Warehouse REIT (LON:WHR)**, which owns a portfolio of multi-let warehouses located near the end users. These are an essential part of the logistics supporting the growth of online shopping. He says that the fund is geographically diverse, with a manageable LTV ratio of around 40%, and has a 6% yield that is fully covered by earnings. The shares are available on a four percent discount.

He also likes the £472m **Target Healthcare REIT (LON:THRL)**. It owns more than 50 modern, purpose-built UK care homes to help cater for the ageing population. It has a fully drawn down debt-to-equity ratio of 28% and is yielding 5.75%, which is not quite covered by earnings. The shares are trading on an eight percent premium.



"ONE OF THE REAL BARGAINS IN THE SECTOR IS STENPROP (LON:STP), WHICH IS TRADING ON A 23% DISCOUNT AND PAYING A FULLY COVERED YIELD OF 6.1%."

Safe and secure

The **Secure Income REIT (LON: SIR)** invests in a mixed portfolio of hotels, leisure and healthcare assets. The three main tenants are Ramsay Health Care, Travelodge and a consortium of private equity investors that recently bought the theme-park operator Merlin Entertainment. The latter accounts for around a third of the company's total rent roll, but the new buyers are long-term investors; the average term to expiry of the relevant leases is 23.5 years without a break clause.

In July the fund announced the sale of eight out of the 19 private hospitals let to Ramsay Health Care to a US specialist healthcare REIT at a 19% premium to NAV. The proceeds will be used to repay debt with the net loan-to-value (LTV) ratio falling to 33.5%. Secure pays a fully covered dividend equivalent to a yield of 3.9% on the current share price.

Numis says that the fund has an enviable track record since listing in June 2014, with NAV total returns of 20.9% per annum and annual share-price returns of 20.6%. Numis also believes that the portfolio is robust and likes the fact that the management team has a strong alignment with shareholders, with a 13.4% stake worth around £173m. The shares are currently trading around NAV and the fund remains on their buy list.

Their other core buy is the **PRS REIT (LON:PRSR)**. It offers a pure play on the private rented sector, providing newly constructed homes for middle-income families paying rent at market levels. Numis believes that this is an attractive area of the property market, well-aligned to the government's ambition to deliver more affordable family homes.

PRS targets a total return of 10 percent per annum, which includes a dividend of six percent that is paid quarterly and should rise in line with inflation. The shares are currently trading close to NAV and are below the issue price at IPO. This is partly because the fund is paying an uncovered dividend as the home developments pass through the construction phase.

Trading buy

One of the real bargains in the sector is **Stenprop (LON:STP)**, which is trading on a 23% discount and paying a fully covered yield of 6.1%. It is currently in the process of transitioning to become a specialist UK multi-let industrial (MLI) property company and these assets now make up around 43% of its portfolio by value.

During the financial year to the end of March, the fund completed the sale of 23 properties, all above book

FUND OF THE MONTH

Standard Life Investments Property Income (LON:SLI) has delivered consistently strong performance and has a high weighting to industrial property, which bodes well for the months ahead. As well as targeting capital growth, manager Jason Baggaley also prioritises the security of income and has managed to achieve an attractive five percent yield that is fully covered by earnings.

Baggaley, who has run the fund since 2006, actively manages the portfolio's assets to help drive capital growth and improve the security of the income stream. He has consistently been able to add value in this way, which is an important factor given that base returns are likely to be weaker in the period ahead.

The manager expects a low-return environment over the next three years for the commercial real-estate market, with total returns of just 1.9% per annum over the period 2019-21. He also thinks that the current wide spread in the sector-level returns will endure in the short term, with industrial strength and retail weakness both driven by structural trends.

Given this backdrop, it is reassuring that at the end of March the fund had a 52% exposure to industrial properties, with offices accounting for a further 32%. Retail made up just 2% of the assets, although an additional 7% was invested in retail warehouses.

Over the last five years the fund has generated an impressive NAV total return of 73% that is well ahead of both its benchmark and peer group, with the portfolio well-positioned for the tougher conditions ahead. The shares are trading on a small two percent premium to NAV, which reflects their strong track record and they are recommended by both Investec Securities and Winterflood.

Fund facts

Name:	Standard Life Investments Property Income (LON: SLI)
Type:	Investment Trust
Sector:	Property – Direct UK
Total assets:	£499m
Launch date:	December 2003
Current yield:	5.4%
Gearing:	35%
Ongoing charges:	1.98%
Website:	www.slipit.co.uk

value. This included the disposal of seven of its eight sites in Switzerland, 14 Aldi properties in Germany and the last remaining places in central London. The proceeds after repaying the associated debt were reinvested into 30 MLI estates that the manager says were at a 50% discount to their estimated replacement cost.

Stenprop aims to increase the UK MLI component of its portfolio to at least 60% within the year to 31 March 2020 and then to 100% in the following two years. This will require the disposal of around £140m of property, with the proceeds being used to buy about £100m of MLI assets. Numis rates the company as a trading buy and believes that the use of share buybacks could provide a potential catalyst for a rerating prior to the completion of the transition.

The weakness in the retail sector and Brexit-related uncertainty have weighed heavily on the performance of REITs in the last few months. It now looks likely that Brexit will come to some sort of resolution by the end of October. If this is the case, the volatility in the coming weeks could provide some highly attractive buying opportunities.

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

MITIE DISAPPOINTMENT OR MITIE DIVIDEND POTENTIAL?

Mitie's share-price performance has been disappointing of late. But with sensible management, the company could return to health in the coming years, argues John Kingham.

Mitie is the UK's largest facilities-management (FM) company. In layman's terms, that means it provides corporate and government clients with property-related services so they can focus more intently on their own core activities.

These services range from single-service offerings, such as security guards or cleaning, all the way to integrated FM (IFM). IFM means largely taking over all building-related operations. It goes beyond simple security, cleaning and engineering maintenance, and can include projects to improve the energy efficiency of a building; micromanaging an office's temperature and humidity to optimise employee productivity (so that workers are, for example, less likely to fall asleep after lunch); or helping a company reduce its water, waste or carbon footprint.

After many years of outstandingly consistent and rapid growth, Mitie is now a turnaround story. In the last 10 years the company's previous management made some serious mistakes, leaving Mitie unfocused, inefficient and over-indebted. In 2016 the dividend reached a high point of just over 12p before being cut to 4p in 2017, and that's where it remains today.

With its share price currently close to 160p, Mitie has a dividend yield of just 2.5%. For an income investor that isn't very interesting, and it shows that 'Mr Market' expects the dividend to head back upwards – sooner rather than later.

So, the investment case for Mitie hangs on whether that dividend can return to anything like the 12p it reached in 2016, or whether Mitie and its dividend have been damaged beyond repair. As usual, I'll try to answer that by starting with a little history.

"AFTER MANY YEARS OF OUTSTANDINGLY CONSISTENT AND RAPID GROWTH, MITIE IS NOW A TURNAROUND STORY."


mitie

Management incentive through investment equity

Mitie was founded in 1987 and from the very beginning it was built around the idea that people could produce extraordinary results if the potential rewards were extraordinarily large. This idea was turned into reality through the 'Mitie Model', which gave entrepreneurs the opportunity to start, grow and eventually sell their own business, all with the help of Mitie.

Here's how it worked: let's say Bob, an employed heating engineer, wants to start his own boiler-maintenance business in Kent. Unfortunately for Bob, he doesn't have sufficient start-up funding or a long-enough list of clients to make the business viable. Then he hears about Mitie, which is offering to help FM start-ups. Mitie will put up 51% of Bob's start-up funds in exchange for 51% ownership of the new company. Mitie will also help with business management, accounting and other back-office needs, and will give Bob access to its existing clients. Finally, Mitie offers to buy Bob out of the new business in five years if Bob can grow its annual profits to £100k. Mitie will pay 10-times earnings, so Bob will make a cool million pounds in five years if he can keep up his end of the bargain.

"TO KEEP THE MITIE GROWTH JUGGERNAUT THUNDERING ALONG, MANAGEMENT TURNED TO THE OBVIOUS SOLUTION: LARGE DEBT-FUELLED ACQUISITIONS. UNFORTUNATELY, THIS IS RARELY A GOOD IDEA."

How hard is Bob going to work under those conditions? Unbelievably hard. How effective is this as a way of scaling up a conglomerate of start-ups? Amazingly effective.

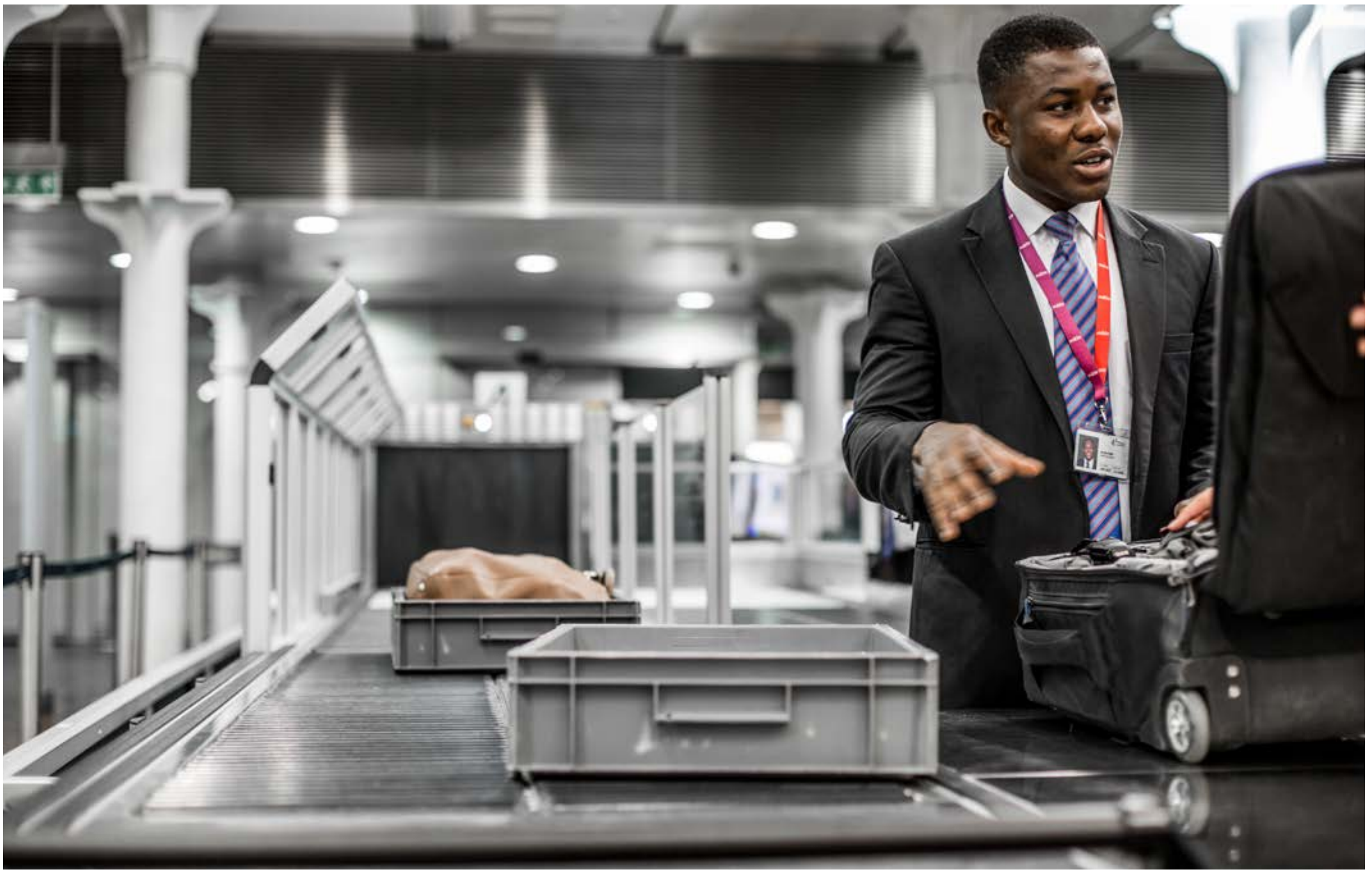
This, along with a string of bolt-on acquisitions, is how Mitie managed to grow revenues by a compound rate of 40% per year for more than 20 years.

Driving rapid growth by dangling enormous carrots in front of people is an obvious and effective way to grow a company. But the approach has several limitations, of which I'll mention two.

Startups, scale and the lure of big acquisitions

The first problem is that the number of available plumber, painter or security-guard start-ups did not keep pace with Mitie's growth. For example, let's say Mitie can find 10 good entrepreneurs to back each year. At the end of year one Mitie consists of 10 start-ups. At the end of year two it has 20, double the number it had a year before. By the end of year five Mitie owns 50 start-ups, but adding 10 start-ups in year six will only increase their number by 20%. And every year bolting on 10 more start-ups will produce less and less growth in percentage terms.

After 20 years, the impact of a few more Mitie start-ups becomes inconsequential to a conglomerate with more than a billion pounds of revenue and almost £50 million pounds of profit. So, to keep the Mitie growth juggernaut thundering along, management turned to the



"WHILE THE BIG BALL OF MUD STRUCTURE ALMOST INEVITABLY LEADS TO A CRISIS, IT ISN'T NECESSARILY A DEATH SENTENCE."

obvious solution: large debt-fuelled acquisitions. Unfortunately, this is rarely a good idea.

In Mitie's case, its debts went from virtually zero in 2005 to £200m in 2011. Much of this debt was used to fund almost £300 million of acquisitions, with the gap funded via rights issues (ie selling new shares to shareholders).

Mitie's acquisitions during this period started out quite sensibly. For example, it spent £90m on security-guard companies in 2006, making Mitie the second-largest provider of security guards in the UK. It also spent £130m on an engineering-maintenance company with a focus on energy-efficiency technologies for offices and other buildings.

Later acquisitions, such as the £40 million spent acquiring a social-housing-maintenance business, were less obviously related to Mitie's core business, which was to provide FM services to offices, shops, factories and government buildings.

By 2011 Mitie had borrowings of £200 million and 10-year average net profits of £38 million. That gave the company a debt to average profits ratio of 5.3, which is above my preferred maximum of 5.0. However, it wasn't nearly enough for Mitie's management, so in 2013 they took another risk and spent almost £120 million acquiring a business providing care at home to the elderly.

I have no idea what providing care to elderly people has to do with Mitie's core business of cleaning, guarding and maintaining large office buildings, shops and factories, but Mitie's management seemed to think it was a perfect fit.

This final big acquisition took Mitie's total borrowings to a very worrying £290 million, giving the company a debt to average profit ratio in 2013 of 7.0. That's way beyond anything I'd call prudent. However, even with that enormous debt pile I think Mitie may have been able to avoid the crisis of the last few years if its internal structure had been highly standardised, optimised, efficient and effective. But it wasn't.

A big ball of mud

I said earlier that there are (at least) two problems with an acquisition-driven growth strategy (in Mitie's case it effectively grew by acquiring start-ups). The first is that you eventually get too big to grow by bolting on start-ups and that often leads to the dark path of debt-fuelled acquisitions. The second problem is structural. In other words, if you grow a company by lumping together dozens or even hundreds of start-ups and other acquisitions, it's very easy to end up with a 'big ball of mud'.

A big ball of mud is a phrase from the world of computer programming, where badly structured systems are all too common. Here's the original definition from Brian Foote and Joseph Yoder:

> *"A Big Ball of Mud is a haphazardly structured, sprawling, sloppy, duct-tape-and-baling-wire, spaghetti-code jungle. These systems show unmistakable signs of unregulated growth, and repeated, expedient repair. Information is shared promiscuously among distant elements of the system, often to the point where nearly all the important information becomes global or duplicated."*

This lack of organised structure started to show up in 2013 when the company began offloading its struggling contract-engineering businesses, which did engineering work on a one-off basis, rather than as part of a long-term FM contract. At one time these businesses had been a significant part of the company, but Mitie's sprawling array of services made it incapable of competing in such a highly competitive, low-margin market against more focused competition. Exiting these businesses eventually cost Mitie more than £120 million.

Mitie's haphazard, sprawling structure also made it hard to pin down exactly what its core business was. Was it security guards? Cleaners? Designing energy-efficient lighting systems or waste-to-heat power plants? Or was it project-management consulting? The lack of focus meant that the previous management team felt comfortable acquiring a homecare business and social-housing-maintenance businesses. Unfortunately for shareholders, these large and expensive acquisitions eventually proved to be too unrelated to Mitie's core FM business, and both were eventually sold at a loss.

While the big ball of mud structure almost inevitably leads to a crisis, it isn't necessarily a death sentence. For example, **Compass Group (LON:CPG)**, the world's largest catering company for corporate clients and a previous holding in my portfolio, grew by acquisition until it was bloated, unfocused and loaded with debt. The turnaround began in the mid-2000s. Compass sold off non-core businesses and used the proceeds to pay down debt while building a highly efficient, narrowly focused core

"WITH THE OLD MANAGEMENT TEAM LONG GONE, MITIE IS NOW SOMEWHERE CLOSE TO THE MIDDLE OF A MULTI-YEAR TURNAROUND EFFORT."

catering business. After a multi-year turnaround effort, Compass has gone on to be very successful over the last decade, and I think Mitie could do the same.

Narrow focus, effective structure, strong foundations

With the old management team long gone, Mitie is now somewhere close to the middle of a multi-year turnaround effort. If Mitie is to replicate Compass Group's successful transformation from a big ball of mud into a lean, focused growth machine, I think it needs three things:

1) More focus: instead of working with both government (local and central) and business (small, medium and large), across single or multiple sites, offering single, bundled or fully integrated FM services, Mitie needs to become much more focused in terms of the clients it goes after and the services it offers them.

Fortunately, this is exactly what the company is now trying to do. Gone are the short-term contracting businesses, along with care for the elderly and social housing, replaced with a greater focus on providing fully integrated FM services to large blue-chip clients. Although Mitie will still provide some clients with single services such as security or cleaning, this is a shrinking part of its business and in my opinion that's a good thing. Unlike the complex business of optimising every aspect of a company's buildings across multiple sites, single services such as cleaning or security are more of a commodity, with lots of competitors and low profit margins.

2) Better structure: growing by bolting together dozens of painting firms, cleaners, decorators, roofers, security companies, engineering contractors and consultants was always going to be problematic at some point. Now that Mitie has long since reached that point, a better internal structure should give the company a lower cost base through greater efficiency and better services, thanks to more consistent processes and the ability to quickly learn from its numerous successes and mistakes.

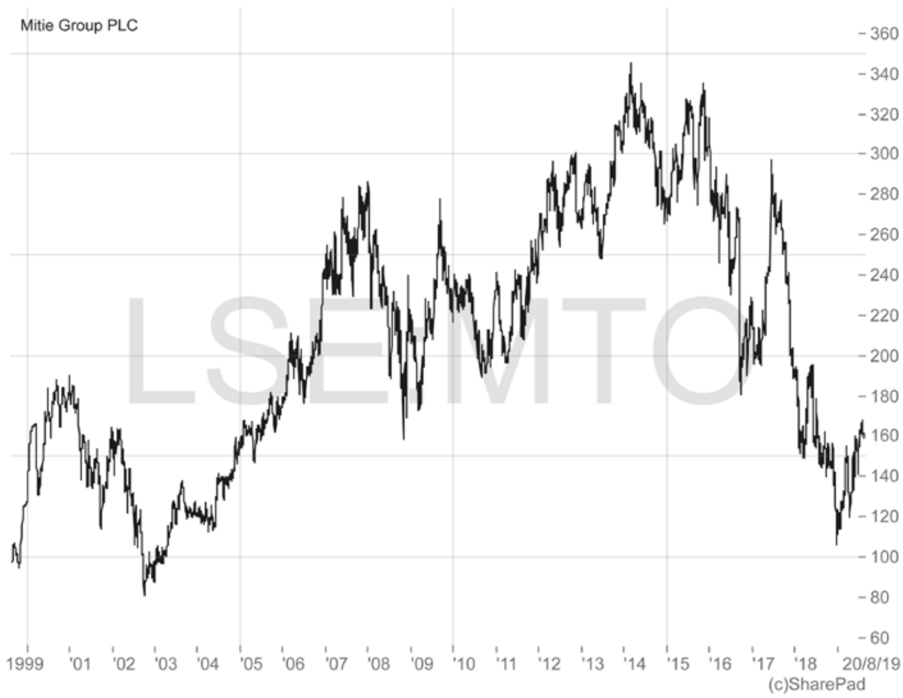
To be fair, Mitie has been working to integrate its companies since the 1980s, although it clearly didn't do a good job (otherwise it probably would have avoided the current crisis). But at least it's doing the hard work now. It has spent much of the last three years working through Project Helix, a £50 million effort to adapt Mitie's DNA from that of a loose collection of companies to one more fitting of a single, fully integrated business, which is exactly what large blue-chip clients want to interact with.

3) Less debt: even the sturdiest building will crumble if its foundations are not strong enough to withstand the mildest of earthquakes. In the same way, a strong company will crumble at the next recession if its balance sheet is weak. And with total borrowings of almost £270 million (almost eight-times its 10-year average profits of £35 million), Mitie's balance sheet is definitely still weak. In fact, if you factor in Mitie's £75 million or so defined-benefit pension deficit then its debt mountain begins to look almost insurmountable.

For me, this is the most disappointing aspect of Mitie's restructuring effort. Despite offloading numerous underperforming non-core businesses, the (meagre) proceeds from these sales have barely reduced the company's debts at all. However, that may be about to change as Mitie recently announced the sale of its catering business for £85 million. That should help the company reduce its debts by a significant amount and focus more acutely on the areas where it does have the necessary economies of scale to compete (such as security, cleaning, engineering maintenance and the fully integrated and endlessly optimising 'smart workplace' of the future).

Future prospects and valuation

I think it's likely (ie twice as likely to occur as not) that Mitie will make it through this restructuring phase successfully. Like Compass Group, I



> **“I THINK IT’S LIKELY (IE TWICE AS LIKELY TO OCCUR AS NOT) THAT MITIE WILL MAKE IT THROUGH THIS RESTRUCTURING PHASE SUCCESSFULLY.”**

think it has strong core businesses in security, cleaning, engineering maintenance and integrated FM, and it has the market-leading positions and scale in these areas to compete with the best FM companies in the UK.

It has been working through this restructuring phase since 2013, with many non-core businesses already exited and many millions of pounds and years of effort put into upgrading the company's operating system to something much more efficient and effective. This process continues with the recent sale of its catering business and the launch of Project Forte, a renewed effort to drive simplicity and efficiency in Mitie's largest business (engineering maintenance).

In terms of the numbers, if you strip out the losses from exiting businesses and the cost of internal restructuring, then Mitie returned an average of 15% on capital employed over the last decade, which is comfortably above average. Its revenues have also been very steady over the years, showing that FM should be a relatively defensive activity. Another plus is that Mitie isn't very capital intensive, which means if management can meaningfully reduce its debt pile it shouldn't need to load up on debt to invest in growth assets (such as new buildings, factories, supertankers etc.).

On the downside, average profit margins are thin at 3.3% (again, adjusted to take out non-recurring costs), which may make profits more volatile, but that's the nature of the FM industry; you either accept it or you don't (and as a general rule I don't). And then we have the company's still weak balance sheet. However, hopefully that will become less of a problem if the proceeds from its catering business are primarily used to pay down debt. Also, if Mitie does show a sustained recovery over the next five years, I think it would be best if management kept the dividend at its current depressed level of 4p and used the excess cash to lower Mitie's debts to no more than £100 million.

So, by 2025, I think it's likely that Mitie will have a repaired balance sheet and a healthy core business generating earnings per share of around 15p, which is still less than it managed a decade ago. With earnings of 15p it would be able to easily afford a 10p dividend, which would be a yield of 6.3% on today's share price of 160p. And if the dividend can return to steady growth after that, of perhaps 2% to 5% per year, then I think it's likely that the share price would double from where it is today, perhaps reaching 300p or more and giving the company a reasonable yield of slightly more than 3%.

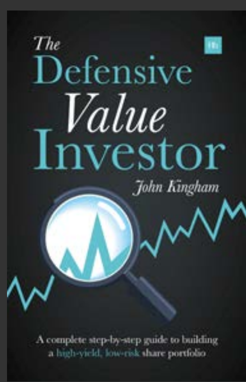
Obviously, that's conjecture, and as a Mitie shareholder since 2011 I am more than used to being disappointed. But I still think Mitie is fundamentally a good company, and that with sensible management it's likely to do well over the next five to 10 years.

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

IS IT TIME TO BUY THE POUND?

The UK's currency has taken a drubbing since March. But has the market's pessimism been overdone?

The story so far

While it may feel like the Brexit discussions have been going on forever, it is of course just three years since the UK voted to leave the European Union (EU). Prior to the vote, the pound/US dollar (GBP/USD) exchange rate had been sliding for a couple of years – the summer of 2014, when the pound in your pocket bought $1.70, now seems a very distant memory.

The shock referendum result to leave the EU saw GBP/USD plunge from 1.50 to 1.32 in very short order. This 12 percent drop even exceeded the volatility seen on "Black Wednesday" in 1992 (for those of us with long memories) when the UK government was forced to withdraw the currency from the European Exchange Rate Mechanism.

As can be seen from the chart above, the referendum knee-jerk collapse was not the end of the pound weakness and it slid further into the end of 2016 and the beginning of 2017, with the exchange rate hitting 1.20. However, the next 18 months did see an impressive near-20 percent recovery (admittedly helped by a very poor year for the US dollar) with GBP/USD trading above 1.43 by April 2018.

"I THINK WE WOULD HAVE TO RETURN TO THE FINANCIAL CRISIS IN THE LAST DECADE TO FIND A TIME WHERE SO MUCH OF WHAT COULD HAPPEN WITH A PARTICULAR ASSET DEPENDED ON THE RESPONSE – OR LACK OF IT – FROM POLITICIANS."

Where we are now

Earlier this year the pound was looking strong once again. The Brexit deadline in March loomed large, but GBP/USD seemed unfazed and pushed higher. But of course, numerous votes were defeated and since then financial markets have become increasingly worried about a no-deal Brexit – the pound has come under what feels like relentless pressure. The change of UK prime minister saw some relief – the "Boris bounce", shall we say – but this was very short-lived and by mid-August the pound was once again back at that $1.20 level, completely wiping out any recovery since October 2016.

What next?

This is the 'crystal ball' question and reminds me of one of my favourite quotes, attributed to various people over the years, from J.P. Morgan to Yogi Berra: "Avoid forecasts, particularly those involving the future".

Forecasting markets is difficult enough at the best of times, but trying to call the next major move for the pound at the moment is not just challenging, but perhaps also futile. I think we would have to return to the financial crisis in the last decade to find a time where so much of what could happen with a particular asset depended on the response – or lack of it – from politicians.

Markets have clearly been spooked by the new UK prime minister, Boris Johnson vowing to leave the EU come what may on 31 October. And perhaps the right approach for the more cautious investor is to forget about the fortunes of the pound for the next couple of months, until that date is out of the way and we all hopefully have a bit more clarity on what Brexit looks like, assuming it has actually happened. But I feel there is still one important number to keep in our minds until then – and for me it is all about how the market reacts around here that could set the tone for the pound for months to come.

It Is all about that historical low

I also write a regular charting article in this magazine and have been a technical analyst for more than 20 years. Now, I don't buy into a lot of the 'hocus-pocus' that surrounds charting, but I *do* think that major historical turning points can tell us an awful lot about market sentiment.

In the months after the UK's referendum, the pound remained under pressure, but eventually the collective wisdom of all market participants was not prepared to push GBP/USD much lower than 1.20.

You can see from this 35-year chart of the exchange rate how important the 1.40 area had been all the way through the 1990s and right up to the Brexit vote – the pound did not spend much time below it and was viewed as undervalued against the US dollar on the occasions it fell into that area.

Even though it has not been in place for anywhere near as long, I feel the 1.20 area is the current make-or-break zone for GBP/USD. However, we do not know for sure what the next few weeks will bring. Maybe there will be a deal with the EU. Perhaps there will be a general election. Prime Minister Johnson could stick to his guns and take the UK out with no deal. Or something else could happen – something that's entirely unexpected at the time of writing.

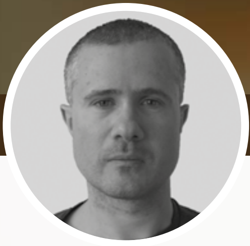
"IT IS ALL ABOUT HOW THE CURRENCY PERFORMS AROUND THAT 1.20 ZONE."

I think it is too easy to get carried away with the pessimistic outlook from commentators in the media. Financial markets look the most bullish at market tops – and the flip side is of course that markets will start to bottom when every man and his dog feels there is no end in sight to the slide.

So, to reiterate – for me it is all about how the currency performs around that 1.20 zone. At the time of writing there has been the smallest of recoveries − but there has been an awful lot of false dawns for the pound since the referendum. If 1.20 does get taken out, you can see from the chart above there is a lot further to go, to the next major low, set in the glorious decade that was the 1980s. It seems incredible to think of it, but that low is down at 1.05. I do feel that patience is the best approach here − I have been wrong-footed a couple of times in recent years betting on a major recovery for the pound only for the politicians to spoil the trend. Hopefully, after Halloween we will all have a better idea of just what is in store for the UK – and whether or not we can start becoming a bit more optimistic about its currency.

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

AN INVESTOR'S GUIDE TO RESTAURANT FRANCHISING

Franchisors with profitable concepts and expansion potential can present outstanding investment opportunities, explains Andrew Latto, CFA.

To franchise a business concept, it needs to be simple, scalable and profitable. Franchising removes the need for significant capital investment and helps drive growth. Restaurants are one area where franchising has worked out well.

Quality investors have often invested in listed franchisors, due to their ability to earn a high return on capital employed (ROCE). Franchisors are also cash generative and pass on much of the business risk to franchisees.

The formula has paid off handsomely for restaurant franchisors **McDonald's Corp (NYSE:MCD)** and **Domino's Pizza Inc (NYSE:DPZ)**. McDonald's Corp has seen its shares increase from $25 in 2004 to $220 today.

Shares in Domino's Pizza Inc have increased from $14 in 2014 to $240. That's not bad for companies that have been around since 1955 and 1960 respectively.

Quality investors

Fundsmith, Blue Whale and Lindsell Train are three prominent UK-based quality investors. Fundsmith Equity Fund currently owns InterContinental Hotels Group, which has moved towards a franchising model.

Fundsmith Equity Fund used to own Domino's Pizza Inc and

> **"THE FACT THAT A BUSINESS OPERATES AS A FRANCHISOR IS A POSITIVE SIGN. TO HAVE ATTRACTED FRANCHISEES IT MUST OWN A PROFITABLE AND SCALABLE FRANCHISE CONCEPT."**

"FRANCHISING IS A BUSINESS MODEL THAT CAN WORK WELL FOR INVESTORS. FRANCHISORS ENJOY THE FRUITS OF BUSINESS SUCCESS AND AVOID MUCH OF THE DOWNSIDE RISK."

McDonalds Corp share price

Source: SharePad

Domino's Pizza Inc share price

Source: SharePad

McDonalds Corp. Domino's was sold on valuation grounds in October 2015 and McDonalds Corp was sold in July 2013 after like-for-like store sales stalled.

The Blue Whale Growth Fund currently owns the hotel franchising group Wyndham Hotels and Resorts. Nick Train, co-founder of Lindsell Train, highlighted McDonald's in a January 2019 note: *What Makes Us Think and What We're Thinking About.*

Train noted that the share price of McDonald's has increased by 161 times since 31 October 1980 (excluding dividends). He argued that it is best to hold on to quality companies and avoid the temptation to trade them on valuation grounds.

Why franchisors appeal

The fact that a business operates as a franchisor is a positive sign. To have attracted franchisees it must own a profitable and scalable franchise concept.

Free cash flow (FCF) is the excess cash flow that is available to be distributed to shareholders. Share prices move in line with FCF per share over the long term.

Investing is not a charitable enterprise; the point of investing is to get something back. Companies that can increase FCF per share tend to see their valuations increase.

The UK property portal **Rightmove (LON:RMV)** provides a case in point. The share price of Rightmove has moved in line with FCF per share since 2005.

The business model of franchisors makes them good at generating FCF, as it is the franchisees that do the 'heavy lifting'. To grow FCF, the franchise concept needs to have scope to expand.

McDonald's has been successful because the Big Mac bun has been popular around the world. The franchising concept needs to be profitable and scalable for the formula to work.

A high-end restaurant may be profitable, but it is unlikely to work as a franchising concept. Franchisees are unlikely to have the skills needed to successfully replicate a three-star Michelin restaurant.

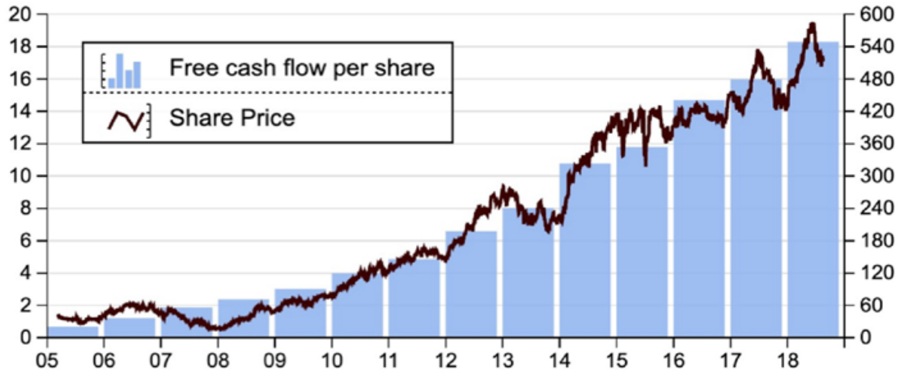
Concept durability

Franchising is no panacea for a bad concept or a lack of innovation. McDonald's reported a 1% decline in same-store sales in 2014 and has taken steps since then to reinvent the business.

Changes include a refreshed store estate and the introduction of self-order kiosks. The group has also introduced all-day breakfast, healthier meals and improved coffee options.

Steve Easterbrook, who was appointed chief executive in January 2015, led the turnaround effort. It started to pay off in 2017 when McDonald's reported its strongest same-store sales growth in six years at 5.3%.

Rightmove FCF and share price



Source: SharePad

McDonald's is one of the world's largest franchisors

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"WITH FRANCHISEES FINANCING THE BULK OF GROWTH CAPITAL SPENDING, FRANCHISORS GENERATE HIGH INCREMENTAL RETURNS ON CAPITAL."

How franchising works

The franchisor owns the underlying brand concept and licenses the use of it to franchisees. In exchange, the franchisor receives some form of ongoing compensation.

The three main types of compensation are a royalty payment for the use of the trademark; a reimbursement for franchisee services or products; and a set percentage of the sales that the franchisee generates.

Franchisors are compensated according to franchisee activity rather than franchisee profitability. Franchisors get paid even if franchisees are losing money. This makes them resilient during economic downturns.

Over the long term, franchisors perform well only if their franchisees also do well. Profitable franchisees remain in business and will expand their estate; unprofitable franchisees will eventually go out of business.

Franchisor free cash flow

Franchisors only need to invest in the infrastructure needed to support franchisees. Franchisors therefore operate as capital-light businesses that receive regular cash payments from franchisees.

Restaurant franchisors need to establish several sites to produce and supply ingredients to franchisees. They also need to undertake marketing, training and other activities needed to support the brand and franchisees.

Restaurant franchisors generate much higher returns than restaurant chains that own their stores. They aren't exposed to the risk of individual locations becoming unprofitable, with this burden falling on franchisees.

Domino's Pizza Inc's 2018 annual report stated that its business model can "yield significant cash flow to us, through a consistent franchise royalty payment and supply chain revenue, with moderate capital expenditures."

Free cash flow growth

In his 1992 Berkshire Shareholder Letter, Warren Buffett stated that "the best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return."

With franchisees financing the bulk of growth capital spending, franchisors generate high incremental returns on capital. Franchisors can spread their existing infrastructure over a larger revenue base.

Restaurant franchisors do need to invest in new supply infrastructure from time to time. But it is the franchisees that finance new stores and run them at a loss until they reach critical mass.

A key risk in the restaurant business is overexpansion and the related long-term store leases on loss-making sites. Franchisees tend to take on this risk, which makes restaurant franchisors lower-risk investments.

Restaurant franchisors

Leading restaurant franchisors include McDonald's Corp, Domino's Pizza Inc, **Yum Brands (NYSE:YUM), Dunkin Brands (NASDAQ:DNKN), Restaurant Brands (TSE:QSR)** and **Wingstop (NASDAQ:WING)**. They offer simple propositions with a good chance of franchisee success.

Restaurant franchisors focus on marketing, technology and making the restaurant concept more appealing. A key risk for franchisors is that franchisees fail to maintain the quality and consistency of their brand.

Most franchisees, though, are motivated to perform well given the capital they have invested. The franchisor also has the power to rescind the franchisee's licence in certain circumstances.

McDonald's Corp and Domino's Pizza Inc

Two of the world's most prominent restaurant franchisors are McDonald's Corp and Domino's Pizza Inc. Both are the master franchisors, which means that they own their respective brands.

McDonald's Corp is one of the largest listed franchisors with 93% of its 37,855 outlets franchised at the end of 2018. Domino's Pizza Inc is also a major franchisor with nearly all of its 16,314 stores franchised.

McDonald's Corp

The McDonald brothers created an efficient self-service restaurant in 1948 that focused on hamburgers and milkshakes. This contrasted with full-menu diners that relied on waiter and waitress service.

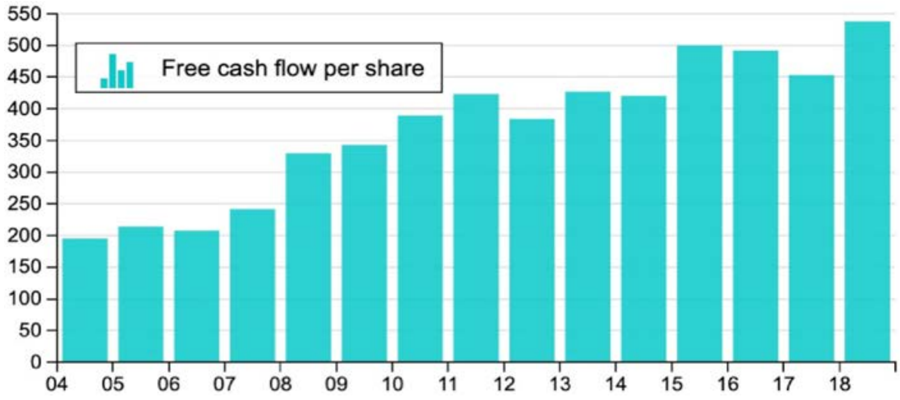
NP27 / Shutterstock.com

The simple formula allowed McDonald's to undercut the competition on price and convenience. Ray Kroc started franchising the business in 1955 and bought out the founding brothers in 1961.

The company was listed in 1965 and reached 10,000 restaurants by 1988. The history of McDonald's is set out in the movie *The Founder.* The McDonald brothers developed a great concept and Ray Kroc franchised it.

The resilience of McDonald's Corp as an investment is highlighted by its FCF per share since 2004. FCF increased in every year from 2006 to 2011 with the global financial crisis having no discernible impact.

McDonald's: a resilient and growing business



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Domino's Pizza Inc

Domino's Pizza Inc was started when two brothers took over the DomiNick's restaurant in Michigan in 1960. The first franchise was opened in 1967 and by 1978 the company had 200 stores.

The original promise was to deliver a pizza within 30 minutes of ordering for no extra charge. This was best achieved from a small takeaway store rather than from a restaurant.

With pizza relatively low cost and easy to make, it lends itself well to food delivery. Like McDonald's, the group focused on making the process of pizza preparation faster and more efficient.

Domino's Pizza went through a difficult period from 2006 to 2008 when US like-for-like store sales declined. Franchisee profitability suffered and the pizza crust was memorably described as tasting like "cardboard."

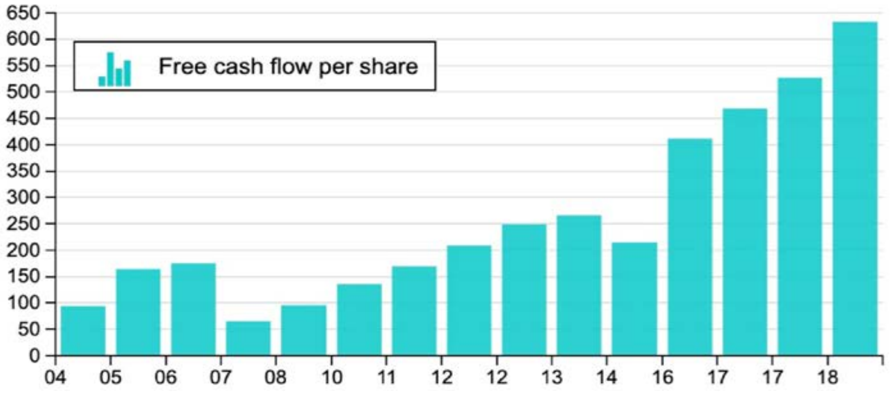
A determined turnaround effort to improve the quality of the food has paid off since then. FCF per share fell from $1.75 in 2006 to $0.65 in 2007 but has since rebounded to US$6.33 in 2018.

Domino's Pizza Inc: financial returns

Domino's Pizza Inc highlights how profitable master franchisors can be. ROCE is over 100% and CROCI (the cash flow return on capital invested) is over 50%.

The business remained highly profitable even during the weak period of trading from 2006 to 2008. Domino's Pizza Inc collects a consistent royalty income stream from franchisees, which is calculated as a percentage of their revenue.

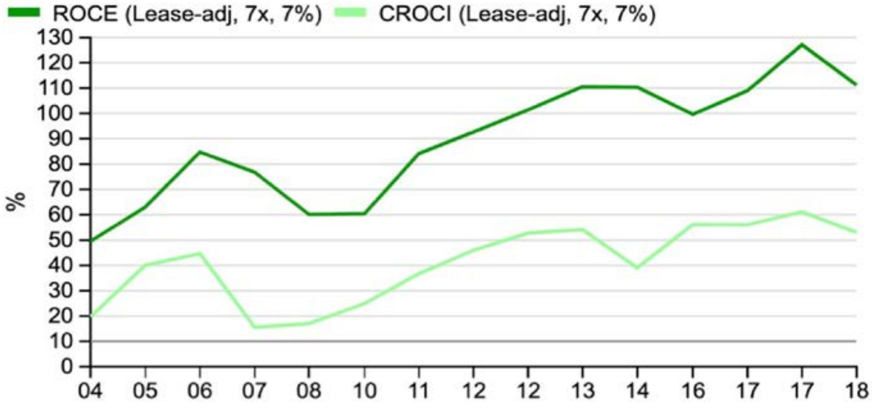
Domino's Pizza Inc FCF per share



Source: SharePad

“DOMINO’S PIZZA INC HIGHLIGHTS HOW PROFITABLE MASTER FRANCHISORS CAN BE. ROCE IS OVER 100% AND CROCI (THE CASH FLOW RETURN ON CAPITAL INVESTED) IS OVER 50%.”

Domino's Pizza Inc's financial returns



Source: SharePad

Domino's Pizza: the "number one pizza brand in the world"

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What's in it for franchisees?

Franchising primarily serves the interests of franchisors. They control the franchising terms and transfer much of the business risk onto franchisees. But franchisees can also do well.

The success rate for start-up businesses is relatively low, not least in the restaurant sector. There can also be a significant burden in terms of the administration and the sheer hours needed to make it work.

Franchisees benefit from a proven business concept and the support network to make a success of it. They benefit from a strong brand and the scope to increase the number of outlets over time.

Becoming a franchisee can be a better option than starting a new business from scratch. There is no question, though, that franchisors earn higher returns and are exposed to less risk than their franchisees.

Restaurant master franchisees

Master franchisors like Domino's Pizza Inc and McDonald's Corp own the underlying brand. They have sometimes chosen to award a master franchise licence for a country or region to another company.

In exchange, the master franchisor receives a reliable royalty income with very little capital expenditure and no country risk. Domino's Pizza Inc stated in its 2018 annual report that "The vast majority of [international master franchise] royalty revenue results in profits to us."

Master franchisees are in the middle of the franchising food chain. They are less profitable than the master franchisors but are more profitable than store franchisees.

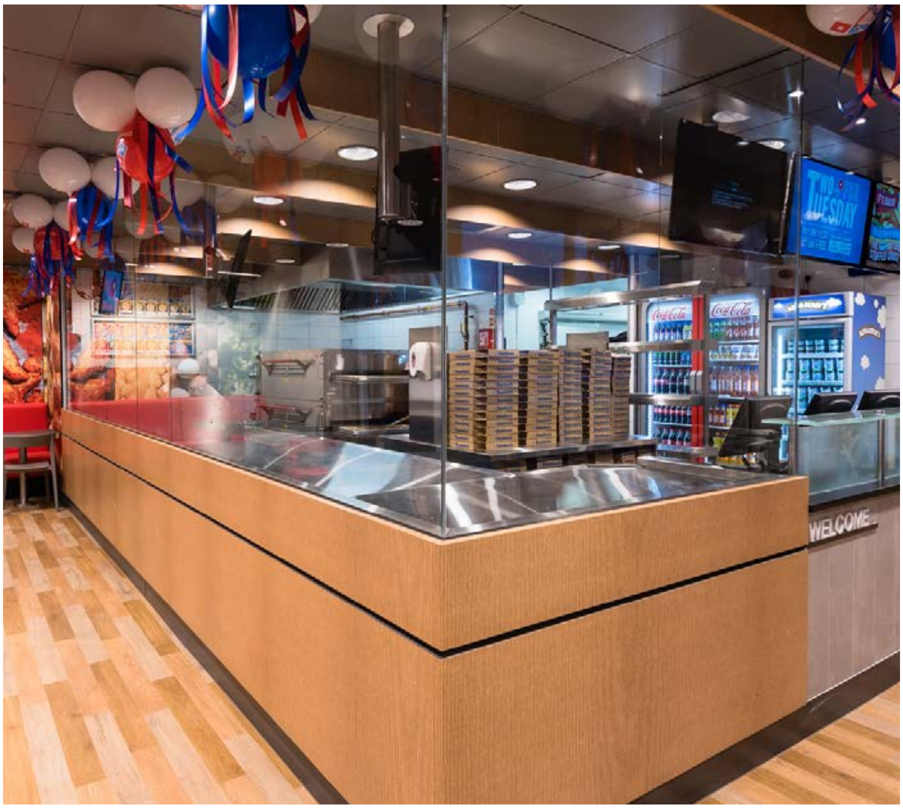
Other things being equal, it is better for investors to own the master franchisor. Master franchisees do not own the underlying brand and have sometimes failed to make a concept work eg **DP Poland (LON:DPP)**.

Franchisee conflicts

The relationship between franchisors and franchisees is not always a happy one. Franchisors are incentivised to grow the number of outlets while franchisees focus on store profitability.

The franchisor may push for store growth even when the market is saturated. Store expansion increases franchisor royalty income but may reduce franchisee profitability.

Franchisors can also aggressively mark up goods that are supplied to franchisees and make the franchise terms more onerous. This will benefit franchisors in the short term but will make it harder to attract new franchisees.



If franchisees club together, they can exert some influence over franchisors. This is not least the case when a few franchisees dominate. Franchisors therefore often seek to keep individual franchisees relatively small.

Franchisee revolt at Domino's Pizza Group (UK)

Domino's Pizza Group (LON:DOM) highlights the conflicts that can arise. The company is the master franchisee in the UK and several European countries.

Domino's Pizza Group has been pushing for growth in the UK at the expense of franchisee profitability. Higher costs have also hit franchisee profitability and have led to calls for Domino's Pizza Group to absorb some of the pain.

Franchisees are now negotiating as a group and stepping back from opening new outlets in the UK. The breakdown of relations may be one factor behind the recently announced departure of chief executive David Wild.

Summary

Franchising is a business model that can work well for investors. Franchisors enjoy the fruits of business success and avoid much of the downside risk.

Restaurant franchisors Domino's Pizza Inc and McDonald's Corp have been particularly successful. Franchisors with profitable concepts and expansion potential can present outstanding investment opportunities.

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

BELLWAY

A CHEAP STOCK WITH LONG-TERM GROWTH POTENTIAL

Robert Stephens discusses why the FTSE 250 housebuilder could offer a more robust financial outlook than its current valuation suggests.

The unpopularity of UK housebuilders such as Bellway could present a buying opportunity for long-term investors. Although house prices have fallen in the last two months according to the Halifax House Price Index, they are 4.1% up over the last year. This suggests that while further falls may be unsurprising as the Brexit process approaches its conclusion, a lack of supply and robust demand may act as catalysts on the wider industry over the long run.

Indeed, the imbalance between supply and demand within the housing market is expected to increase. This could provide Bellway with robust operating conditions – even as government policies such as Help to Buy and stamp duty land tax (SDLT) relief evolve over the medium term.

With the company having a net cash balance, it is in a strong position to increase the size of its land bank and invest in new sales outlets. Its solid customer-satisfaction rating reduces the risk of customer redress, while a diverse geographical exposure across the UK means that it could capitalise on house-price growth outside London and the South East, where prices are at historic highs when compared to average incomes.

Since the stock trades on a low rating, it appears to offer a margin of safety. Although it may not be a favourite of many investors at the moment, the company could deliver a potent mix of income and capital growth over the long run.

Favourable position

While a number of Bellway's sector peers have experienced significant criticism for the quality of their homes, the company was recognised as a five-star housebuilder by the Home Builders Federation in 2019. This means that over 90% of its customers would recommend the company to a friend, and it is the third year in succession that it has been awarded five stars. It should mean that the prospect of major customer redress or a slowdown in completions in order to address quality issues, which have affected peers such as Bovis and Persimmon in recent years, are minimised.

In fact, Bellway has increased the number of annual completions in each of the last 10 years. It now builds over 10,000 homes per year and has the potential to maintain robust growth over the long run. Its forward order book comprises of 4,878 homes, while demand among consumers has remained robust according to its recent updates.

Its net cash position of £201 million means that it is in a strong position to purchase additional land in what remains an attractive wider market according to the business. Should the property market experience a prolonged downturn, it may be able to significantly increase

"IN 2019, THE AVERAGE HOUSE IN THE UK COSTS ALMOST SIX TIMES THE AVERAGE ANNUAL SALARY."

the size of its land bank. Since the property market has historically been cyclical, doing so could put the company in a stronger position to generate a relatively high return on capital over the long run.

The company's diverse geographical exposure may be a major ally in what is proving to be a two-tier UK housing market. While London and the South East has experienced a marked slowdown in the rate of house-price growth in recent months, other UK regions are enjoying more robust levels of performance. As a result, the business may be able to better overcome what could prove to be a rather mixed housing market, in the short term at least, compared to many of its sector peers.

Market prospects

Given the high employment levels in the UK and the competitive mortgage market, demand for new homes could remain robust over the medium term.

Clearly, affordability is seen as a risk by many investors at a time when house prices are close to their highest-ever level when compared to average annual incomes. In fact, in 2019, the average house in the UK costs almost six times the average annual salary. The last time it was at a similar level was shortly before the financial crisis, after which house prices experienced a period of decline.

Despite a high price-to-earnings multiple, house prices remain affordable for a wide range of consumers across the UK. Evidence of this can be seen in the proportion of average incomes that are spent on mortgage repayments. Currently, this figure stands at under 30%. Prior to the financial crisis it stood at almost 50%, with its current level being the same as it was in the year 2000 following a 'lost decade' for house prices.

Clearly, low interest rates have been a key factor in improving the affordability of homes across the UK. Interest-rate rises could reduce affordability, although a loose monetary policy is expected to remain in place over the medium term. Interest rates, for example, are forecast to reach around 1.25% in 2022. This suggests that new homes could remain highly affordable for a prolonged period, which may equate to stronger operating conditions for Bellway than the stock market is currently pricing in.

The main catalyst for house prices over the long term is likely to be a continued imbalance between demand and supply. The projected household formation rate in England is currently running at 233,000. The supply of new-build completions is around 184,000. Even when conversions of existing buildings into residential dwellings are included in the figures, the annual supply of new homes stands at 217,000. As a result, demand is higher than supply. This could provide support to house prices, and allow housebuilders to enjoy rising profitability over the long run.

Possible threats

With Brexit now a matter of weeks away, Bellway's UK focus could mean that it faces a period of uncertainty. Moreover, a fluid political situation means that changes to government policies such as Help to Buy and SDLT relief may be ahead. Since they have had a positive impact on the wider sector, and have helped to further increase the affordability of houses during a period of low interest rates, there is the potential for a slowdown in growth across the sector.

The political consensus, though, is likely to remain supportive towards aiming to increase the number of new

233,000
Projected annual household formation rate (England)

184,000
Annual supply of new-builds

"THE RISKS TO THE WIDER UK ECONOMY FROM BREXIT-RELATED DISRUPTION APPEAR TO BE PRICED IN TO BELLWAY'S VALUATION."

homes being built each year. This may mean that while policy changes are somewhat inevitable, they are unlikely to inhibit the industry over the long run.

Therefore, while the housebuilding industry is likely to experience change over the next few years as the Help to Buy scheme is forecast to wind down, the fundamentals of the market in terms of supply and demand could lead to growth opportunities in future years.

Investment potential

The risks to the wider UK economy from Brexit-related disruption appear to be priced in to Bellway's valuation. It has a P/E ratio of around 6.6, while it trades on a price-to-book ratio of 1.3. These figures suggest that investors are anticipating a slowdown in demand for new homes that leads to a decline in the company's growth rate. While this is a possibility, the fundamentals of the housing market suggest that operating conditions for Bellway and its peers may be more positive than the stock market is expecting.

As well as a low valuation, the stock also has an impressive income-investing outlook. It currently yields around 5% from a dividend payment which was covered three times by earnings in the 2018 financial year. Since it plans to maintain dividend cover at the current level, its dividend growth rate could prove to be similar to its increase in profitability over the long run. And, due to it having a strong net cash position, its capacity to pay a rising dividend may not be impacted by opportunities to invest in future growth opportunities.

Future outlook

The uncertain outlook for the UK economy and housebuilding sector in the second half of 2019 means that other FTSE 350 shares may offer more robust investment prospects – particularly in the short run. Factors such as Brexit and the political uncertainty it may produce could mean that investors demand a wider margin of safety for companies that are highly dependent upon the UK economy for their sales and profitability.

However, Bellway appears to be in a strong position to generate improving financial performance over the long term. It has a net cash position, a strong order book and its operating conditions may prove to be more robust than many investors are currently anticipating. Factors such as a continued low interest rate, an increasing imbalance between the demand and supply of new homes and the affordability of homes relative to historic levels suggest that the housebuilding industry may experience favourable trading conditions.

With Bellway having a low valuation, as well as the potential to offer a high and growing income return, its investment prospects appear to be bright. It may continue to be an unpopular share over the coming months, with many investors likely to remain cautious regarding its future financial prospects. But, with an encouraging long-term outlook for the wider housebuilding industry and a solid position relative to its peers, it could deliver high returns.

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

THE FUTURE OF (ALMOST) EVERYTHING

HOW OUR WORLD WILL CHANGE OVER THE NEXT 100 YEARS

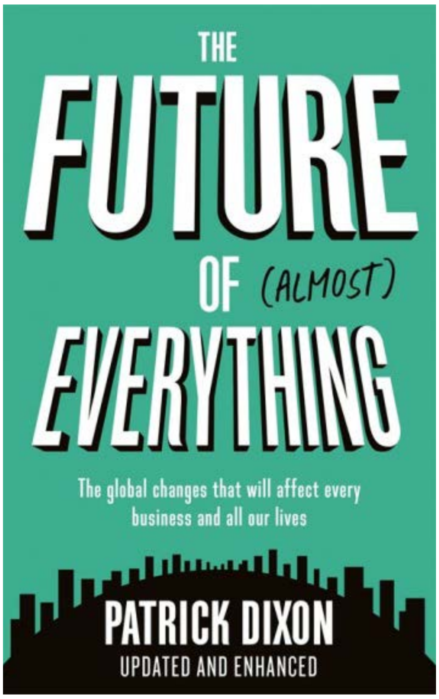
BY PAUL DIXON

Richard Gill, CFA, reviews *The Future of (Almost) Everything* by Patrick Dixon, who has a reputation as a credible and insightful long-term trend forecaster.

Trying to predict what will happen in the near future is not only a mainstay of the finance industry, but also of life in general. Thousands of people across the world, from equity analysts, weather forecasters, sports tipsters and even psychics, work in professions that try to guide people by predicting what's likely to happen in the coming hours, days, weeks, months and beyond. Finance, however, (along with Mystic Meg and her ilk) has gained a notable reputation for not being particularly good at it. Who could forget the quip from American economist Paul Samuelson: "Wall Street indexes predicted nine out of the last five recessions!"

With short-term trend forecasting often being just as accurate as a monkey throwing a dart, how can you go about predicting things in the longer term? Perhaps surprisingly, longer-term trends can frequently be forecast more easily than events with a near-term time horizon. A decade ago, for example, it might have been pretty obvious that global smartphone sales were set to rise substantially. But trying to predict exactly how much money Apple would make from selling iPhones in Q2 2010 was a lot more difficult – in fact iPhone revenues fell that quarter. The key point is that long-term, or 'mega' trends, evolve more slowly and steadily than periodic booms and busts, so should be easier to spot.

One person who has gained a reputation as a credible and insightful long-term trend forecaster, or 'futurist', is author of *The Future of (Almost) Everything*, Patrick Dixon. A prolific writer, having written 15 books, today he is a consultant to the senior teams of many large businesses on subjects such as strategy and risk management. He was ranked one of the 20 most influential business thinkers alive, according to The Times' *Thinkers 50* survey. If you want to check out his record for yourself, aside from reading



"WE HAVE ANOTHER DIGITAL REVOLUTION TO LOOK FORWARD TO."

his previous books, he has published a multitude of videos and articles online.

Tomorrow's world

As we approach the year 2020, Dixon's latest and updated book attempts to provide readers with a clearer vision of what the world will be like in 10, 20, 30 and many more years into the future, up until the early decades of the 22nd century. This is the second edition of a book that was first published in mid-2015, with the author showing how recent global events have confirmed his previous predictions. Timely topics added to this version include how artificial intelligence and robotics are gaining influence, the longer-term future of the EU and UK beyond Brexit (if it happens) and the effects of the MeToo movement on sexual equality.

The core text is contained within six main chapters which follow Dixon's 'six faces of the future' cube model. Perhaps not coincidentally, this spells out FUTURE as an acronym. Featuring first is Fast, discussing the speed of change and in particular how developments in certain technologies will affect the future. Technologies can facilitate rapid change in many areas of life, from turning people into screen-staring zombies to enabling payments to be made with a microchip implant. Amongst other things, Dixon believes we have another digital revolution to look forward to in the coming years but with the challenges of a huge increase in cybercrime.

Urban, the next side of the cube, looks at topics such as demographics, urbanisation and health. It's pretty clear that some of these areas will see their recent growth trends continue, with nine billion humans expected on the planet in the next 20 years and 11 billion by 2090. Asia will continue to be a booming growth area and people will continue to move into cities in search of a better life. Income inequality is also expected to grow, with 1% of humanity forecast to own 65% of the wealth in 30 years' time. However, the wealth of the expected population of 'humonkeys', an apparently technologically feasible human/monkey hybrid, has not been predicted.

The four remaining faces of the cube are: Tribal, covering nations, cultures and other ways humans organise themselves into groups and identities; Universal, the opposite of tribalism and looking at globalisation and trade; Radical, discussing politics and ideologies; and Ethical issues. Some of the more interesting possibilities mentioned in these chapters include the likely break-up of the UK into separate sovereign states, America adjusting to a more modest world status as other superpowers emerge and a potential assassination of Pope Francis. Sadly, there was no prediction about when Bradford City might get back into the Premier League.

Also new in this updated edition, chapter seven sets out a sci-fi-esque scenario of a time when probably (but maybe not all) readers will be six feet underground. This is written from the perspective of Predictor MK31, an early 22nd century robot owned by the Global Democratic Forum (GDF). The GDF, the successor to the United Nations, is founded in 2071 to foster global peace and harmony. There are some dystopian elements, with stories of climatic disasters and flu pandemics ravaging populations. But on the bright side, GDF members have voted to destroy nuclear weapons, the human population is falling from a peak of 11.8 billion in 2073 and only 0.5% of humanity is in need of food, power or clean water. We also have 'happy drugs' to look forward to; and mood-facilitating pills which can moderate appetite and obesity, as well as sex drive and the desire to associate with other humans.

Take hold of your future...

Dixon has produced yet another masterpiece here, with the sheer breadth of material covered being a standout achievement and far too much to cover adequately in this review. All is easy to read, well-researched and laid out (typically two sections per page) with the author packing in the stats and the reasoning behind his future visions. While much of the book covers potential threats and challenges to human life over the coming 100 years, Dixon errs on the side of optimism, avoiding making any alarmist or sensationalist claims in favour of a hope for continuing human resilience and innovation. The book is ideal for a range of readers including investors, business owners, chief executives and world leaders. After all, planning ahead is part of being human.

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

JAPANESE LESSONS

The West has learnt nothing from the experience of Japan's lost two decades. That could prove to be painfully expensive.

"You think the odds look right, that they are in your favour?

This is a billiard table. An easy, flat, green billiard table. And you have hit your white ball and it is travelling easily and quietly towards the red. The pocket is alongside. Fatally, inevitably, you are going to hit the red and the red is going into that pocket. It is the law of the billiard table, the law of the billiard room.

But outside the orbit of these things, a jet pilot has fainted and his plane is diving straight at that billiard room, or a gas main is about to explode, or lightning is about to strike.

And the building collapses on top of you and on top of the billiard table. Then what has happened to that white ball that could not miss the red ball, and to the red ball that could not miss the pocket? The white ball could not miss according to the laws of the billiard table. But the laws of the billiard table are not the only laws in this particular game."

— Extract from the novel *From Russia with Love*, by Ian Fleming.

"In the 1970s, the Yale economist Herbert Scarf determined that the time to equilibrium scales exponentially with the number of products and services in the economy to the power of four. The intuition behind this relationship is straightforward: the more products and services, the longer it takes for all the prices and quantities to adjust... if we optimistically assume that every decision in the economy is made at the speed of the world's fastest supercomputer (currently IBM's Blue Gene, at 70.72 trillion floating-point calculations per second), then using Scarf's result, it would take a mere 4.5 quintillion (4.5 x 1018) years for the economy to reach general equilibrium after each exogenous shock. Given that shocks from factors such as technological change, political uncertainty, weather and changes in consumer tastes buffet the economy every second, and the universe is only about 12 billion (1.2 x 1010) years old, this clearly presents a problem."

— **Eric Beinhocker**, ***The Origin of Wealth***.

As Ian Fleming implies, there are laws, and then there are laws. Meanwhile, we make our fragile plans, unaware of just how much we don't know.

Economics, it turns out, is not a science at all. In science, there are testable and falsifiable hypotheses. As the philosopher of science, Karl Popper, reminds us, one failed experiment is all it takes to refute a theory. Now apply that logic to an economic experiment like quantitative easing (QE). This correspondent would argue that the fundamental purpose of QE was to help governments inflate away an unpayable mountain of global debt. So, after 10 years of QE, where's the inflation? The Federal Reserve has just *cut* interest rates for the first time since 2008 – despite a sub-par US inflation rate, almost full employment and stock markets close to record highs.

Could QE perhaps be deflationary, instead? Allied with NIRP (negative interest-rate policies), it could well be. Low or negative interest rates allow profitless companies that would otherwise be forced to close, to shamble on like zombies, with access to artificially low, government-sanctioned credit. Their products and services then compete with those from businesses that are economically viable, driving down prices in the process. That sounds deflationary to me.

The world, it would seem, has turned into 1990s Japan, as many financial strategists have long feared it would. Here is a letter to the Financial Times from a Mr. Takashi Ito in Tokyo, from August 2010:

"Sir, 'Can the Fed prevent Japanese-style deflation, a period of falling prices associated with economic stagnation, from taking hold?' is a common refrain nowadays.

"WE MAKE OUR FRAGILE PLANS, UNAWARE OF JUST HOW MUCH WE DON'T KNOW."

"The US Federal Reserve's obsession with Japan is pretty disastrous. First, Alan Greenspan opened the taps wide for too long, fearing Japanese-style deflation, which fuelled the housing bubble that led to the recent financial crisis. Now, fearing the lost decade plus, the Fed is probably going to keep easing until some different but unpleasant outcome is the result. Stagflation perhaps, or hyperinflation?

"This is so ironic, because for so long people have sneered at the Japanese for their inability to steer their economy to recovery. Perhaps because they have sneered so much, it is no longer possible to admit that after a huge housing bubble bursts, there is nothing to do except suffer many years of economic indignity.

"The fixation with Japan was not helpful during Mr Greenspan's watch, nor I fear will it be of much use this time. The Japanese may be different, but they were not stupid."

You have to admire that phrase "years of economic indignity". Only the Japanese could coin something with such exquisite understatement.

It is 30 years since Japan's Nikkei 225 stock index hit an all-time high of 38,915 (a level it reached on the last trading day of 1989). As Peter Tasker, co-founder of Arcus Investments, points out, within nine months of reaching this peak, the index had halved in value. By the time Shinzo Abe was re-elected as prime minister in late 2012, the index was trading below 9,000 – or less than a quarter of its 1989 level.

It is difficult to appreciate just how much psychological, let alone financial, damage Japan and its investors have endured since the collapse of its late 1980s 'bubble economy'. One estimate has it that, in terms of the subsequent loss of wealth suffered by property and equity prices, the Japanese economy has been hit by the equivalent of not one but ***two*** American Great Depressions. Given that measures like GDP growth and unemployment have held up remarkably well over the period in question, and that Japanese

"JAPAN IS NOW PERHAPS THE CHEAPEST DEVELOPED STOCK MARKET IN THE WORLD."

society never once threatened to disintegrate into lawlessness or violence, you have to wonder whether the West might aspire to the level of stoicism that the Japanese have displayed.

But the Japan of 2019 is not the Japan of 1989. Japan is now perhaps the cheapest developed stock market in the world – as you might expect, given what its economy has been through. As Peter Tasker observes, at its 1989 peak, the Japanese stock market traded on a p/e ratio of 70 times, and a dividend yield of 0.5%. Today the p/e ratio of the Japanese stock market is at a 48-year low. Its dividend yield is now 2.5%. Its overall cash return yield (ie dividends plus stock buybacks) is at over 5%. Japanese stocks now yield more than their US cousins.

That a combination of domestic and foreign investors remain traumatised by that two-decade bust is only another reason to be bullish. Other investors' psychology need not dictate your own.

Financial markets globally, however, are now extremely risky. However, perhaps "risky" is not the most accurate adjective. Consider this presentation by Gerd Gigerenzer, director at the Max Planck Institute for Human Development and Director of the Harding Centre for Risk Literacy in Berlin. Mr Gigerenzer distinguishes between risk and uncertainty, as follows:

> RISK: How should we make decisions when all relevant alternatives, consequences, and probabilities are known? *requires statistical thinking.
> UNCERTAINTY: How should we make decisions when NOT all alternatives, consequences, and probabilities are known? *requires smart rules of thumb (heuristics) and intuition.

How best to describe financial markets? Modern portfolio theorists would describe them as risky. We would describe them as acutely *uncertain.*

In this interview between Gerd Gigerenzer and Michael Covel, the following magical phrase pops up:

> "The art of knowing what one doesn't have to know."

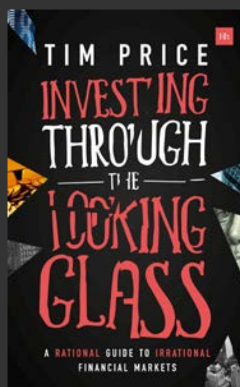
Since we are all drowning in information but starved of knowledge, it helps to be able to filter all the myriad distractions of 'Finance World' down into a circle of competence and then never depart from that circle. For ourselves, that circle of competence comprises three types of assets:

- Shares in high-quality businesses run by principled, shareholder-friendly managers who are also adept at capital allocation, *particularly* when those shares can be acquired at a discount to those companies' inherent worth (see Japan for more);
- Systematic trend-following funds that are uncorrelated to the major asset classes of stocks and bonds, and that offer the potential for portfolio protection during market shocks;
- Real assets – tangible, non-financial assets that offer the potential for portfolio protection during market shocks and also the potential for protection against inflation and ongoing fiat currency 'debauchery'.

Surviving whatever the markets throw at us over the coming months and years will require brains. It will also require guts. And, perhaps, a healthy respect for what economics doesn't teach us, and never will.

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'.



SEPTEMBER 2019

INVESTOR EVENTS DIARY

EVERY WEDNESDAY

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

THURSDAY, 19 SEPTEMBER

Event:	Ready Steady Grow!
Organiser:	EISA
Time:	18:00-20:30
Place:	TechHub, London
Tickets:	https://eisa.org.uk/events

THURSDAY, 12 SEPTEMBER

Event:	Ready Steady Grow!
Organiser:	EISA
Time:	08:00-10:30
Place:	Barclays Eagle Lab, Manchester
Tickets:	https://eisa.org.uk/events

TUESDAY, 24 SEPTEMBER

Event:	Ready Steady Grow!
Organiser:	EISA
Time:	18:00-20:30
Place:	Barclays Eagle Lab, Liverpool
Tickets:	https://eisa.org.uk/events

WEDNESDAY, 18 SEPTEMBER

Event:	The resilience of prime property in uncertain times
Organiser:	Capital Rise
Time:	18:30-21:00
Place:	The Clubhouse, 50 Grosvenor Hill, Mayfair, London W1K 3QT
Tickets:	https://intelligent-investing.capitalrise.com/september-event-rsvp

TUESDAY, 8 OCTOBER

Event:	Ready Steady Grow!
Organiser:	EISA
Time:	18:00-20:30
Place:	Spaces, Edinburgh
Tickets:	https://eisa.org.uk/events

WEDNESDAY, 16 OCTOBER

Event:	Ready Steady Grow!
Organiser:	EISA
Time:	18:00-20:30
Place:	PwC, 19 Cornwall Street, Birmingham
Tickets:	https://eisa.org.uk/events

THURSDAY, 17 OCTOBER

Event:	Ready Steady Grow!
Organiser:	EISA
Time:	14:30-18:00
Place:	The Mac, Belfast
Tickets:	https://eisa.org.uk/events

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

TUESDAY, 12 NOVEMBER

Event:	Ready Steady Grow!
Organiser:	EISA
Time:	08:00-10:30
Place:	Clarion Solicitors, 13-19 Queen Street, Leeds
Tickets:	https://eisa.org.uk/events

WEDNESDAY 13 NOVEMBER

Event:	Investing in the age of Longevity
Organiser:	Master Investor and Longevity Forum
Time:	10:00-17:00
Place:	Science Gallery, Great Maze Pond, London SE1 9GU
Tickets:	50% discount using code: MIF071 https://milongevity.eventbrite.co.uk

THURSDAY, 21 NOVEMBER

Event:	Ready Steady Grow!
Organiser:	EISA
Time:	08:00-10:30
Place:	Engine Shed, Bristol
Tickets:	https://eisa.org.uk/events

TUESDAY, 26 NOVEMBER

Event:	Ready Steady Grow!
Organiser:	EISA
Time:	08:00-10:30
Place:	Tramshed Tech, Cardiff
Tickets:	https://eisa.org.uk/events

WEDNESDAY, 27 NOVEMBER

Event:	Future Forward: UKBAA Winter Investment Forum
Organiser:	UKBAA
Time:	14:00-21:00
Place:	CMS, Cannon Place, 78 Cannon Street, London EC4N 6AF
Tickets:	https://www.futureforwardukbaa.org

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:	50% discount using code: MAG08 https://masterinvestorshow.eventbrite.co.uk

MARKETS IN FOCUS

AUGUST 2019

GLOBAL EQUITIES

Index	Last Month %	YTD%	52-Week Strength
Swiss Market	-0.2	17.4	
CAC 40	-0.7	15.8	
CSI 300	-0.9	26.2	
Bovespa	-1.3	14.4	
Euronext 100	-1.6	16.1	
Dow Jones	-1.7	13.2	
S&P 500	-1.8	16.7	
NASDAQ 100	-2.0	21.5	
DAX Xetra	-2.1	13.1	
FTSE All-World	-2.6	11.9	
S&P/ASX 200	-3.1	17.0	
Nikkei 225	-3.8	3.5	
Russian TSI	-4.9	21.0	
FTSE 100	-5.0	7.1	
Hang Seng	-7.4	-0.5	

COMMODITIES

Commodity	Last Month %	YTD%	52-Week Strength
Silver	11.7	17.8	
Gold	6.9	19.6	
Platinum	4.7	14.8	
Palm Oil (Crude)	3.5	1.5	
Natural Gas	2.8	-22.4	
Crude oil (Light Sweet)	-3.2	23.8	
Copper	-3.3	-1.9	
Palladium	-3.5	22.9	
Coffee	-4.4	-6.5	
Bitcoin	-5.4	162.0	
Crude oil (Brent)	-6.7	9.8	
Cocoa	-6.8	-9.6	
Cotton	-6.9	-18.4	
Sugar (No. 11)	-8.2	-6.8	
Iron Ore	-26.3	14.4	

FOREX

Pair/Cross	Last Month %	YTD%	52-Week Strength
GBP/AUD	1.9	-0.3	
USD/CAD	0.7	-1.8	
GBP/USD	0.2	-4.7	
EUR/USD	-0.1	-4.0	
EUR/GBP	-0.4	0.7	
USD/CHF	-0.8	0.6	
EUR/CHF	-0.9	-3.2	
AUD/USD	-1.6	-4.5	
USD/JPY	-2.2	-3.1	
EUR/JPY	-2.3	-7.0	

CENTRAL BANKS – RATES & MEETINGS

Central Bank	Key Rate	Next	After
Bank of England (BoE)	0.75%	Sep 19	Nov 07
European Central Bank (ECB)	0.00%	Sep 12	Oct 24
Federal Reserve System (FED)	2.25%	Sep 18	Oct 30
Bank of Japan (BoJ)	-0.10%	Sep 19	Oct 31
Bank of Canada (BoC)	1.75%	Sep 04	Oct 30
Reserve Bank of Australia (RBA)	1.00%	Sep 03	Oct 01
Swiss National Bank (SNB)	-0.75%	Sep 19	Dec 12
Banco Central do Brasil (BCB)	6.00%	Sep 18	Oct 30
Central Bank of Russia (CBR)	7.25%	Sep 06	Oct 25
Reserve Bank of India (RBI)	5.40%	Oct 04	Dec 05

FTSE 350 TOP RISERS

Company	Last Month %	YTD%	52-Week Strength
Kier Group PLC	90.6	-71.2	
Greene King PLC	34.5	59.3	
Entertainment One Ltd	32.7	64.0	
Fresnillo PLC	23.2	-13.9	
Polymetal International PLC	18.8	43.9	

FTSE 350 FALLERS

Company	Last Month %	YTD%	52-Week Strength
Amigo Holdings PLC	-51.8	-71.7	
Micro Focus International PLC	-36.2	-19.8	
Sirius Minerals PLC	-31.1	-50.0	
KAZ Minerals PLC	-30.3	-24.3	
Wood Group (John) PLC	-29.0	-25.5	

FTSE 350 SECTORS RISERS

Sector	Last Month %	YTD%	52-Week Strength
Technology Hardware & Equip	16.8	55.9	
Health Care Equipment & Serv	4.9	26.2	
Mobile Telecommunications	3.6	3.9	
Personal Goods	3.5	25.6	
Electricity	3.1	2.8	

FTSE 350 SECTORS FALLERS

Sector	Last Month %	YTD%	52-Week Strength
Industrial Metals	-23.4	3.8	
Oil Equipment, Services & Dist	-20.7	-19.8	
Life Insurance	-16.3	-3.4	
Fixed Line Telecommunications	-13.8	-29.3	
Software & Computer Services	-11.8	11.4	

IA SECTORS RISERS

Sector	Last Month %	YTD%	52-Week Strength
UK Index Linked Gilts	8.1	19.2	
UK Gilts	4.9	12.1	
£ Corporate Bond	1.6	9.7	
Global Bonds	1.0	9.7	
£ Strategic Bond	0.9	8.2	

IA SECTORS FALLERS

Sector	Last Month %	YTD%	52-Week Strength
Global Emerging Markets	-6.2	9.2	
North American Smaller Comp	-5.3	23.3	
Asia Pacific Excluding Japan	-4.9	11.4	
Japanese Smaller Comp	-4.8	9.2	
European Smaller Comp	-4.5	13.2