

# SHARES

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YOUR MONEY

### UNSTOPPABLE FEVERTREE

Earnings forecasts  
hiked six times in  
two years

### GENEROUS HSBC

6.5% yield and  
scope for even  
bigger returns

### STRIKE IT RICH

Analyst eyes 660%+  
share price upside  
for oil stock

# Let us help you find investment ideas

Why it can pay to not follow the herd when looking for stock or fund ideas

It is hard being an investor, isn't it? Two major themes this year have been political uncertainty destabilising markets and asset valuations either very expensive or cheap for a reason. Those themes remain in play.

At the time of writing, the US elections were drawing to a close and a potential delay to starting Brexit had seen renewed volatility in sterling.

Compounding the problem has been the difficulty of finding good companies in which to make an investment at a fair price.

## WE HAVE A SOLUTION

But fear not. One of the reasons for reading *Shares* digital magazine each week – and our website every day – is to cut through the noise of the market. Our goal is to help you spot opportunities that the rest of the market hasn't yet picked up on.

There are a few really interesting stocks in this week's edition. **Independent Oil & Gas' (IOG:AIM)** broker FinnCap believes the share price could rise by more than 600% over the next 12 months. We explain why in the *Smaller Companies* section of the magazine.

I've written an article on **RM2 (RM2:AIM)** which has the right ingredients to stage a comeback after



a string of problems. It is very high risk, but most of the market has long given up on the stock which means you can pick up shares cheaply at the moment.

I'm also interested by the fact there isn't a single 'buy' rating on **WM Morrison Supermarkets (MRW)** from the analyst community. There are 10 'hold' ratings and nine 'sell' ratings according to Bloomberg data. That suggests no-one is willing to stick their neck out and make a brave call on the

supermarket's recovery potential.

We don't sit on the fence. Morrison's is a cracking 'buy', in our view. You should read James Crux's article in the *Larger Companies* section to discover why he is bullish on the stock.

## GO AGAINST THE FLOW

The best investors can be the ones with confidence to make conviction calls on stocks, even in the face of opposing market views.

If everyone loved a certain company, the share price would be bid up and it would have a rich valuation. Yet the best time to buy is often when other parts of the market aren't really interested. That's why you will often see us take contrarian views.

### WHO WE ARE

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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.



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## DISCLAIMER

### IMPORTANT

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# Fevertree keeps on raising the bar

Posh tonic water-to-ginger ale supplier continues to fizz along

**H**igh-end tonic water-to-ginger ale supplier **Fevertree Drinks (FEVR:AIM)** continues to look a long-term winner after treating investors to a sixth round of earnings upgrades since listing on AIM two years ago (7 Nov '14).

Forecasts were revised upwards again following the latest trading update (7 Nov). Management flagged a continued strong performance in the second half of 2016 and said calendar year results would be materially ahead of current market expectations.

A buyer with a new £11.40 price target, Investec Securities has upgraded its 2016 sales estimate by 11% to £93.9m and pushed through a 17% upgrade to its pre-tax profit forecast to £30.9m. The broker now expects 2016 earnings of 21.3p following the latest upgrade. The stock now trades on a prospective PE ratio of 52 times.

Fevertree says it grew particularly strongly in the UK, its biggest market, reflecting new distribution gains and growth in existing accounts in both the 'On Trade' (restaurants, hotels, bars) and 'Off Trade' (retailers) channels. We see scope for further near-term upgrades, since consumers will splash out on high quality mixers to complement vodka, gin and whisky over the festive period. A big overseas earner, Fevertree is also a notable beneficiary of sterling weakness.

We were among the first to spot the potential of Fevertree at just 212.75p in February 2015 and



flagged scope for continued growth again in an in-depth interview with co-founder and CEO Tim Warrillow on 19 November 2015. We are mindful of the risk that any slowing of the growth rate would be punished by the market, but do not expect this in the near-term.

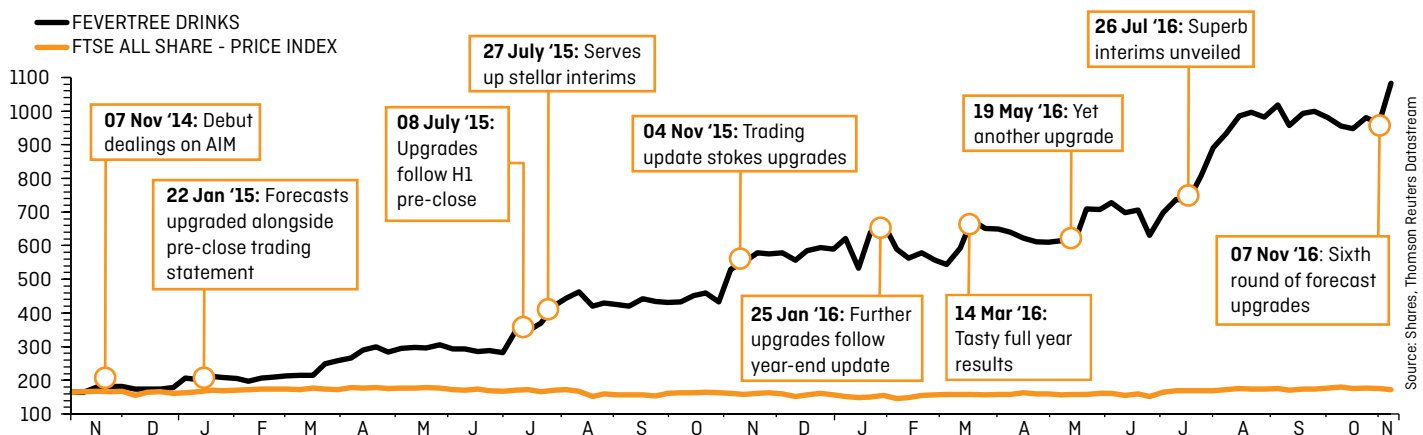
An increasingly iconic brand, Fevertree is riding an international boom in gin and tonic. And while the overall mixer market is mature, the soft drinks star turn has first mover advantage in premium mixers. An asset-light outsourced production model also means Fevertree is extremely cash generative and offers a progressive dividend. (JC)

## SHARES SAYS: ↗

At £11.01 Fevertree's growth rates continue to justify a premium valuation.

## BROKER SAYS

3 0 0





# Reasons to be positive on HSBC's 6.5% yield

Third quarter results imply lofty capital surplus

AMID FEARS IT would deliver soft third quarter numbers, **HSBC (HSBA)** is flying high after beating consensus forecasts with a 7% increase in underlying pre-tax profit to \$5.6bn.

Investors can have greater confidence in the current prospective yield of 6.5% as the company reported capital ratios which were, in the words of UBS, 'substantially ahead of expectations'.

There is also scope for further share buybacks following the conclusion of the current \$2.5bn programme.

The company's core tier one capital ratio – a measure of how much cash the company has as a buffer against a financial shock – has improved to 13.9%.

Shore Capital analyst Gary Greenwood reckons this leaves the company with excess capital of \$8.1bn down to the upper end of management's targeted range of 12% to 13%.

Despite this cash surplus Greenwood remains a seller. 'With the shares currently trading around tangible book value but with the forecast return on tangible equity set to remain stuck below the cost of equity (c10%) for the foreseeable future, we re-iterate our negative stance regardless of whether the dividend is ultimately maintained or



cut,' he says.

Investors shouldn't get swept away by the headline dividend yield. It is always important to remember that banks are inherently complex companies and certainly not risk-free investments.

## SHARES SAYS: ↗

The stock has already rallied from an April low of 418p but even at 615p the yield looks attractive and, for now, secure. (TS)

## BROKER SAYS

5 10 8

## Sepura in the crosshairs

Walkie talkie technology play in demand as buyout talks continue

A TAKEOVER BATTLE could emerge at struggling walkie talkies technology company **Sepura (SEPU:AIM)**. Buyout negotiations with Chinese suitor Hytera Communications were confirmed on 4 November.

Although a firm offer has yet to be made the news sparked a 47%

jump in Sepura's share price to 21.75p. Sepura's scope to expand into the US, where it this year inked a deal with the New York Transit Authority, and other markets could spark rival interest for the TETRA technology specialist.

US companies Motorola Solutions and Harris Corp could be tempted

to open talks, especially given the weakness of the pound. Earlier this year Sepura moved its R&D centre and headquarters into a state of the art facility in the Cambridge Research Park in Waterbeach, Cambridgeshire, keeping most of its costs in the UK.

Sepura has struggled with delayed orders and mounting debts this year, resulting in a big share price decline from peaks of 197.5p in April. (SF)

# M&S out of fashion

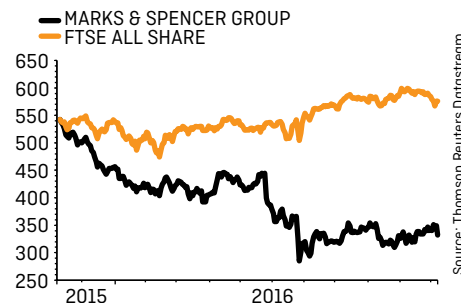
CEO Steve Rowe unveils strategy to return retailer to growth

Retail titan **Marks & Spencer's (MKS)** half year results (8 Nov) reveal an 18.6% underlying pre-tax profit slump to £231.3m amid another drop in Clothing & Home sales. However, CEO Steve Rowe has a strategy to return M&S to sustainable profitable growth which we think investors should back.

Following a 'forensic review' of the retailer's store estate at a time when shoppers continue to migrate online, Rowe will reduce M&S' reliance on fashion. He plans to shutter around 60 UK Clothing & Home stores over the next five years. In food, where M&S now has a record market share, Rowe remains committed to the roll-out of Simply Food outlets.

Internationally, M&S will focus on its profitable franchise model whilst exiting 10 loss-making owned markets through the closure of 53 stores (including 10 in China and seven in France) at a cost of £150m-£200m.

Sensibly, Rowe has also decided not to make an additional return of cash to shareholders in the second half given the costs required to fund his



restructuring, though the cash-generative retailer held the half year dividend at 6.8p.

Shore Capital believes that

'the component parts of his plan have individual and collective merit and as such do prime M&S for a brighter more profitable future.' However M&S is a high-risk opportunity, hence the broker has placed its forecasts and prevailing 'Buy' recommendation under review, 'until we have greater clarity as to the quantum of medium-term financial expectations.' (JC)

## SHARES SAYS: ↗

Continuing weak clothing sales are cause for concern, yet Rowe's plan is decisive and 340.8p looks a good entry point.

BROKER SAYS **9** **11** **8**

## Investors wary of Imperial's plan

TOBACCO FIRM **Imperial Brands (IMB)** is under some pressure as it announces plans to step up spending as it faces the prospect of an enlarged competitor in the form of the combined **British American Tobacco (BATS)** and **Reynolds American (RAI:NYSE)**, as recently proposed. The increase expenditure is expected to take 2017 earnings growth below its medium-term target of 4% to 8%. (TS)

## Oil firm IPO in dividend pledge

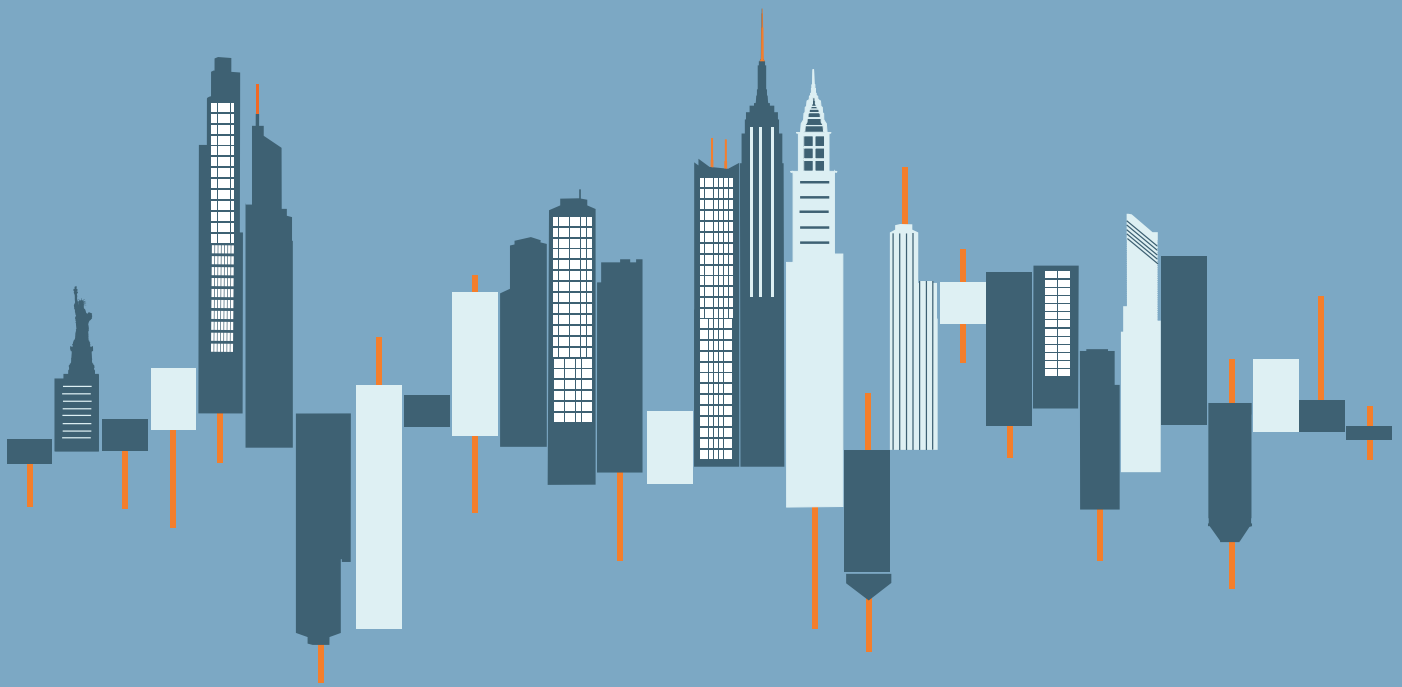
OIL COMPANY **Diversified Oil & Gas** is looking to raise £48m through an AIM IPO to support its production-led buy-and-build strategy in the US Appalachian basin. The company says it plans to pay a dividend by 30 June 2017 after joining the junior market this December. Efficient management of its oil and gas fields is allowing it to generate significant cash even at lower commodity prices. (TS)

## Market sweet on Associated

PRIMARK OWNER **Associated British Foods (ABF)** is in demand as it hails 2016 as a 'turning point' for its sugar business. The company reported (8 Nov) a 5% increase in full year revenue to £13.4bn, with its earnings per share and dividend also up 5%. As well as a boost from sterling weakness, the company says the Brexit vote could lead to beneficial changes in legislation and trade agreements. (TS)



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Each day we provide analysis and opinion on large and small companies, as well as major economic announcements, interesting data points and important events in the funds world.

The majority of these stories are exclusive to our website and do not appear in the weekly digital magazine.

For example, over the past few weeks we've looked at accounting scandals, earnings upgrades, big themes and explained the important areas of financial results from some of the market's most popular stocks.

We recommend you visit *the site* every day to get the news most relevant to investing.

We also provide all the official announcements from companies on the stock market and bite-sized stories explaining the news ([click here](#)) which also includes the ability to search by company name or specific terms.



Click on the following links to get a flavour of our recent online news coverage:

• **RYANAIR PROFIT HIGHER DESPITE BREXIT IMPACT**

• **CAN REDCENTRIC SURVIVE ACCOUNTING SHOCKER?**

• **KEYWORDS' €30M OF DEALS SPARKS UPGRADES**

• **GVC'S DIVIDEND SURPRISE**



## LOOKING FOR COMMENT ON THE US ELECTION RESULT?

DONALD TRUMP'S VICTORY was announced as we were finishing the last touches to this week's digital magazine.

We have published commentary on our website looking at how stocks, sectors and markets have reacted to the news.

[Click here](#) for the latest comment from the Shares team.

Next week's issue of Shares will look at how Trump's Presidency could affect the fortunes of UK stocks and other asset classes.



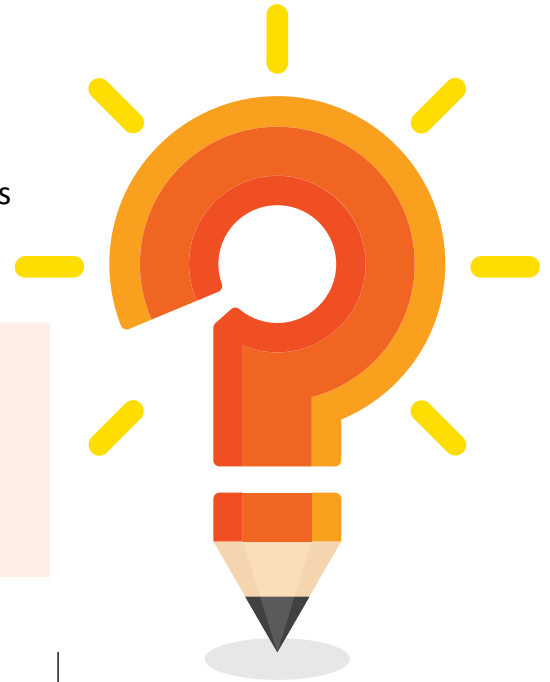
## WELCOME TO 'YOUR VIEWS'

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 the one bit of advice you would give to someone new to investing?



I would advise anyone starting out as an investor to focus on companies operating in areas they already know something about. Investing in something you don't understand is always a bad idea and some sectors have a lot of complicated jargon to navigate.

Michael B, via Email

Speaking from experience it is best to avoid getting too emotionally attached to a stock. I have lost money on a few names in the past after being

reluctant to sell and realise a loss!

Patrick Williams, via Email

Understand that by investing in a company you become a part owner in a business, with all your trades handled electronically it can be easy to think stocks and shares are just numbers on a screen but that's not the case. This can help you think more clearly about whether you genuinely want to own part of the company you are investing in.

Ken Perry, via Email

A good stock in a bad sector can underperform a bad stock in a good sector! If an industry is under pressure a company can struggle no matter how good its management/product/track record is.

Larry Browne, via Email

You invest in the stock market to make money not lose it. If you want to gamble out your money put your money on a horse race.

Blair Thorpe, via Email

## THE BIG QUESTION FOR NEXT WEEK

How important are dividends when deciding whether to buy or sell a stock?



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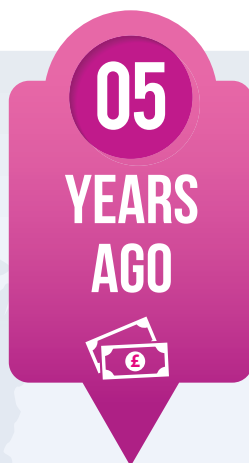
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2006



2011



2015

IN NOVEMBER 2011 the FTSE had just broken through 6,200 and the Bank of England's key interest rates was 5% and rising. Could the FTSE 100 rise through the 7,000 mark by 2007, *Shares* asked? 'As long as the Bank of England doesn't keep tightening the screws, we should be OK', we said. A year later rates were 5.75% and the FTSE did not hit 7,000 until early 2015. Key picks in that edition included **Experian (EXPN)** at 586p (up 155% since then) and, err, Northern Rock. (WC)

IN THE SEARCH for companies with a cutting edge, intellectual property incubators **IP Group (IPO)**, **Angle (AGL:AIM)** and Sagentia (now **Science Group (SAG:AIM)**) featured in November 2011. Both IP Group and Science Group have since gained 100% and 50% respectively, while Angle fared badly, down 29%. Elsewhere, *Shares* speculated the European Central Bank would need to start printing money to save the euro: it launched quantitative easing in 2015. (WC)

*IS YOUR INCOME Safe?* we asked in November 2015 as blue chip dividends began to look shaky. The FTSE 100 was trailing the FTSE 250 index in 2015 as dividends at index heavyweights **GlaxoSmithKline (GSK)**, **HSBC (HSBA)**, **Shell (RDSB)**, **BP (BP.)** and **Anglo American (AAL)** looked under threat. Anglo cut its dividend while question marks remain today at the other four. But the FTSE 100 index one year on is now well ahead of the mid cap FTSE 250 benchmark. (WC)



THIS IS A staggeringly large number but if the technology forecasting boffins at Juniper Research are right, there will be enough digital coupons and vouchers by 2021 for a deal a week for every man, woman and child on earth. This is already a hot market with 225bn vouchers estimated

to have circulated in 2016. But as retailers, restaurants, hotels and holiday firms desperately try to tempt new customers, and keep existing ones loyal, this space will continue to expand rapidly. That could be great news for AIM-quoted vouchers specialist **Eagle Eye Solutions (EYE:AIM)**. (SF)



## 3.3 million square metres

THIS IS THE size of the warehouse portfolio being acquired by Singapore sovereign wealth fund GIC in a €2.4bn deal with US private equity firm TPG. GIC is buying P3 Logistics Parks in order to tap into the e-commerce boom with heavy demand for warehousing space from online retailers such as **Amazon (AMZN:NDQ)**. The UK's largest listed industrial property outfit **Segro (SGRO)** announced a doubling of its 2016 investment budget in February in response to this trend. (TS)

## 40%: energy switching to independents

ACTOR PHILIP GLENISTER is the latest celebrity to front a TV advertising campaign telling consumers to switch energy supplier, and independents are winning. Between January and August the number of UK households to switch to

an independent supplier jumped 40% year-on-year, according to data from Energy UK. Analysts at equity research house Jefferies reckon this trend will accelerate, anticipating independent suppliers' market share to jump from 17% to 28% by 2019. (SF)

## FTSE INDICES' DIVIDEND YIELDS

Valuations on UK large, mid and small caps (2016, forecast)

<b>FTSE 100</b>	<b>4.0%</b>
<b>FTSE '20'</b>	<b>4.5%</b>
<b>FTSE 'Next 80'</b>	<b>3.0%</b>
<b>FTSE 250</b>	<b>3.1%</b>
<b>AIM</b>	<b>1.5%</b>

Source: Liberum, 2 Nov 2016

## BEST & WORST - BROKER FORECAST CHANGES (FTSE 250)

FTSE 250 STOCK	% change year to date
Kaz Minerals	28.6%
Hochschild Mining	26.1%
Acacia Mining	18.7%
Bellway	17.2%
Tullow Oil	12.9%
Man Group	-11.0%
Sports Direct	-16.7%
Keller	-17.8%
Mitie	-18.8%
Laird	-31.1%

Source: Liberum, 2 Nov 2016

## FTSE 350 OVER LAST 3 MONTHS

### BEST PERFORMERS

	COMPANY	(%)
1	KAZ Minerals	75.74
2	OneSavings Bank	41.67
3	Vedanta Resources	34.18
4	Tullow Oil	30.93
5	G4S	30.89
6	Shawbrook	30.77
7	Tesco	30.18
8	Metro Bank	29.76
9	Aldermore	29.37
10	SVG Capital	27.43

### WORST PERFORMERS

	COMPANY	(%)
1	Randgold Resources	-21.37
2	Countrywide	-24.75
3	Regus	-24.97
4	Aggreko	-25.00
5	Berendsen	-25.18
6	Hikma Pharmaceuticals	-26.76
7	CMC Markets	-28.38
8	NCC	-37.92
9	Capita	-40.37
10	Laird	-58.05

\* Excluding Equity Investment Instruments, Nonequity Investment Instruments  
Source: Thomson Reuters Datastream

# New factory and contract wins to lift RM2

Pallet maker aims to win back market support as it fixes problems

**I**mminent news from pallet maker **RM2 International (RM2:AIM)** could help it regain the market's interest. Buy at 27.5p.

The £110m business looks to have fixed its problems and should soon announce its lower-cost production line in Mexico is up and running.

It has also bagged contracts with big names including **Unilever (ULVR)** and **Nestle (NESN:VTX)**.

## WHAT DOES IT DO?

RM2 has devised a more durable glass fibre and resin pallet which lasts longer than traditional wood products, many of which break after a few trips or are riddled with bugs. It currently has 500,000 pallets deployed in the market.

The company floated in January 2014 with half its market cap in cash and board members including former **Diageo (DGE)** boss Paul Walsh.

## CREDIBILITY PROBLEM

Last year RM2 said customer feedback had prompted it to change the friction coating method from powder to a gel-based system. This would make it better for health, hygiene and safety needs.

The company then admitted it wasn't cost effective to manufacture pallets in Canada, despite having already built a

## RM2 INTERNATIONAL

BUY

(RM2:AIM) 27.5p

Stop loss: 19.25p

Market value: £110m



large factory. Unsurprisingly, the share price collapsed.

'We over-estimated the ability to mass produce at a reasonable price,' confesses chief executive John Walsh in an interview with *Shares*.

## HOW HAS IT FIXED THE PROBLEM?

RM2 struck a deal with two well-known manufacturers to set up new factories on its behalf in Mexico and China, taking equipment from its Canadian plant.

'We didn't develop a fully automated production process. It wasn't cost effective to have human intervention in Canada, but it does work in Mexico and China where labour is cheaper,'

explains Walsh.

Mexican production could become live within the next two months, we understand. Chinese operations should follow in early 2017, although there have been delays importing the kit.

A deal has been struck with **AT&T (T:NYSE)** to install chips in pallets so customers can track and trace their goods in transit.

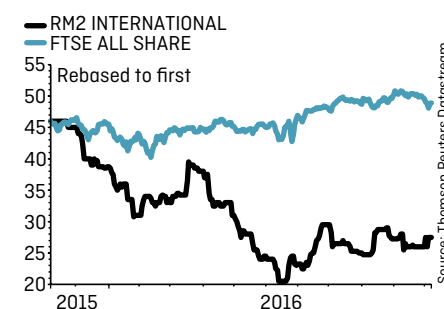
Walsh believes earnings visibility will soon improve as it keeps winning new business. He hopes by mid-2017 to be able to tell the market how new pallets will be deployed out to the end of 2018.

RM2 expects to rent out 85% of its pallets on three to five year agreements and sell the remaining 15% of production.

Key risks include further delays to the Chinese plant start-up, potential fundraising and slow pace at which contracts are fulfilled.

The business hasn't been very transparent in the past with contract awards, so it must improve communication. (DC)

## BROKER SAYS: 1 0 0





# Elementis has the right kind of mud

Hectorite mine is unique asset says hedge fund manager Hempton

**H**edge fund manager John Hempton at Australia-based Bronte Capital has found what he believes to be a gem of an investment on the UK stock market: specialty chemicals producer **Elementis (ELM)**.

Hempton, best known for a long-running stand-off over controversial nutrition products group **Herbalife (HLF:VYSE)** with fellow financier Bill Ackmann, flags a number of attractions.

Key to the investment story at Elementis is its world-leading hectorite mine which features a rare, greasy mud that is an important input into many industrial chemical products.

Other attractions include a flourishing Speciality Chemicals division producing ingredients into everything from nail varnish to fracking chemicals and market leadership in the domestic supply of chromium in the US.

## GROWTH BUSINESS

Speciality Chemicals is by far the largest of Elementis' divisions though this was not always the case.

Rewind back to 2006 and the unit recorded £74m (\$60m) in sales, roughly the same amount as Elementis' Chromium division. Today it generates \$453m of revenue with juicy operating profit margins of close to 20%.

How? Elementis has market-leading expertise in a branch of science called rheology, which is

## EARNINGS ESTIMATES: ELEMENTIS - KEY METRICS (\$M)

	2015	2016	2017
Revenue	679.0	646.0	670.0
Operating profit	123.0	99.0	106.0
Net earnings	97.0	74.0	83.0
Earnings per share	21c	16c	18c
Dividend per share*	11.8p	12.7p	12.7p

Source: UBS, 28 Oct 2016

\*includes special dividends

the study of how different liquids flow in varying temperatures and under different stresses. Applications are varied: Elementis sells additives that improve flow characteristics of products used in the industrial coatings industry (55% of divisional sales), decorative coatings industry (23% of sales), including paint, and oilfield products (10% of divisional sales).

## MARKET LEADER

Chromium does not have the same growth characteristics as Speciality Chemicals though it boasts strong margins at 27% and Elementis is the only domestic supplier in the US.

Elsewhere, Elementis has a small Surfactants business which is likely to decline over

time as customers are converted into higher margin additives available through the Speciality Chemicals unit.

Competitive advantage at Elementis comes from its hectorite mine in California. Hectorite can be used to improve flow characteristics of liquids as well as to filter oil from water, among other applications.

'This meets many Bronte tests for a fantastic business,' wrote Hempton in an October commentary.

'The product is a small thing that makes big things better (which gives it a lot of pricing power) and it is a consumable. And there are some pretty solid defenses against excessive competition.'

Risks at Elementis include continued weakness in the US oil and gas market as well as shipping, which has dragged on sales and profitability in the past few years. Chemical companies also tend to be sensitive to the general economic environment.(WC)

## ELEMENTIS BUY

(ELM) 234.5p

Stop loss: n/a

Market value: £1.08bn

Prospective PE 2017: 16.1

Dividend yield: 5.4%

**BROKER SAYS:**   

## SSP

(SSPG) 342p

**Gain to date: 5.9%**

**Original entry point:**

**Buy at 323p, 13 October 2016**

THERE ARE MIXED views on **SSP (SSPG)** among analysts, although we maintain our bullish stance on the transport hubs food seller.

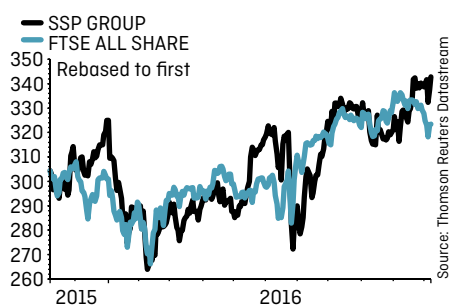
Canaccord Genuity has upgraded its earnings forecasts for SSP for the next three years as result of beneficial foreign exchange rates and contribution from a new Indian joint venture.

The investment bank's earnings per share estimates have been lifted by 5% to 14.6p for the year to September 2016 (figures to be reported on 29 November). It lifts estimates by 8.4% to 16.8p for the 2017 financial year; and pushes up 2018 numbers by 10.4% to 19.1p.

SSP earns 58% of its earnings before interest and tax outside of the UK. This international exposure is very attractive to anyone interested in mid-caps as the FTSE 250 has historically been heavily populated by UK-focused businesses.

UBS has a 'sell' rating on SSP, saying its valuation is too rich. It notes a significant reduction in UK

air passenger growth forecasts – that matters because airports are a source of earnings for the group. (DC)



### SHARES SAYS: ↗

We believe it warrants a premium rating because of its large scale and captive audience. If you're stuck waiting for a plane or train, you're going to buy its food and drinks as there may not be time or opportunity to find cheaper alternatives.

**BROKER SAYS:** 6 6 1

## SAVANNAH RESOURCES

(SAV:AIM) 4.5p

**Gain to date: 12.5%**

**Previous Shares view:**

**Buy at 4p, 3 November 2016**

A POSITIVE RESOURCE update on **Savannah Resources' (SAV:AIM)** mineral sands project in Mozambique helps to drive shares in the miner.

The resource estimates is 3.5bn tonnes at a grade of 3.8% total heavy minerals. It contains 81m tonnes of ilmenite, 2.2m tonnes of rutile and 3.8m tonnes of zircon.

House broker Northland Capital says the Mutamba project is one of the largest ilmenite-dominant mineral sands deposits on the east coast of Africa.

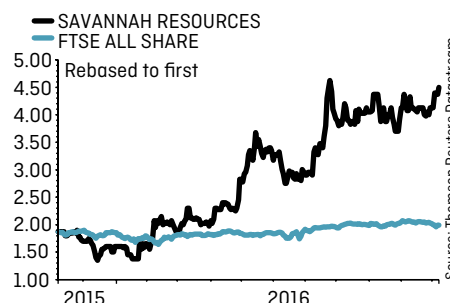
Savannah's resource statement covers two of the four deposits that make up Mutamba. It owns 10% of the project and is earning up to 51%.

A scoping study on the project should be completed within three to four months. 'The resource estimate will form the foundation of the scoping study that will focus on the high-grade areas where there is little or no overburden,' says Northland.

We wrote last week that Savannah was focused on only bringing the best parts of the project into production, in order to maximise return on investment.

Savannah's copper interests in Oman will be brought into production before the mineral sands

assets. This may potentially happen in late 2017, according to the company. (DC)



### SHARES SAYS: ↗

Our trade on Savannah is up 12.5% in just a week. We're really excited about its prospects and see considerable upside for the share price. Buy.

**BROKER SAYS:** 0 0 0



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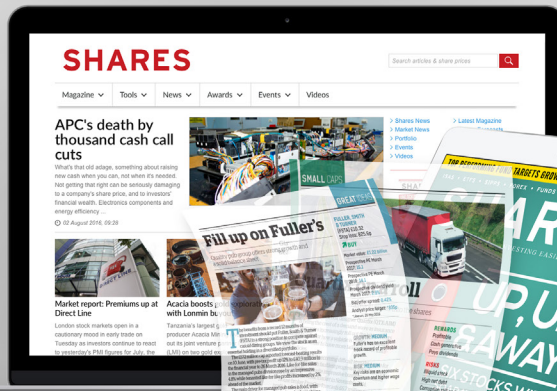
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# **INFLATION AHEAD!**

**DON'T LET THE RISING COST  
OF LIVING CHIP AWAY AT  
YOUR MONEY**



Everyday life is becoming more expensive as inflation rears its head for the first time in years. You must now look at your savings and investments to see if they can still deliver a positive return in real terms.

For example, if inflation goes up by 4% – as predicted on 2 November by NIESR (National Institute of Economic and Social Research) – then you need to make a minimum 4% return on your savings and investments just to protect the real value of your assets.

The situation is so important that a stark warning was issued last week by the Bank of England that inflation was about to accelerate in the UK. It predicts inflation will move from 1.3% this year to 2.7% in 2017 and 2018.

We now explain what inflation means for shares, funds, your pension as well as everyday costs of living. We also give suggestions for investments to beat inflationary pressures.

## STOCKS AND FUNDS TO BUY WHEN INFLATION IS RISING

Investments suitable for an inflationary environment include commodity producers and real estate, in our opinion. They should protect your capital at worst, and grow the value of your money at best.

You should look for stocks that grow dividends at least in line with inflation such as utility companies **National Grid (NG.)** or **SSE (SSE)**. A good fund for dividend growth is **Perpetual Income & Growth (PLI)**.

Inflation-linked bonds may also appeal, although these are quite expensive to buy at present. You might find it easier to buy a fund or investment trust that already has a wide range of these bonds in its portfolio. A good example is **Capital Gearing Trust (CGT)**.

We explain the different ways to buy gold as that has historically been a hedge against inflation. Our top gold mining pick is **Centamin (CEY)**.

It is also worth backing companies with pricing power. This is the ability to pass on extra input costs to customers through higher selling prices and not see a massive deterioration in demand as a result of this action.

Investment fund **Evenlode Income**

**(GB00B42KPP53)** has plenty of top quality stocks in its portfolio that have pricing power like Tampax tampon seller **Procter & Gamble (PG:NYSE)** and baby powder-to-medical devices giant **Johnson & Johnson (JNJ:NYSE)**.

## WHY IS INFLATION RISING IN THE UK?

The slump in the pound as a result of the UK's decision to leave the European Union has made imported goods much more expensive. Households are starting to feel a pinch; next year we'll really see inflation hit our wallets.

UK inflation shot up in September this year to 1% versus 0.6% in August, according to the Office for National

Statistics (ONS). The general consensus is that inflation will keep rising over the next year or two.

'The direct impact of sterling's depreciation on CPI inflation will ultimately prove temporary,' says Mark Carney, governor of the Bank of England. 'In the MPC's (Monetary Policy Committee) judgement, attempting to offset it fully with tighter monetary policy would be excessively costly in terms of foregone output and employment growth.'

'The MPC is choosing a period of somewhat higher consumer price inflation in exchange for a more modest increase in unemployment.'

This is not entirely new territory. Peel Hunt economic strategist Ian Williams says there is a reasonably recent precedent for the Bank of England's analysis in the shape of the 25% depreciation that sterling suffered during the 2007/08 financial crisis.

That was a contributory factor to an extended period of CPI inflation running ahead of target in subsequent years, he explains.

## HOW INFLATION WILL HIT YOUR SHOPPING BILL

Your weekly shopping bill is likely to rise. Milk and petrol prices are going up faster than at any time during the past three years. Even making a cup of tea will be more pricey soon.

Popular consumer electronics look likely to follow with phones and laptops expected to become even more expensive. You may want to buy Christmas presents earlier than normal to beat any price hikes.

### FUND IDEAS

#### GREAT FOR DIVIDEND GROWTH

Perpetual Income & Growth (PLI)

### FUND IDEAS

#### GREAT FOR EXPOSURE TO STOCKS WITH PRICING POWER

Evenlode Income (GB00B42KPP53)



We are nervous about the retail sector if inflation remains elevated. Retailers may have to cut prices to stimulate sales – that would mean lower profit margins.

The only situation to make us reconsider this cautious stance would be an increase in wage inflation across the UK.

It is hard to predict if wages will go up, given that employers will also feel the pain of inflation. For example, software giant **Microsoft (MSFT:NDQ)** plans to raise prices by up to 22% for its online cloud services and push through price hikes for many of its software product lines. These actions will directly hit thousands of UK businesses.

### WINNERS AND LOSERS IN RETAIL SECTOR

General retailers can either pass inflation on to customers, take the hit in reduced margins or seek to mitigate the impact through the supply chain.

Structural winners are better placed to mitigate the impact than structurally-challenged operators, since the formers' volume growth means suppliers will be willing to share the currency pain with them.

In a recent Peel Hunt note – 'The impact of rising UK inflation' – retail analysts John Stevenson and Jonathan Pritchard point out that the good shopkeepers tend to get stronger when conditions are tough.

Their key differentiators include 'market leadership/pricing power, elasticity of demand and the ability to mitigate cost pressures, be that by finessing the product, or by simply having strong underlying volume growth anyway'.

High street clothing colossus **Next (NXT)** has said it expects to push up prices in its core range by about 5% next year, though **Associated British Foods' (ABF)** retail chain Primark has stated it won't pass on the price hike to customers and will instead mitigate the impact or take the margin hit.

Among the winners identified by Peel Hunt are budget greetings cards seller **Card Factory (CARD)**, whose vertical integration gives it scope to hold down prices and boost its value for money credentials in a category with low demand elasticity.

Possible losers include department store **Debenhams (DEB)**, as rising rent and wage costs will compound its ability to mitigate another cost pressure.

### STOCK IDEAS

COULD BENEFIT FROM  
CONSUMERS SEEKING  
CHEAPER ITEMS

Card Factory  
(CARD)

### DOES THE POUND REBOUND MEAN INFLATION COULD GO AWAY?

The pound has staged a minor rally of about 3% in the past week or so. Key to this event has been the High Court ruling that Parliament must vote on when to start the Brexit process.

We believe investors should continue to expect inflation as the pound has a long way to go before it recovers lost territory. As such, we still believe inflation will push up the cost of living and is a major threat. Other market commentators are more optimistic.

'While Carney will doubtless be relieved to see too much inflation rather than too little, he is now on alert for too high an overshoot (versus the Bank of England's 2% target),' says Russ Mould, investment director at share dealing specialist AJ Bell.

### HOW INFLATION IMPACTS OUR LIVES

#### 1. SAVINGS

Anyone with their savings still sitting in cash is going to struggle to generate real returns when we have ultra-low interest rates and rising inflation. To stand any chance of generating a return you need to take some risk, investing in corporate bonds, funds or shares.

#### 2. HOUSE PRICES

Property prices tend to rise with inflation. It also lowers the value of remaining mortgage debt in real terms.

#### 3. PENSIONS

With many retirees going for the predictability of fixed-income assets, inflation is an unseen leech that steadily drains the value of retirement savings.

#### 4. DIVIDENDS FROM INVESTMENTS

Rising business costs could put less secure dividends at risk. Investors also need to make sure predicted payout growth is above inflation rates.

#### 5. TRAVEL COSTS

Rising oil costs will hit right across the travel sector, from supply chains to holiday flights.

#### 6. ENERGY PRICES

Winter energy bills are likely to increase. Switching tariffs or between energy suppliers can help offset inflationary pressure.

'This suggests he may not be displeased by the rebound in the pound, which could help limit inflation and remove any need to consider an interest rate hike.'

Kallum Pickering, senior UK economist at investment bank Berenberg, believes the lower risk of a hard Brexit will take some of the downward pressure off the pound near-term.

'If sterling appreciates a little over the coming months inflation may not rise as high next year as previously thought – a positive for real spending and near-term growth,' he says.

### WHAT'S GOING UP?

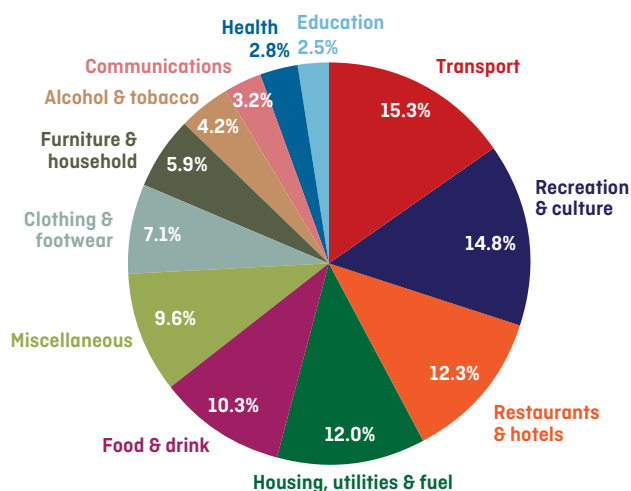
Rebounding oil prices versus weak year-on-year comparatives are a big part of the latest CPI data, with housing, utilities and fuel, and transport worth 27% of the overall CPI basket of goods.

A 6%-plus jump between August and September in clothing prices was a major upside influence, but this is broadly in line with typical seasonal trends after prices fell earlier in the year, claims Ian Williams at stockbroker Peel Hunt.

The cost of staying in a hotel was another riser albeit against weak comparatives, while food prices had a deflationary impact.

'Consumer food prices have been in a declining trend from their peak in 2014, reflecting prior sterling strength and the intensely competitive pricing environment in the food retail markets, as the hard discounters (Lidl and Aldi in particular) have taken a growing share of the market,' explains Williams.

### WHAT'S IN THE CPI BASKET? (2016 % WEIGHTINGS)



Source: Thomson Reuters Datastream

### STOCK IDEAS

**AIMS TO GROW  
DIVIDENDS AT LEAST IN  
LINE WITH INFLATION**

**National Grid  
(NG.)**

### WHAT INFLATION MEANS FOR YOUR PENSION

Given super low interest rates, inflation is a double whammy for pensioners sitting on a large pile of cash in the bank.

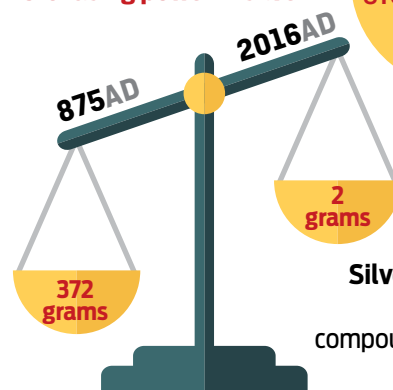
A 2.7% rise in inflation versus a typical 0.7% interest rate on cash in the bank would mean the real value of your savings falls by 2% in a year. Your money wouldn't buy you as much as it did in the past, so your standard of living could fall.

'Rising inflation should act as a wake-up call to anyone who has used the pension freedoms to cash in their pension and stuck the money in a low or zero-interest paying bank account,' explains AJ Bell senior analyst Tom Selby.

'With interest rates unlikely to increase any time soon, such an investment strategy will guarantee their spending power will be eroded as inflation rises,' he adds.

'For people approaching retirement, the combination of rising inflation and low interest rates creates a difficult decision between an annuity or income drawdown.' (SF, JC)

#### Sterling – Purchasing power in silver



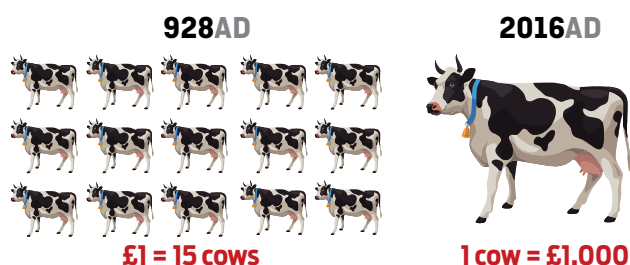
**Inflation:  
A history of  
sterling, silver  
and cows**

**Silver inflation**  
(1,241 years, compound annual)  
**0.4%**

**When sterling was introduced in 775AD £1 bought 12 troy ounces (one pound) of silver**

Source: World Economic Forum

#### Sterling – Purchasing power in cows



**Cow inflation (1,088 years, compound annual): 0.9%**

Source: World Economic Forum; Calculations: Shares

# TIME TO BUY GOLD

GOLD IS TRADITIONALLY seen as a hedge against inflation. It is generally considered to be an asset that holds its value in real terms in times of unease. You aren't guaranteed to make a profit if inflation rises; but there is a good argument to warrant having it as part of a diversified portfolio.

You can get exposure to gold through various different ways.

## 1. SHARES IN GOLD MINERS.

The historical trend has been for gold miners to outperform a rising gold price. The higher the value of the metal, the more income a miner gets from selling its gold. Should the miner make an exploration discovery or exceed its production targets, then its share price is likely to get an additional kick upwards.

Gold miners with high levels debt could get a further boost as the market prices in a lower risk of defaulting on borrowings. Theoretically the miner would have greater profit margins by which to service repayments.

**Our top pick: Centamin (CEY) at 165.1p**

## 2. GOLD MINING FUNDS

Funds and investment trusts are ideal for anyone who wants the upside of backing a gold miner but does not want to buy individual stocks. You can get exposure to multiple companies through a single product.

**Our top pick: BlackRock Gold & General D Acc (GB00B5ZNJ896) at £11.98**

### STOCK IDEAS

#### BEST WAY TO PLAY RISING GOLD PRICE

Centamin  
(CEY)

## 3. EXCHANGE-TRADED PRODUCTS

You can get a wide range of products that track the gold price. You should expect to pay a small annual charge circa 0.3% to 0.4% in exchange for a fund that moves in line with the value of gold.

Go for the ones that actually own gold bars rather than use derivative contracts to get exposure to gold. Look for the 'physical' name in the product description, not 'synthetic'. If you invest £500, for example, the ETF provider would hold £500 worth of gold bars in a vault on your behalf.

**Our top pick: Source Physical Gold P-ETC (SGLP) at £101.47**

## 4. PHYSICAL COINS AND BARS

If you want to buy physical gold, we would suggest going to a reputable dealer or using the services of the Royal Mint which has an online trading platform. You can get gold sent in the post or stored in one of the Royal Mint's vaults.

## 5. MARGIN TRADING AND COVERED WARRANTS

You can trade gold via derivatives such as spread betting, contracts for difference (CFDs) and covered warrants. Apart from the latter, there is a risk you can lose more than you initially invest. Covered warrants come with the risk of volatility which means you could see the value of the product temporarily fall even if gold rises.

We do not recommend you go down the margin trading or covered warrants route unless you are a sophisticated investor and fully understand the products and services. (DC)





# WHAT HAPPENS IF THERE ISN'T SOARING INFLATION?

EXPECTATIONS OF FUTURE inflation are now firmly established in the UK but what if the price surge turns out to be lower than expected?

Even today, most forecasters say inflation in excess of 2% in the years ahead will be a temporary, rather than permanent, result of a weaker currency.

Asset manager Ruffer's investment strategy is based on preparing for higher prices. It admits inflation in the UK is not a foregone conclusion in some economic and political scenarios.

## PAY CLOSE ATTENTION TO EUROPE

While the immediate impact of the UK's vote to leave the EU is a weaker currency and inflation, this outcome could reverse if Europe itself starts to struggle.

'We have always maintained that it is easy to bring about inflation when conditions, as they are today, are horribly deflationary,' wrote Ruffer in an August commentary.

'It does however mean a fundamental compromise of the currency – not something done lightly, but, like virtue, jettisoned advisedly when the alternatives are sufficiently unattractive. Expect the EU to pump liquidity – the *mot du jour* is "helicopter money" – into the system.

'The place to look at the moment is what is happening in Italy, and, in particular, the Italian banks, which are being bailed out in a way which will be the first of many such instances. The markets will turn on such behaviour, sooner or later

– and when that happens, the euro will prove very remarkably weak.

'Alas, when the euro is weak, expect sterling to lose its competitive advantage as it strengthens. The tensions in the financial system are every bit as worrisome as those in the political arena, and it might just be that the lasting legacy of Brexit is financial turmoil – not political.'

Ruffer runs open-ended funds as well as **Ruffer Investment Company (RICA)**, a listed investment company which trades at a slight premium to net asset value. The fund's main investments are inflation-linked government bonds and Japanese bank stocks.

## PAY CLOSE ATTENTION TO COMMODITY PRICES

Other factors which could UK stop inflation dead in its tracks are weaker commodity prices. For example, oil prices have gained from February lows of \$27 per barrel but there remains potential downside if key producers fail to agree on output curbs.

A decline from today's \$44 a barrel would apply similar deflationary pressure to the UK economy as it did over the past two years when consumer prices turned negative in November 2015.

Inflation in the years ahead also assumes sterling stays weak for the entire period. While this is possible, there is upside potential to sterling if the economy performs better than expected, if interest rates are forced higher or if the UK's trade deficit improves, among other potential outcomes. (WC)



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# Should trusts sell assets to fund dividends?

Controversy is brewing as more investment trusts adopt a new way to pay for shareholder rewards

Investment trusts are starting to embrace a technique to ensure shareholders receive dividends every year or enjoy a better yield than in the past. It's caused some controversy in the market and could become a hot topic over the coming months.

The strategy involves selling little chunks of an investment portfolio to fund dividends. The technical description is paying dividends out of capital.

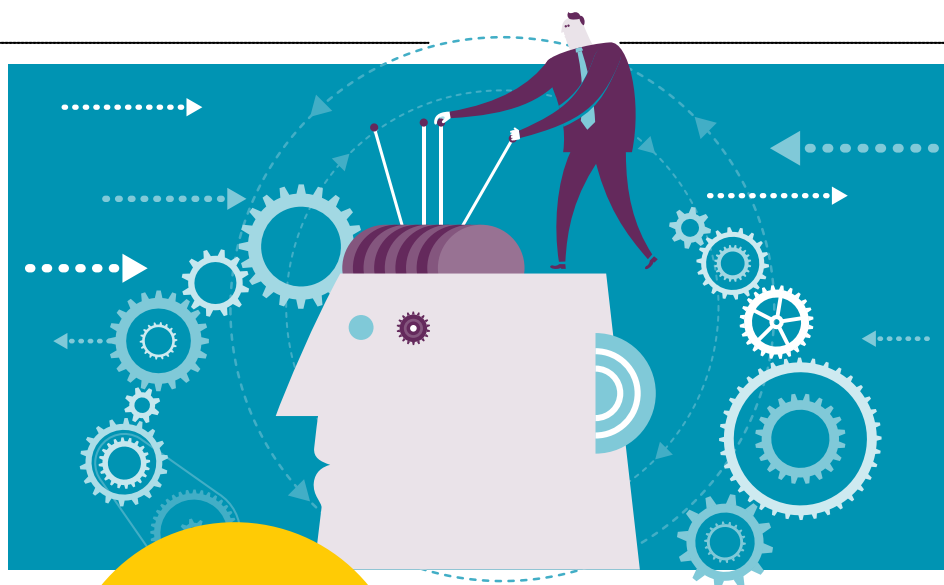
The term capital refers to assets in the investment trust including underlying holdings and proceeds derived from selling assets.

**JP Morgan Global Growth & Income (JPGI)** has just adopted this new dividend technique; and **International Biotechnology Trust (IBT)** will soon do the same.

## EATING YOUR INVESTMENTS

Historically investment trusts have relied on income from underlying assets to fund dividends. They've also been able to keep 15% of income each year in a rainy day fund to pay dividends in more difficult market conditions.

Dipping into capital is allowed, so trusts aren't doing anything wrong going down that route. However, it is essentially like pinching bits off a cake where eventually there would be nothing left on the plate.



**INVESTMENT TRUSTS HAVE SEVERAL LEVERS TO SUPPORT DIVIDENDS**

## WHY IS PAYING DIVIDENDS OUT OF CAPITAL 'CONTROVERSIAL'?

At the most extreme, it implies dividends are unsustainable unless there is always an increase in the value of the trust's capital every year.

The market has been nervous for some time about the ability of specific individual companies to sustain their dividend payments including **BP (BP.)**, **Royal Dutch Shell (RDSB)** and **GlaxoSmithKline (GSK)** due to cash flow pressures.

Imagine if the broader investment community started

fretting about funds' ability to pay dividends.

## WHERE TO FIND INFORMATION ON HOW DIVIDENDS ARE FUNDED

With this in mind, investors should look closer than before at financial accounts to see where investment trusts obtain money to fund dividends, says James de Sausmarez, head of investment trusts at Henderson Global Investors.

He says industry body The Association of Investment Companies (AIC) has been encouraging trusts to explicitly state the split of dividends from income or capital, in order to help investors.

## HOW MANY TRUSTS HAVE GONE DOWN THIS ROUTE?

UK-domiciled trusts were first allowed four years ago to use



capital to fund dividends but only a handful of trusts have so far adopted the more flexible dividend policy.

We believe there could be a step change in the market over the coming months as it becomes harder to get a decent yield from the market.

Investment trusts may find themselves having to use different methods to top up dividend payments including capital. They may increase the use of gearing where they borrow money to make more investments, thereby having a greater asset base from which to derive income to fund dividends.

It is also worth considering that dividends are a good selling point for investment trusts looking to attract new customers.

Having a (relatively) new way by which to pay dividends could encourage more investment trusts to use capital in order to make them look more attractive.

## OUR VIEW ON THE MATTER

We've got an open mind towards paying dividends out of capital. You need to look at the make-up of each investment trust and their stated investment strategy.

Some fund managers say dividends should only be paid from income; and capital should be restricted to investments.

However, some investment trusts hold assets that aren't necessarily big dividend payers and so they may not generate a big income.

The biggest group of trusts that already pay dividends out of capital is private equity. That makes sense as most of their underlying assets won't be paying dividends. The trusts

realistically have no choice but to fund payments to shareholders out of capital.

As a counter argument, you could suggest that investment trusts that don't have underlying income shouldn't be paying dividends in the first place.

## WHAT THE EXPERTS THINK

Investment trust analysts at financial services group Winterflood have voiced reservations about International Biotechnology Trust's plan to use capital to help fund dividends.

However, their concerns are only related to that specific trust. They say biotech is a volatile asset class so there is a risk of selling investments to fund dividends at the point when share prices are weak, thereby significantly reducing the opportunity for long term returns.

Overall, Winterflood's analysts say the capital policy could be beneficial in certain cases. 'We do not believe the practice is necessarily a good thing in all

circumstances but given the voracious demand for income in the current low interest rate environment, it would seem like a sensible option for some funds.

'In particular we believe it is beneficial as a tool for smoothing out dividends, in the same way that revenue reserves have traditionally been used,' adds Winterflood.

'For example, where a fund expects a shortfall in revenue for a certain period or where revenue is expected to ramp up and capital can be used to increase dividends immediately. In addition, we believe that using a small amount of capital to boost a dividend to an attractive level can also be positive.'

## PUTTING THE POLICY INTO PRACTICE

**Securities Trust of Scotland (STS)** recently adopted the capital funding policy to boost its dividend. Chairman Rachel Beagles said it was one of the factors that enabled an 18% hike in its shareholder payout during

## INVESTMENT COMPANIES THAT PAY DIVIDENDS FROM CAPITAL

Investment company	Sector
3i	Private Equity
Apax Global Alpha	Private Equity
Dunedin Enterprise	Private Equity
Electra Private Equity	Private Equity
European Assets	European Smaller Cos
F&C Private Equity	Private Equity
International Biotechnology Trust	Biotechnology & Healthcare
Invesco Perpetual UK Smaller Companies	UK Smaller Companies
JPMorgan Global Growth & Income	Global Equity Income
Personal Assets	Flexible Investment
Princess Private Equity	Private Equity
RIT Capital Partners	Flexible Investment
Securities Trust of Scotland	Global Equity Income
Utilico Emerging Markets	Global Emerging Markets

Source: AIC, Shares 2/11/16  
Excludes VCTs

its past financial year.

‘Many pensioners are now taking more control of their income in retirement, and one of our priorities as a board is to make Securities Trust of Scotland as attractive as possible to investors,’ says Beagles. ‘Currently yielding 3.7%, the trust offers a high level of income compared to many other savings products in this low rate environment.’

**Personal Assets Trust (PNL)** says it has always paid a dividend and never cut it, yet admits it has become hard to earn a decent income in the current environment. The 2013/2014 financial year was the first time it didn’t earn enough income from its portfolio to fund dividends, says executive director Robin Angus.

‘We had a choice: increase the dividend on the portfolio (investing in higher risk stocks) or use capital to help fund the dividend. We felt capital was the most conservative option for us, in line with how the investment trust is run.’

Angus says the trust has pledged to pay back all money taken from capital for dividends as soon as it is possible in the future.

**YES!**  
**Securities Trust**  
**of Scotland**  
**uses capital**  
**to help fund**  
**dividends**

### **SAYING ‘NO’ TO THE CAPITAL ROUTE**

Another conservatively-run investment trust has shunned the capital route, saying it is not in shareholders’ best interests.

**Ruffer Investment Company (RICA)** warned in its 2016 annual report it may have to cut its dividend over the following 12 months as income had fallen below the level of dividend distributions.

**NO!**  
**Ruffer Investment**  
**Company says**  
**using capital for**  
**dividends is not in**  
**shareholders’ best**  
**interests**

JP Morgan Global Growth & Income’s shareholders last week approved changes to the way it pays dividends, to include money from capital. JP Morgan’s head of investment trusts Simon Crinage says this is part of a broader change for the product that used to be called JPMorgan Overseas Investment Trust.

‘The fund manager won’t change the way the trust is run. But the dividend has been set differently by the board,’ he explains. ‘The trust will endeavour to pay dividends equal to 4% of net asset value (NAV) at the start of the year, with distributions every quarter.’

Crinage says investors shouldn’t view this as a progressive dividend as the amount of money paid to shareholders could fall if there

is a decline in NAV. ‘In a stock market downturn, it would pay 4% on the reduced net asset value figure.’

The dividend change went down well with retail shareholders, says Crinage. He notes the trust’s discount to NAV has also narrowed since the strategy announcement, implying positive market interest.

### **SECOND NATURE FOR ONE PRODUCT**

F&C-run **European Assets Trust (EAT)** has used capital to help fund dividends for more than 15 years. It falls under different rules to UK-domiciled investment trusts because it is Dutch-domiciled.

‘In the UK, there are two distinct pots for accounting purposes – one for revenue, one for capital,’ says Simon Cordery, head of investor relations and business development for investment trusts at F&C. ‘For us, there is only one pot under Dutch laws so we have been able to distribute from capital for a long time.’

He says the trust’s investors are fully aware of how the product works, adding that some people actually chose not to invest in European Assets because of its dividend process.

‘The trust focuses on small and medium-sized companies. Smaller companies aren’t really an income asset class, but over the long term they can outperform larger companies. Over the market cycle, if you are getting better total return, a trust can still pay out a bit to shareholders from capital as dividends and still deliver both capital growth and income.’ (DC)

# 'Best buying opportunities' for drugs stocks

The brains behind two successful investment trusts implies market worries are a good time to buy



One of the brains behind two highly successful pharmaceutical and biotech funds says a new US President could be good for the drugs sector, despite market concerns about the new leader imposing a price cap on drugs.

Sven Borho is the founding partner of investment firm OrbiMed which manages **Biotech Growth Trust (BIOG)** and **Worldwide Healthcare Trust (WWH)**. Together these funds have nearly \$2bn of assets under management.

The two investment products had enjoyed stellar share price success up until 2015 when Hillary Clinton started to voice her concerns about drug companies charging too much money for their products. They were subsequently caught

up in a sector-wide sell-off which saw shares prices de-rate across the board.

Speaking at an event in London on the eve of the US elections, Borho said political intervention in the drug sector could provide a great opportunity for investors.

'Every single time politics was involved in healthcare, these were the best buying opportunities in the history of the sector,' he commented.

## CLINTON'S VOW TO TACKLE 'PRICE GOUGING'

The Nasdaq Biotechnology index – which tracks more than 180 drug firms on the US stock market – fell by 5% immediately after a single comment on Twitter by Clinton in September 2015.

She said: 'Price gouging like this in the specialty drug market

is outrageous' and promised a plan to 'take it on'.

Her comment was in response to Turing Pharmaceuticals which acquired an old antibiotic drug and subsequently raised its price by more than 50-fold.

## ARE PRICE CAPS ACHIEVABLE?

In August 2016, Clinton called for **Mylan (MYL: NDQ)** to drop the price of its EpiPen emergency

5%

The drop in Nasdaq  
Biotechnology  
index after  
Clinton's 'price  
gouging' tweet  
in September  
2015



allergy shot, resulting in a 6% decline in its share price and the pharmaceutical company promising to cut the cost.

Despite Clinton's influence, Borho said in his presentation that he believed there would be no outright drug controls in the US. He argued legislative changes were required by a filibuster-proof majority in the Senate, which he did not see as an achievable feat.

Saxo Bank head of equity strategy Peter Garnry believes reforms could come in future years with Congress coming together to fix rising healthcare costs 'because it's squeezing the middle class family'.

### POLITICAL RHETORIC VS. INFORMATION

OrbiMed has had to navigate the quick-fire response of the market from key players in the election concerning drug prices.

'If you listen to politicians, you think drug pricing is outrageous and is spiralling out of control. However, the facts don't match the political statements,' said Borho.

Drug spending as a percentage of total healthcare costs over the past 50 years has remained stable

at 10% with no huge inflation. That paints a different picture from the political rhetoric.

In his presentation, Borho claimed 90% of prescriptions in the US were for generic drugs. He said the remaining 10% were for branded pharmaceuticals.

He highlighted how the ways in which drug prices are reported do not tell the full story.

For example, last month American politician Bernie Sanders tweeted that **Ariad Pharmaceuticals (ARIA:NDQ)** raised the price of a leukaemia drug to nearly \$199,000 a year. Borho countered that it cost Ariad \$1.5bn to get the drug to market, which took 20 years and the firm spent more on research on development than it obtained in revenue.

Without higher drug prices, investing in new treatments to tackle diseases would become more difficult. 'If you want to have the socialist nirvana of super-low drug prices, you have no innovation,' argued the portfolio manager.

### GENERIC DRUG MAKERS UNDER FIRE

Generic drug makers recently collapsed on the US stock

**BIOTECH GROWTH TRUST** has underperformed against the FTSE All-Share index in the year to date for the first time in history. Its performance was -3.7% compared to the All Share index's 9% gain.

Annualised returns over the past three and five years are more positive at 19.9% and 32.8%.

In the year to date, Worldwide Healthcare Trust has nearly matched the All Share index at 8.8% and achieved annualised returns over the same three and five year period of 25.1% and 26.2%.

market on speculation the US Justice Department's probe into collusion would bring charges by the end of the year.

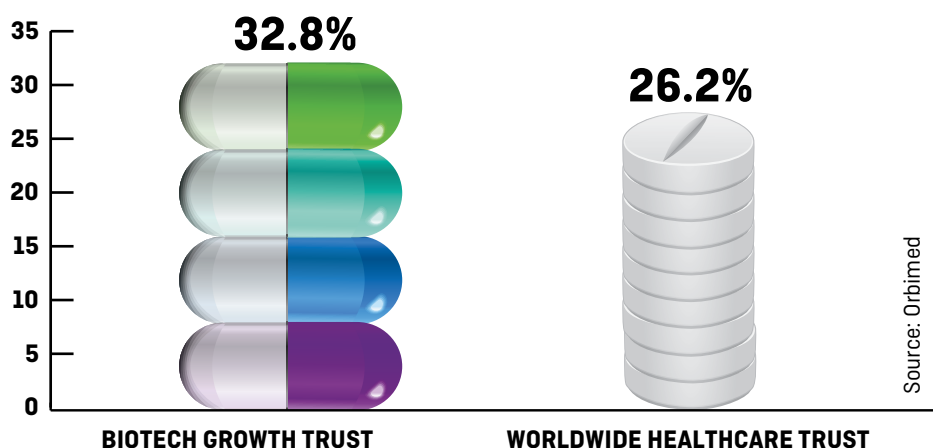
US prosecutors are undertaking a criminal investigation over suspected price collusion, which started two years ago and spans more than a dozen companies.

A barrage of negative news from politicians has created a 'wall of worry', creating an environment where investors are trimming their healthcare holdings.

This is reflected in the healthcare sector trading at a price to earnings discount to the S&P index of US stocks, which historically occurs during political interventions, according to Borho.

In 2008, the sector traded at a discount during the implementation of Obamacare, as well as between 1993 and 1994 under then-President Bill Clinton's healthcare reform. (LMJ)

ANNUALISED RETURNS OVER PAST FIVE YEARS



# Morrisons has momentum

Grocer is back on form but swirling sector headwinds remain



**W**M Morrison Supermarkets' (MRW) impressive turnaround continues under chief executive David Potts' *Fix, Rebuild and Grow* strategy.

It recently reported a forecast-beating 1.6% growth in like-for-like sales (ex-fuel) for the 13 weeks to 30 October.

This represented a fourth quarter of like-for-like sales growth on the spin, although total sales were 1.2% lower due to supermarket closures and the sale of convenience arm M local.

By going back to the basics of low prices, great value and fresh food, Morrisons is successfully battling Asda, Aldi and Lidl and has momentum at its heels.

## LESS AFFECTED BY FALLING POUND

We acknowledge the groceries industry remains fiercely competitive and headwinds include higher wages and the fall in sterling.

Yet Morrisons is better insulated against the plunging pound's impact on imported food prices than rivals as a high proportion of its food is produced in the UK.

We like Morrisons' wholesale supply agreement with **Amazon (AMZN:NDQ)**. There is merit to a renegotiated tie-up with **Ocado (OCDO)** and we also like a joint venture with dry cleaning, photo processing and shoe repair firm Timpson – 'Timpson at Morrisons' – all inspired moves from

the entrepreneur Potts.

Fourth quarter earnings last year were good so Morrisons faces tough comparative figures to beat this year. We'll find out how it fared when a trading update is published on 10 January 2017.

## IMPROVING FINANCIAL PROFILE

The business has a freehold property-backed balance sheet and generates decent amounts of cash that is reinvested into shops. It has a £1.2bn year-end net debt target, which is more than half the £2.82bn figure at the end of the 2014 financial year.

For the year to 31 January 2017, Shore Capital forecasts pre-tax profit of £330m (2016: £302m) for earnings per shares of 10.6p (2016: 9.6p) and a 5.3p dividend.

A year later, the broker looks for £356m pre-tax profit, 11.5p earnings per share and 5.7p dividend.

On these estimates, Morrisons does trade on a punchy 'recovery' multiple of 20.7 with a yield of 2.4%, yet we have faith in the recovery under the mercurial Potts. He could surprise with further innovative, value-adding deals. (JC)

## SHARES SAYS: ↗

We are big fans of Morrisons and believe the shares are well worth buying at 219.7p as a long-term holding.

**BROKER SAYS:** 0 10 9

# Independent gets pearl of a gas deal with Oyster

Broker reckons share price could increase seven-fold in next 12 months

**T**he scope for considerable share price upside means investors should be adequately compensated for the risks associated with small cap oil exploration and production firm **Independent Oil & Gas (IOG:AIM)**.

Completion of the company's acquisition of Oyster Petroleum (28 Oct) helps underpin its natural gas 'hub' development strategy in the southern North Sea.

This involves bringing on a number of fields in close proximity at the same time in order to share infrastructure and reduce costs.

## GOOD TIME TO BUY

An inconclusive result from the company's hotly anticipated Skipper well (30 Sep) has created an interesting entry opportunity as that news pulled down the share price.

House broker FinnCap's 110p price target implies upside of 664% at the current 14.4p price.

The Oyster deal cost an initial £1m, rising to as much as £5m depending on certain milestones. It adds tax losses of \$25.6m (£20.5m) which can be offset against future production. FinnCap reckons first gas may be



possible as soon as 2018.

Ahead of this, a number of incremental catalysts in 2017 could fire the share price. These include a fresh audit of the Oyster assets, submission of a field development plan and agreements with service providers.

An existing £10m convertible loan facility should fund acquisitions and administrative costs through to 2018. (TS)

## SHARES SAYS: ↗

The balance between risk and reward looks attractive. Buy at 14.4p.

## Corero wins DDoS deals

A MINI STREAM of new business wins may suggest **Corero Network Security (CNS:AIM)** is starting to build meaningful market share against bigger rivals. Since publishing half year results on 13 September, the distributed denial of service (DDoS) cyber security company has bagged \$1.1m worth of contracts. (SF)

## ITM rides high with Hyundai

ENERGY STORAGE AND clean fuel designer **ITM Power (ITM:AIM)** has signed a refuelling contract with Hyundai Motor UK. This is the fifth fuel supply contract using ITM's hydrogen fuel cell technology, a potential rival to electric-powered cars. ITM now has £16.85m of projects under contract and £4.15m of contracts in final negotiation. (SF)

## Fishing Republic looks enticing

WE LIKE **FISHING Republic (FISH:AIM)** despite it trading water at 39p following a profit warning (22 Sep). One of the UK's biggest fishing tackle retailers by floor space, Fishing Republic is consolidating a highly fragmented market and may itself draw a bid in time. Northland has a 47p price target. (JC)



# Hayward boost from emerging markets expert

Engineer receives thumbs-up from Baillie Gifford investor Sneller

Engineer **Hayward Tyler (HAYT:AIM)** is worth a closer look by investors after Baillie Gifford fund manager Richard Sneller snapped up a personal stake representing 6.5% of the business.

At the current price of 86.5p that stake is worth £3.1m.

Hayward was set up in 1815 and designs and manufactures specialist motors and pumps for energy, petrochemical and defence customers. It sells to countries around the world and has been investing heavily in new capacity.

As well as a vote of confidence from Sneller, Hayward's attractions include a global market share estimated at 60% in large scale boiler circulating pumps as well as a strong aftermarket offering which creates recurring revenue streams.

## FUND MANAGER DIGS DEEP

Sneller, who manages the **Baillie Gifford Emerging Markets Growth (GB006017825)** fund, is understood to like Hayward's exposure to markets including the Asia-Pacific region where it generates 25% of its sales.

Another 25% is generated from the US with the remainder split across the world. Despite an attractive geographical spread of earnings, Hayward's performance in recent years has been held back by its US dollar cost base, which is being squeezed higher because of the strength of the US economy and its currency.

Hayward's annual report says every 10% gain in the dollar versus sterling shaves around £500,000 from profit.

Expanded UK production capacity in Luton could help limit exposure to dollar costs on new pumps in the future.

Aftermarket revenues, which are sales of maintenance services for Hayward's 2,300 boiler circulating pumps around the world, comprised more than half the company's revenue in its last financial year and close to all its profitability.

Chief executive Ewan Baker-Lloyd owns 7.6%



## EARNINGS ESTIMATES

Hayward Tyler - Key metrics (£m)

	2016	2017e	2018e
Revenue	61.6	80.2	82.3
Adj. EBITDA	7.2	10.3	11.1
Adj. profit-before-tax	5.1	6.4	7.1
Adj. earnings per share	8.1p	8.2p	9.1p

Source: Cantor Fitzgerald (Year-end: 31 Mar)

of the business and Hayward has a well-aligned management team and knowledgeable investors willing to back them.

## SHORT-TERM PRESSURES

While long-term demand for Hayward's products looks good, in the short term earnings and company's share price are volatile. Baker-Lloyd said the business registered a loss of around £5.5m in the six months to 30 September 2016.

It now needs deliver £12m of operating profit in the second half of its financial year to hit analyst earnings estimates.

We remain sceptical this target will be achieved but the market might forgive an earnings miss if Hayward is able to provide a positive update on its order book for new pumps in the years ahead. (WC)

## SHARES SAYS: ↗

Sneller's stock purchases are a big endorsement of Hayward's business model, yet investors should expect near-term volatility in the share price.



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## November 17th

### Companies presenting

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#### **AB Dynamics (ABDP) Tim Rogers, MD**

The Group is engaged in the design, manufacture and supply to the global automotive industry of advanced testing and measurement products for vehicle suspension, brakes and steering both in the laboratory and on the test track. With over 90% of sales to export, the Group's products are used for research, development and production quality control. The Directors believe that the Group is one of the leading UK suppliers in its market.

#### **C4X Discovery (C4XD) Clive Dix, CEO**

C4X Discovery brings a new dimension to drug discovery. Using its unique NMR-based technique to determine 3D molecular structures with high accuracy, C4X Discovery is focused on optimising the design and development of medicines and partnering with the pharmaceutical sector to generate better, safer products.

More to follow...

## ...and on November 29th

### Companies presenting

#### **Bacanora Minerals (BCN) Peter Secker, CEO**

Bacanora Minerals Ltd is an explorer and developer of industrial minerals in Mexico with a primary focus on Borates and lithium. It was incorporated in Alberta, Canada in September 2008 and is listed on the TSX Venture Exchange (ticker = BCN). Although listed in Canada, we are proud to consider ourselves a Mexican Company. Bacanora Minerals strives to replicate this tradition of skill and dedication to quality in its own operations.

#### **Kennedy Ventures (KENV) Giles Clarke, Chairman**

Kennedy Ventures plc is an investing company listed on AIM, focused on principally, but not exclusively, in the resources sector. The Company has made a first investment in African Tantalum (Pty) Ltd, a Namibian based operation producing tantalite concentrate. In view of the attractive opportunities in tantalum, the Company is likely to initially focus on related projects located in Southern Africa.

#### **Valirx (VAL) Dr. George Morris, Chief Operations Officer**

Valirx Plc is an oncology-focussed Biopharmaceutical Company, developing treatments and diagnostics. Technologies are selected by using rigorous clinical and commercial processes to address unmet market needs.

### Why attend?

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#### **For any enquiries, please contact:**

Chris Williams, Spotlight Manager  
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# DIVIDEND GROWTH: 50 YEARS AND COUNTING

WHY THE CITY OF  
LONDON INVESTMENT  
TRUST IS HITTING  
THE HEADLINES





**T**he squeeze on income-yielding assets has made the hunt difficult for income investors. Interest received on savings accounts is close to zero, translating into a negative real return when accounting for inflation.

Bonds – a traditional asset class for income – also yield poorly. For example, German 10-year bonds were negative until recently.

Central banks from across the globe have been printing money to buy bonds and drive down interest rates, hoping to encourage spending over saving to rattle domestic economies into growth.

It has skewed the risk / reward dynamic, prompting investors to consider dividend-paying stock market investments to find a better return.

The environment has led to rampant demand for income yielding equities, pressure that is only likely to increase.

### RETIREMENT MONEY

The pension freedoms that came into effect in April 2015 have enabled retirees to sidestep annuity purchases and instead draw income direct from their invested pensions. Coupled with rates now at half of what they were in 1994<sup>[1]</sup>, annuity sales have fallen dramatically, with two thirds of retirees electing for non-annuity options, including equity income<sup>[2]</sup>.

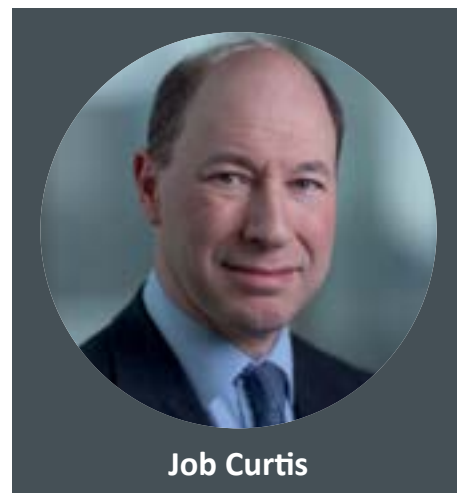
There are numerous equity income products on the market, but we think investing for equity income within the investment trust structure may be the best way for investors to achieve a long-term income objective.

### A SMOOTH PAYMENT

The investment trust sector is a small corner of the industry – around 400 investment trusts exist today. They differ from open-ended funds (known as OEICs and Unit Trusts in the UK) in a number of important ways.

- The pool of money they invest is fixed allowing for much longer investment horizons.
- They can borrow money (gearing) from institutions such as banks to make extra investments with the aim of boosting returns (this can be double-edged sword, however)
- They have an independent board tasked specifically with looking after shareholder interests.
- In particular, one key difference aids the income investor: a UK-domiciled investment trust is permitted to retain up to 15% of its annual dividend income in a revenue reserve account.

It means that during the more plentiful years a small percentage of the dividend payments can be put aside. During lacklustre years, for example during an economic downturn, the fund manager is able to use the reserve to top-up the dividend it pays to investors and smooth the income-stream



**Job Curtis**

over time. This structure has enabled some stellar income records. Open-ended funds, by contrast, must pay out all of their income which may lead to volatile payments.

According to the Association of Investment Companies (AIC) – the investment trust industry trade body – 19 investment trusts have been consecutively growing their dividends for 20 years or more. The City of London Investment Trust tops the list, having grown its dividend every year since 1966.

### MILESTONE ACHIEVEMENT

Upon reaching its 50-year milestone, the investment trust's chairman, Philip Remnant, said: 'I am delighted that City of London has reached this momentous milestone which demonstrates the strength of our long-standing conservative investment approach'.

Job Curtis has been the steward of this trust since



1991. He and the board believe the smooth dividend payment to investors is a vital part of the Trust's philosophy.

## A GOOD INVESTMENT FOR THE LONG TERM?

Investing over the longer term helps to mitigate some of the short-term risks and volatility inherent in equity markets, and can maximise your potential returns.

The City of London Investment Trust aims to unlock value in equities on a medium to long-term basis, potentially interesting investors looking to gain UK stock market exposure through a broad, conservatively managed portfolio of blue-chip investments.

Looking back over the past 50 years – the length of City's unbroken dividend record – short term investors may have been unnerved by any number of macroeconomic events: the 73/74 bear market, the winter of discontent, severe unemployment, interest rates hikes to 15%, 'Black Monday', 'Black Wednesday', The Asian Financial Crisis, the dotcom crash, or the Global Financial Crisis; all potentially leading to performance damaging withdrawals in the process.

## ANNUAL PERFORMANCE (CUM INCOME) (%)

Discrete year performance % change (updated quarterly)	Price	NAV
30/09/2015 to 30/09/2016	12.1	12.4
30/09/2014 to 30/09/2015	5.5	4.9
30/09/2013 to 30/09/2014	6.4	6.6
28/09/2012 to 30/09/2013	22.0	24.6
30/09/2011 to 28/09/2012	23.5	21.5

All performance, cumulative growth and annual growth data is sourced from Morningstar.

\*Please note, the Morningstar UK Equity Income is not the benchmark, it is the size weighted average of the AIC UK Equity Income sector.

The accompanying chart demonstrates the performance of £100 invested 50 years ago in various assets, including The City of London, and run through to the present day.

Adjusted for inflation, £100 in cash 50 years ago would be worth just over £1,600 today. With income reinvested, £100 put into gilts would have handed back just under £7,000; a broad basket of UK equities would have earned you over £27,000; and £100 into the City of London Investment Trust would have earned just under £64,000.

Whatever your investment, you would have achieved the best outcome with a long term approach. Please remember past performance doesn't indicate what will happen in the future. The value of an investment and the income from it can fall as

well as rise and you may not get back the amount originally invested.

## LOW CHARGES

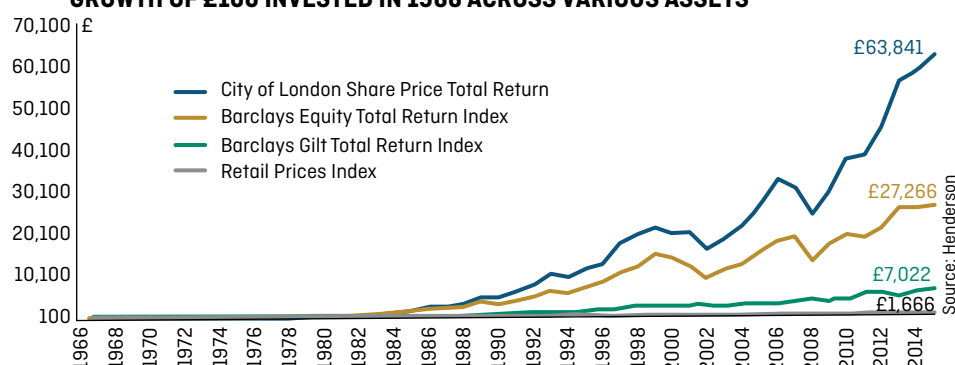
Charges have become an important issue for investors, particularly as many active funds across the globe have failed to outperform their benchmarks. This has led to a rise in popularity of passive strategies such as ETFs, which have attracted a total of \$200bn in inflows in 2015 versus \$124bn of outflows for active funds over the same period.

The reason is that while, in a single year, one fund's higher charge may not dramatically effect performance in comparison to a lower charging fund, the compounded effect over many years can be a significant drag.

Using a simple mathematical model, a £10,000 investment growing at 6% for 30 years would be worth around £51,000 in a fund charging 0.4%, but only £42,500 in an identical fund charging 1%.

The City of London's board have been determined to keep its ongoing charges low for investors, which they are able to do because of the trust's

## GROWTH OF £100 INVESTED IN 1966 ACROSS VARIOUS ASSETS



size (current total assets are over £1.4bn) and its ability to spread costs over a large base of investors. This means it charges the lowest in its sector, at 0.42% per annum (at the trust's year end: 30 June 2016).

### SO WHY CONSIDER CITY OF LONDON?

- Considering current low yields and savings rates, income-yielding equities are an attractive asset class.
- The trust has weathered a myriad of economic events and market turmoil through its conservative, blue-chip investments, and presents a potentially good investment for the long term.
- It has the longest growing dividend record of any investment trust, aiming to provide a smooth stream of income to its investors.
- It has the lowest ongoing charge of any investment trust in its sector, reducing the drag to potential future performance.

### RISKS

Where the trust invests in assets which are denominated in currencies other than the base currency then currency exchange

rate movements may cause the value of investments to fall as well as rise.

The trust may use gearing as part of its investment strategy. If the trust utilises its ability to gear, the profits and losses incurred by the trust can be

greater than those of a trust that does not use gearing.

If a fund is a specialist country-specific or geographic regional fund, the investment carries greater risk than a more internationally diversified portfolio.



Before investing in an investment trust referred to in this article, you should satisfy yourself as to its suitability and the risks involved, you may wish to consult a financial adviser.

The value of an investment and the income from it can fall as well as rise and you may not get back the amount originally invested.

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[1] Moneyfacts; as at 15 September 2016

[2] Pensions World; as at 15 September 2016





# HOW to take part in Sirius Minerals' open offer

Step-by-step get to buying the miner's shares below market price

**S**hareholders in **Sirius Minerals (SXX:AIM)** have a chance to buy shares below market prices as part of the company's \$1.2bn fundraising to build a potash mine in Yorkshire.

As this may be the first time many investors

have taken part in an open offer, here we look at how the process works and what investors should consider before participating.

First, the details: Sirius has invited existing shareholders to apply for 2 new shares at the discounted price of 20p for every 25 that they already own. This is the 'open offer'.

## SHOULD INVESTORS TAKE PART IN THE SIRIUS OPEN OFFER?

This depends on each individual investor's available funds, appetite for risk and investment time horizon.

Fundamentally we believe the project will create significant value in the long term and see 20p as a good price at which to buy more shares.

## IS THIS A BARGAIN OR NOT WORTH THE EFFORT?

This looked to be an absolute bargain when considering the shares were trading at 37p just before the fundraising was announced.

Sadly the market hasn't responded that

favourably, meaning the shares have been in a falling trend since Sirius explained how it would get enough money to build the first phase of its mine.

The shares at the time of writing had fallen to 23.44p. That's still above the open offer price, but potentially at the point where some investors may question whether it is worthwhile taking part in the fundraising exercise.

## WHAT ARE THE OPTIONS?

Existing Sirius investors have four choices:

- 1** Apply for a full allocation of shares at 20p. If the entitlement to new shares isn't a whole number, it will be rounded down to the



nearest whole number.

**2** Apply for more than your allocation of shares at 20p. There is no guarantee an investor will receive more than their basic entitlement, but Sirius will allocate extra stock if there is enough left over after filling all the 'basic' orders.

**3** Apply for less than the basic allocation. For example, an investor entitled to 100 new shares may only want to buy 50 new shares.

**4** Investors that do not wish to take part do not need to do anything.

Applications for new shares need to be made by 23 November 2016. Details of how to apply are in the prospectus available on Sirius' website – or you can apply directly through your stockbroker. Capita Registrars is administering the open offer for Sirius.

### STEP-BY-STEP GUIDE

Let's assume you apply directly through your stockbroker – that's the company through which you may have an ISA, a SIPP (self-invested personal pension) or dealing account. We'll use AJ Bell Youinvest's process as the working example.

Investors should have received a secure message from their broker's corporate actions team. Electing for a basic entitlement of shares can be completed using online corporate action tools.

Investors must have sufficient cash in their investment account at the time the order is placed.

Anyone who wants to apply for excess shares will most likely have to send a secure message to the stockbroker, requesting X number of shares in excess. Your broker will then apply for those shares on your behalf.

### WHAT HAPPENS NEXT?

Once a broker's corporate actions team have processed all the applications, both basic and excess, they will credit customers with the shares once received. They will also send a message

notifying shareholders of this event.

Stockbrokers usually add a note regarding excess shares, especially if applications are scaled back, to explain how many shares have been allocated.

The new shares will be admitted to the stock market on 28 November 2016.

### WHY HAS THE SHARE PRICE FALLEN SINCE THE FUNDRAISING ANNOUNCEMENT?

There are a lot of reasons why the stock has fallen since Sirius said it had found a solution to building its mine.

**a** Existing shareholders will get diluted by the significant number of new shares (priced at a discount) being issued.

**b** Part of the broader funding scheme involves the issue of \$400m worth of convertible bonds to a select group of institutional investors, due to be settled by 2023. Essentially Sirius is borrowing money at an agreed rate of interest with the option of either paying back the cash or settling the debt via the issuance of new shares.

The convertible shares can be exercised if Sirius' share price trades higher than 25p (31c). Investors would hope that Sirius' share price is trading at many multiples of 25p by 2023 – which means the bondholders could be getting a bargain at the expense of the company's other investors and shareholders.

**c** Many shareholders forget it costs a lot of money to build mines, so they panic sell when a miner announces a large fundraising exercise.

### WHAT'S THE DIFFERENCE BETWEEN AN OPEN OFFER AND A RIGHTS ISSUE?

An open offer is an invitation for existing investors to buy new shares. A rights issue is the same thing with one key difference.

You can sell your right to buy shares to a third party in a rights issue; therefore the event is open to anyone to take part. An open offer cannot be traded and is therefore restricted to qualifying investors. (DC)



# Get to grips with pension deficits

What to focus on when assessing deficit risks

**U**nderfunded pension schemes have become a political football since BHS failed under the weight of its pension deficit.

Many companies listed in the UK – particularly large businesses founded many decades ago – also have large pension obligations to employees.

Understanding a few simple rules can help investors weigh up the risks around a company's pension deficit and decide whether the risk is worth taking.

There's no need to be an actuary to understand the basics of a corporate pension scheme. We use the example of telecoms giant **BT (BT.)**, which has the UK's largest defined benefit pension scheme, to run over some of the key points.

## **RULE ONE – UNDERSTAND THE ASSETS**

Pension scheme assets are straightforward. All of the assets which have been accumulated by BT's pension scheme over the years equal £44bn, an amount bigger than the company's entire market capitalisation of £36bn.

These assets are amounts BT has set aside in the past to cover its future obligations to pensioners. Included in these assets are £14.7bn of equities, £7.3bn of bonds, £11.7bn of property assets and £4.6bn of other assets including emerging market debt.



In total, BT's pension fund assets are around one-tenth the size of **Legal & General's (LG.)**, one of the UK's largest life insurance companies.

Unfortunately, it's still not enough!

## **RULE TWO – UNDERSTAND THE LIABILITIES**

Even with £44bn of assets, BT's pension assets are £6.4bn lower than its reported liabilities. BT's pension scheme liabilities are estimated by actuaries at £50.4bn.

Liabilities, importantly, are estimates. The best way to understand pension scheme liabilities is to consider them as

an estimate of how much a company would need today to meet pension future payments assuming the company's assets were invested in corporate bonds.

Within these estimates, which are common to all pension schemes, are:

- Estimated inflation
- Estimated life expectancy
- Estimated returns on corporate bonds

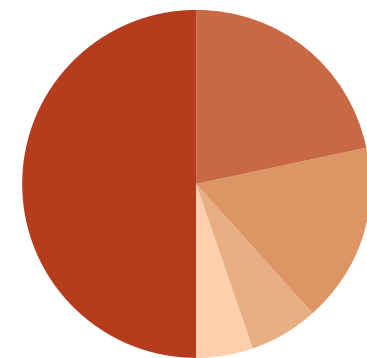
After compiling all of these estimates, as well as a few minor additional ones, BT's pension liabilities are £50.4bn on an accounting basis.

Changes in the assumptions alter the estimate of the liability.



## BT PENSION SCHEME

Breakdown - Assets (£bn)\*



Bonds	19.0
Equities	14.7
Property	5.5
Other	4.6
<b>Total</b>	<b>43.8</b>

\*last year-end

An increase in expected inflation or life expectancy increases the liability. On the corporate bond assumption, falling corporate bond yields reduces the expected return on bonds and increases the size of the liability. This is why companies often refer to falling bond yields when they talk about why their pension liabilities and deficit have increased.

## RULE THREE – UNDERSTAND THE DEFICIT

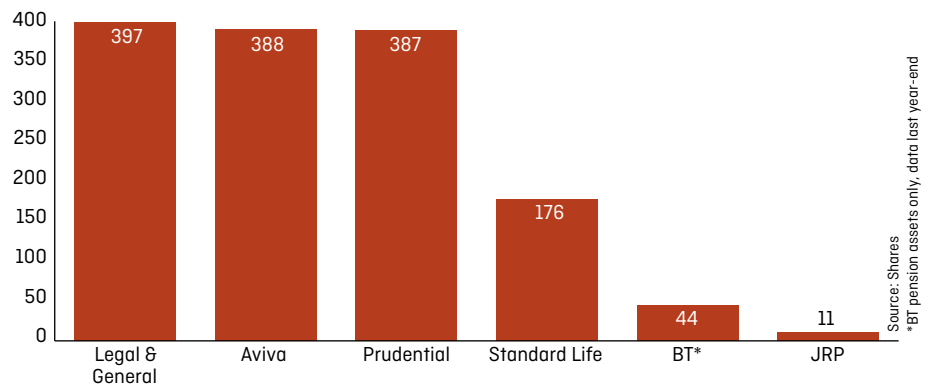
Pension assets minus liabilities equals the estimated account deficit. Tax reduces the deficit somewhat because corporate payments into a pension scheme attract a tax break. In BT's case, the value of this tax break is about £1.1bn.

Eagle-eyed readers may have spotted there is one glaring difference between the accounting estimates used to calculate BT's pension liability and the economic reality of how the scheme is run.

Pension liabilities, the amount

## LIFE INSURER OR TELCO?

BT - Pension assets versus UK life insurance sector (£bn)



BT must have to fund its pension obligations, are calculated as if the company's pension scheme was invested in corporate bonds.

In reality, the assets in its scheme are invested around one-third in equities, 43% in a mix of bonds and the remainder in other assets.

## INVESTMENT IMPLICATIONS

This has a few important implications for investors in BT and other companies with large pension deficits.

For example, holding all other variables constant, a gain in BT's equity portfolio of around 44% would wipe out its entire £6bn-plus pension deficit. That's not an implausible scenario – it could happen in one year if the stock market had a particularly good run.

Equally, if global equities declined by a similar amount, BT's deficit would increase by a little over £6bn, doubling the size of the deficit.

This is an important factor for all companies with pension schemes which have some or all of their assets invested in equities.

Movements in the general stock market – other company's share prices – have at least as

big an impact on companies like BT as their own performance in providing telecoms services, for example.

If a large number of companies listed on the stock market, as they do in the UK, have big pension deficits, a falling stock market may become self-fulfilling to a certain extent. The stock market falls, pension deficits widen, share prices of companies with pension deficits fall – which causes the stock market to fall further.

The opposite is also true: if share prices rally even modestly over the next few years, pension 'black holes' will be out of the newspapers for good. Companies and the government might even start to wonder if defined benefit plans are a good idea again.

While this is a hypothetical argument – by changing only one variable in a complex set of interrelated factors – it is worth thinking about when picking stocks.

As an investor, ensuring your portfolio is well diversified not just by sector but also by limited overall exposure to companies with large pension deficits or other balance sheet risks could help you enjoy more stable stock market returns. (WC)

# Guide to sector investing

What are the best vehicles to use and how much should you invest?

If you think a particular sector of the economy is about to take off you might want to consider sector-focused investments, but it's important to be aware of the greater risks involved.

The attraction of investing in specific sectors is it enables you to avoid parts of the economy which are performing badly and concentrate on the parts that are doing well. This could, in theory, lead to better overall returns.

Over the last 10 years, the technology and consumer goods sectors have significantly outperformed whereas the financial and mining sectors have struggled. If you succeeded in building a portfolio reflecting these trends you'd be sitting in a very strong position today.

It can be very difficult to predict how sectors will perform, as evidenced by the surprise dotcom crash back in the early noughties. This year, the mining, oil and gas sectors have bounced back due to a recovery in commodity prices.

## TIME AND EFFORT

Investing in sectors takes a lot of time and effort because you need to keep track of both economic news and company announcements. Ryan Hughes, head of fund selection at AJ Bell, says company announcements enable you to take a temperature check of a specific industry and are often a good guide for when a certain sector is picking up or potentially slowing down.



‘Importantly, investors should take their time to read and digest company statements as hidden in the words of the chairman and chief executive are often little clues as to their thinking on the health of not only their business but the wider sector and economy that they operate within,’ he says.

Unless you have a particular view on an individual stock, it's generally better to opt for a diversified vehicle such as a fund, investment trust or exchange-traded fund (ETF). Gavin Counsell, senior multi-asset fund manager at Aviva, says there is nothing worse than getting the right investment thesis, only to have the return profile

dominated by an individual company-related issue.

A good example of this is **BP (BP)**. As one of the largest oil producers, many people have used BP to invest in the energy sector, but its performance has been rocked by the Deepwater Horizon oil spill in April 2010.

## FUNDS VS ETFs

A fund or an ETF lets you invest your money across several companies, spreading the risk.

There are specialist funds and ETFs covering a wide range of sectors, from mainstream ones like financials and mining through to niche ones like water, timber and clean energy.

ETFs are good at getting broad

## FUNDS IN FOCUS

### SECTOR: BIOTECHNOLOGY

#### AXA Framlington Biotech (GB00B784NS11)

5 year annualised return: 27.6%

##### Top holdings:

Biogen

Gilead Sciences

Celgene

Alexion Pharmaceuticals

Vertex Pharmaceuticals

Source: Morningstar, Trustnet

### SECTOR: HEALTHCARE

#### Polar Capital Healthcare Opportunities (IE00B3NLDF60)

5 year annualised return: 25.7%

##### Top holdings:

Merck

Novartis

Abbott Laboratories

Amgen

### SECTOR: WATER

#### Pictet Water (LU0448836600)

5 year annualised return: 14.9%

##### Top holdings:

Veolia Environnement

Xylem

Pentair

Danaher

Suez

exposure for a low cost, whereas funds offer access to an active manager who has the specific skills to hopefully outperform the market. Funds tend to be more expensive and there is always the chance that the manager will stray from the theme.

Sector-focused funds and ETFs are riskier than broader investments because companies often move together and are impacted by the same factors. Adam Laird, head of ETF strategy, Northern Europe at ETF provider Lyxor, says the whole energy sector dropped when oil prices crashed, resulting in an 18.4% decline in the MSCI World Energy index in 2015.

### SECTOR DYNAMICS

Before investing in any sector you need to understand its dynamics. Counsell at Aviva says a good starting point is to look at the sector's valuation – for example the price to earnings ratio and dividend yield.

'Then there will be sector-specific information you need to take into account – for example energy stocks will be impacted by oil prices, potential announcements by (oil producers' cartel) OPEC,

expected global trade and so on. Such factors will be less important if you were investing in, say, healthcare,' says Counsell.

In general, sectors such as tobacco and pharmaceuticals typically perform well in bear markets. Mining and oil and gas are inherently more volatile, while other sectors are more defensive and exhibit less volatility, such as consumer goods and services. Some sectors have fewer stocks so will be less diversified.

Counsell says another risk



that has developed recently is the demand for income, which has pushed up the price of sectors compared to historic levels. 'These are sectors such as utilities that are often viewed as bond-proxies – i.e. lower risk with stable dividends more correlated to bond yields. If yields were to rise dramatically, these sectors would be more significantly affected. We have started to see the volatility of sectors like utilities increase over last 12 to 18 months,' he warns.

### PORTFOLIO ALLOCATION

Given the greater risks, it's advisable to keep your investment in any individual sector to less than 10% of your overall portfolio. You might also want to consider blending a few sectors to spread the risk.

Hughes at AJ Bell suggests using sector investing as a way of tilting exposures within your portfolio, rather than using it as a core element.

'This can be a useful method of increasing or decreasing the risk as you see fit, without becoming wholly reliant on one or two sectors to drive performance,' he explains. (EP)



# Picking your perfect retirement income product

New research back-tests the performance of different investments popular with retirees

**I'**m often asked which pension product is the 'best' for retirement income investors, and my answer is always the same: 'If only it were that easy!'

What matters is choosing the product – or mix of products – and investments that best suit your needs and appetite for risk.

According to PWC research, around two-thirds of people cite certainty of income as an important factor in determining how to manage their pension pot, while 61% point to tax efficiency and life expectancy, and 41% investment risks.

Other things mentioned include current health, inflationary risk, simplicity of the product and the ability to leave something behind to loved ones.

It's worth thinking about how important each of these is to you when building your retirement income strategy.

## WHAT ABOUT ACTUAL RETURNS?

Consultant The Lang Cat has modelled how well someone with £100,000 to invest 25 years ago would have done if they'd bought an annuity, a guaranteed drawdown product,



a 'third-way' product, or gone into drawdown.

If you think of retirement income as a spectrum, annuities – offering a guaranteed income for life – sit at one end. Drawdown – where your money is invested in the stock market – is at the other end.

Guaranteed drawdown is usually more expensive than 'standard' drawdown and allows you to lock-in investment growth, while third-way products combine annuities and drawdown in one tax wrapper.

It is important to remember that past performance is no guide to the future and investments can go down as well as up.

Also, the research has used a number of assumptions which

mean the final numbers are purely indicative.

The assumptions include charges, how you invest your money and annuity rates.

## TELL ME THE RESULTS

Our annuity investor got £116,000 over the period, while someone who bought a third-way product would have received £225,000 (income of £125,000 and a final pot value of £100,000).

Someone who bought a guaranteed drawdown product would have got a whopping £259,000 in total. This was broken down into £167,000 from income and a final pot value of £92,000.

Drawdown was the runaway winner, delivering total returns of £336,000 – £135,000 of income, plus a final pot value of £201,000.

The results demonstrate the potential power of investing over the long-term, but remember you'll probably have to put up with choppy waters along the way.

Ultimately, which product you choose should depend on your retirement goals and willingness to take on investment risk.

TOM SELBY  
AJ Bell Analyst

## FRIDAY 11 NOVEMBER

## INTERIMS

Castings	CGS
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## AGMS

Galliford Try	GFRD
Ludgate Environmental Fund	LEF

## ECONOMICS

## UK

Construction Output
---------------------

## MONDAY 14 NOVEMBER

## TRADING STATEMENTS

Taylor Wimpey	TW.
William Hill	WMH

## Final

Carr	CARR
------	------



## TAYLOR WIMPEY

Investors will be watching closely to see if Taylor Wimpey (TW.) can match the positive noises from several its housebuilding peers after they shrugged off any impact from the Brexit vote. Alongside half year results on 27 July the company said it was 'encouraged' by the first month's trading since the referendum vote. (TS)

Lonmin	LMI
--------	-----

## AGMS

OPG Power Ventures	OPG
--------------------	-----

## TUESDAY 15 NOVEMBER

## FINAL

Enterprise Inns	ETI
EasyJet	EZJ
McCarthy & Stone	MCS

## INTERIMS

BTG	BTG
FirstGroup	FGP
Intermediate Capital	ICP
Imimobile	IMO
Land Securities	LAND
McKay Securities	MCKS
Oxford Instruments	OXIG
Picton Property Income	PCTN
TalkTalk	TALK
Vodafone	VOD

## TRADING STATEMENTS

Amec Foster Wheeler	AMFW
Card Factory	CARD
Meggitt	MGGT

## AGMS

Avation	AVAP
Bluefield Solar Income Fund	BSIF
Smiths Group	SMIN

## ECONOMICS

## UK

PPI, HPI, RPI, CPI
--------------------

## WEDNESDAY 16 NOVEMBER

## INTERIMS

British Land	BLND
Fenner	FENR
HICL Infrastructure	HICL
ICAP	IAP
Schroder Real Estate	SREI

## TRADING STATEMENTS

Aggreko	AGK
Barratt Developments	BDEV

## AGMS

AB Dynamics	ABDP
-------------	------

## ECONOMICS

## UK

Unemployment Rate
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## THURSDAY 17 NOVEMBER

## Final

Tracsis	TRCS
---------	------

## INTERIMS

Creston	CRE
Great Eastern Energy	GEEC
Great Portland Estates	GPOR
Investec	INVP
Johnson Matthey	JMAT
NewRiver Retail	NRR
QinetiQ	QQ.
Royal Mail	RMG
Majestic Wine	WINE

## TRADING STATEMENTS

Premier Oil	PMO
Safestore	SAFE

## AGMS

Sirius Petroleum	SRSP
------------------	------



## ROYAL MAIL (RMG) 493P

Royal Mail (RMG) trades close to a third cheaper than rivals in the logistics sector, according to Cantor analyst Robin Bye, at around 11 times earnings. A half-year results update (17 Nov) promises to reveal whether the market's caution on the stock is merited or not. (WC)



## MAJESTIC WINE (WINE:AIM)

Marked down to 282.5p, Majestic Wine (WINE:AIM) needs to restore confidence with forthcoming interims (17 Nov). Downgrades have shaken investors' faith in the Naked Wines owner, yet Liberum Capital is a buyer with a 380p price target, arguing results 'should contain signs that the new strategy is working'. (JC)

## ECONOMICS

## UK

Retail Sales
--------------

## EX-DIVIDEND

Balfour Beatty	BBYB	5.38p
Braemar Shipping Services	BMS	9p
Bunzl	BNZL	13p
Edinburgh Dragon Trust	EFM	3.2p
Volusion Group	FAN	2.6p
Finsbury Food	FIF	1.87p
Fidelity Special Values	FSV	2.7p
Gattaca	GATC	17p
Gleeson MJ	GLE	10p
Genus	GNS	14.7p
Kennedy Wilson Europe Real Estate	KWE	12p
London Finance & Investment Group	LFI	0.55p
Lok'n Store	LOK	6.33p
Manchester & London Investment Trust	MNL	1.85p
Manchester & London Investment Trust	MNL	10.5p
MedicX Fund	MXF	1.49p
Raven Russia	RUSP	3p
Softcat	SCT	3.6p
Softcat	SCT	14.2p (special)

Sanditon Investment Trust	SIT	1.1p
Scottish Mortgage Investment Trust	SMT	1.39p
Spire Healthcare	SPI	1.3p
Tristel	TSTL	2.19p

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Angle (AGL:AIM)	12
Anglo American (AAL)	12
Ariad Pharmaceuticals (ARIA:NDQ)	29
Associated British Foods (ABF)	8, 20
AT&T (T:NYSE)	19
Baillie Gifford Emerging Markets Growth (GB006017825)	32
Biotech Growth Trust (BIOG)	28
BlackRock Gold & General D Acc (GB00B5ZJN896)	22
BP (BP.)	12, 24, 42
British American Tobacco (BATS)	8
BT (BT.)	40
Capital Gearing Trust (CGT)	19
Card Factory (CARD)	20
Centamin (CEY)	19
Corero Network Security (CNS:AIM)	31
Debenhams (DEB)	20
Diageo (DGE)	14
Diversified Oil & Gas	8
Eagle Eye Solutions (EYE:AIM)	12
Elementis (ELM)	15

European Assets Trust (EAT)	27
Evenlode Income (GB00B42KPP53)	19
Experian (EXPN)	12
Fevertree Drinks (FEVR:AIM)	6
Fishing Republic (FISH:AIM)	31
GlaxoSmithKline (GSK)	24
Hayward Tyler (HAYT:AIM)	32
Herbalife (HLF:NYSE)	16
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IP Group (IPO)	12
ITM Power (ITM:AIM)	31
Johnson & Johnson (JNJ:NYSE)	19
JP Morgan Global Growth & Income (JPGI)	24
Legal & General (LGEN)	40
Majestic Wine (WINE:AIM)	45
Marks & Spencer (MKS)	8
Microsoft (MSFT:NDQ)	20
Mylan (MYL:NDQ)	28
National Grid (NG.)	19

Nestle (NESN:VTX)	14
Next (NXT)	20
Ocado (OCDO)	30
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Segro (SGRO)	13
Sepura (SEPU:AIM)	7
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SSP (SSPG)	16
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## KEY

- Main Market
- AIM
- Overseas Market
- Fund
- Investment Trust
- Exchange-Traded Product
- Ipo Coming Soon

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