STOCKS | FUNDS | INVESTMENT TRUSTS | PENSIONS AND SAVINGS

VOL 18 / ISSUE 42 / 20 OCTOBER 2016 / £4.25

SHARES

WE MAKE INVESTING EASIER

5 STOCKS BUFFETT WOULD BUY NOW

HOW TO APPLY THE INVESTMENT GURU'S METHODS TO THE UK MARKET

RWS +45% SINCE WE SAID TO BUY 7 MONTHS AGO

PRICING POWER IS A SIGN OF QUALITY
Learn valuable lesson from Marmite spat

HOT PROSPECT AS ENERGY BILLS RISE
The FTSE 250 stock primed to benefit

WE EXPLAIN HOW INVESTMENT TRUSTS CAN ***BOOST RETURNS***

Domino's looks bloated

Fast food seller cannibalises existing sales territory to keep growing

Market saturation is a major problem clouding the casual dining sector. Cracks are appearing everywhere and investors would be wise to take a cautious stance towards the sector.

Restaurant chains are obsessed with growth for growth's sake. This is unsustainable and threatens to damage shareholder returns unless the restaurant has a good value proposition that can steal market share from rivals.

FOOD IN A FLASH

Competition is intense from both physical restaurants and takeaways. New delivery services like Deliveroo mean you can have any food imaginable in just a few swipes of a smartphone.

Sitting in the middle of this fanfare is **Domino's Pizza (DOM)** which continues to feed the nation with its cheese-laden goods. It's quite impressive how the rise of the sourdough pizza, smokehouse barbeque joints or superfood salads from a wide range of start-up companies have yet to derail the appeal of Domino's.

Domino's earnings disappointed the market last week – and the shares have since been weak.

You may be surprised to see how its UK growth is playing out. Thirty four of its 51 new stores so far this year have been created by opening sites in existing trading areas rather expanding into new geographic territories. This is referred to as 'splitting' in its results.

That suggests to me it is finding growth harder to achieve in the UK. It also raises the risk that the new stores could cannibalise sales in territories that have been split into two smaller areas.

A local nightclub near my house recently reopened as a Domino's site. It is less than a mile from another outlet. I'd theoretically get my pizza delivered a bit faster from the new site due to its proximity to my home but I can't ever recall the service being slow when Domino's only had one hub from which to send out orders.

AT BURSTING POINT

At some point something has to give. There are simply too many restaurants and too many brands in the industry to meet demand. For Domino's, how can it keep sales growing when consumers have so many alternatives?

Langton Capital suggests it should expand overseas and buy **DP Poland (DPP:AIM)**, the AIM-quoted Domino's Poland franchise owner.

The point at which everyone is opening restaurants or takeaways left, right and centre is when investors should take profit and look elsewhere. You could argue this situation has been in play for several years, yet the market refuses to acknowledge the problem. It can't act blindly for ever. (DC)

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BROKER RATINGS EXPLAINED:

We use traffic light symbols in the magazine to illustrate broker views on stocks.

Green means buy, Orange means hold, Red means sell.

The numbers refer to how many different brokers have that rating.

Eg: 4 2 1 means four brokers have buy ratings, two brokers have hold ratings and one broker has a sell rating.

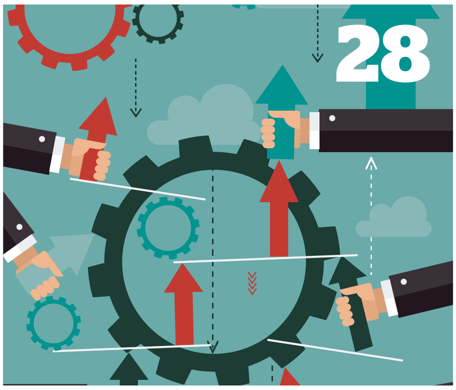
The traffic light system gives an illustration of market views but isn't always a fully comprehensive list of ratings as some banks/stockbrokers don't publicly release this information.

Contents

20 October 2016

INTERACTIVE PAGES

CLICK ON PAGES NUMBERS TO JUMP TO THE RELEVANT STORY



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Switch into Telecom Plus to heat up returns

Research highlights stocks which will benefit from EU departure amid volatile sterling

Households and businesses face rising energy bills this winter as wholesale gas prices reverse more than three years of steady declines.

This could result in headaches for both the big six suppliers and many smaller independents, for different reasons, yet create a unique opportunity for selected stock market-quoted operators, such as **Good Energy (GOOD:AIM)** and **Telecom Plus (TEP)**.

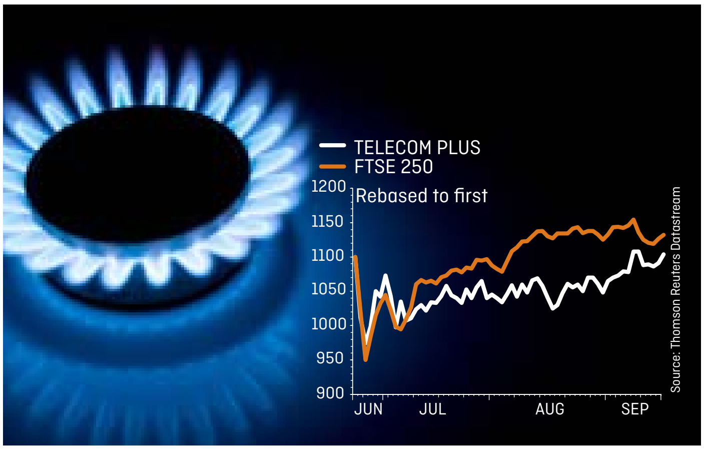
The wholesale price of energy has surged since early September, and this cost has been consistently passed on to customers by suppliers. Experts says that most of the rise stems from supply uncertainty in the wake of the EU referendum vote, volatility in the Middle East and storage shortfalls.

The UK starts what market watchers refer to as the 'heating season,' which runs from October and through to March, with less gas in long-term stockpiles than normal. An unexpected outage at the Rough gas storage facility on England's east coast, the largest in the country, to test the integrity of its wells in June caused it to start the winter with 1.3bn cubic meters (46bn cubic feet) of gas, 54% down from last year.

A rebound in the price of oil and decline in the value of the pound has also lifted the cost of natural gas.

Raising tariffs mean the main big six energy suppliers, including British Gas owner **Centrica (CNA)** and **SSE (SSE)**, will be able to narrow the gap that had opened between spot prices and hedging contracts put in place during the past couple of years at much higher prices. But such moves typically prove hugely unpopular with users and prompt outcry from consumer groups and popularity-seeking politicians.

That could spark a renewed bout of switching by consumers. This has proved a boon for small energy independents in the past. According to



analysts at Macquarie Research, independents have grown their share of the UK consumer energy supply pie from less than 2% in 2012 to around 14% now. But with most of these operating limited or no hedging, they are most exposed to hikes to wholesale prices.

'We believe that a few of these players might come under financial stress in coming months,' Macquarie comments.

According to its estimates, Good Energy is among those running on negative operating margins at present, although the company's clear business model of supplying 100% clean energy may count in its favour. Telecom Plus is arguably the best placed of all thanks to its 20-year fixed-term wholesale energy supply agreement with Npower that includes working capital buffers.

'Telecom Plus is a must own company in a rising power price environment,' conclude Macquarie's analysts. (SF)

SHARES SAYS: ↗

Rising energy prices is always a hot political potato. We agree that Telecom Plus's model neatly places it to maximise new customer growth, cap churn and deliver shareholders returns.

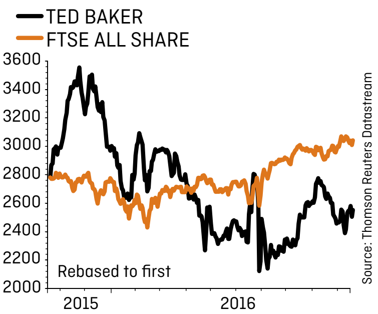
BROKER SAYS 4 2 0

Ted Baker is tailored for smart growth

Half year results remind market of quirky fashion brand's potential

Strong half year results (11 Oct) from **Ted Baker (TED)** demonstrate the strength of the designer label brand, one boasting abundant long-term growth potential across many channels (retail, wholesale, licensing) and geographic markets.

Ted Baker, the aspirational fashion brand which doesn't advertise, boasts brand strength and pricing power, as demonstrated by gross margins well north of 60%. The stock has fallen from last November's peak as sentiment soured on the back of lower density store sales.



The delivery of a better-than-expected 20.5% increase in interim pre-tax profit to £21.5m shows the quirky brand still has growth legs.

Famed for its product quality and detailed designs, Ted Baker's winning brand contrasts with that of struggling peer **French Connection (FCCN)**, whose 'FCUK' logo now appears dated.

Ted is pushing ahead with its international roll-out of new stores and concessions across the UK, Europe, North America and Asia. The e-commerce business is on a growth tear with sales up 29.7% to £29.7m in the six month period. Ted also confidently raised its dividend 12.1% to 14.8p.

Broker Canaccord Genuity has a 'buy' rating and £35.71 price target for Ted Baker, implying upside of 41%. (JC)

SHARES SAYS: ↗
While Ted Baker trades on well over 20 times forecast earnings at £25.39, the premium valuation is more than merited given the brand's global growth potential.

BROKER SAYS 5 1 1

Investors told to get 'real'

Bank of America says financial assets are overvalued

COMMODITY RETURNS OVER the last 10 years are at their lowest since the 1930s depression indicating it could be time for investors to load up on so-called 'real assets'.

Real assets like property, commodities and infrastructure assets trade at low multiples to financial assets like stocks and bonds, say analysts at Bank of America-Merrill Lynch (BAML). Economic and political developments could favour the real rather than the paper economy argues chief investment strategist Michael Hartnett.

'Our themes of peak liquidity, peak globalisation and peak inequality argue for small absolute returns from financial assets but big rotations across markets,' writes Harnett.

'The 2016-17 policy flip from quantitative easing, zero interest rate policies to less monetary stimulus and more fiscal stimulus reflects rising political pressure to reduce wealth inequality.

'The protectionism and redistribution themes are also aimed at boosting Main Street at the expense of Wall Street.'

Hartnett adds: 'As part of this rotation we expect real assets to outperform financial assets.'

Among the potential winners from the investment rotation to real assets include, according to Hartnett's research, commodities like diamonds, gold, platinum and silver, US and UK property, collectibles, art and wine. Losers include small cap and large cap stocks and long-term government bonds. (WC)

'Electric cars are good for GKN'

Analyst's jibe at engineer's low key assessment

Automotive engineer **GKN (GKN)** needs to shout louder about its opportunity in electric-powered vehicles, according to Panmure Gordon analyst Sanjay Jha.

GKN, which is set to deliver a third quarter trading update on 25 October, held a dinner with analysts in September to talk about its Driveline division.

'Last night, I witnessed the first signs of excitement from the company on electrification of cars even though most of the energy was coming from Michigan-based senior vice president Dr Ray Kuczera,' wrote Jha.

'If GKN was a US company it would have finished the analyst presentation with a table-thumping slogan. Instead it ended with "electrification is good for GKN".'

GKN's Driveline business has a 'great opportunity', Jha says, because new entrants into the electric vehicles market are more likely to outsource production than existing manufacturers. Smaller and more complex than standard vehicles, e-vehicle drivelines also deliver higher than average margins.

Opportunities in GKN's Driveline unit are offset

by the group's £2.1bn pension deficit, which is a key risk for investors. Jha estimates sales in 2016 will come in at around £9bn, pre-tax profit at £683m and earnings per share at 29.4p. GKN's shares trade at 329p. (WC)

SHARES SAYS: ↗
Even with a large pension deficit this looks like a good business.

BROKER SAYS 11 7 1

Burberry on the back foot

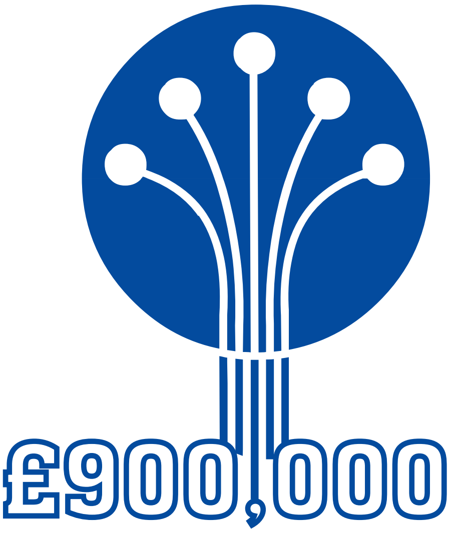
TRENCH COATS, BAGS and cashmere scarves retailer **Burberry's (BRBY)** post Brexit vote bounce has been halted by a first half trading update (18 Oct). It is cautious on the Americas, Hong Kong, Macau and major European markets. The weak pound has at least helped drive UK sales by 30% in the UK and Burberry's ambitious sales growth and productivity plans are 'well underway'. It trades at £14.01. (JC)

Cash return from SSE

BIG SIX ENERGY suppler **SSE (SSE)** is considering a return of value to shareholders after selling a stake in its Scotia Gas Networks arm. The 16.7% equity stake is being sold to the Abu Dhabi Investment Authority for £621m. This could be reinvested in the business but funds back to investors as a shareholder sweetener looks likely, implying a potential 60p per share payout. The group will announce its decision on 9 November. (SF)

Can GAME score an extra life?

OUR BEARISH STANCE on **GAME Digital (GMD)** since its 2014 stock market return is validated by a weak share price and poor full year results (13 Oct). It is trying to become a multi-channel retailer including live gaming. It remains dependent on the timing of console and game releases. (JC)



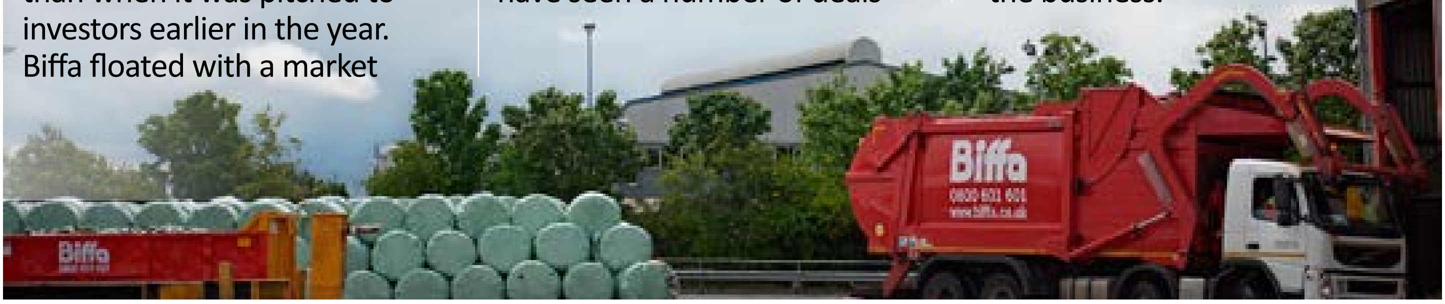
THIS IS THE cash value of share sales by directors of fibre optic network builder **CityFibre Infrastructure (CITY:AIM)** just a week after pulling off a contact expansion with partner Onecom. But do not panic, these are the first boardroom stock disposals since the company listed on AIM on 17 January 2014 at 60p per share. All three directors retain substantial stakes in the business, including CEO Greg Mesch, whose 572,803 share stake is currently worth in excess of £352,000. (SF)

YOU WON'T FIND lobster in the consumer price inflation basket but could surging costs of the luxury crustacean could be a sign of brewing price pressure? Lobster prices hit $6/lb this week, their highest in 11 years. Increases are being put down to the popularity of lobster rolls, now a feature at burger chains, and increased demand in markets including Japan, Korea and Thailand. (LMJ)

VIRTUAL REALITY (VR) may still seem like science fiction for many investors so you might be surprised that 800,000 is the expected number of VR headsets to be sold in the UK this year. Globally the equivalent figure is an impressive 15m, at least according to predictions by mobile market researcher CCS Insight. Headsets may still look boxy but the high resolution displays, lenses and head-tracking sensors increasingly make for the sort of visually immersive, 360-degree, experience consumers are demanding. (SF)

£250M: BIFFA IPO FALLS SHORT

WASTE MANAGEMENT business **Biffa (BIFF)** has rejoined the stock market with an enterprise value of £750m, a quarter of a billion lower than when it was pitched to investors earlier in the year. Biffa floated with a market cap of £450m and net debt at around £300m. Investors are driving a harder bargain in 2016 on IPOs amid more uncertain economic conditions which have seen a number of deals scrapped. Biffa's main private equity backers Avenue Europe, Angelo & Gordon and Bain are retaining around 39% of the business.



1.15%

BOND YIELDS PUSH HIGHER

TEN-YEAR GOVERNMENT bond yields in the UK hit 1.15% – their highest level since the country's vote to leave the EU. Fund managers at Barings say the hike in yields may be, in part, a result of comments by Prime Minister Theresa May which potentially undermine the independence of the Bank of England and the tenure of Governor Mark Carney. Inflation worries are also an issue because of the fall in sterling against other currencies. Carney said the Bank would 'look through' short-term increases in prices to protect jobs.

$2,500

PRICES OF ZINC, used in industrial markets to galvanise steel, are on track to hit their highest levels since 2011.

Supply conditions are 'super tight' and the zinc price could hit $2,500 a tonne by March, according to Osamu Saito, general manager at Mitsui Mining and Smelting. However, a reversal of production cuts at **Glencore (GLEN)** could push prices back down to $2,100. 'There's nothing out there that we can see capable of driving prices below $2,000 per tonne,' notes Saito in a *Bloomberg* interview.

Consumer Price-to-Earnings ratios

Selected cross-sector valuation metrics (PE ratio)

Source: FinnCap

BEST & WORST - EQUITY INCOME FUNDS

Fund	Year-to-date (%)
UBS Equity Income Fund Class C	25.9
Evenlode Income Class C	21.2
Schroder Charity Equity Fund A	20.3
Jupiter Income Trust	17.9
Franklin UK Equity Income	16.4
Marlborough Multi-Cap Income A	-6.2
Stan. Life UK Equity Income	-5.7
Smith & Williamson UK Equity	-4.6
MI Chelverton UK Equity Income	-3.9
Unicorn UK Income Fund A	-3.4

Source: Morningstar. Note: Different fund classes with same manager and similar portfolios excluded

FTSE 350 IN A MONTH

BEST PERFORMERS

	COMPANY	(%)
1	Evraz	55.10
2	Just Retirement	37.62
3	KAZ Minerals	36.69
4	Hunting	34.61
5	Tullow Oil	32.36
6	Vedanta Resources	26.87
7	Tesco	25.97
8	Glencore	25.79
9	Anglo American	25.19
10	Cairn Energy	23.16

WORST PERFORMERS

	COMPANY	(%)
1	Royal Bank of Scotland	-12.46
2	ITV	-12.53
3	Pets at Home	-13.43
4	CMC Markets	-13.66
5	Countrywide	-14.87
6	Polymetal International	-15.30
7	EasyJet	-18.74
8	IP	-19.67
9	MITIE	-24.92
10	Capita	-40.05

* Excluding Equity Investment Instruments, Nonequity Investment Instruments
Source: Thomson Reuters Datastream
Data 1 month to 14 Oct 2016

Quixant is in the growth slot

Gaming brain designer is closing on major outsourcing bonanza

The next year or so should transform gaming platform designer **Quixant (QXT:AIM)**. Enjoying rapid growth, a technological edge and reasonable pricing power, we firmly believe this is a must-have stock for your ISA or SIPP.

The Cambridge-based company designs the logic boxes that control pay-to-play digital gaming machines – one arm bandits, quizzes, casino; it is the brains behind the games.

IT'S A WINNER

Outsourced logic boxes are fast becoming the accepted norm across the vast and highly competitive gaming machine industry. Quixant's all-in-one boxed solution offers a low-cost, high-quality and innovative product that increasingly appeals to manufacturers keen to concentrate their own research and development (R&D) efforts on game design and development, the core differentiator in attracting players from one terminal to another.

This is a niche but large market. Estimates suggest around 8m gaming machines installed worldwide but very few gaming platform suppliers. Most production is in-house and there are clear drivers to outsource, such as the increasing cost of development and an ever-changing legislative environment.

There are five major (or tier-1 as they are called) gaming machine designers in the world; a couple in the US, one in Australia, two more in central Europe. All operate globally and Quixant has long-standing relationships with them all. This small group owns about 90% of the gaming machines worldwide.

RISING THROUGH THE TIERS

So far Quixant's main customers have been smaller tier-2 operators, such as Ainsworth Game Technology based in Australia, with whom Quixant signed a new multi-year deal in May. Earlier still Ainsworth sold a majority stake in its business to Novomatic of Austria, one of the tier-1 players, effectively giving Quixant an even bigger foot in the door to volume orders.

The potential difference could be massive. According to Quixant management, a typical tier-2 contract would be for 10,000 logic boxes – in a good year, a tier-1 order would be 10 times that amount.

Sealing a meaningful tier-1 agreement has taken longer than hoped, but for good reasons. Over the last 18 months or more there have been quite a few takeovers in this space, with bigger players hoovering up the small.

Analysts believe this corporate activity may have put outsourcing on hold temporarily, a dynamic that is likely to change through 2017 as customers extract value from their own operations. In the meantime, Quixant has worked at cementing its place at the negotiating table with proof-of-concept-type deals. (SF)

QUIXANT BUY
(QXT:AIM) 285p
Stop loss: 228p

Market value: £185.8m

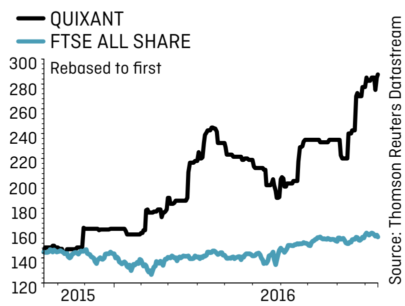
Prospective PE Dec 2017: 19.7

Prospective PE Dec 2018: 13.2

Dividend yield: 1.4%

Analyst price target: 250p (FinnCap)

BROKER SAYS: 1 0 0



Electrical surge as investors rush for Luceco

Light up your portfolio with power and wiring specialist

The average home is littered with chargers and leads for phones, laptops and tablets. It is easy to lose part of a charging unit, causing frustration. It can also be difficult to find a spare socket as homes now have so many electrical devices.

That's created a market for new electrical wall sockets that contain both three pins and a USB port. Embracing this sales opportunity is **Luceco (LUCE)**, a lighting and wiring specialist that's just floated on the stock market (17 Oct 2016).

LUCECO ↗ BUY
(LUCE) 150p
Stop loss: 105p

Market value: **£241m**

IN HOT DEMAND

Shares in Luceco have increased by 15% to 150p since its IPO (initial public offering) earlier this week. It is easy to see why investors want to light up their portfolios with the stock. We see considerable upside for the share price.

Luceco makes and distributes wiring accessories, power products and LED lights. It has a diversified customer base, selling to trade, retail and direct to corporates for specific projects. For example, it changed all the lighting to LEDs in Screwfix stores across the UK.

In addition to opportunities with USB charging points, take-up of LED lighting is gathering pace. LED lighting is more efficient, becoming cheaper and supports public policy as incandescent lights are phased out. That plays to Luceco's strengths.

The UK LED lighting market is expected to enjoy 15.4% compound annual growth between 2015 and 2020, forecasts AMA Research. Globally the LED market is estimated to see 16.8% compound annual growth between 2014 and 2019, reckons Frost & Sullivan.

PROFIT SURGE

Luceco's earnings growth has been impressive. Revenue increased from £65.6m in 2013 to £103m in 2015. It earned almost as much in the first half of 2016 (£60m) as it did in the whole of 2013.

Pre-tax profit moved from £2.2m in 2013 to £8.3m in 2015. The first six months of the current year imply this stellar growth trend is firmly intact, having made £5.3m pre-tax profit – or £10.6m annualised.

Luceco is in expansion mode. Cash generated from operations is being reinvested into new facilities and offices. For example, it has been expanding its manufacturing operations in China and has opened sales offices in Europe, Asia and the US.

DIVIDENDS IN SIGHT

The company raised £22m after fees at the IPO to repay debt and bolster working capital. Dividends are scheduled to begin next year, paying 20% to 30% of adjusted net income.

We impose a wider than normal 30% stop loss to accommodate for any short-term profit taking by people who made a quick buck on the IPO. Earnings forecasts are expected in the next month or so.

Risks include a UK economic downturn. Luceco is also reliant on three customers which accounted for 38.5% of group revenue in 2015. (DC)

RWS
(RWS:AIM) 300p

Gain to date: 45.6%

Previous Shares view:
Buy at 206p, 3 Mar 2016

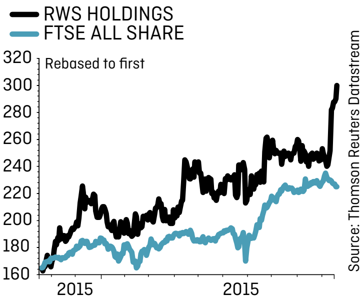
A SOLID TRADING update (11 Oct) at translation specialist **RWS (RWS:AIM)** indicates its $70m (£57m) acquisition of US-based Corporate Translations Inc. (CTi) is delivering against expectations.

While we are now wary of the stock's price at more than 30 times earnings, there is an argument RWS's 10% compound annual growth rate in revenue over the last decade (excluding results to be reported) merits some sort of premium.

Chairman Andrew Brode says full year revenue in the year to 30 September is expected to be up at least 28% at not less than £122m when RWS reports full-year results on 6 December. Adjusted profit-before-tax is expected to be above £30.5m.

Earnings per share should come in around 9.5p, according to our calculations, up from 7.3p a year earlier helped by an 11-month contribution from CTi.

Analysts at Shore Capital estimate RWS has £100m of extra firepower to pursue further acquisitions, via its capacity to raise debt, and this could provide further upside for the share price. (WC)



SHARES SAYS: ↗
We're waiting for more detail at full-year results but on balance the trading update is positive.

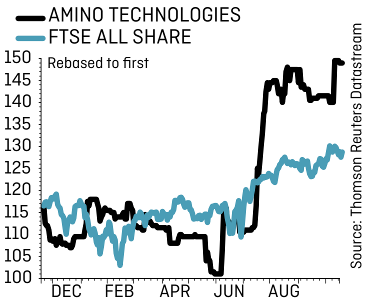
BROKER SAYS: 2 0 0

AMINO TECHNOLOGIES
(AMO:AIM) 149p

Gain to date: 30.7%

Previous Shares view:
Buy at 147p, 18 Aug 2016

NEARLY TWO MONTHS before the end of its financial year on 30 November **Amino Technologies (AMO:AIM)** spelled out that it would beat expectations. The home broadcast and connectivity kit designer has had a cracking couple of months through August and September, maintaining the stellar traction in its Latin American markets seen at the half year stage, plus showing real progress in part of Europe. What this amounts to is another increase to forecasts, even after many analysts nudged estimates ahead following the interims, and we wouldn't rule out a hat-trick of upgrades come the full year results, likely in February. (SF)



SHARES SAYS: ↗
Amino has proved to be a cracking contrarian play since the profit warning that prompted us to have a 'buy' rating on 29 October 2015 at 114p. We have been long-run fans of Amino. A 180p share price would still imply a quite reasonable cash adjusted November 2017 price to earning (PE) multiple of about 16 for a company increasingly flexing its strong technology in this growing market niche. Still a buy. (SF)

BROKER SAYS: 2 0 0

5 STOCKS BUFFETT WOULD BUY NOW

THE UK-LISTED STOCKS WHICH MEET THE GURU'S INVESTMENT CRITERIA

Investors aiming for big returns on the stock market can learn a lot from the **Berkshire Hathaway (BRKA:NYSE)** business model built by legendary investor Warren Buffett.

We've spotted several companies on the UK market that meet the criteria he desires in an investment. Read on and you'll discover the names he would theoretically want to buy.

WHO IS BERKSHIRE HATHAWAY?

Berkshire Hathaway is an American conglomerate business run by Buffett. In 2014 and 2015, Berkshire earned about as much from its wholly-owned utilities businesses as it did from its stock market investments.

Looking at Berkshire Hathaway's performance is an education in how to pick stocks as well as how to build a solid, well-diversified portfolio.

Berkshire Hathaway's four main divisions are focused on insurance, utilities, manufacturing and services and financial products.

Importantly, Buffett argues 'there are important and enduring economic advantages' to owning all of these four very different divisions within one business.

WHAT DOES THIS MEAN?

Partly, it means drivers of profitability across these four divisions are very different.

If Berkshire suffers large insurance losses in one year, it is possible one of its other divisions will deliver stronger performance to offset them.

'If the insurance industry should experience a $250bn loss from some mega-catastrophe – a loss of about triple anything it has ever experienced – Berkshire as a whole would likely record a significant profit for the year because of its many streams of earnings,' wrote Buffett in a 2015 shareholder letter.

When economies go through a soft patch and general business activity is slow, insurance and utilities companies are capable of delivering solid profits when other sectors struggle.

Stronger periods of economic growth should see Berkshire's manufacturing and services and financial products businesses register more impressive performance while Utilities and Insurance plod along.

APPLY BUFFETT'S GENIUS TO YOUR PORTFOLIO

There are several companies on the UK market that meet the criteria Buffett desires in an investment.

We've selected five stocks from this list that fit into Berkshire's three main investment categories: insurance, utilities and manufacturing and services.

Our key pick in insurance is **RSA (RSA)**, a good quality general insurer in the midst of a turnaround which could deliver substantial shareholder value.

In utilities, options are limited in the UK: we've singled out **National Grid (NG.)**. As well as defensive qualities, National Grid has a few investment catalysts on the horizon in the near-term.

Manufacturing and services is the area where Buffett's policy of buying wonderful businesses at reasonable prices is most apparent.

Our top picks in this section are **Spirent (SPT)**, soft drinks brand owner **Nichols (NICL:AIM)** and speciality chemicals outfit **Victrex (VCT)**.

Trading at an average price-to-earnings (PE) ratio of 17.2 these stocks are expensive based on this year's earnings forecasts. Longer term, all have relatively low risk growth drivers, in our view. This means they may still be incredibly cheap.

'Some of our picks look expensive on current forecasts. Longer term they have low risk growth drives. This means they may still be incredibly cheap.'

SHARES' BUFFETT PICKS

Company	Sector	Price (p)	EPS estimate* (p)	Earnings yield
RSA	Insurance	560	34	6.1%
National Grid	Utilities	1070	63	5.9%
Spirent	Communications	84	6	7.1%
Nichols	Beverages	1403	66	4.7%
Victrex	Chemicals	1761	94	5.3%
Average (equal weight)				5.8%
PE ratio average				17.2x

* Forecast.
Source: Sharepad, as at 6 Oct 2016

Why Buffett likes INSURANCE

INSURANCE HAS BEEN the engine of growth at Berkshire Hathaway ever since Buffett bought a quirky business called National Indemnity in 1967 for $8.6m.

Headed by maverick businessman Jack Ringwalt it insured circus performers and lion tamers, among others. Today, under the Berkshire umbrella, it is the largest property-casualty insurer in the world.

Property-casualty insurance is a key part of Berkshire's business though it is important to note Buffett is not as keen on life insurance companies, which are very different businesses.

So why does Buffett like insurance? Two attractions of the property-casualty insurance industry are the 'free money' it generates, known as insurance float, and an unusual earnings profile which may add diversification to an equity portfolio.

We've chosen RSA as our preferred UK-listed non-life insurance stock as management initiatives have helped the business return to what are now sustainable profits, in our view.

'FREE MONEY'

Insurance companies, like Berkshire's National Indemnity, generate free money.

Payments from customers to insurance companies for products like home or auto insurance are paid up-front. Claims, however, only have to be paid out in the future.

In the interval between when a customer pays an insurance premium and when they make a claim, insurance companies have access to capital at zero cost.

Float builds up as an insurance company writes more premiums: Berkshire's float, thanks in part to National Indemnity's growth, now totals around $90bn.

As long as Berkshire writes a similar amount of insurance each year, it is able to hold on to and invest what is essentially its customers' cash in assets for itself.

Berkshire's equity and bond portfolios are mainly funded by this unusual and highly valuable source of capital.

On top of investment returns earned from investing insurance float, the industry tries to make money from underwriting, though this is not always the case.

Underwriting profit is earned when an insurer's premium income from customers exceeds the amount it pays out in claims and other operating costs, like staff salaries and administration.

DIVERSIFICATION BENEFIT

Property-casualty insurance companies' earnings should not be affected too much by the general economy, so neither should their share prices.

Insurance is a not just a necessity but also a legal requirement in many cases and while customers may shop around more in hard times, auto and home insurance in particular enjoy fairly stable demand.

Provided insurance companies attract good quality customers, price their policies correctly and invest insurance float conservatively they should make money in most economic environments.

Diversification benefits provided by insurance companies may reduce risk in a portfolio and could be one reason why Buffett likes the insurance industry.

RSA (RSA) 562P
MARKET CAP: £5.7BN

PROGRESS ON A management turnaround plan at RSA and the potential for further profit improvements are two reasons for investors to check out the pet cover-to-commercial insurance writer.

A third quarter trading update scheduled for 3 November could prove to be a further catalyst at RSA if improvements outlined in the first half of the year continue to be delivered.

Run by former **Royal Bank of Scotland (RBS)** chief executive Stephen Hester, the insurer is selling underperforming assets and trying to improve a key measure of profitability, RSA's combined ratio.

An insurer's combined ratio shows how much money it is making from ordinary insurance policies, before including returns on investment activities.

RSA's combined ratio declined from 96.4% to 94.1% in the first half of 2016. A number below 100% shows the business is making a profit from insurance underwriting.

Investment returns, another key source of earnings for insurers, were also better than expected because lower interest rates increased the value of its bonds. Investment grade bonds represent more than 80% of RSA's £14.5bn portfolio.

Consensus analyst estimates are for earnings per share of 33.5p in 2016 and 42.2p in 2017.

Why Buffett likes

UTILITIES

EARNINGS FROM BERKSHIRE Hathaway's wholly-owned utilities businesses contributed almost a third of its profit in 2015.

Railroad Burlington Northern Sante Fe, purchased by Berkshire in November 2009, is by far the largest of its utility assets, followed by energy utilities in North America and the UK.

'Society will forever need huge investments in both transportation and energy'

REGULATED MONOPOLIES

Railroads must be maintained at great expense to keep freight moving around the US while ongoing investment in energy infrastructure is vital to keep businesses and households supplied with reliable power.

'We relish making such investments as long as they promise reasonable returns – and, on that front, we put a large amount of trust in future regulation,' wrote Buffett in Berkshire's 2015 shareholder letter.

'Our confidence is justified both by our past experience and the knowledge that society will forever need huge investments in both transportation and energy.'

BOND-LIKE CASH FLOWS

Utilities are regulated by governments to ensure they do not seek to exploit monopolies of supply at the expense of other businesses and households.

Regulated profitability removes, justifiably, some of the upside for investors in monopolies.

Downside risk to profitability at utilities is also typically low, however, meaning cash flows are very stable over time.

Utilities as a result have a performance profile similar to bonds and their profitability is usually not affected too much by economic cycles.

NATIONAL GRID (NG.) £10.69
MARKET CAP: £40.3BN

POWER TRANSMISSION network National Grid offers a good, defensive portfolio diversifier for investors pursuing more eye-catching gains elsewhere – a strategy Buffett uses at Berkshire Hathaway.

An all-weather business that should deliver even in tough economic conditions, National Grid also has a couple of near-term investment catalysts.

First, it is selling a stake in its gas distribution network which analysts estimate is worth £12bn in total. This could lead to a special dividend of around 40p a share sometime in 2017.

Second, National Grid has North American assets which contribute around 30% of operating profit. Management has struggled to make the most of this business and there could be upside to earnings per share if profitability improves over the period to 2020, as expected.

Risks include lower future dividend cover as the gas distribution stake sale will reduce earnings. Consensus earnings per share forecasts for the year to 31 March 2017 are 63p and 64p in 2017. Forecast dividends at 44p imply a yield of 4.1%.

Investors preferring more diversified exposure to utilities could consider **iShares Global Infrastructure ETF (INFR)** which is full of utilities including National Grid. Half the fund is allocated to US utilities and infrastructure assets.

How does Buffett

PICK STOCKS?

BERKSHIRE HATHAWAY'S MANUFACTURING and services division and stock market portfolio are the area where chairman Warren Buffett is best known for working his magic.

Defensive qualities provided by Berkshire's large investments in the utilities and insurance sectors mean Buffett can afford to be more adventurous in other areas.

Buffett's policy of buying high quality businesses at reasonable prices – both on the stock market and from private owners – is one of the main reasons Berkshire's long-term returns exceed the S&P 500 index by 10% per year since 1965.

It makes sense investors seeking better-than-average returns to look for better-than-average businesses like those Berkshire owns outside its insurance and utilities units.

Reasonable profit margins, low debt and high and sustainable returns on equity are key features.

We now explain what Buffett means when he talks about investing in 'wonderful businesses at reasonable prices'.

WHAT IS A WONDERFUL BUSINESS?

BERKSHIRE HATHAWAY'S manufacturing and service business unit includes a number of companies which Buffett has bought outright from private owners or, occasionally, from the stock market. Key attributes include:

1 REASONABLE MARGINS

Operating profit margins are a measure of the percentage profit a company earns per dollar of revenue.

High profit margins are often a sign of better quality businesses.

Berkshire Hathaway's manufacturing and services division boasts reasonable though not stand-out margins, at around 7%.

All three of our UK stock picks deliver operating margins above this level.

2 SENSIBLE BALANCE SHEET

Berkshire Hathaway as a whole and its manufacturing and services business division as a group carry no significant levels of net debt.

Businesses listed on the stock market usually carry some debt because it can increase shareholder returns.

Debt is not usually a problem provided the amount relative to equity and to earnings is reasonable. In this case, we've opted for three stocks which all had more cash than debt on their balance sheets at their last year-end.

3 SUSTAINABLE RETURNS ON EQUITY

Businesses which can deliver high returns on equity (RoE), measured as profit divided by the difference between assets and liabilities (book value), are usually considered high quality.

Berkshire Hathaway's manufacturing and services division delivered a pre-tax RoE of 12.5% in 2015.

It is impressive given Berkshire's businesses employ very little debt or other forms of leverage, which tend to magnify return on equity.

Trailing 12 month returns on equity among our stocks picks are around 3.6% at Spirent, which we expect to improve significantly; 35% at Nichols; and 23% at Victrex.

Buffett's preference for companies with strong brands and pricing power are also features of his investing approach. To a large extent these features are captured within the aforementioned key financial ratios, in our view. (WC)

Stocks that tick the right boxes

FOR BUFFETT

NICHOLS (NICL:AIM) £14.03
MARKET CAP: £518M

A RANGE OF highly profitable niche soft drink brands which sell all over the world and a rock solid balance sheet give Nichols its star quality.

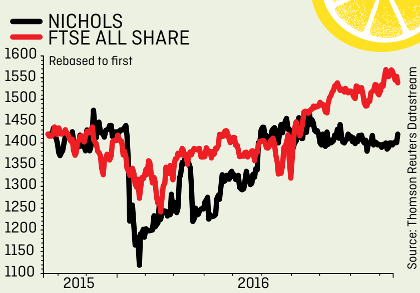
Key brands *Vimto*, *Levi Roots*, *Sunkist* and *Panda* are consumer favourites in some key geographies.

While Nichols competes against some formidable rivals in the beverages market its smaller scale has some advantages.

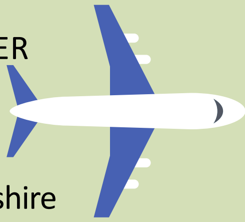
Acquisitions of up-and-coming brands can enhance Nichols' profitability significantly but would not move the dial at multi-billion dollar companies like **Coca-Cola (KO.:NYSE)**.

Recent deals include the purchase of premium juices outfit Feel Good and iced drinks specialist the Noisy Drinks Co. Both boosted earnings in the half year to 30 June 2016. Even after the deals, Nichols recorded balance sheet cash of £33m.

Risks include a tough UK soft drinks market, a proposed UK sugar tax and competition from larger rivals. (JC)



VICTREX (VCT) £17.61
MARKET CAP: £1.5BN



MANUFACTURER of polyether ether ketone (PEEK) products, Victrex is a Berkshire Hathaway-quality business as measured by its high profit margin and return on equity, coupled with a conservative balance sheet and good market position.

Invented by ICI in 1978, PEEK is a plastic used in aerospace, automotive and electronics markets because of its light weight, durability and strength. Victrex was created as the business to exploit the new technology.

From £17m of sales in 1993, Victrex delivered revenue of £263.5m in 2015 with operating margins of 40% and return on equity at 23%.

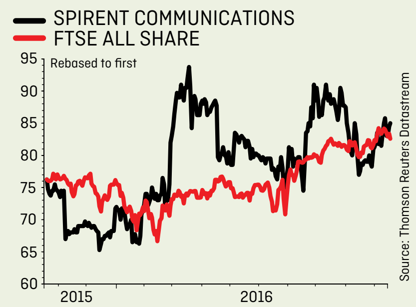
Analysts at Liberum say Victrex is selling into an addressable market with future potential demand at seven times today's capacity. Risks include competition from larger rival **Solvay (SOLB:EBR)**. (WC)

SPIRENT COMMUNICATIONS (SPT) 84P
MARKET CAP: £512M

A GLOBAL SUPPLIER of testing and performance measurement equipment to the telecoms industry, Spirent's aim is to deliver around 50% of its forecast \$540m (£443 million) sales from recurring sources, as opposed to one-off contract revenues, by the end of 2018.

Spirent's peak operating margin in 2011 was close to 25% providing a glimpse of what could be possible as a corporate turnaround gathers pace. Analysts currently forecast margins of 11.4% in 2018.

On a 2017 price-to-earnings (PE) multiple of 11.8, Spirent trades at a large discount to historic PEs in the low 20s. Firmer evidence of improving profits could bring the double-whammy of a re-rating on top of earnings curve benefits. (SFr)



Why pricing power can boost shareholder return

Marmite spat is a useful reminder to look at companies' ability to hike prices

The battle over *Marmite* pricing between consumer goods giant **Unilever (ULVR)** and supermarket **Tesco (TSCO)** is a welcome reminder of why pricing power is one of the key traits of a successful company.

Billionaire investor Warren Buffett says the single most important factor when evaluating a business is pricing power.

'If you've got the power to raise prices without losing business to a competitor, you've got a very good business,' he says.

'If you have to have a prayer session before raising the price by 10%, then you've got a terrible business.'

PRICE IS DRIVING UNILEVER SALES

Unilever's third quarter numbers (13 Oct) showed 3.2% underlying sales growth driven by price rather than volume.

The company doesn't necessarily need to shift more goods to drive its sales, but clearly it would be nice to have both higher price and volume.

Unilever is able to charge more for its brands because it knows they are a central part of households across the country – and world.

In particular, Unilever knows that people won't suddenly stop buying these brands if they become slightly more expensive. That's because it commands pricing power.

DIDN'T TESCO WIN?

In the Tesco case, Unilever was looking to push up prices because weaker sterling is driving up costs – or will do in the near future. It naturally sought to pass this on to the consumer.

The spat was ultimately in neither party's interest and reports suggest Unilever made some accommodations to get its products back on Tesco's shelves.

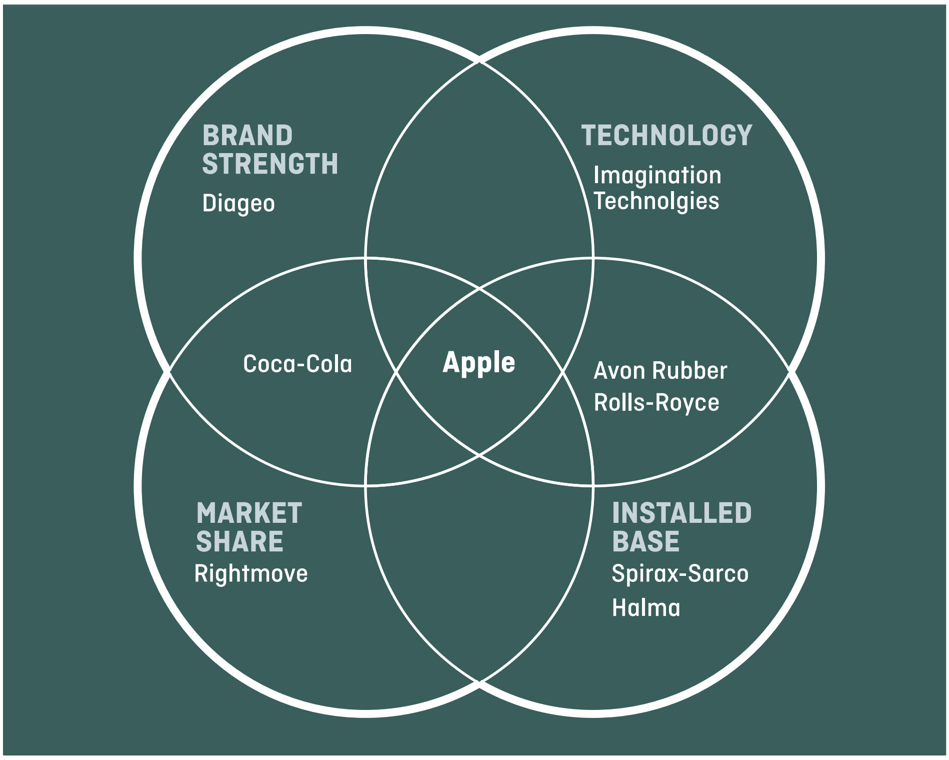
It will not be the last of the consumer goods and food producers to attempt to pass on higher input costs. The likes of **Reckitt Benckiser (RB.)** and **PZ Cussons (PZC)** are likely to be doing the same, although whether these negotiations will play out in public is uncertain.

The issues are particularly acute for companies in the groceries sector. Prices have been squeezed by the emergence of discount operators Aldi and Lidl as a major competitive threat.

SECRET TO BIGGER RETURNS

'Pricing power is important because if a firm can charge what it wants to charge it should generate high margins, consistent earnings and robust cash flow,' says AJ Bell investment director Russ Mould.

'It can then turn this into the reliable and growing dividends which provide such a large



percentage of long-term total shareholder returns, especially once they are reinvested.'

Firms without pricing power – such as producers of commodities like paper, pulp or steel – tend to churn out more volatile earnings and more volatile dividends,' claims Mould. 'As a result, their stocks also tend to enjoy lower, long-term trend valuations than those firms with pricing power.'

HOW TO SPOT PRICING POWER

Identifying companies with pricing power is the backbone of a successful long-term stock picking strategy. There there are a number of factors to seek:

1. BRAND STRENGTH

As the Unilever example demonstrates, strong brands go hand in hand with pricing power. But brand strength can be quickly lost if a company doesn't maintain investment in marketing and product development. It can also take a big hit if there is a high profile problem.

Just look at how sentiment has turned against electronics business **Samsung (005930:KS)** because its phones are bursting into flames.

The Korean firm has been forced to pull the Galaxy Note 7 smartphone off the market due to battery fires at an immediate cost of £4.4bn but with perhaps more lasting damage in terms of the integrity of its brand.

2. TECHNOLOGICAL EDGE

A prime example of a company with a technological edge and significant brand power is consumer electronics firm **Apple (AAPL:NDQ)**.

It may have reached saturation point in terms of its smartphone adoption but still retains an enviable ability to charge consumers a significant sum for an upgraded product on an annual or bi-annual basis.

3. LARGE INSTALLED BASE

It could be argued Apple ticks another box in the pricing power arsenal; a large installed base. Millions of us are tied to iPhones on at least a two-year upgrade cycle through our phone network. Many of us will return to our local Apple store if we encounter technical problems.

A less high profile example of this phenomenon at work is Cheltenham-headquartered **Spirax-Sarco Engineering (SPX)**. The company makes valves and specialist pumps. Steam at high temperatures and pressures is highly erosive. This means parts often need renewing and Spirax sells a significant volume of replacement products on its large installed base of equipment.

Spirax is well positioned to raise prices because its relatively low cost products (typical invoices are between £1,000 and £50,000) are integral to the machinery used by its customer base. It also enjoys plenty of recurring revenue which underpins earnings visibility and an exceptional track record of dividend growth.

4. DOMINANT MARKET SHARE

Being the dominant player in a market can also make it easier to ramp up prices without affecting demand.

Property website **Rightmove (RMV)** is an excellent example. Its website has the most listings, so it is the one most prospective property buyers go to when looking for their next home. This makes it a must-have product for estate agents and results in significant pricing power. (TS)

BAE hits the bullseye on fattened military budgets

Improving picture for high yielding defence giant

Global defence company **BAE Systems (BA.)** is a rare beast. It is one of the few stocks yielding more than 4% which also has a track record of consistent dividend growth.

Improving cash flow, a growing order book and recovering end markets are all reasons to be positive on the stock.

CLEAR OPPORTUNITY

Military budgets are expanding amid rising global tensions connected to Russian aggression and Islamic State militants.

The UK Strategic Defence and Security Review in November 2015 reaffirmed a commitment to meet the NATO target of spending at least 2% of GDP on defence.

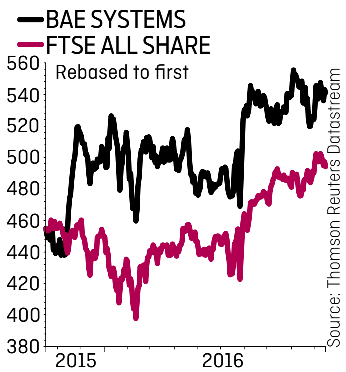
After several years of scaling back, NATO members across the board are on track to allocate more to defence in 2016 according to the organisation, with an overall increase estimated at about $3 billion.

There seems to be scope for budgets to grow further, with analysts at Credit Suisse recently noting European Union and US defence spending is 18% and 10% below its 20-year historical norm as a percentage of GDP.

In a 6 October 2016 trading update BAE noted: 'In the US the defence market outlook remains positive and the production ramp up on a number of the group's long term programmes is progressing to plan.'

BIG CASH FLOWS

Investment bank Berenberg expects a 10-20% uplift in the £36.6bn order book by early next year. It claims revenue stability is provided by the fact '45% of BAE's sales are from services and support, and 35% are from major programmes'.



Underpinning the dividend is a forecast improvement in cash flow as spending in certain areas, including on a new shipyard in San Diego, winds down.

Berenberg reckons free cash flow will increase from £303m in 2016 to £999m in 2017. That suggests a bigger pot from which to pay dividends to shareholders.

Despite this improving picture the company trades at a near 30% discount to the average forward price to earnings ratio of its US peers, according to Berenberg.

The main risk investors need to weigh is the pension deficit which is likely to have widened substantially from the previously reported £2.6bn at the next triennial valuation in April 2017.

The company has the option of smoothing deficit payments by extending the recovery plan from the current nine years to 12 or more. (TS)

SHARES SAYS: ↗

A secure yield and improving trends are an attractive mix at 540p. Buy.

BROKER SAYS: 14 3 4

Is Elegant Hotels' 11% yield too good to be true?

Earnings downgrades and debt fears suggest it needs to rethink dividends

Fancy getting 11% dividend yield from investing in a Caribbean hotel operator? **Elegant Hotels (EHG:AIM)** owns plush hotels in Barbados and is expanding into Antigua. Sadly there's a catch to the investment case which suggests dividends may need to be cut.

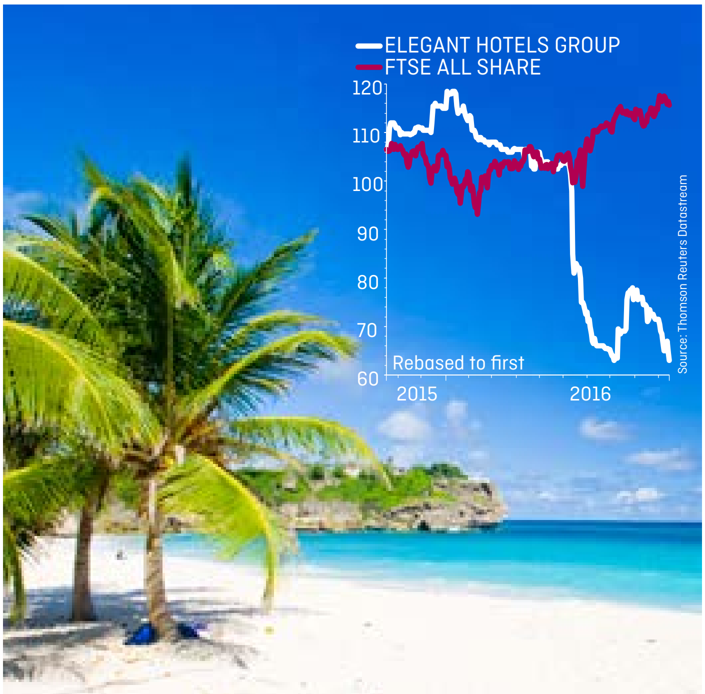
Earnings forecasts have been downgraded several times this year and there is a material risk to demand near-term.

VACATION VERSUS STAYCATION

Approximately 70% of its customers come from the UK. Currency weakness and concerns about economic conditions would suggest people in the UK may think twice about splashing out for a Caribbean holiday at the moment.

The pound has weakened by approximately 17% against the Bajan dollar, making it more expensive for UK customers to go to Barbados. Elegant last week confirmed forward bookings for its current financial year ending 30 September 2017 are weaker than at the same point last year.

Liberum responded by slashing its profit forecasts by a third for 2017 and 2018. The investment bank had already downgraded estimates by circa 14% and 10% respectively four months ago.



TAKEOVER TARGET?

At 62.5p, the company trades at more than 40% discount to net asset value. 'The disparity to the land value is material and we feel this could result in a bid approach,' says Liberum.

Nearly half the company is owned by UK fund managers with Vision Capital holding a further 23.8% stake. We doubt these investors would accept an opportunistic takeover bid given the shares trade significantly below last year's 100p IPO (initial public offering) price.

A typical 40% bid premium on the current share price would only pitch a potential takeout at 87.5p – so original IPO investors would still be losing money.

DEBT PRESSURES

The company is forecast to pay 7p (8.8c) per share dividend for the next few years, which equates to an 11% yield. Net debt to EBITDA (earnings before interest, tax, depreciation and amortisation) is forecast to be 3.5 times in the current financial year. That's danger territory for many companies.

Liberum believes debt covenants won't be breached, yet we reckon Elegant should avoid any problems by cutting the dividend now.

This stock was originally sold to investors as a dividend story, so cutting the shareholder reward so early into its life as a listed company wouldn't go down well. (DC)

SHARES SAYS: ↘

Value investors may find the stock appealing. We are less enthusiastic, believing the shares will struggle to fight the current negative market trend until there is clear evidence of a recovery in trading. For that reason, avoid.

BROKER SAYS: 1 0 0

Utilitywise hires Sage, Augean execs

Woodford favourite delivers decent results and unveils new CEO

Controversial Neil Woodford stock pick **Utilitywise (UTW:AIM)** is worth a closer look as investors ponder full year results and a boardroom reshuffle at the commercial energy consultancy.

Utilitywise divides opinion among investors following criticism of its accounting policies. That is unlikely to change much after the business moved on to its third finance officer in little over four years.

The boardroom changes are a long-term positive for us and results (18 Oct) also showed impressive discipline on costs and productivity, albeit at slower rates of revenue growth in the second half of its financial year.

Chairman Geoff Thompson announced former **Sage (SGE)** executive Brendan Flattery as the company's new chief executive and Richard Laker, previously at waste management outfit **Augean (AUG:AIM)**, as chief financial officer.

Thompson said changes in the finance department were partly linked to the change in chief executive.

Laker could be a good fit at Utilitywise as disclosure at Augean was exemplary during the former **Northgate (NTG)** executive's tenure, as

previously covered by *Shares (Understanding Cash Flow, 2 Apr 2015)*.

Earnings per share estimates in the year to 31 July 2017 are 18.5p and 21.7p the year after, according to analyst Andrew Bryant at house broker Liberum. Utilitywise shares trade at 130p.

Risks include further accounting controversies and the possible need for new capital from shareholders to deliver growth. (WC)

SHARES SAYS:
Impressive hires in both executive roles and solid results.

BROKER SAYS: 3 1 0

Walker's big deal

Walker Greenbank (WGB:AIM) looks interesting at 202.5p in light of its proposed acquisition (12 Oct) of interior fabrics and wallcoverings distributor Clarke & Clarke. Complementary in terms of brands, profitable Clarke & Clarke will enhance Walker's dividend-paying capacity, while also boosting buying power and growth prospects in the US. (JC)

IoT war chest

CONNECTIVITY KIT designer **Telit Communications (TCM:AIM)** has sealed $110m of new credit facilities as it accelerates growth into Internet of Things (IoT) technologies. The loans will provide the financial clout needed to continue its big bet on IoT, an area that is seeing huge investment. (SF)

SDX on the hunt

EGYPTIAN OIL PRODUCER **SDX Energy (SDX:AIM)** continues to make progress as it lays the groundwork for low risk exploration drilling on its South Disouq concession. Initial findings from a 3D seismic survey suggest there is potential for both gas and oil. At 28.25p the shares are already up 56.9% since joining AIM in May. (TS)

FRIDAY 21 OCTOBER

RESULTS

Interims

Acacia Mining	ACA

TRADING STATEMENTS

Computacenter	CCC
Dechra Pharmaceuticals	DPH
InterContinental Hotels	IHG

ECONOMICS

EU

Flash Services PMI

Flash Manufacturing PMI

US

Flash Services PMI

Flash Manufacturing PMI

MONDAY 24 OCTOBER

TRADING STATEMENTS

Petra Diamonds	PDL

TUESDAY 25 OCTOBER

RESULTS

Interims

Atlas Mara Co-invest	ATMA
Whitbread	WTB

TRADING STATEMENTS

Anglo American	AAL
GKN	GKN
National Express	NEX
St James's Place	STJ

ECONOMICS

UK

BBA Mortgage Approvals

Prelim GDP

US

Richmond Manufacturing Index

WEDNESDAY 26 OCTOBER

RESULTS

Interims

JZ Capital Partners	JZCP

COBHAM

Aerospace and defence firm Cobham (COB) is set to update on trading on 26 October ahead of the introduction of a new management team. The arrival of new finance director David Mellors and new chief executive David Lockwood in the coming months may see expectations rebased.

TRADING STATEMENTS

Antofagasta	ANTO
British American Tobacco	BATS
Cobham	COB
Genel Energy	GENL
Lloyds Banking	LLOY

LLOYDS BANKING

Lloyds Banking Group (LLOY) will be the first of its domestic focused banking peers to report on third quarter trading when its statement is released on 26 October. Investors are likely to focus on dividend guidance, with the stock currently yielding 6%, and post Brexit-vote appetite for its banking services.

AGMS

AFI Development	AFRB
Maxcyte	MXCT
Oil & Gas Development	OGDC
Redde	REDD
Zibao Metals Recycling	ZBO

ECONOMICS

UK

GfK Consumer Confidence

THURSDAY 27 OCTOBER

RESULTS

Finals

Debenhams	DEB
Redefine International	RDI

Interims

C&C	CCR
Bloomsbury Publishing	BMY

TRADING STATEMENTS

Barclays	BARC
BT	BT.A
Kaz Minerals	KAZ
Henderson	HGG
Inchcape	INCH
RELX	REL

EX-DIVIDENDS

AIREA	AIEA	1.5p
Avingtrans	AVG	2.1p
Bankers' I.T.	BNKR	4.4p
Barratt Developments	BDEV	12.4p
Booker	BOK	0.63p
CareTech	CTH	3p
Dechra Pharmaceuticals	DPH	12.91p

DEBENHAMS

The market will be watching full year numbers from department store Debenhams (DEB) closely to see if, like a number of its peers, the company took any hit from the UK's 'Indian Summer'. The update is published on 27 October.

El Oro	ELX	2.405p
Exova	EXO	1.05p
Galliford Try	GFRD	56p
Haynes Publishing	HYNS	4p
Ideagen	IDEA	0.12p
ITV	ITV	2.4p
Lookers	LOOK	1.28p
M&C Saatchi	SAA	1.85p
Moss Bros	MOSB	1.91p
Mulberry	MUL	5p
Next Fifteen	NFC	1.5p
Provident Financial	PFG	43.2p
Rotala	ROL	0.8p
Thorpe (F W)	TFW	2.85p
TLW Worldwide	TLA	0.23p
Triple Point VCT 2011	TPO	24p
Unilever	ULVR	28.9p
Wolseley	WOS	66.72p

AGMS

Argos Resources	ARG
Blenheim Natural Resources	BNR
City of London Investment Trust	CTY
Premaitha Helth	NIPT

ECONOMICS

US

Unemployment Claims

FRIDAY 28 OCTOBER

TRADING STATEMENTS

Berensden BRSN	
Elementis ELM	
Royal Bank of Scotland	RBS

AGMS

Ideagen	IDEA

ECONOMICS

UK

Mortgage Approvals

US

Advance GDP

For complete diary go to www.moneyam.com/forward-diary

How fund managers apply a fuel injection

Gearing can enhance dividend yields and boost capital gains

Investment trusts have a trick up their sleeve in their effort to enhance shareholder returns. 'Gearing' involves a fund manager using debt to invest in more companies or other assets and boost the value of a portfolio. It creates a bigger pool from which to earn dividends and/or generate capital gains.

The term 'gearing' often appears on financial literature, but is seldom understood by investors. We now explain how it works, what it means for your wallet and reveal some investment trusts using this as a tool to turbo charge returns.

THIS IS HOW GEARING WORKS

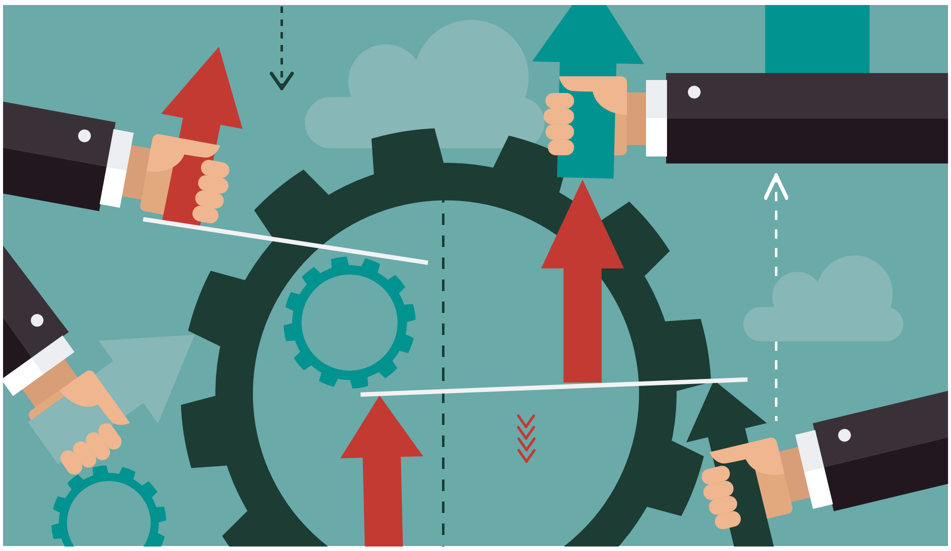
We have created two hypothetical investment trusts as a way of illustrating the concept of gearing.

Trust #1 has £100m invested in a range of different companies and 10m shares in issue. The underlying holdings in the portfolio pay dividends to the trust which it then distributes to shareholders.

Let's say the investment trust earns 4% annual income from its underlying holdings. It passes all of that money to shareholders.

LET'S DO THE MATHS: TRUST # 1

- 4% income from £100m invested assets = £4m to be shared among the investors.
- £4m ÷ 10m shares in issue = 40p per share dividend.
- Shares in the investment trust trade at £10 each.
- 40p as a percentage of £10 gives you a 4% yield.



Trust #2 also has £100m invested in a portfolio of companies. It decides to borrow money equivalent to 15% of its portfolio to have an extra £15m to invest in more companies. That is what's referred to as gearing.

The investment portfolio now totals £115m.

DOES GEARING PUSH UP THE SHARE PRICE?

You mustn't presume the share price will be inflated by 15% to reflect the extra cash suddenly in the trust's account. The *net* asset value is still £100m. The share price tends to be influenced by net asset value.

Net asset value, or NAV, is assets minus liabilities. In this case it would be £115m investment assets minus £15m debt liabilities = £100m.

The only scenario where the cash injection might influence the price is if market sentiment is negative towards stocks and investment trusts with debt, so a discount might be applied.

The same applies if sentiment is positive and so investors put a higher price on the trust because they think it is going to make higher returns.

For purposes of our illustration, we assume no change to the share price. The dividend calculation will be based on the invested assets, which in this case is £115m.

We will assume the portfolio of companies generates the

same 4% annual income for the investment trust and that there are 10m shares in issue.

LET'S DO THE MATHS: TRUST # 2

- 4% income from £115m invested assets = £4.6m to be shared among investors.
- We have to take off something for the interest on the debt, lets say 2% or £300,000. That gives us £4.3m in dividends to be shared among investors. This is a bigger pot of cash than the non-geared trust.
- £4.3m ÷ 10m shares in issue = 43p per share dividend.
- Trust #2 also trades at £10 per share. 43p as a percentage of £10 equates to a 4.3% yield.

You can see how the use of gearing has enhanced the dividend yield on the second investment trust.

This is a simple explanation of gearing. The calculations do not factor in any cash held in reserve to help smooth dividend payments in more difficult market conditions. Neither do the calculations include fund management charges.

BUY MORE STUFF

Gearing is a useful tool for the fund manager as it means they don't always have to sell holdings when they find something else in which they'd like to make an investment.

The fund manager needs to be confident they can earn a better return on the additional investments than the cost of borrowing the money.

There are different methods by which a fund manager can gear up a portfolio including bank debt, loan stock, debentures, foreign currency loans or preference shares.

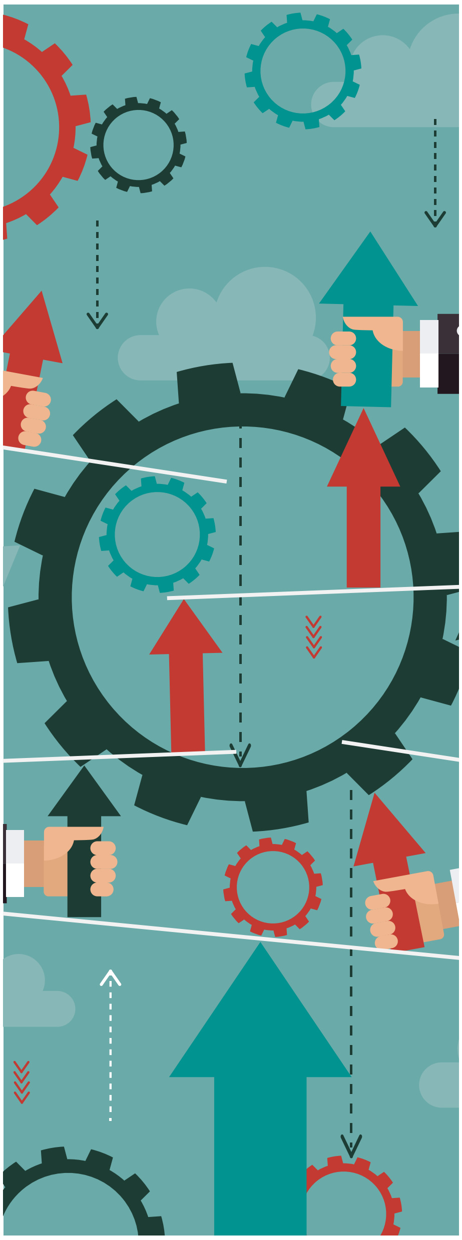
Gearing can enhance portfolio returns yet it can also magnify losses in negative market conditions.

THEY CAN'T GO CRAZY

Investment trusts normally follow a pre-defined gearing strategy which is published on their website or in financial reports. For example, the board might say the fund manager is allowed to use up to 10% gearing. The fund manager needs to keep within the range agreed by the board of directors.

Temple Bar Investment Trust (TMPL) says it can go as high as 50% with its gearing but adds that a more normal range is 0% to 30%.

Blue Planet Investment Trust (BLP) can go to 75% gearing but is presently at just under half this level at 33.4%. There are plenty of investment trusts which choose to have no gearing at all. (DC)



AN EXAMPLE OF GEARING LEVELS AMONG INVESTMENT TRUSTS

Investment Trust	AIC sector	Gearing %
British & American	UK Equity Income	122
Candover	Private Equity	86
Blue Planet Investment Trust	Global Equity Income	33
BlackRock Throgmorton Trust	UK Smaller Companies	28
Value and Income	UK Equity Income	27

Source: AIC, 16 Oct 2016

WELCOME TO 'YOUR VIEWS'

This is your platform to talk about key investing issues.

Each week we will pose a question and publish the best comments in a future edition of *Shares*. You can comment on our Facebook page, send us an email or interact via our Twitter account.

This week's question...

What's your view on the housebuilders? Will share prices in the sector rise or fall over the next six months?

I am sceptical about the positive messages coming from the housebuilders. I can see a lot of unsold properties on the market where I live in London, or many that have 'under offer' signs which haven't changed for months. I fear property market transactions will show a big decline by the end of the year. That could panic investors and see them sell their shares in housebuilders or at least trim positions.

Richard Pickson, Email

The housebuilders are in much better shape than the last time the economy went into decline. I hold them for income and won't be selling any – even if you do see some negative property market data. I find it hard to believe people will stop buying houses. Profits may be reduced at the housebuilders, but they are survivors.

L.Sidcombe, Email

(Shares prices will go) Down. Affordability will dampen demand.

@DaveAtkins3, Twitter

Depends on balance between the £2.5bn promised to housebuilders by Government and the effect of increased costs due to pound devaluation.

@harry_southdown, Twitter

Sideways. I can't see housebuilders doing much in 2017 apart from wiggling around and decent dividends.

@wheeliedealer, Twitter

I own shares in three housebuilders and have no intention of selling. Supply still falls short of demand and will continue to do so.

@RodneyHobson, Twitter

THE BIG QUESTION FOR NEXT WEEK

What are the best books for learning about investing?

Please feel free to comment on why you have chosen these books.

EMAIL: yourviews@sharesmagazine.co.uk

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City of London reveals secrets of its success

Fund manager explains how his dividend-paying portfolio is constructed

Housebuilders represent an important element of **City of London Investment Trust (CTY)**, one of the UK's best known investment collectives thanks to 50 years of consecutive dividend growth.

Fund manager Job Curtis believes the sector, which was hit hard by the Brexit vote, is at 'peak profitability' with strong margins of 20%.

Curtis is still positive about housebuilders despite being one of the biggest detractors in his fund over the past year. He highlights strong balance sheets and net cash as the reason for adding to **Persimmon (PSN)** and **Taylor Wimpey (TW.)** after the vote in June to leave the EU.

He believes house prices need to be stable and not necessarily rise to ensure these companies remain profitable. 'I think as the UK hasn't been building enough houses, both of these companies have enough land to build for at least five years,' explains Curtis.

STAR PERFORMER

City of London has the longest track record of continuous dividend growth of any investment trust, claims the Association of Investment Companies. It also has the lowest ongoing charges ratio of 0.42% in the AIC UK equity income sector.

A 4% yield will certainly interest investors looking for decent levels of income from either their ISA or SIPP (self-invested personal pension).

The investment trust aims to provide long-term growth in income and capital, mainly through investment in UK equities using a conservative approach.

According to Curtis, one of the biggest contributors to the portfolio's success has been cigarette giant **British American Tobacco (BATS)**. He says the average price paid for shares in the portfolio was £4.70 and the stock is now worth 10 times as much at £47.

BREXIT BOOST

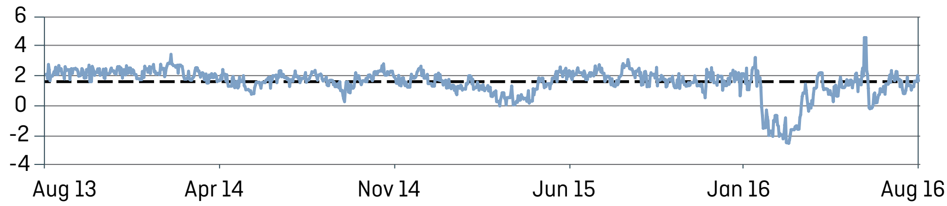
The investment trust has a large cap bias with just over two thirds of its assets in the FTSE 100. The blue chip index generates approximately 80% of its earnings from outside of the UK.

Higher exposure to the overseas markets particularly helped the fund following the Brexit vote in June when investors turned their back on UK domestic stocks for fear of a weaker economy caused by leaving the EU.

'I woke up on June 24 with a portfolio well-positioned for Brexit as it turned out we're 68% in FTSE 100 companies and they are predominately international,' says the fund manager.

Top holdings in the investment trust include **Vodafone (VOD)**, **Diageo (DGE)**, **Unilever (ULVR)**, **National Grid (NG.)**,

DISCOUNT/PREMIUM (%) WITH AVERAGE LINE (CUM INCOME)



Source: Henderson

GlaxoSmithKline (GSK) and **Imperial Brands (IMB)**.

Despite still being one of the top holdings, Curtis has scaled back the position in GlaxoSmithKline due to concerns about earnings and free cash flow being inadequate to cover annual dividend payments near term.

INTEREST RATE PRESSURES

The portfolio is underweight in the banking sector versus its FTSE All Share index benchmark. The sector is battling with low interest rates which is bad for lenders.

Market concerns about the health of **Deutsche Bank (DBK:ETR)** have also dampened investor sentiment towards the broader banking sector.

However, Curtis remains optimistic about the banking stocks that do feature in his portfolio including HSBC and **Lloyds Banking Group (LLOY)**. 'It's quite nice to have something in the portfolio that's going to benefit when interest rates eventually go up,' he explains.

SHIFTING GEARS

There have been significant changes to the portfolio over the past year or so to find stocks with an attractive dividend yield.

£5,000 invested in City of London Investment Trust 10 years ago would now be worth **£10,488** if you reinvested all dividends

Source: Thomson Reuters, Shares

Auto-related stocks have been appealing as oil prices are still relatively low and the interest rate of 0.25% has made it cheaper for people to buy cars.

Curtis has also bought new holdings in German-listed **Daimler (DAI:ETR)**, British auto components stock **GKN (GKN)** and UK garage retailer **Pendragon (PDG)**.

Also joining the portfolio has been car seller **Inchcape (INCH)** which is considered particularly desirable as its sales are 80% overseas and 20% in the UK so there is geographic diversification. 'This was a good opportunity to buy into an international auto car retailer at a discounted price,' Curtis comments.

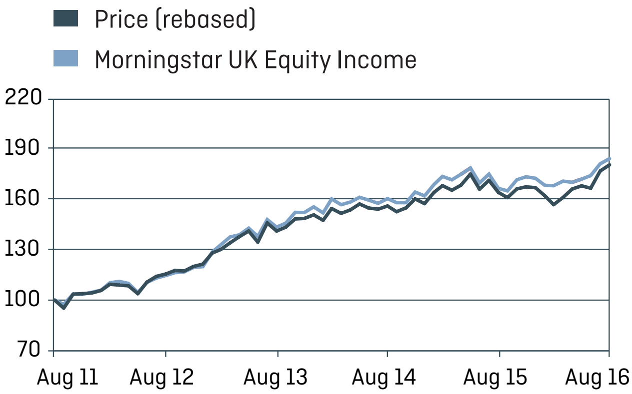
The oil and gas sector has been one of the biggest detractors in the fund as producers have seen their earnings hit by a lower oil price over the past few years. However, City of London still holds shares in **Royal Dutch Shell (RDSB)** and **BP (BP.)** which are currently yielding 6.6% and 6.7% respectively, based on dividend forecasts for their current financial year.

Miners are only a small part of the investment trust. They've had to prioritise debt repayments over cash rewards for shareholders, so miners are less attractive to income investors.

'The story in the mining sector has been one of dividend cuts as every single mining company has had to cut its dividend,' explains Curtis.

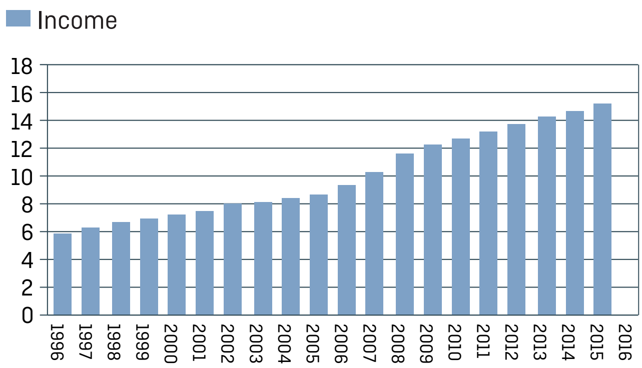
'We've kept a small weighting in this sector of about 1.4%, mainly through **Rio Tinto (RIO)**. **Anglo American (AAL)** actually stopped paying a dividend completely and so we had to sell that one.' (LMJ)

SHARE PRICE PERFORMANCE (TOTAL RETURN)



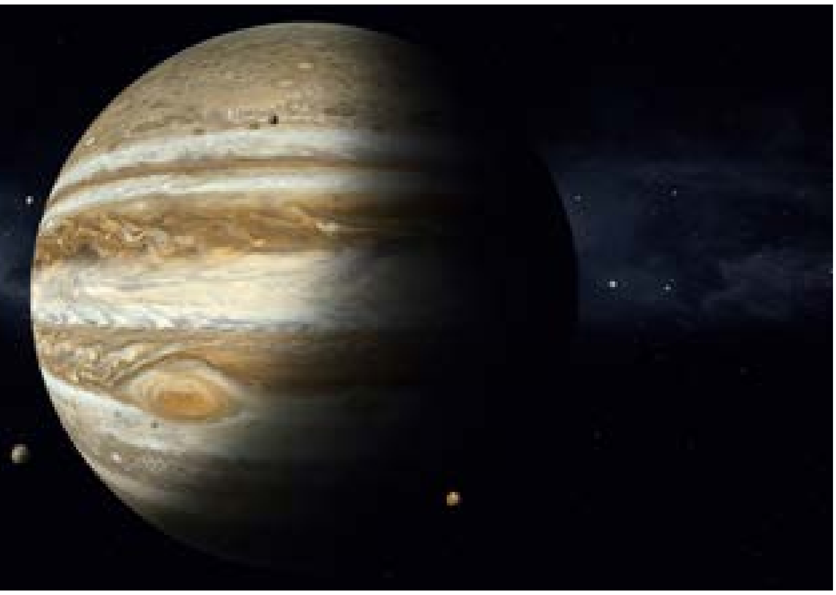
Source: Henderson

DIVIDEND HISTORY (PENCE/SHARE)



Please note that this chart could include dividends that have been declared but not yet paid.

Source: Henderson



Jupiter's rocketing returns

Short-selling guru has made money in all market conditions

Wild swings in stock markets can provoke panic, though it is important to remember volatility also provides opportunities for investors to make profits.

One way of positioning portfolios for an uncertain investing climate ahead is to put money to work with 'absolute return' funds. These seek to make positive returns regardless of underlying market conditions.

Absolute return strategies provide an alternative prospect to traditional equity and bond funds as they can use a variety of instruments across different asset classes as well as a blend of short and long stock positions to generate positive returns from falling or rising markets.

ABSOLUTE STAR TURN

Successful absolute return investing should generate returns with low correlation to the wider market, while limiting the impact of volatility by managing downside risk.

A proven exponent is the **Jupiter Absolute Return Fund (GB00B5129B32)**, a long/short global fund that utilises manager James Clunie's recognised specialisation and edge in single-stock short-selling. The highly diversified portfolio seeks to generate absolute return over a three year rolling period.

Since taking over Jupiter Absolute Return in September 2013, Clunie, who bought his first shares at the age of 13, has successfully pursued a lxong/ short equity strategy that has sought 'value-out of fashion' long positions and 'over-priced, with a catalyst' shorts.

Jupiter Absolute Return
Type: Unit Trust
Manager: James Clunie
Benchmark: LIBOR GBP 3 Months
IA Sector: IA Targeted Absolute Return
Fund size: £572.4m (as at 30/09/2016)
Long holdings (as at 31/08/2016): 77
Short holdings (as at 31/08/2016): 117

TOP TEN HOLDINGS (AS AT 31/08/2016)	
UK Treasury 1.75% 22/01/17	7.2%
UK Treasury 5% 07/03/18	6.5%
UK Treasury 1% 07/09/17	6.3%
UK Treasury 1.25% 22/07/18	6.2%
Physical Gold ETF	3.2%
US Treasury 2% 15/02/23	2.8%
BP (BP.)	2.7%
Burford Capital (BUR:AIM)	2.0%
Esure (ESUR)	1.8%
Centrica (CNA)	1.7%

Source: Jupiter

Clunie has conducted academic research on short selling which gives him an edge when it comes to understanding the informational value of stock lending and short-selling data. Working with a tight-knit team, Clunie applies a combination of quantitative and fundamental analysis of short positions which can make the fund more robust to shocks.

'I've read everything on the topic and written on the topic and we practise it every day,' says Clunie, adding that 'we combine appropriate behaviour with a data edge'.

Supported by analyst Ivan Kralj, Clunie believes his edge in single-stock short-selling comes from his understanding of stock-lending datasets and his adherence to two important behaviours. The first is being patient.

Once an overpriced asset has been identified, he argues short-sellers shouldn't 'strike too early'. It is better to wait until you see others shorting, or wait for a catalyst, as 'then you have an overpriced asset with a reason to go down'. The second behaviour is that 'you must accept your mistakes and take your losses' – with short selling you 'can lose a lot more than all your money in theory', though in practice you'll be stopped out with a large loss.

James Clunie

A bottom-up investor who makes use of quantitative screens to identify potential long and short stock ideas, Clunie's short positions have to be taken via derivatives in line with UCITs rules. Clunie also tries to understand the ecology of the ownership and short interest in each stock to gauge whether or not there are potentially informed traders holding opposing views to his own.

NETFLIX – A TURN OFF?

Among Clunie's shorts is American video-streaming company **Netflix (NFLX:NDQ)**, famed for political drama *House of Cards*. With unlimited, commercial-free viewing for a low and flat subscription fee, Netflix has been able to rapidly grow its subscriber base.

However, as Kralj writes on the Jupiter site: 'while Netflix might be creating an army of happy customers, it does not seem to be creating sustainable wealth for its shareholders in the process.' The managers argue a 'rather offensive US $43.13bn cap might suggest otherwise' and given an eye-watering PE of 319.31, according to Morningstar, 'you would expect the company to be operating a highly profitable, wide-moat business with no contenders for the throne. That is not the case, so we are bearish and short.'

Reed Hastings, the charismatic founder and CEO, readily admits that the number of players trying to eat Netflix's lunch is significant. **Amazon (AMZN:NDQ)** in particular, with its Prime Video service, is ramping up its content offering and, thanks to an equally attractive price for customers, is growing membership numbers at a faster rate than Netflix.

BIG SHORTS

Jupiter Absolute Return is also short **Nexstar Broadcasting (NXST:NDQ)**, a $1.74bn cap broadcaster and digital media play which 'buys TV stations in America on borrowed money' according to Clunie. 'To us, it looks expensive, it is highly levered and has a negative catalyst in terms of big earnings downgrades which are coming through. And yet the shares are bobbing around at all-time highs,' he says

'**Tesla Motors (TSLA:NDQ)** is possibly the riskiest share that we are short right now,' adds Clunie. 'It is obvious to many investors that Tesla is an ugly stock, but there are lots of believers in the Elon Musk vision,' he explains, referring to the billionaire SpaceX founder who drives the electric automaker's fortunes. 'It is beautifully ugly – it is a whole panel of red lights on a quant,' says Clunie, whose bearish stance reflects cash concerns, an inflated valuation and poor corporate governance.

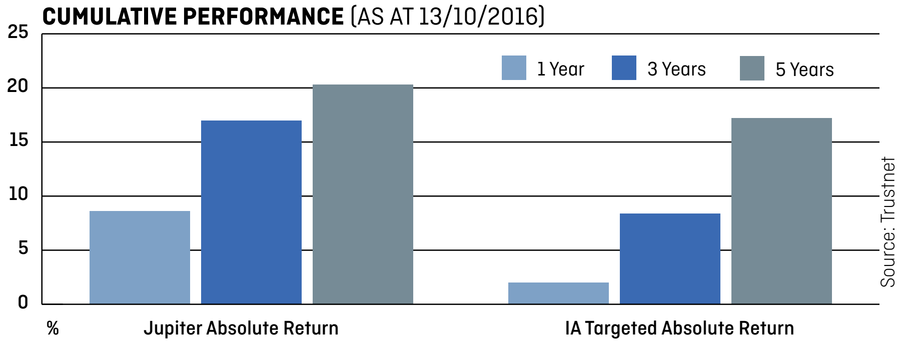
The latter manifests itself in Tesla's proposed merger with **SolarCity (SCTY:OQ)**, the renewable energy seller chaired by Musk, its biggest shareholder, and run by his cousins Lyndon and Peter Rive. Clunie is in good company; New York short-seller Jim Chanos, who famously predicted Enron's collapse, is also betting against Tesla's stock.

LONG POSITIONS

Jupiter Absolute Return's current long positions include litigation funder **Burford Capital (BUR:AIM)**, oil major **BP (BP.)** and the home, car and travel insurer **Esure (ESUR)**, as well as Denmark's **AP Moller-Maersk (MAERSKB:CO)**, the world's largest container shipping group.

'We're buying it because it is the highest quality company in its space,' says Clunie who notes the financial muscle to swallow up struggling competitors in an industry heading for further consolidation. (JC)

CUMULATIVE PERFORMANCE (AS AT 13/10/2016)



Tate & Lyle is a sweet looking investment

Turnaround upside and FX tailwind are reasons to like food producer

Surprisingly for a £3.72bn cap that generated the best part of £2.4bn sales in the year to March 2016, **Tate & Lyle (TATE)** is often misunderstood by commentators and investors.

In a nutshell, its innovative technology turns raw materials into high-quality ingredients that add taste, texture and nutrition to food and drink products.

NO MORE SUGAR

The Tate & Lyle name is still heavily associated with sugar.

In fact the London-listed food producer sold its EU sugar refining operations to American Sugar Refining (ASR) in 2010 for £211m in order to focus the business, reduce volatility and improve earnings quality.

The disposal included Tate's cane sugar refineries in London, the UK and Lisbon; the Lyle's Golden Syrup factory in London; as well as the associated sugar and syrup brands.

Under the deal, the 'Tate & Lyle Sugar' name was licensed to ASR, ensuring the Tate & Lyle brand remains on supermarket shelves to this day. And not long thereafter, Tate also hived off its remaining businesses within the Sugars division, namely Molasses and Vietnamese sugar.

Present-day Tate & Lyle is a major supplier of ingredients to global food and beverage clients and selected industrial customers, operating from more than 25 large scale manufacturing plants around the world.

TODAY'S TATE

Tate & Lyle's two divisions are the Speciality Food Ingredients (SFI) arm and a Bulk Ingredients unit. SFI, the long-term growth driver, consists of ingredients that use technology or IP and enable Tate to obtain premium prices and generate higher margins.

Products span texturants such as starch and gums, sweeteners, comprising nutritive sweeteners and a range of no-calorie sweeteners including 'SPLENDA Sucralose', and also wellness ingredients including speciality fibres and Tate's salt-reduction offering.

Bulk Ingredients is the relatively commoditised division selling bulk sweeteners, industrial starches and fermentation products (primarily acidulants). Corn co-products from both divisions are primarily sold as animal feed for livestock, fish and pets.

HEALTHY MOVES

So rather than a sugar producer, Tate & Lyle in fact offers a play on drives to reduce sugar and salt in diets around the world. Consumers and governments are focused on healthier lifestyles, with the rising prevalence of diabetes and obesity in both developed and developing markets driving food and beverage companies to develop healthier alternatives.

Other drivers are the volatile and high sugar prices that have led to an increased focus by customers on cost reduction, while rapid urbanisation and rising levels of disposable income in developing markets are increasing the penetration of packaged and convenience foods in Asia and Latin America.

TALE OF TWO INDUSTRIES

Investors should also understand that Tate & Lyle mainly operates in two industries: corn wet milling and high-intensity sweeteners. Corn wet milling is a major industry in the corn-growing parts of the world and Tate & Lyle has a network of corn wet milling plants in the US, where it processes around 2% of the annual corn crop, and in Europe.

Tate's plants take shelled corn (maize), separate the kernels into their core components (starch, oil, protein and fibre), and process them to create a range of products including high

Drinks with Tate's Stevia sweetener

fructose corn syrup, food starch, ethanol and animal feed.

Tate & Lyle is also the leading supplier by value in the global high-intensity sweeteners (HIS) market, where sucralose holds a 30% value share and its SPLENDA Sucralose product is the biggest brand. SPLENDA Sucralose is a high quality sweetener with a sugar-like taste and a sweetening power roughly 600 times that of sugar. Manufactured in Alabama, SPLENDA Sucralose can withstand high temperatures during processing and has a long shelf-life, though it has encountered downwards pricing pressure in competitive market conditions.

SWEET TURNAROUND

We outlined the compelling turnaround at Tate & Lyle on 19 November 2015 at 605p. The share price has since appreciated 30% to 789.5p, helped by solid full-year results (26 May) showing margin expansion in both divisions, a strong first quarter update (21 Jul), as well as Tate's status as a prized 'dollar earner' in the current weak sterling environment. Tate generates less than 2% of sales in the UK and most of its revenues are dollar based.

Tate & Lyle still has exposure to rising commodity costs, while weakness in large sweetener customers in the US and in the Chinese dairy market are negatives to weigh.

Our bullish thesis remains intact. Chief executive Javed Ahmed has stabilised the business following a poor 2014 and 2015, caused by supply chain disruptions, competitive pressure for sucralose and a lack of SFI capacity. Tate has completed necessary SFI capacity expansion and set out exciting and ambitious new targets to drive sustainable earnings growth and cash flow generation.

THE RIGHT STRATEGY

We believe Ahmed's strategy to focus on the SFI arm is the right one. Lessening exposure to commoditised bulk ingredients, Ahmed plans to deliver 70% of group profit from the higher-margin SFI business (excluding any contribution from Sucralose) as well as 30% of SFI sales from Asia Pacific and Latin America by 2020.

He believes Tate can outperform the SFI market with the help of acquisitions while improving margins. In addition, management is targeting $200m worth of revenue from an innovative new product pipeline, spanning sweeteners, texturants and health and wellness products, by the aforementioned date.

HOW MUCH MONEY WILL IT EARN?

For the year to March 2017, Liberum Capital forecasts pre-tax profit of £230m (2016: £193m) for earnings of 41.2p and a 29.4p dividend, rising to £245m, 43.53p and 30.87p respectively by 2018. On these estimates, we concede a prospective price to earnings ratio of 19.2 times is rather full, though investors are also being paid an attractive 3.7% yield while they await further benefits from the turnaround to materalise. Though dividend cover looks somewhat skinny, net debt is coming down.

On balance, we believe it is worth taking a taste of Tate & Lyle ahead of next month's (3 Nov) half-year results, with further earnings upgrades highly likely this year if current FX rates persist. (JC)

SHARES SAYS: ↗

We're staying positive on Tate & Lyle at 789.5p, being believers in the strategy and anticipating further currency-driven earnings upgrades.

BROKER SAYS: 4 10 0

Fund fees in focus

We analyse whether high ongoing charges can ever be justified

Despite growing pressure on investment houses to reduce fees, there is still a huge gulf between the cheapest and most expensive funds which often can't be explained by manager skill or outperformance.

Some actively-managed funds charge three times as much as similar funds within their sector yet fail to provide a return that compensates for this fee. In the majority of cases, the high charge results in the fund underperforming.

'Managers charging above average management fees are simply being greedy and the only way to stamp out this practice is to avoid them'

SURPRISING RESULTS

A fee calculator from financial guidance website Candid Money demonstrates how fees can compound over time and eat into your overall returns.

If you invested £5,000 into a fund with an annual return of 6% and a 0.6% charge, the fund would be worth £5,855 after three years and your investment fees would be £101. If the same fund had a 1.5% charge, it would grow to £5,706 and the fees would be £249.

Invest the same amount over 15 years and the 0.6% charge would result in the fund growing to £11,005 with £978 lost to fees. A 1.5% charge over 15 years would see the fund growing to just £9,677 with the lost investment due to charges amounting a substantial £2,306.

Justin Modray, founder of Candid Money, says a fund manager could justify high charges if they always delivered after-charge returns well above everyone else, but in practice consistent outperformance rarely happens.

'Managers charging above average management fees are simply being greedy and the only way to stamp out this practice is to avoid them,' he states.

Even if a fund charges a typical annual management charge (AMC) of 0.75% this is often overshadowed by other costs charged to the fund, such as custodian and administration fees, resulting in the fund having a high ongoing charge figure (OCF). This is particularly the case for small funds.

'Fund managers have had it too good for too long with minimal price competition in the actively-managed fund arena,' says Modray.

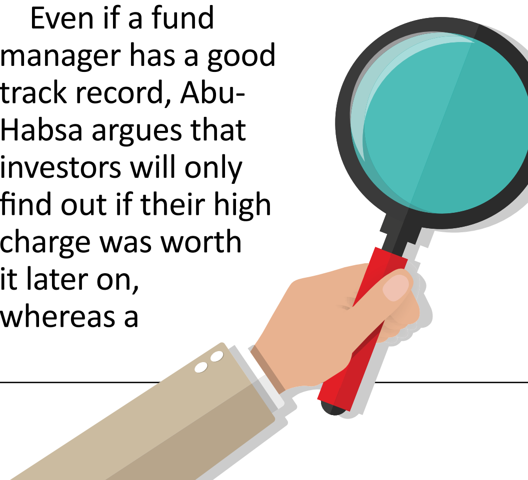
Recent analysis of US-domiciled funds by Morningstar found the cheapest funds were at least two to three times more likely to survive and outperform their category group than the priciest funds, regardless of the asset class and time period.

INVESTOR CONTROL

Cost is just one of five factors that Morningstar looks at when rating funds, but for individual investors it's a good place to start, according to Morningstar senior analyst Muna Abu-Habsa. She points out there are many factors outside an investor's control – for example, stock market volatility and a fund manager's decision to leave – whereas price is constant.

'The more you can do to manage fees in your favour, the better off you are,' she says.

Even if a fund manager has a good track record, Abu-Habsa argues that investors will only find out if their high charge was worth it later on, whereas a



decision based on fees can be controlled at the outset.

Morningstar upgraded **Woodford Equity Income (GB00BLRZQ737)** to a Silver rating when Woodford Investment Management announced in April that it was going to absorb all the fund's research costs rather than passing them on to investors through the OCF. With an OCF of 0.75%, it is 0.1-0.2% cheaper than many funds.

CHEAP BUT GOOD

Ryan Hughes, head of fund selection at AJ Bell, likes **Royal London UK Equity Income M (GB00B8Y4ZB91)**, which has an OCF of 0.66% when bought via a fund platform. It has a 10-year annualised return of 8.67% versus 5.84% for its benchmark, the FTSE All Share Total Return.

'The fund has been managed for over 10 years by Martin Cholwill who has built up a very strong track record through a disciplined focus on higher-yielding UK equities. Cholwill looks at sustainable businesses that generate significant amounts of cash which gives comfort that those companies will be able to pay and importantly grow their dividends over time,' says Hughes.

Franklin Templeton cut the AMC on three of its funds, including **Franklin UK Equity Income W Acc (GB00B7DRD638)**, from 0.75% to 0.45% in June, giving it an OCF of just 0.54%. However, Alex Brotherston, head of UK retail sales at Franklin Templeton, explains this is largely because the fund concentrates on blue-chip stocks, which are easy to gather data on. In addition, the fund overweights and underweights stocks rather than using an intensive stock-picking strategy.

'Small cap funds are more intensive because the managers spend time talking to and visiting companies which might only have one house broker. FTSE 100 companies are very well-researched,' Brotherston says.

Franklin UK Smaller Companies W (GB00B7FFF708) has a much higher OCF of 0.83%. Abu-Habsa says it is important to look at fund fees within the same category so you can make a fair comparison.

'Sector-based funds can be expensive; sometimes this is justified, sometimes not. For regional funds, liquidity and trading costs are other drivers of charges,' says Abu-Habsa. 'At the same time, investors should also look at fees in absolute terms because that cost will eat into your returns and compound over time,' she adds.

With an OCF of 1.2%, **GAM Star Capital Appreciation US Equity (IE00B5SLLT59)** is a lot more expensive than other funds in the North America sector; for example **Schroder QEP US Core I Acc (GB0007648347)** has an OCF of 0.32%.

Wellington Management, which manages the GAM fund, points out its investment team comprises three portfolio managers supported by six dedicated analysts and a large team of global industry analysts. It says the fund's alpha generation after fees has beaten the S&P 500 by 0.9% (net) since 1997.

'Once a shortlist of funds has been identified there is a balance between cost and performance to consider'

RISK AND OBJECTIVES

Joshua Gerstler, financial adviser and company director at financial advice firm The Orchard Practice, says it's very important for investors to look at charges, but they should also consider volatility and the level of risk the fund manager is taking with their money.

AJ Bell's Ryan Hughes agrees that fees shouldn't be looked at in isolation. He says investors first need to identify the fund or funds that fit with their investment objective. This will be determined by how much risk they want to take and time horizon for investing.

'Once a shortlist of funds has been identified there is a balance between cost and performance to consider. Investors may be happy to pay a slightly higher cost in return for the skills of a fund manager that has proven to outperform the market over the long term. So while it is important not to pay unnecessarily high charges, the performance and objective of the fund are also important considerations,' Hughes explains. (EP)

Pensions versus ISAs: Which is the best to use?

A new report looks at how tax reforms have impacted the appeal of two major investment wrappers

Stand aside pensions, ISAs are the new kid in town. That seems to be the conclusion of a report published last week by the Office for Budget Responsibility (OBR), a body set up by the Government to provide independent analysis of the UK's public finances.

The evidence since 2010 certainly seems to back that assertion. George Osborne, the former Chancellor of the Exchequer, repeatedly wielded the axe to pension tax incentives, while simultaneously announcing dramatic increases in ISA allowances.

This series of reforms prompted the OBR to declare: 'Broadly speaking, these (reforms) make pension saving less attractive and non-pension saving more attractive, particularly for high earners.'

Let's take a look at the various pension and ISA tax allowances to see if they've changed in recent years. We'll also explore whether the balance has really shifted in favour of the ISA.

Source: OBR

PENSIONS VS ISAS: WHAT ARE THE MAIN DIFFERENCES?

Pensions and ISAs are often pitted against each other as rival savings products, but in reality they operate in very different ways.

For starters, they are not taxed in the same way. Your pension contributions are tax-free, as is any investment growth on your fund. You can take 25% of your pot out after age 55 without paying any tax at all.

Any other withdrawals are taxed at your marginal rate, meaning the money is added to your earned income to determine how much you pay to the taxman in any given year. You might hear this regime described as 'exempt-exempt-taxed', or EET.

ISAs, on the other hand, are 'taxed-exempt-exempt', or TEE. This means there is no tax relief on money paid in, but investment growth and withdrawals are tax-free.

Pensions also remain more restrictive than ISAs. Your pension will have to remain untouched until you hit your 55th birthday. The penalties for trying to break this rule are extremely severe. ISAs, on the other hand, can be accessed as and when you want, penalty-free.

HOW MUCH CAN I PUT IN A PENSION OR AN ISA?

Both pensions and ISAs are subject to restrictions on how much you can pay in.

The maximum you can save in a pension each year without paying tax – known as the annual allowance – has plummeted from £255,000 in 2010 to £40,000 today.

And if you have income over £150,000, your annual allowance falls progressively to a minimum of £10,000 for those receiving £210,000 or more a year.

The lifetime allowance – a cap on the total value of assets you can hold in a pension – has also been pegged back, from £1.8m in 2010 to £1m in 2016. If when you come to take money out of your pension(s) your pot is worth more than this amount, you'll be hit with a tax charge on the excess.

By contrast, the amount you can save in an ISA has increased during the same period, from just £10,200 in 2010 to £15,240 this year, with a further increase to £20,000 scheduled for 2017/18.

PENSIONS STILL PUT UP A GOOD FIGHT

Despite huge reductions in tax allowance in recent years, for most people – and particularly higher earners – the pension remains the most tax-efficient retirement savings vehicle available.

Pension tax relief – effectively a savings bonus from the Government – means the value of each contribution is instantly increased. So if you're a basic–rate taxpayer, an £80 monthly contribution out of your pocket becomes £100 through tax relief. If you're a higher rate taxpayer, you can claim another £20 through your tax return.

You can also pass on a pension tax-free to your loved ones if you die before age 75. If you die later than this, the money you leave behind will be taxed at your beneficiary's marginal income tax rate. ISAs, on the other hand, are subject to inheritance tax.

While ISAs are more flexible and money taken out isn't taxed, you don't get a monetary bonus from the Government for using them.

Even if you're earning over £210,000 – and thus have an annual pension allowance of £10,000 – you should still seriously consider maximising your tax incentives, if you can afford to, before moving on to ISAs or other long-term savings vehicles.

So while it's clear the tax tables have been tipped towards ISAs over the past six years, when it comes to saving for retirement the pension still sits at the top of the tree.

TOM SELBY
Senior analyst, AJ Bell

WRONG WEATHER AND OTHER EXCUSES FOR POOR TRADING

CAN YOU SPOT THE DIFFERENCE BETWEEN A CREATIVE FIB AND THE TRUTH?

Companies on the stock market have more excuses as to why trading has been poor than even the sneakiest student trying to dodge their homework.

Just as the nation loves to talk about sun and rain; quoted companies love to blame the weather for their tills not ringing.

Some firms will be telling the truth. Most will just be clutching at topical events to mask what is fundamentally just poor market demand or a badly-run business.

Your job as an investor is to work out who is to blame – storm clouds or rubbish management.

WILTING IN THE HEAT

Bisto gravy and *Hovis* bread maker **Premier Foods (PFD)** on 12 October cooked up an absolute stinker of an excuse, in our opinion.

It attributed weak trading to the weather. The group blamed unseasonably high temperatures for a 1.8% decline in sales in the final month of its six month trading period to September.

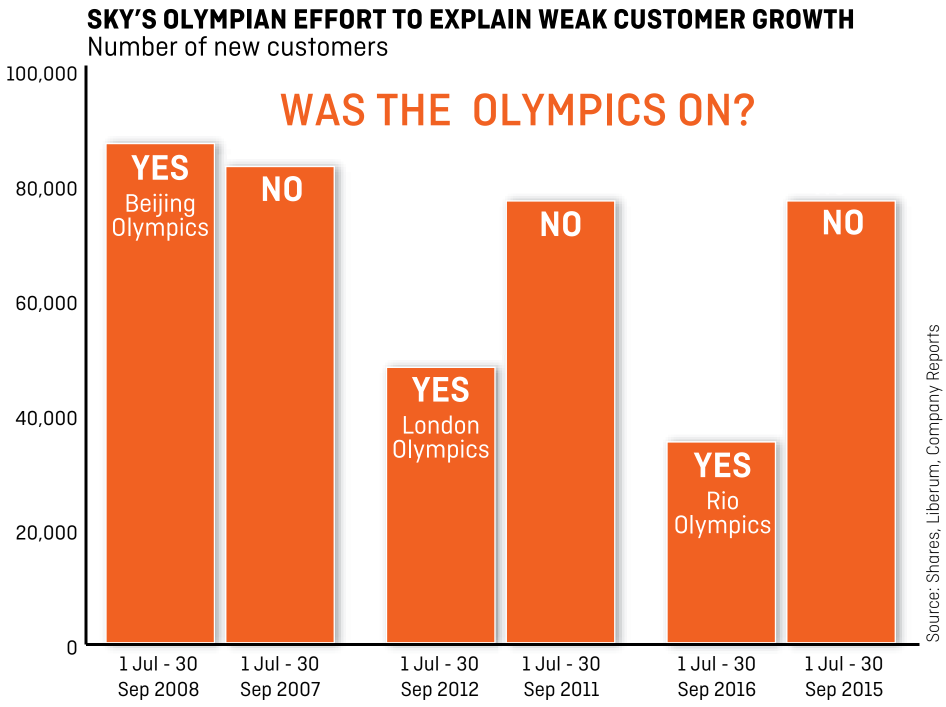
The market seemed sceptical of an accompanying pledge to hit full year numbers. The shares fell by up to 10% on the news.

Grocery sales fell 9.5% and gravy and dessert sales dropped 13% and 9% respectively, in the second quarter. Its Sweet Treats and International business fared better, up a respective 6% and 13%.

If you think a bit of autumn sun means we don't want any gravy on our sunday roast – as Premier Foods would have you believe – just imagine what excuses it may produce for its newly-launched Cadbury cakes range in the Middle East where it is hot for most of the year.

WHEN THE WEATHER DOES MATTER

There are times when the weather does have a clear impact on the trading of certain sectors.



For example, pubs tend to do well when it's sunny.

A warm autumn and winter is bad news for the sales of high street retailers' high margin coats and sweaters.

Heavy rainfall does not help the sale of fizzy drinks. Investors simply need to decide if an excuse is credible.

IRN-BRU seller **A.G. Barr (BAG)** is a quality name with a consistent record of creating shareholder value but half year results (27 Sep) still reflected poor early summer weather.

Total sales fell from £130.3m to £125.6m year-on-year. In our view, this is a blip rather than a poorly performing company searching for something to blame for its own failings.

NOT STOCKING THE RIGHT CLOTHES

There have been warnings of late from a number of high street clothing retailers including **Next (NXT)**, John Lewis and River Island. Many fashion sellers will have stocked autumn clothes in September, but you're hardly going to have bought a big coat when the sun was still shining.

Women's value fashion operator **Bonmarche (BON)** recently cited the wrong kind of weather for yet another poor trading performance. It is a serial offender and we wonder if there is a bigger problem afoot with the business given a string of disappointments since joining the stock market in 2014.

You need to compare like with like when it comes to the retail sector. A weak period for clothing doesn't necessarily mean sellers of any kind of product will also struggle.

Soft furnishings firm **Dunelm's (DNLM)** suggestion (6 Oct) that a warm September hit store footfall did not look too clever when sofa and carpets firm **DFS Furniture (DFS)** reassured on its own trading the same day alongside record full year results.

SHALL WE ALL BLAME BREXIT?

The timing of major events and even religious festivals have been used to explain weaker-than-expected trading. The Brexit vote is increasingly being used by companies in 2016 as the central reason behind trading volatility.

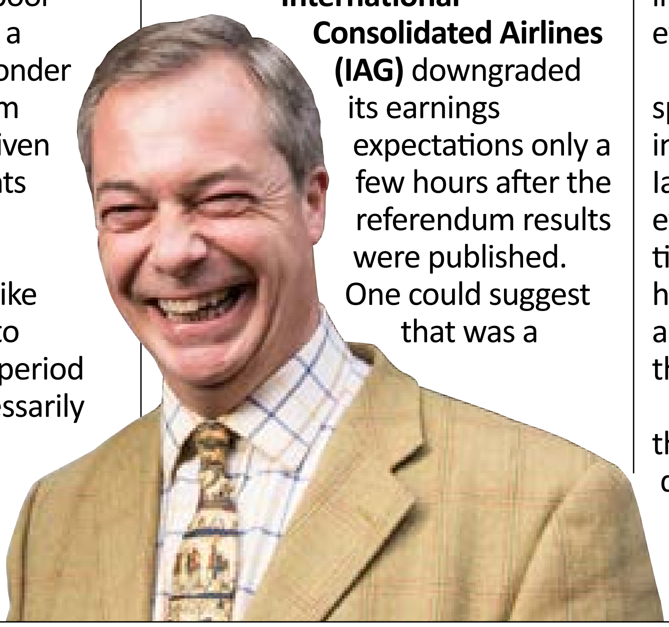
British Airways owner **International Consolidated Airlines (IAG)** downgraded its earnings expectations only a few hours after the referendum results were published. One could suggest that was a 'convenient' event on which to blame weaker trading which may have already been trending before the vote.

Pay TV giant **Sky (SKY)** on 13 October attributed a slowdown in UK & Ireland customer growth to the Euro 2016 football championship and the Olympics. Quarterly growth of 35,000 customers compares with 77,000 in the same period last year.

While the company cites a similar weakening around the London 2012 games, investment bank Liberum is sceptical and helpfully draws a comparison instead with the Beijing Olympics event in 2008.

'The London Olympics was a special event, happening as it did in the UK,' says Liberum analyst Ian Whittaker. 'Given this year's event was in Rio, was several time zones away and did not have the "Home Effect" we think a better comparable to look at is the Beijing Olympics in 2008.'

As the broker points out there was no obvious yearly deterioration in customer growth linked to the Olympics event eight years ago. (TS)



INDEX

KEY

- Main Market
- AIM
- Overseas Market
- Fund
- Investment Trust
- Exchange-Traded Product