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RBS SHARE BUYBACK: WHAT DOES IT MEAN FOR INVESTORS? MORTGAGE
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FOR THOUSANDS

GERMANY DISAPPOINTS: IS EUROPE'S LARGEST ECONOMY HEADED FOR RECESSION?

# Insights from the experts

As star fund manager Terry Smith publishes his latest letter to shareholders we consider the value of this type of commentary

he idea of a 'letter to shareholders' might strike some of you as a touch old fashioned and grandiose but the commentary presented by some fund managers can actually offer very useful insights and up-to-the-minute market intelligence.

As we write Warren Buffett's annual missive to shareholders should be about to drop and Fundsmith's Terry Smith has just popped his own in the post.

Smith is a newcomer relative to Buffett who has been completing this exercise since 1965. His ninth annual letter contains too many nuggets to summarise in full in this article – you can read it for yourself at **this link** and as far as this author is concerned it is well worth doing so.

Particularly as Smith is responding to the worst absolute annual performance since the inception of his **Fundsmith Equity (B41YBW7)** fund.

Smith's perspective shows the benefit of experiencing multiple economic and market cycles. Comparing the recent volatility in stocks with the 22.6% decline in the Dow Jones Industrial Average on Black Monday in October 1987, he notes looking at a long-term chart of the Dow Jones you would need 'good eyesight or reading glasses' to spot this precipitous collapse in the index more than 30 years ago.

The letter also includes a very good summary of how a genuinely long-term investor should respond to swings in the wider market.

'A bear market will occur at some point. We may indeed already be in one. The best stance is to ignore it since you can't predict it or position yourself effectively to avoid it without impoverishing yourself by forgoing gains. But you have to possess the emotional and financial stability to stick to this stance when it strikes.'



A bear market will occur at some point. We may indeed already be in one

#### A CONSISTENT APPROACH

He also shows zero sign of abandoning the focus on quality businesses which has underpinned his investment strategy to date, with no intention of rotating into value stocks. Instead he will stick with an approach which involves buying good companies, not overpaying and then doing nothing.

There are plenty of good communicators in the fund management industry who produce freely available commentary on the markets and their portfolios, often on a monthly basis.

As well as providing a useful perspective on the financial markets as a whole, they often provide expert views on individual stocks in their portfolio. Some other names worth seeking out in our view include, appropriately enough, Buffett disciple Keith Ashworth-Lord who runs the **UK Buffettology Fund (BKJ9C67)**.

We would also flag noted contrarian investor Alastair McKinnon who heads up the **Scottish Investment Trust (SCIN)** and Nick Train from **LF Lindsell Train Equity (B18B9X7)**.

You might not agree with everything you read but, at the very least, it can be useful to challenge your thinking with a well-supported alternative view.



By Tom Sieber Deputy Editor



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# ontents

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## **VALUE INVESTING: IS THE TIDE TURNING?**

aic DIVIDEND HERO

by Alasdair McKinnon, manager of the Scottish Investment Trust

Growth or value? That has been the question on many investors' minds as markets have taken a turbulent turn. They represent two main schools of thought when it comes to investing and investors often try to lump stocks into one or other of the two categories. Of course, it's not so clear cut as Box A for fast-growing glamour stocks and Box B for dowdy, old cheap shares – the lines are often blurred.

Both have their attractions. Growth stocks inspire hopes and dreams, with investors willing to strap themselves into the love train, usually paying up for the thrill. Value stocks, on the other hand, are the lonely singletons of the stockmarket world – they are priced for their less obvious charms and astute investors can pick up a hidden gem without betting the farm. Of course, investing is full of ups and downs and no style is 'right' or 'wrong' all of the time – they go in and out of fashion. This raises an interesting question – as the rally in growth stocks gets long in the tooth, are the value stocks that have been long overlooked a budding contrarian opportunity?

#### Cheap money

For over a decade, growth stocks have been cresting the wave of loose monetary policy leaving value stocks languishing in the doldrums. The tide may be turning and, as contrarians, we've been keeping a watchful eye on these contrasting fortunes.

Firstly, let's consider why growth stocks have fared so well. It's not by chance that the strong performance over the last 10 years coincides with the decade following the global financial crash. The conditions that ensued have been unusually flattering for growth investments.

Stunned by the severity of the crisis, central bankers took the unprecedented action of cutting interest rates to near zero and launching quantitative easing (QE) – a scheme that injected cash into the financial system via central banks' purchase of, mostly, government bonds. As growth stocks are often valued by discounting their future cash flows into a 'present value' and, given that most of their profits will be earned in the future, lower interest rates made these stocks look far more appealing to investors using this measure.

#### Turning off the tap

But 10 years on, the fuel for this cheap money appears to be running out. The US has begun withdrawing QE, while the European Central Bank stopped making new purchases in December. Central banks' withdrawal of accommodative policies, alongside rising yields, creates an environment less supportive for growth stocks, effectively reversing the valuation argument described above.

The trend of increasing interest rates is exacerbated by the rise of populist politicians to power, who are throwing budgetary caution to the wind to satisfy their voter bases. We have seen this lately in Italy, where the country's anti-establishment government announced a budget that conflicted with the EU's rules.

There's also the question of market cycles. The post financial crisis conditions we discussed earlier have prolonged the bull market for growth stocks – we believe that a number of growth companies are in bubble territory. They're 'priced for perfection' and even the smallest disappointment could lead to a share price correction. Some of the

internet and technology stocks, characterised by the FANGs, fit this bill. If these companies do fall off their perch, value stocks may well benefit from a rotation of investment flows. Certainly, the balance between risk and reward of growth stocks is less favourable.

#### Looking at value through a contrarian lens

Contrarian investment is distinct from value investing, but the two styles do have some things in common at this point in time. Both aim to identify undervalued stocks that have the potential for an improvement in circumstances. However, as contrarians, we also specifically seek out unfashionable and unloved stocks where we believe sentiment is overly pessimistic. As we know, market sentiment towards a company can quickly change and that the sentiment cycle tends to swing too far, thereby creating investment opportunities. Part of our job is to identify and investigate these opportunities, looking for tangible signs of positive change. For example, these could include new management, a turn in the industry cycle or other factors that the broader market has overlooked and underestimated.

Our 'belt and braces' approach means that, as well as being unloved, we like companies to have strong balance sheets that facilitate planned change and support dividends to provide us with income while we wait for the tide to turn. In the current climate, there are many interesting opportunities for contrarian investors. Areas such as Brexit blighted Britain, Europe and recently battered emerging markets may all provide fruitful hunting grounds.

Taking a contrarian position can be uncomfortable – it often takes time for change to be recognised, meaning that patience is a necessity. Because ours is an independent, closed-ended fund, we have the freedom to commit to this long-term approach for our investors. We're in pursuit of the most compelling contrarian investments and those are not found in asset bubbles or 'hot trades'. Value stocks might appear out of favour now, but when the sea change comes, they could become fashionable again. ■ \*21 January 2019



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## Where next for Brexit?

We preview next week's vote in the House of Commons

s we write the market appears to be pricing in an increasing likelihood a no-deal Brexit can be avoided with sterling largely holding on to the gains it has enjoyed in 2019.

As a reminder, strength in the currency reflects hopes that the market's preferred outcome of a softer, or at the very least, orderly exit from the EU will be achieved.

For now, Theresa May seems committed to a tweaked version of her Brexit deal despite the heavy defeat it suffered on 15 January.

A vote on 29 January will not be on a revised version of this deal, prompting accusations from some quarters that May is running down the clock to hold MPs feet to the fire and get them to approve her plan to avoid a no-deal outcome.

Instead it will be a 'neutral' motion to which backbenchers from across the House of Commons are already busily adding their own amendments.

#### In summary these are aimed at:

- Stopping a no-deal Brexit by extending Article
   50 beyond 29 March
- Giving parliament greater control of the whole process
- Offering a vote on Labour's plan for membership of a customs union, single market alignment and protections on the environment and workers' rights as well as the option of voting on a second referendum
- Providing a series of indicative votes which would indicate which option can command parliamentary support

Other possible amendments which could be in the offing might include an attempt to force a second referendum and to limit the Irish backstop – one of the key apparent sticking points for Brexiteer MPs.

Crucially these amendments will not be legally binding, however if any secure majority support there would be political pressure on the government to act in accordance with MPs wishes. The Speaker will decide which

amendments are voted on.

Chancellor Philip Hammond told business leaders in a conference call MPs would block a no-deal Brexit, though this has been contradicted, at least in public, by the Government.

With guidance for a second vote on a Brexit deal to take place in mid-February there is little sign of the clarity craved by the corporate world and investors being forthcoming.

Asset manager Rowan Dartington's technical investment manager Donald Maxwell-Scott says: 'Even though it shouldn't be ruled out, we don't believe that we will end up with a no-deal Brexit.

'An election is also unlikely as the government won their vote of no confidence. This also reduced the chances of a second vote on Brexit.

'A Norway plus deal is also unlikely, although this would solve the problem of the Irish backstop. Given that the government remains in power after the vote of no confidence then the only way forward would be further amendments to Theresa May's deal.'



29 Jan – vote on Government motion (plus amendments)

Mid-Feb – possible timing of second vote on Brexit deal

**29 March** – UK set to leave EU





By **Tom Sieber** Deputy Editor

# Royal Bank of Scotland in buyback surprise

Proposed move could help bank back towards private ownership



nvestors in Royal Bank of Scotland (RBS) got a pleasant surprise last week when the company slipped out a seemingly routine regulatory news release.

In its 'Notice of GM' (general meeting) the bank said it would propose a special resolution asking shareholders for permission to buy back shares from the Treasury.

The bank is holding its annual shareholder meeting on Wednesday 6 February.

As chairman Howard Davies explains, 'This resolution would provide the bank with the flexibility to use some of its excess capital to buy back Government shares at a time and price agreed with HM Treasury.'

The purchases will be off-market and agreed beforehand with the Treasury.

There could be one or more standalone purchases, an ongoing buy programme managed by a broker, or the bank could buy back stock in a placing or offer for sale by the Treasury.

Howard Davies again, 'The board believes that this is in the best interests of the bank and its shareholders by helping to facilitate the return of the company to full private ownership.'

#### **SURPRISE, SURPRISE**

The first surprise is that the news wasn't negative as RBS has tended to slip out bad news in its New Year trading updates.

Previous releases have contained warnings about restructuring charges, mis-selling charges,

bad loans and pension costs.

While the news is good this time round it should be put into context. The Treasury still owns 62% of the ordinary shares of RBS with a market value of £18.3bn.

In other words, to buy 1% of its shares the bank needs to spend about £300m.

RBS has around £4bn of excess cash after it resolved a long-running dispute with US regulators last year over its role in the mis-selling of mortgage-backed products.

According to analysts at Jefferies, the bank could have as much as £7.6bn of surplus capital by 2020, or enough cash to buy back 26% of its shares.

#### **BUYBACKS LEAVE ROOM FOR DIVIDENDS**

A more realistic target would be to purchase say 5% of its shares a year which at the current price would mean spending £1.5bn, leaving plenty of cash for dividends.

RBS paid a 2p per share last October, its first dividend since being bailed out by the Treasury in 2008.

Since then investors have been hoping for a sign that it wasn't a one off and that the bank will return to regular dividends.



By Ian Conway Senior Reporter

# Just Eat chief executive resigns amid pressure from US shareholder

Cat Rock Capital criticised Peter Plumb's strategy in an open letter in December

e believe the reign of online delivery platform Just Eat's (JE.) chief executive officer Peter Plumb may have been cut short following pressure from US shareholder Cat Rock Capital.

Plumb, who is leaving with immediate effect after less than 18 months in the role, was under fire from Cat Rock, who has a 2% stake in Just Eat.

The shareholder criticised Plumb's failure to introduce appropriate financial goals or hold management accountable via remuneration packages.

Key requests include linking management's remuneration with publicly disclosed three-year financial targets and aiming for at least 20% organic order growth.

Shares in Just Eat have slumped 17.9% to 654.2p over the last year after revealing it would be investing £50m for delivery services in March 2018. Previously it had principally been an online platform for takeaway outlets who handled the deliveries themselves.

This was already viewed as an expensive investment by the market and was hiked to a range of £55m to £60m in July, causing the shares to fall further.

Just Eat revealed earnings before interest, tax, depreciation and amortisation (EBITDA) will be between £172m and £174m in the year to December 2018. In 2019, EBITDA is forecast to hit a range of £185m to £205m, roughly in line at the top end with consensus forecasts for £204m.

Sales are forecast to rise from £780m to between £1bn and £1.1bn this year.

The company has not responded to Cat Rock's open letter in the trading statement, which included a recommended sale of the iFood business in Brazil in order to return capital to shareholders.

#### **MARKET SHARE OF THE UK TAKEAWAY MARKET 2017\*** Other delivery services 9% **Branded Pizzas Telephone 17%** 42% Source: company\* Just Eat pro-forma **Just Eat** for Hungry House; Other delivery apps include Deliveroo and Uber Eats; **32**% Branded pizza includes Domino's and Papa John. Based on Just Eat's

#### WHY IS PEEL HUNT NO LONGER A FAN?

Despite the relatively reassuring trading update, not everyone is convinced.

Broker Peel Hunt has been a fan of Just Eat since 2013 but changed its tune in October 2018 following rumours that rival Uber Eat may acquire Deliveroo.

Even if Deliveroo is not acquired, Peel Hunt analyst James Lockyer is concerned as Uber Eats could gain more traction via smartphone apps and benefit from a richer dataset compared to Just Eat.

Lockyer also argues Deliveroo has bigger pockets to help it thrive in a new market that Just Eat may not be able to match.

The analyst is confident Just Eat made the right move investing in delivery (albeit three years too late), but flags investing in technology and using its data to help customers is essential if it is to prosper going forward.



By Lisa-Marie Janes Reporter

# Ryanair, Whitbread, Sophos and more news from the past week

We look at some of the big announcements and the market reaction to them

ith the New Year well underway there have been plenty of news items to catch investors' attention of late. There was a reminder of the continuing pressures on the airline sector as **Ryanair (RYA)** and **EasyJet (EZJ)** landed the market with mixed updates on 18 January and 22 January respectively.

Ryanair warned on profit again, lowering guidance from a range of €1.1bn to €1.2bn down to €1bn to €1.1bn in the 12 months to 31 March 2019.

It pinned the blame on lower winter fares, although chief executive Michael O'Leary expressed his hope the pressures on the industry as a whole would shake out some of the competition.

An update from EasyJet was better received despite flagging a £15m hit from the drone disruption at Gatwick in December as the company unveiled 13.7% revenue growth in the last three months of 2018 compared with the same period in 2017.

On 17 January Whitbread's (WTB) Premier Inn



operation was exposed to the harsh glare of the market post the £3.9bn sale of Costa Coffee to Coca-Cola. Investors largely ignored a £500m buyback to punish the company for a 0.6% decline in like-for-like sales.

The weak trading update raises question marks about whether investors will want to stick around once the proceeds from the Costa sale have been distributed as promised.

One of the more obvious casualties in the FTSE 350 was cyber security firm **Sophos (SOPH)** which updated on trading on 18 January. Wiping off more than a fifth of the company's market value, the market was spooked by the same concern which dogged a similarly poorly received update in November.

Namely the level of growth in billings, or new business invoiced in the period under review, is slowing.

Up just 2% in the third quarter and for the year-to-date, compared with 3% in the first half, billings offer a better measure of how sustainable growth really is as revenue, which was up 7.3%, can include income from previously-agreed contracts.



In the small cap space AIM-quoted **Arena Events** (**ARE:AIM**), which provides seating and other equipment and services for sporting, commercial and cultural events, hit the skids as higher-than-anticipated costs in its UK business led to profit downgrades.

With the shares diving to 37.8p, investors who participated in a £20m fundraising at 60p per share in September will be feeling particularly sore.



By Tom Sieber Deputy Editor

# SDL has recovery play credentials

Niche translation technology firm is finally starting to look like a growth company again

his is a technology company that has been on the UK stock market for close on two decades, yet we wouldn't be at all surprised to find most investors asking... SDL (SDL) who?

The Maidenhead-based business is a content management and language translation software and services specialist. It helps typically large multi-national clients manage their content across multiple platforms (web, mobile, print etc) in a multitude of languages and dialects.

For example, SDL has more than 3,300 enterprise customers, including 88 of the top 100 global brands in the world, according to analysts at Numis, and operates in 39 countries, de-risking to some extent its exposure to any single region or industry segment.

According to research, an organisation needs about 14 separate languages to reach about 75% of internet users worldwide. But accessing the other 25% means adapting an extra 40-plus languages.

That requires real specialisation of the sort provided by SDL. It helps clients really reach out to the limits of a geographic or cultural market by tailoring content in a way that is accurate, efficient and cost-effective.



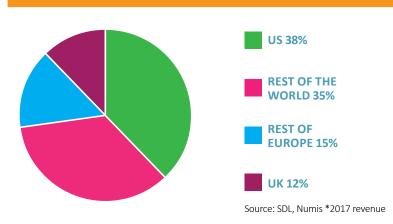
Most investors will have an obvious objection at this point. Doesn't Google Translate, Apple's Siri or Alexa by Amazon do this?

Frankly, no. SDL meets far more complex requirements, such as intricate and nuanced advertising campaigns, detailed legal papers, scientific and medical research and other confidential, sensitive and complex documentation.

That's what differentiates it from the impressive but fairly mainstream translation engines.

SDL does this either through its automated platform, Helix (the Language Technology division) or through its 1,200-strong team of in-house specialist translators (Language Services), supported by an army of 15,000-odd freelancers that can be called upon when needed.

#### WHERE SDL MAKES ITS MONEY\*



#### **SELF-INFLICTED WOUNDS**

Several years of weak end markets, poor execution and a handful of self-inflicted wounds saw SDL fall off the radar for most investors.

But the arrival in 2016 of current chief executive Adolfo Hernandez saw a root and branch rethink.

This, in turn, sparked a three year turnaround programme that would see SDL return to its translation roots, drive higher value revenues and invest in innovation.

Most of the heavy lifting of that plan has now been actioned and the results are starting to show through in operational and financial performance.

In its recent year end (to 31 December 2018) trading update the company was able to confirm revenue somewhere in the £323m to £325m range (marginally better than £322m consensus expectations) and underlying operating profit of no less than £28.5m, about £1m more than expected.

This should inspire increased confidence in mid-teens revenue growth this year and next that implies £399m of top line income in 2020, according to latest Numis estimates.

#### **SCOPE FOR OUTPERFORMANCE**

There may also be scope for outperformance as SDL extracts extra value from July's acquisition of DLS, a translation specialist to financial and life sciences clients where there is clear scope for operational improvement.

That would tally with underlying operational improvements still be made in the core SDL business, such as bringing around 80% of clients to its automated Helix Platform (lowering costs), streamlining the sales processes and using neural network machine learning and artificial intelligence linguistics.

If all goes well it could have a big impact on profit beyond underlying growth. For example, Peel Hunt estimates that 2017's operating profit margins of 7.7% will be closer to 8.5% for 2018, and could hit close to 10% by 2020, implying something like 50% operating profit growth over the next couple of years, to around £43m to £44m.

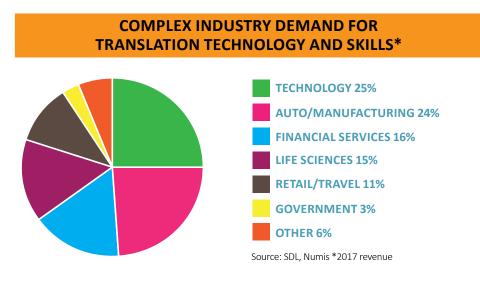
#### WHAT'S REQUIRED TO **ACHIEVE GROWTH**

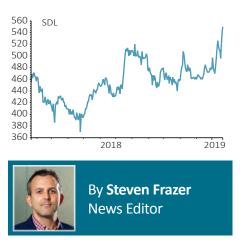
This sort of outcome will clearly rely on no serious deterioration in end market demand for its services. How a global recession might impact business is difficult to predict given the internationalisation of so much commerce these days.

It also requires management to deliver on the implied benefits from DLS (and any future acquisitions), getting integration right and extracting extra value. And the pressure will remain on to carefully balance nearerterm benefits for shareholders with longer-term investment in innovation.

Recent improvements in cash flow metrics are an encouraging development, another step along the road to rebuilding previously damaged investor sentiment. A 2019 price to earnings multiple below 20 (19.6) could re-rate rapidly if signs emerge that SDL is pulling off its return to quality growth status.

SDL is a higher risk investment but an ongoing commitment to a regular and growing dividend, albeit offering a modest 1.3% yield, demonstrates rediscovered financial discipline that some investors will welcome.





# **AFH Financial's** growth plan adds up

Wealth manager looks set for further expansion in funds under management

**IM-quoted AFH** Financial (AFHP:AIM) has grown rapidly in the last few years to become one of the UK's leading financial planning ledwealth managers with more than £5bn of funds under management (FUM).

Thanks to strong organic growth and the potential to add more customers through welltimed acquisitions, AFH could easily double its assets and profits in the near future.

#### **EXPERIENCE COUNTS**

The business was set up nearly 30 years ago by chartered financial planner and chief executive Alan Hudson to provide advice to high net worth clients.

The firm's 250 independent financial advisers (IFAs) are highly experienced in helping customers plan their financial future and they are backed up by in-house investment experts.

Unusually, client funds are managed in-house on an advisory or discretionary basis rather than being outsourced to big-name fund managers.

#### **ORGANIC GROWTH HELPED** BY STRUCTURAL DRIVERS

In the year to the end of October underlying growth in assets was 13% or £440m, marking a third successive year of doubledigit growth.

#### **AFH FINANCIAL 7 BUY**

(AFHP:AIM) 345p Stop loss: 276p

Market cap: £146.6m



Like-for like turnover was up 21% thanks to the increase in assets and greater demand for financial advice, while the gross margin was steady at 55% of revenues.

As well as providing advice and managing assets, AFH has a successful protection broking division offering life insurance and critical injury cover.

Historically these products were sold by the major banks on a face to face level but as

the banks cut back on staff and pulled back from the high street a gap appeared in the market which AFH was quick to fill.

In under two years the business has grown to 200 advisers and turnover of £9m with a gross margin of 45%.

#### **WELL-EXECUTED ACQUISITIONS ADD FURTHER GROWTH**

Like many other service industries, the IFA business is highly fragmented and AFH has seized the opportunity to acquire high-quality firms and teams often for five times earnings or less.

The firm has its own acquisitions team and thanks to its strong balance sheet, bolstered by organic cash-flow growth and two timely cash raises last year, it is equipped for further acquisitions.

Having already hit two of its three 2020 targets by the end of 2018, £5bn of FUM and a 20% EBITDA (earnings before interest, tax, depreciation and amortisation) margin, the firm has set out new targets.

In the next three to five years it is aiming for FUM of £10bn, an EBITDA margin of 25% and revenues of £140m.



By lan Conway Senior Reporter

### Small is beautiful



#### Seneca Global Income & Growth Trust plc

Our smaller size allows us to explore all investment opportunities.

The Seneca Global Income & Growth Trust plc is designed for investors seeking a quarterly income with long-term capital growth and low volatility. The Trust employs a proprietary Multi-Asset Value Investing approach. The core principle of value investing, buying good quality assets when they are under-valued, is applied to every investment decision we make.

We also think that small is beautiful. The industry is full of asset gatherers when it could be full of asset managers. Larger funds have a reduced investment universe because they find it difficult to invest in smaller assets. This may impair the ability to generate returns. Our smaller size allows us to explore all investment opportunities including ones our competitors cannot access. The less crowded areas of the market are a fertile hunting ground for under-valued assets.

In the UK equity market, we invest primarily in mid-caps, an area which has demonstrated long term outperformance, as many good quality assets are under-valued due to a lack of coverage.

Elsewhere, our size enables us to access a range of specialist investment trusts focused on property (REITs), infrastructure, leasing and other forms of finance, as well as private equity, many of which are too small or illiquid for larger funds to manage actively.

We use third party fund managers for overseas equities who like us, invest in smaller or mid-cap stocks in various global equity markets, where we believe the best opportunities lie.

Small is indeed beautiful!

#### Growth, Income and Low Volatility

- Our multi-asset expertise and approach have delivered successful outcomes for investors over the last five years\*.
- The Trust pays quarterly dividends, offering a current yield of circa 4.1%<sup>1</sup>. Over its last five financial years to April 2018 the Trust has grown its dividend at a compound rate of 4% per annum, ahead of CPI every year.\*\*
- Over a typical investment cycle<sup>2</sup>, we aim for the Trust to achieve a total return of at least CPI plus 6% after costs, with low volatility. In addition, we aim to grow aggregate dividends at least in line with inflation.
- Over the five years to end December 2018, the Trust delivered a NAV return of +35.7% with volatility circa two thirds that of the major equity indices<sup>3</sup>. Details of the Trust's returns can be found in the performance tables below.

Cumulative performance (%) to 31.12.2018	3 months	6 months	1 year	3 years	5 years
Trust share price	-4.7	-5.6	-5.6	24.2	46.4
Trust NAV	-3.5	-3.9	-4.8	22.6	35.7
Benchmark <sup>4</sup>	1.9	4.1	8.1	19.0	27.6

Discrete annual performance (%)	31st December 2018	31st December 2017	31st December 2016	31st December 2015	31st December 2014
Trust share price	-5.6	15.2	14.3	11.0	6.1
Trust NAV	-4.8	14.4	12.5	7.8	2.7
Benchmark <sup>4</sup>	8.1	6.3	3.6	3.6	3.6

#### Find out more about Seneca Investment Managers at senecaim.com or call us on 0151 906 2450

#### **Things To Be Aware Of**

<sup>1</sup>Current yield: the yield calculation is based on the latest quarterly dividend, annualised, compared against the month end share price.

<sup>2</sup>Seneca Investment Managers Ltd defines a typical investment cycle as one which spans 5-10 years, and in which returns from various asset classes are generally in line with their very long term averages.

There is no guarantee that a positive return will be achieved over this or any other period.

<sup>3</sup>Annualised volatility of returns over five years versus FTSE World ex-UK and FTSE All Share.

- <sup>4</sup>Benchmark: CPI plus 6% from 06.07.17. Previously LIBOR GBP 3 Months plus 3%, all after costs for the period ending 31.12.2018 a forecast CPI is used.
- \* The Trust has outperformed its benchmark over the last five years and has grown its dividends in excess of inflation over each of the last five financial years. It has delivered these returns with materially lower volatility than equity markets over the last five years.
- \*\* There is no guarantee that dividends will continue to increase or grow ahead of CPI.

Performance and dividend data sources: Seneca Investment Managers Ltd, Bloomberg & Morningstar. Share prices calculated on a total return basis with net dividends reinvested. NAV returns based on NAVs excluding income and with debt valued at par. Returns do not include current year revenue.

Past performance should not be seen as an indication of future performance. The information in this article is as at 31.12.2018 unless otherwise stated. The value of investments and any income from them will fluctuate, and investors may not get back the full amount invested.

Seneca Investment Managers Ltd does not offer advice to retail investors. If you are unsure of the suitability of this investment, take independent advice. Before investing you should refer to the Key Information Document (KID) for details of the principle risks and information on the trust's fees and expenses. Net Asset Value (NAV) performance may not be linked to share price performance, and shareholders could realise returns that are lower or higher in performance. The annual investment management charge and other charges are deducted from income and capital. The KID, Investor Disclosure Document and latest Annual Report are available in English at www.senecaim.com Seneca Investment Managers Limited is the Investment Manager of the Trust (0151 906 2450) and is authorised and regulated by the Financial Conduct Authority and is registered in England No. 4325961 with its registered office at Tenth Floor, Horton House, Exchange Flags, Liverpool, L2 3YL All calls are recorded. FP19 007

#### **KEYSTONE LAW**

(KEYS:AIM) 400p

Gain to date: 8.1% **Original entry point:** 

Buy at 370p, 20 December 2018





SHARES IN TOP 100 'challenger' law firm **Keystone** Law (KEYS:AIM) traded sharply higher on 21 January after the company revealed that full year profits will be 'comfortably ahead of market expectations'.

Keystone's platform model continues to attract experienced lawyers with new clients and strong trading in the second half of the firm's financial year has driven 'significant growth' according to chief executive James Knight.

A key factor in Keystone's growth is its ability to sell more and different services to existing clients as more lawyers join its network.

There is very little additional cost to Keystone when new lawyers join therefore its margins grow as fees rise and the business grows.

In the year to January 2018 the firm's margin of earnings before interest, tax, depreciation and amortisation (EBITDA) to sales was 10.3% against 9% the previous year.

The EBITDA margin forecast for the year to the end of January 2019 was 11.5% but thanks to today's announcement there is a good chance it will be higher.



#### SHARES SAYS: 🔊

Given the size of the UK legal mid-market, over 10,000 lawyers, there is plenty of room for Keystone to keep growing the number of lawyers on its platform and therefore revenues and margins.

#### COATS

(COA) 84.4p

Gain to date: 9.2% **Original entry point:** 

Buy at 77.3p, 20 December 2018





SOMETIMES PRICE isn't everything when selling assets. That is certainly the case with threads expert Coats (COA) whose disposal of its North America Crafts business for a mere \$37m (or 0.2 times revenue) may initially look a poor deal.

In reality selling the business for any price is strategically sound. It has been the only real problem area of the group and its sale to Spinrite leaves a more focused group firing on all cylinders.

Canaccord Genuity analyst Caspar Trenchard says the crafts business made 4% net margins versus 13.5% from Coats' industrial threads operations.

By removing crafts from the equation, group net margins expand from 12.3% to 13.5% and EBITDA (earnings before interest, tax, depreciation and amortisation) margins expand from 14.3% to 16.5%.

'Crafts was substantially diluting group returns,' says Trenchard. 'As a progressively higher margin business emerges investors can expect an expansion of the rating for the shares. Crafts has been a perennial distraction and its sale is, in our view, transformational.'



#### SHARES SAYS: 7

We flagged the crafts arm was the weak part of the business in our original article on Coats. Removing this operation from the business effectively removes one of the key risks to the investment case. Keep buying

#### **TRACSIS**

(TRCS:AIM) 603p

Gain to date: 17.1%

**Original entry point:** 

Buy at 515p, 22 February 2018

QUITE A BIT has happened since the start of the new year at **Tracsis (TRCS:AIM)** with the acquisitions of Compass Informatics and event traffic planning provider Cash & Traffic Management recently signed off.

These will bolster the Traffic and Data Services (TDS) part of the transport technology and analytics company, bringing extra scale, some new clients and offering good cross-selling opportunities. Both are classic Tracsis buys, relatively inexpensive, with solid profitable growth and recurring revenue.

This is important since TDS is the lower margin bit of the company, with earnings before interest, tax, depreciation and amortisation (EBITDA) margins of 12.5% last year. That compares to roughly 36% margins earned on Rail Technology and Services (RTS), the other part of the company.

But trumping that was news earlier in January that chief executive John McArthur is standing down. This is undoubtedly a blow since he has created huge value for shareholders in the 10-plus years on the stock market. The stock floated at 40p.

**Ricardo (RCDO)** executive Chris Barnes will take the company forward from 4 February, with a suitable handover period planned.

That McArthur will still be around in a consultancy capacity to help on future acquisitions is highly reassuringly that despite the management change, Tracsis will be sticking very much to its growth knitting.



#### SHARES SAYS: 🐬

Still a long-term buying opportunity.

#### **STRIX**

(KETL:AIM) 148.2p

Gain to date: 5.9%

Original entry point:

Buy at 140p, 26 April 2018



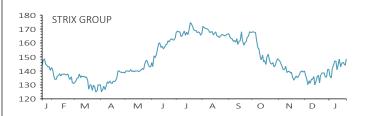
THERE'S A FEW nuggets of information from kettle controls manufacturer **Strix's (KETL:AIM)** latest update (22 Jan) worth noting, not least on the net debt front, where the best part of £10m has been shaved off since the end of June 2018 to £28m now.

That should mean more cash available to pay dividends in future, underlining the 7p per share payout for 2018 and a 10% increase anticipated by analyst in 2019, implying a 5.2% income yield.

The update is a little light on financial detail but investors are told that the underlying kettles market continues to grow at around the 7% mark (as expected) in spite of trade tensions.

We also know that Strix has maintained its market leading 38% share. One question that will need answering when full year results are published is to what extent robust volumes, and new lower cost U-9 series, may have had on profit margins.

In the meantime, the company continues to make excellent progress on its Aqua Optima water filter lines, where it now has a 25% market share in the UK.



#### SHARES SAYS: 7

Analysts continue to see the shares hitting 210p over the coming months despite the modest progress so far, and we have little reason to disagree. Still a buy.



The value of shares in Templeton Emerging Markets Investment Trust (TEMIT) and any income from it can fall in value and investors may not get back the full amount invested. Performance may also be affected by currency valuations. There is no guarantee that TEMIT will meet its objective. Full details of the risks of investing in TEMIT can be found in the Risk and Risk Management section of the current TEMIT Annual Report.

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# Why Germany is slowing down

We dissect Europe's largest economy and the funds which are most exposed

■ igures last week from Germany's Federal Statistical Office showed that gross domestic product (GDP) grew by just 1.5% in 2018, the slowest rate for five years.

That meant that GDP was barely positive in the fourth quarter, up by an estimated 0.1%. If the fourth quarter had been negative like the third guarter, which shrank by 0.2%, Germany would technically be in recession.

With China slowing, UK growth below its potential due to Brexit worries and the US hamstrung by the government shut-down, the last thing investors needed was bad news from Europe's largest economy.

#### **PUBLIC SPENDING AND INVESTMENT OFFSET WEAK EXPORTS**

The main areas of growth last year were government spending on big infrastructure projects, which rose by 3%, and company spending on plant and machinery which rose by 4.5%.

Ry contrast industrial

**Exports** 



production, which accounts for around a quarter of the economy, grew by 1% which was below forecasts and below the 2018 average.

Given Germany's role as a major manufacturer of industrial goods, exports are key to keeping the economy ticking over.

However, exports were also weaker than expected, up 2.4% instead of a forecast 2.8%.

The obvious assumption is that the slowdown was caused by protectionism and weak demand in non-EU markets, but that wasn't the case.

New manufacturing orders from non-EU countries were marginally lower last year, down 6%, but the big drop was in EU orders which were down 16%

In other words, the fall in demand for German goods has come from inside the EU not outside.

#### **WEAK CONSUMER SPENDING**

Another area of disappointment was household spending which grew by just 1% last year against a forecast of 1.6%.

In terms of big-ticket items, car sales showed a major slowdown in the fourth quarter.

Sales for the first nine months were up 2.4% at 2.7m vehicles, making Germany the biggest market in Europe, but in the final three months they were down 8% or nearly 70,000 units.

Germany is also the largest clothing and footwear market in Europe with estimated annual sales of around €55bn.

However, growth is anaemic with the government forecasting an increase in value of just 1.5% last year. Associated British Foods (ABF) owned Primark recently described the market as 'struggling'.

#### STRONG JOB MARKET NOT **BOOSTING CONSUMPTION**

Given that unemployment hit a 38-year low in November, similar to the UK, and core inflation is just 1.5%, household spending power is increasing.

In a sign of the tightness of the labour market, the UK recruiters Hays (HAS), PageGroup (PAGE) and Robert Walters (RWA) all saw a big jump in net fee income from Germany in their last quarterly results.

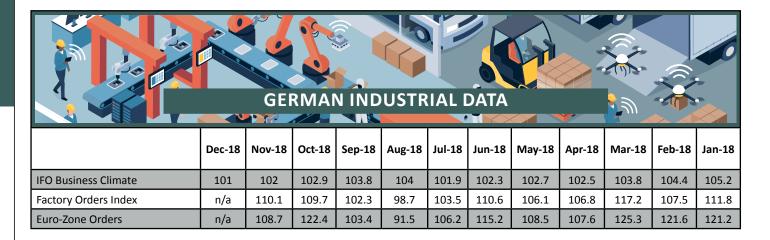
by contrast, industrial Torders which were down 10%.								
GERMAN GDP – BREAKDOWN								
German GDP	2016	2017	2018E	2019E	2020E			
Overall Growth	2.2%	2.2%	1.5%	1.8%	1.7%			
Private/Household spending	2.1%	1.8%	1.0%	2.1%	1.7%			
Public/Government spending	4.0%	1.6%	1.1%	2.3%	1.7%			
Spending on plant & equipment	2.2%	3.7%	4.5%	2.9%	3.3%			
Spending on construction	3.8%	2.9%	3.0%					
Imports	4 1%	4.8%	3.4%	4 2%	4 1%			

2.3%

4.6% 2016-18 figures from Destatis, price-adjusted, 2019-20 estimates from European Commission

2.4%

3.0%



Hays, the biggest recruitment firm in Germany by some margin, saw fees up 15% driven by demand for contract IT and engineering staff.

According to chief executive Paul Venables there are 'no signs of stress' in companies' hiring plans. Also wage pressures are rising as firms compete for qualified staff.

One major reason for consumers being reluctant to spend may be rising rents. Unlike the UK, most people in Germany rent apartments rather than buy houses.

Prices and rents went more or less nowhere from re-unification in 1990 until 2010, but in the last few years they have risen sharply.

It's not uncommon for a single person to have to spend over 40% of their monthly income on rent and services.

The government has offered tax incentives to increase the quantity of new houses until the end of 2021 but there is no cap on rents or any equivalent of the UK's Help To Buy scheme.

#### **GERMAN STOCKS PERFORMED POORLY LAST YEAR**

Investors in German stocks got a poor deal last year with the Dax index losing 18% of its value while the benchmark MSCI Europe index excluding the UK lost just 10%.

Germany's weighting in the MSCI Europe ex-UK index was 19.4% in December, so being overweight or underweight the country could make a big difference to fund performance.

The £5bn Jupiter European Fund (B5STJW8) has 33% of its investments in Germany, more than half as much again as the benchmark. The top two holdings are Adidas and Wirecard with a combined weighting of nearly 17% and a combined value of £850m.

In contrast the £1bn Janus **Henderson European Growth** Fund (3061769) has an 11% weighting in German stocks with only pharmaceutical firm Merck making it into the top 10 (at number 9, with a 2.6% weighting worth £26m).

The £1.1bn Schroder **European Alpha Income** Fund (B8VX2T6) has just a 7% weighting in Germany or less than half that of the index with no German stocks among the top 10 holdings.

#### **MILD RECESSION** ON THE CARDS?

Given that the official GDP

forecast for 2018 was too optimistic, we would expect forecasts for this year and next year to be cut.

The outlook for private spending and exports looks too high given what we now know.

Also, after strong growth in 2017 and 2018, spending on plant and equipment could fall short of estimates.

Concerns over the economy have been growing among German businesses according to the highly-regarded IFO survey.

Its Business Climate index fell to an 18-month low in December with manufacturers' and service providers' future expectations showing a sharp fall.

The IFO survey is often seen a lead indicator on businesses' spending plans and can be a good guide to industrial production figures.

It looks likely therefore that Germany could experience a 'mild recession' in the next 12 months, so we need to watch the economic data for signs of either a further slowdown or of a recovery in European demand.



By lan Conway Senior Reporter

# GLOBAL ENVIRONMENTAL OPPORTUNITIES: TRANSFORMING SUSTAINABLE INVESTMENT



anpur in northern India is known as the Manchester of the East, home to various heavy industries including leather, chemicals and fertilisers.

But, unlike its English twin, the Indian city's economic heft brings enormous side-effects.

Kanpur has gained notoriety as the most polluted urban centre in the world. According to the World Health Organization, Kanpur's three million inhabitants are breathing the air that is up to five times more polluted than its recommended safe limit.

Kanpur is not an isolated case. The WHO estimates pollution kills at least nine million and causes economic losses of USD4.6 trillion, equivalent to more than six per cent of global GDP.

Reversing man-made phenomenon damaging our environment such as pollution or soil contamination will take a monumental effort, involving consumers, businesses and governments. As stewards of global capital, investors will also have a crucial role to play.

But for them, the opportunity to bring about change has never been greater. That's because, with governments and businesses responding to growing public pressure to contain ecological degradation, a distinct group of environmental equity investments has emerged.

The environmental product industry is expected to grow to \$3tn by 2020 from \$2tn just a few years ago.<sup>1</sup>

At Pictet Asset Management, we have developed an investment strategy that focuses exclusively on this sector.

We construct our portfolio – which we call **Global Environmental Opportunities** – with a scientific, rule-based framework based on two novel tools, the Planetary Boundaries (PB) and Life Cycle Assessment (LCA).

The PB is a model that defines the ecological "safe operating space" within which human activities should take place. The PB sets ecological thresholds for nine of the most damaging man-made environmental changes (see chart). It quantifies a set of boundaries, which, if breached, would endanger the environmental conditions that have supported human prosperity over thousands of years.

<sup>1</sup> Source: Bloomberg, Pictet Asset Management

The LCA model calculates the waste emissions and resource usage of the 100 or so industries that makes up the global economy. The model analyses every activity in the production of a good or service: the extraction of raw materials, manufacturing processes, distribution and transport, product use, and disposal and recycling.

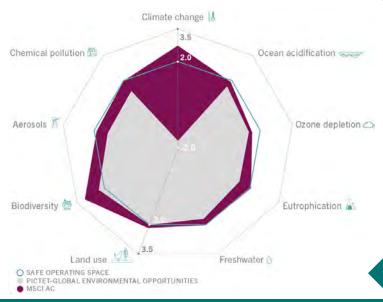
Here is an example of how our process works: The PB states that the ozone layer should be 276 millimetres thick. For the ozone hole to begin to close, the world's total emissions of ozone-depleting substances should remain below 6.6 billion tonnes per year. At the corporate level, this means that the threshold for the emission of such substances is set at 1.05 kg per £1m of revenue per year.

Only companies whose entire LCA-based emissions stay within the PB are eligible for inclusion in our investment universe of 400 stocks.

Combining the PB-LCA analysis with traditional company research, we then identify 50 or so stocks with the most promising investment potential.

Thanks to the emergence of thriving environmental products industry, investing to safeguard the natural world no longer means sacrificing returns. It can enhance them. For more information visit:

#### www.am.pictet/en/uk/individual



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# HOW INVESTMENT TRUSTS OFFER SOME PROTECTION IF THEY UNDERPERFORM

hen investors buy shares in quoted companies they know that their capital is at risk and that the companies they own could underperform or in the worst-case scenario go bust.

If a stock underperforms the market for a long period of time, sometimes a big activist investor will step in and demand changes in order to raise the value of the business and the shares.

Edward Bramson took a stake in Barclays (BARC)

to push for changes and try to increase the share price, while the most famous activist investor is Paul Singer whose Elliott hedge fund has built stakes in dozens of companies.

In the case of investment trusts, if an activist investor doesn't ride to the rescue there are measures which the managers and the shareholders themselves can use to try to limit the underperformance or if necessary to wind up the trust altogether. This offers a potential safety net for anyone who buys shares in an investment trust.

#### **BUYBACKS AND TENDER OFFERS**

One of the key features of an investment trust is its closed-end structure which means that the number of shares issued is fixed at inception.

If the investment trust's shares are underperforming and the discount to the net

asset value (NAV) of its holdings can't be kept 'within reasonable bounds', the number of shares in issue can be reduced through buybacks and tender offers.

A buyback allows the company to reduce the number of shares in issue which normally prevents the discount from widening and can increase the value of the remaining shares.

As Annabel Brodie-Smith, Director of Communications at the Association of Investment Companies (AIC), explains:

'This can provide an exit for uncommitted shareholders, adds value for existing shareholders and is comforting for investors as in many cases it proves an effective tool for the management of discounts.'

Shareholder approval is normally needed for a buyback and most investment trusts routinely ask their investors each year for approval to buy back up to 15% of their shares to 'manage' the discount to NAV.

This is the maximum amount generally allowed by investment trust rules without having to get further shareholder approval.

Purchases of more than 15% of the shares are normally made by way of partial or tender offers.

#### **HOW ARE BUYBACKS FUNDED?**

An investment trust has to have enough cash and 'distributable reserves' to buy back its own shares.

If an investment trust has been trading for many years it is likely to have built up a level of retained profits or 'capital reserves' which it can use to buy back its shares.

However newly-listed trusts or those whose assets have gone down since launch won't have any capital reserves so their only route to buying back shares is to use the 'share premium account'.

The share premium account is created when new shares are issued at a premium to their par value.

Since this is how most new shares are issued investment trusts should usually have enough in their share premium account if they need to fund a buyback.

#### THE PROS AND CONS OF BUYBACKS

When a buyback is used to purchase shares at a discount to NAV and cancel them, the NAV per remaining share increases.

This can also reduce the volatility of the shares and the volatility of the discount although it means there is less liquidity as there are fewer shares in issue.

It also means that ongoing charges increase as the investment trust's fixed costs are spread over a smaller number of shares.

As William Heathcoat Amory, head of investment trust research at Kepler Trust Intelligence points out, this combination is actually counter-productive: 'As the trust becomes smaller and the charges become larger the discount may widen further as the shares are considered less attractive'

If a buyback is used to try to reduce the influence of large and potentially hostile



shareholders, there is a risk that those shareholders refuse to take part in the buyback and their share in the investment trust increases.

'Share buybacks are not a panacea for all of investment companies' problems and will not work if there is no demand for a company due to sustained poor performance or other concerns. They also do not work when an investment company is invested in illiquid assets,' adds Brodie-Smith.

#### **TENDERS AND PARTIAL OFFERS**

If an investment company wants to buy back between 15% and 30% of its shares then it needs to make a tender offer.

These can be at a fixed price or a maximum price but either way they must be in cash and must be available to all shareholders.

Offers must be advertised in two national newspapers for at least seven days and all need approval from the Takeover Panel which rules on takeovers and mergers to ensure fair treatment for shareholders.

Partial offers are similar to tender offers but they can be for more than 30% of the company's shares and they are not limited to cash.

#### LIQUIDATION AND CONTINUATION VOTES

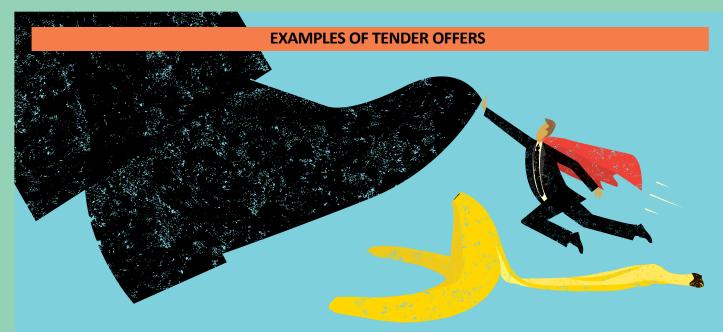
In extreme situations where the discount to NAV can't be reduced sufficiently, the running costs are disproportionately high or the investment trust has ceased to serve its purpose, the board could decide to liquidate the company.

For many small funds with large discounts to NAV and high costs, buybacks and tenders are no help as they will just increase their costs per share so liquidation may be the best option.

At the same time investment trusts usually have a provision which allows shareholders a say in whether the trust should continue trading. This is known as a 'continuation vote' and is normally triggered after a certain period of time, for example three years or five years after the fund is launched.

From this point shareholders are able to vote regularly on whether or not the trust should be wound up, the assets sold and the cash returned to them.

'Continuation votes are useful in more specialist or esoteric asset classes which may move in and out of favour and suffer prolonged periods of poor performance,' explains Brodie-Smith.



One investment company which regularly buys back its own shares is Aberdeen Emerging Markets (AEMC).

In February 2018 it announced its fourth tender offer in five years for up to 10% of its shares at a discount of 3.5% of NAV to narrow the discount which at the time was above 10%. In the event over 80% of the shares were

tendered so it had no problem buying back what it wanted.

Edinburgh Dragon Trust (EFM), also part of the Aberdeen stable, plans to tender for up to 30% of its shares at a 2% discount to NAV before the end of January 2019. The tender could be popular as the current discount is also in the region of 10%.

#### **GOING, GOING, GONE**

Despite raising the dividend by 80% last year in the hope of surviving a continuation vote, the board of **Lazard World Trust Fund (WTR)** got a resounding thumbs down from shareholders in September as they voted to liquidate the trust.

Last month Lazard announced that it would effect 'a managed wind-down of the company' so as to 'realise its assets in a controlled and orderly manner'.

In an unusual turn of events, the boards of two smaller investment companies, **Establishment** (ET.) and Juridica Investments, recently recommended that shareholders vote to wind them up.

Establishment, whose market value had shrunk

to just £40m in mid-November, blamed its decline on its large exposure to Asia and admitted that keeping the trust going was 'not an attractive option for shareholders'.

Analysts at stockbroker Numis says 'performance has been poor, with the NAV up just 20% over the past five years versus 65% for the MSCI World Index'. They believe Establishment may seek to appoint a new manager to grow the fund via a different mandate, rather than disappear altogether.

Juridica, which invested in corporate claims litigation, recommended liquidation as 'the costs to shareholders of continuing the company in operation' were 'outweighed by the benefits of winding up'. It delisted from AIM in December.

#### INVESTMENT TRUSTS WITH UPCOMING CONTINUATION VOTES

Trust	Code	Discount to NAV	Net Assets	Date of continuation vote
JPMorgan Indian	JII	13%	£840m	Jan-19
River & Merc UK Micro Cap	RMMC	16%	£85m	Feb-19
Ecofin Global Utilities	EGL	12%	£150m	Mar-19
BlackRock World Mining	BRWM	12%	£685m	Apr-19
Herald	HRI	18%	£900m	Apr-19
Aberdeen New Thai	ANW	13%	£105m	Jun-19
Invesco Asia	IAT	11%	£205m	Aug-19
Blue Planet	BLP	14%	£20m	Aug-19
Oryx International Growth	OIG	13%	£130m	Aug-19
Aberdeen New Dawn	ABD	13%	£280m	Aug-19
JPMorgan Brazil	JPB	19%	£25m	Sep-19
Strategic Equity Capital	SEC	16%	£150m	Nov-19
TR European Growth	TRG	13%	£445m	Nov-19
City Natural Resources	CYN	15%	£70m	Nov-19
Strategic Equity Capital	SEC	16%	£150m	Nov-19

#### **TROUBLE AHEAD?**

Research house Numis has compiled a table of investment companies with sizeable discounts to NAV where continuation votes are due this year. We publish the list in full in this article.

Many are below £100m in value, which is increasingly considered sub-scale these days, and may come under pressure from their shareholders.

Numis flags Aberdeen Frontier Markets (AFMC), Aberdeen Latin American Income (ALAI), Baring Emerging Europe (BEE), Jupiter Green (JGC) and Jupiter UK Growth (JUKG) as looking vulnerable.

Even some larger funds which suffer persistent discounts or long-term underperformance could come under pressure according to Numis.

Edinburgh Investment Trust (EDIN), which has a market value of £1.25bn and takes a 'value' approach to investing, has posted negative share price and NAV returns over the past year and faces 'a crucial year in terms of maintaining investor confidence'.



By Ian Conway Senior Reporter





# ARE YOU MISSING OUT?

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## Balance sheet clean up in renewables trusts space

Deleveraging could cap share prices short-term, creating potential opportunity to buy at a discount

everal renewables investment trusts could issue a flood of new shares over the coming months, speculate analysts, after a blitz of project funding.

Greencoat Renewables (GRP),



Greencoat UK Wind (UKW) and NextEnergy (NESF) are in the frame, while Foresight Solar (FSFL) is expected to refinance circa £70m of existing debt facilities by the end of June.

'We have reviewed commitment and leverage levels and conclude that given the increasing levels of leverage, a number of the funds are likely to be looking to issue equity in the first half of 2019,' says the investment trust team at broker Stifel.

More than £700m has been lavished on various solar and wind farm sites across the UK. Ireland and Sweden since the end of September 2018. That has left the balance sheets

of some trusts stretched, prompting an anticipated spell of deleveraging.

While this would in theory cap share price returns in the short term Stifel believes it could also provide investors with discount access to an otherwise booming clean energy industry.

Popular industry trusts John **Laing Environmental Assets** (JLEN) and The Renewables Infrastructure Group (TRIG) have already fired the starting gun on the process having slashed debt to zero late last year.



By Steven Frazer **News Editor** 

## **Henderson Smaller's** half-year hurt

Gearing impacted trust's half time performance, yet manager Neil Hermon is still seeing 'exciting growth opportunities'

irst half results (18 Jan) from **Henderson Smaller Companies Investment** Trust (HSL) reveal a rare period of underperformance.

But manager Neil Hermon, who has outperformed the benchmark in 14 of the past

15 financial years, insists his universe 'continues to throw up exciting growth opportunities' and M&A 'remains a supportive feature'.

For the six months ended 30 November, the trust delivered a net asset value



(NAV) total return of -15% versus a 10.1% decline for the Numis Smaller Companies benchmark.

Albeit reduced during the period, 'gearing was a negative contributor to performance as markets fell but has been a significant positive over the near-16 years I have managed the investment portfolio', explains Hermon.

Performance was also hurt by the likes of flooring maker Victoria (VCP:AIM), sports footwear seller Footasylum (FOOT:AIM) and housebuilder Bellway (BWY).

New portfolio additions include pharma products play **Alliance Pharma (APH:AIM)**, financial services software firm

**Microgen (MCGN)** and subsea systems protection products play **Tekmar (TGP:AIM)**.

'Although M&A has been subdued in 2018, there is an expectation that once there is clarity over Brexit there will be increased interest in UK corporates from abroad, given the relatively low valuation of UK equities and a weak currency', insists Hermon, who was able to raise the first half dividend 8.3% to 6.5p thanks to continuing strong dividend growth from his portfolio.



By **James Crux**Funds and Investment
Trusts Editor





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### **HOW I INVEST:**

# Aiming to buy a house and live comfortably in later life

Aaron from North Somerset is investing to achieve three goals



ew dad Aaron has a clear plan which he hopes will result in a comfortable life for his family.

He wants to buy a house in around five years' time, retire aged 60 and have sufficient money invested so that, based on projections, he and his partner won't have to contribute any more cash into long-term savings by the time they are 50.

Engaged to be married and recently celebrating the birth of his first child, Aaron is in his early thirties and invests in shares, funds and investment trusts.

He puts money into three main wrappers: half of his assets are held in a SIPP (self-invested personal pension) and the rest split equally among a stocks and shares ISA for retirement or as back-up rainy day money, and a Lifetime ISA for helping to fund his first property.

The Lifetime ISA only contains cash because Aaron and his partner are worried about shares and funds losing value in the short-term, so they don't want to risk their savings reducing in value just at the point at which they need the money to buy a house.

A fourth account has just been opened, namely a Junior ISA which is primarily for his daughter's grandparents to use as a savings vehicle for her. Aaron hopes he can also gift some of his own money to her later in life for a big event such as a wedding or a house purchase. 'My SIPP (tax-free) lump sum should be

available right around then!' he remarks.

My friend and I often chat about investing. I've recommended peer-to-peer lending to him

#### **INTERESTED IN TECHNOLOGY**

Aaron selffunded a career move in the early 2000s by retraining as a data scientist, during which

time he had limited disposable income to start investing. It wasn't until afterwards that he became serious about investing.

Technology has subsequently become a big theme in his investment portfolio with current holdings including Google's parent company Alphabet, retail giant Amazon, telecoms group BT (BT.A), Ocado (OCDO) which has developed software and systems to power online grocery retail platforms, and electric vehicles expert Tesla.

'Alphabet, Amazon, Ocado and Tesla all understood the importance of robotics and machine learning ahead of many other companies in my opinion,' says Aaron. 'As well as the desire, they have successfully implemented the infrastructure required to collect, analyse and exploit that data.

'I bought these shares several years ago and they make up the majority of my gains. I was reading about BT and how much digital infrastructure the company owns, took a look at the share price and thought it was massively undervalued so bought the shares to hold.'

The investment in Tesla was spurred by a conversation with a friend from university who piqued Aaron's interest in the business. 'My friend and I often chat about investing. I've recommended peer-to-peer lending to him after having some good experience and so he gave it a go.'

#### UNDERSTANDING THE RISKS

Aaron says he likes to own shares in individual companies if he understands the 'value proposition' and envisages that they will do well. 'I'm happy to take the extra risk of holding these directly as these companies are built on foundations related to my profession, software engineering and data science, and I feel I'm convinced of their value.'

However, the recent birth of his child has prompted a slight change in strategy whereby he intends to focus more on funds and investment trusts, albeit keeping his existing stocks.

This strategy is an attempt to reduce volatility in the portfolio and gain exposure to sectors which he doesn't understand 'and would therefore benefit from the expertise of a fund manager or just track an index', he adds.

So far his foray into the funds world has included investments in Jupiter Asian Income (BZ2YMT7) and AJ Bell Passive Balanced (BYW8RX1).



By **Daniel Coatsworth Editor** 

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Please note, we do not provide financial advice and we are unable to comment on the suitability of any investments you have made. If you're unsure please consult a suitably qualified financial adviser.

# Is relief on the way for mortgage prisoners?

Some people stuck on expensive rates could be in line for help

round 140,000 people in the UK are trapped in expensive mortgage deals, unable to switch to a better rate thanks to a frustrating quirk of regulations.

These homeowners, dubbed mortgage prisoners, have fallen onto their lenders' standard variable rate, which is usually the highest interest rate mortgage offered, and is the default rate for those whose fixed-rate deals have ended.

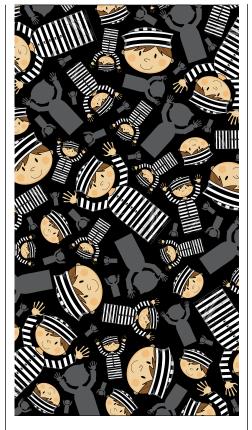
While some homeowners may slip onto this high rate temporarily, because they failed to secure a new, cheaper mortgage deal in time or forgot to do so, mortgage prisoners are trapped on these rates and unable to switch away.

This is because these individuals took out their mortgage before the financial crisis and before new regulations came into place, which place additional affordability checks on individuals applying for a mortgage.

These homeowners end up in the perverse situation where they are told they cannot afford to move to a cheaper deal, even though it would cost them less per month than the current high rates they are paying.

#### WHAT IS A STANDARD **VARIABLE RATE?**

Standard variable rate mortgage rates move in line with changes



in the Bank of England base rate, meaning these homeowners have seen their interest, and so their monthly mortgage repayments, ratchet up as the Bank has increased interest rates.

They are the default rate for mortgage providers and are far more costly than the best rates that same lender will offer. As an example of how bad value these rates are, from our research of a sample of the biggest mortgage lenders the average homeowner on their lender's standard variable rate is paying £3,500 a year extra in interest (based on a £200,000 25-year loan).

For example, HSBC's current

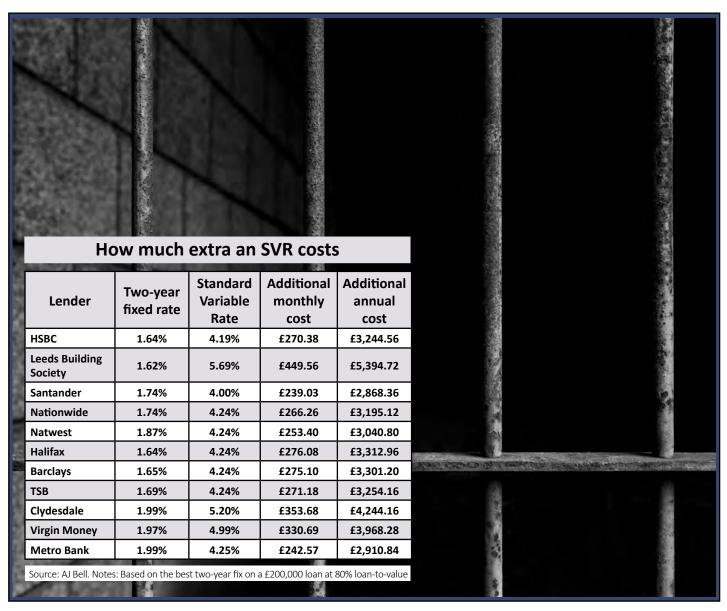
standard variable rate is 4.19%, compared to its two-year fixed rate on an 80% loan-to-value of 1.64%. On a £200,000 loan that works out as £3,245 more each year. The worst offender is Leeds Building Society, with homeowners offered 1.62% as the best two-year fix for a £200,000 mortgage on an 80% loan-to-value, which jumps to 5.69% when they get pushed onto the standard variable rate – costing almost £5,400 a year more.

#### WHY ARE SOME PEOPLE TRAPPED ON THESE RATES?

New regulations introduced after the crisis, known as the Mortgage Market Review, mean that customers face stricter affordability tests. The rules were intended to stop lending to people who ultimately couldn't afford it.

However, it means that anyone who took out a mortgage before the regulations will face tougher tests when they come to remortgage, meaning they could find they don't pass and so are not approved. They are then stuck in limbo - they can continue on their current, poor value, deal but are unable to switch elsewhere.

This is also true if they just want to switch to a better rate with their current provider, as well as if they want to switch provider.



The Bank of England estimates there are 140,000 mortgage prisoners. 10,000 of those are with mortgage lenders who are still operating in the market, while 20,000 are with firms that are classed as "inactive" so are no longer issuing new loans.

The bulk of the group, at 120,000, are with firms whose book of mortgages have been sold on to non-mortgage lenders, for example people with a mortgage with Northern Rock whose mortgages were sold on to investors.

The City regulator, the Financial Conduct Authority, has

already made progress with the first group, the 10,000 who are still with active mortgage lenders, and those who are not in default and not looking to borrow more should now find it easier to switch to a better rate.

The latter two groups are a harder problem to solve, as their lender doesn't offer new mortgages anymore. However, the regulator said this month that it plans to loosen the affordability criteria to allow these homeowners to switch to a better deal.

It proposed moving from an

'absolute' to a 'relative' test of affordability – put simply, if the new mortgage costs less each month than the existing one, it's likely the customer can afford it.

Again, this will only apply to those homeowners who are not trying to borrow more. Homeowners who are in arrears, have very high borrowing relative to the value of the property, have large debts or are in negative equity will be unlikely to benefit.



By **Laura Suter**AJ Bell Personal
Finance Analyst







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**SHARES** 

# 'Will I breach the lifetime pensions allowance?'

Our expert answers an NHS doctor with 30 years in a defined benefit scheme

#### Simon

'I'm consulting doctor for the NHS based in London. I've been in the pension scheme since I started working 30 years ago and am worried about breaching the lifetime allowance.

'What are the rules and is there anything I can do to protect myself?'



By **Tom Selby**AJ Bell Senior Analyst

As you're in a defined benefit (DB) pension scheme the way the lifetime allowance is calculated is a little more complicated than for a defined contribution (DC) scheme.

To recap, the lifetime allowance for UK pension savers is currently set at £1,030,000. This will increase to £1,055,000 – in line with Consumer Prices Index (CPI) inflation – in 2019/20.

For those in a DC scheme like a SIPP, the amount of lifetime allowance you use will be 'tested' by HMRC whenever a 'benefit crystallisation event' occurs. All that means is that your fund is converted into a retirement income, usually by entering drawdown or purchasing an annuity.

For example, if someone with a £2m DC pot used £500,000 to buy an annuity, they would have

used £500,000 of their lifetime allowance.

A further lifetime allowance test is applied at age 75.

DB schemes are different because rather than saving a pot of money you build up rights to an income based on your salary. For each year you're in the scheme you'll be promised a proportion of your salary (either career average or final) as a retirement income – usually this lies somewhere between 1/50th per year and 1/80th per year.

For example, if you'd been a member of a final salary scheme with a 1/60th accrual rate for 30 years and your final salary at retirement age was £50,000, you'd receive 30/60ths of that amount, or £25,000, a year.

This amount will usually be inflation protected and your spouse (if you have one) will likely be entitled to 50% of your pension if you die before they do.

To figure out how much lifetime allowance you have used, a fairly crude multiple

of 20 is applied to your annual entitlement. So in the example above the person has used £500,000 (20 x £25,000) of their lifetime allowance. Any tax-free cash you take will also be added to this figure.

If you do breach the lifetime limit you could end up facing a tax bill from HMRC. Unfortunately there are no easy answers for those who find themselves in this situation.

It's worth considering applying for 'fixed' or 'individual' protection as these may allow you to benefit from a slightly higher lifetime allowance. You can find out more about the rules here: https://www.youinvest.co.uk/pensions-andretirement/pensions-explained/lifetime-allowance.

The other unpalatable options available include reducing your hours, stopping working altogether or quitting the scheme. Before taking any drastic action of this nature it's worth speaking to a regulated adviser to assess your options.

#### DO YOU HAVE A QUESTION ON RETIREMENT ISSUES?

Send an email to **editorial@sharesmagazine.co.uk** with the words 'Retirement question' in the subject line. We'll do our best to respond in a future edition of *Shares*.

Please note, we only provide guidance and we do not provide financial advice. If you're unsure please consult a suitably qualified financial adviser. We cannot comment on individual investment portfolios.

# Explaining stop losses and how they work

These instruments can be used to limit losses, but are they really suitable for genuine long-term investors?

he risk of loss is a reality for all investors so using a stop loss to sell shares if they fall to a certain price sounds like an ideal solution, but the reality can be different.

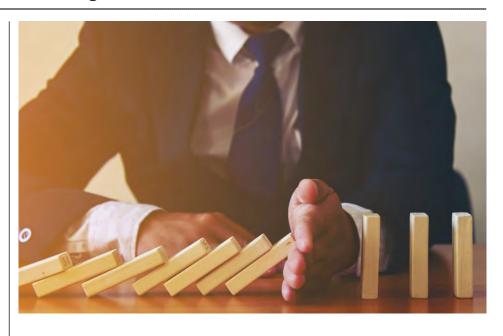
Stop losses send an alert to a stockbroker when a share hits a certain price and instructs them to sell the shares on behalf of an investor.

As with the sale of any asset, a buyer is required. If shares are in freefall on the back of a profit warning, for example, it can be difficult to find a buyer at the designated stop loss, potentially leaving investors with a larger than anticipated loss. This is known as 'slippage'.

Informed Choice Independent Financial Planning spokesman Martin Bamford says stop losses are mainly used by traders and professionals to manage risks when trading on a daily basis.

He argues speed plays a huge role in selling quickly as 'microseconds actually count' and these tools offer a safety blanket of sorts, although he stresses stop losses never guarantee selling at a certain price.

Bamford says retail investors generally avoid stop losses thanks to their long-term investment strategy and acceptance that volatility is 'the price you pay' for getting involved in the stock market.



#### **BASIC, GUARANTEED OR TRAILING?**

The most common form of stop loss is triggered when shares in a company go below a specific level. For example, if you set a stop loss on a share at £1, a request to sell will be triggered when the price goes below £1.

Guaranteed stops aim to ensure your position is sold at the specified level - but this method will cost you extra in the form of a premium charge.

Trailing stops work differently by simultaneously trying to help protect profit and limit losses.

Instead of setting a single sell-out point, several points are set up at a higher level than the original price. If the shares go higher, the trailing stop will move upwards with it.

For example, someone could

place a trade on Lloyds (LLOY) at a price of £40.90 with a trailing stop loss of five points (£35.90). If the stock hits £55.90, the trailing stop will then be £50.90.

#### **DO STOP LOSSES ACTUALLY LIMIT LOSSES?**

'Stop loss is a misleading name, it should be named guaranteed loss', cautions 7IM chief strategist Terence Moll who believes the tool gives the illusion investors can limit their losses.

Share prices generally tend to bounce back within a matter of days or weeks says Moll, although he concedes stop losses are useful for day traders.

Declines in share prices can be a buying opportunity, allowing investors to scoop up more shares at a cheaper price.

If the fundamentals of the

business have not changed, Moll says investors may consider topping up their position.

According to Moll, a better approach for investors would be to decide on their own 'review point'. So, if the shares move higher or slip lower to a certain price, investors should use this as a catalyst to reflect on whether they want to buy, sell or hold their position.

#### **BREXIT BLUES**

The fallout on 24 June 2016 from the UK voting to leave the European Union exposes how stop losses could in theory do more harm than good.

Car insurer Admiral (ADM) is a prime example of how rash selling can impact investors. The shares slumped 14% in early trading on 24 June - but it did not remain this way for long.

By the end of the day, the stock was only 2.2% lower and was up 5.9% a month later. Investors who had set a stop loss 10% below the previous close, for example would have crystallised a double-digit loss when a recovery in the shares was just around the corner.

Being patient would have paid off with fellow insurer Prudential (PRU), which initially plummeted 17.7% on 24 June but recovered to a dip of just 1.3% a month later.

#### **CAN STOP LOSSES ACTUALLY LIMIT LOSSES?**

Naturally there are examples of where a stop loss might have spared you greater pain, shares in embattled Thomas Cook (TCG) were near six-year lows at 37.5p in November,





after a damaging profit warning (27 Nov).

Speculation over its financial position and short selling wiped another 15% off the company's value on 4 December, several days after this warning.

If investors had set a stop loss which was triggered by the profit warning, they would have limited further losses in the short term as the shares eventually fell to a low of 22.7p.

For investors trying to decide

whether to use stop losses, you need to figure out whether you have a long-term view and if you are ready to ride out volatility and regularly review when to potentially sell current holdings. If you can do this, stop losses arguably have few additional benefits to offer.



By Lisa-Marie Janes Reporter



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# Why you should not be blinded by Vodafone's 9.5% yield

Investors should not been drawn in by dividends as substantial challenges need to be overcome

he dividend yield on the FTSE 100 for 2019 is estimated at 5%, according to the latest forecast data from Link Asset Services' Dividend Monitor.

By contrast **Vodafone's (VOD)** forward 12 months income yield stands at around 9.5%, adjusting for its 31 March year end, according to Numis' calculations. Being so out of kilter with its blue-chip peer average tells investors something important; either the share price is too low, or the dividend forecast is too high.

In our view, though there are

routes by which Vodafone could return to a sustainable dividend growth path, there are better supported, perfectly generous yields in the FTSE 100. We also reckon there are serious question marks about the long-term investment case for the business.

This year to 31 March 2019 the mobile giant is expected to hand shareholders €0.1507 per share. Vodafone switched from reporting in pounds to euros in 2016. If forecasts are right this financial year will be the first in two decades when the payout has been held flat.

Between 2001 and 2014 Vodafone's dividend growth far outstripped inflation, increasing by more than 5% every year bar one (2009), and showing double-digit increases on several occasions.

Since 2015, however, the dividend growth engine has started to run out of steam. Few analysts feel brave enough to forecast anything other than pedestrian increases in the payout over the next two or three years, if any.

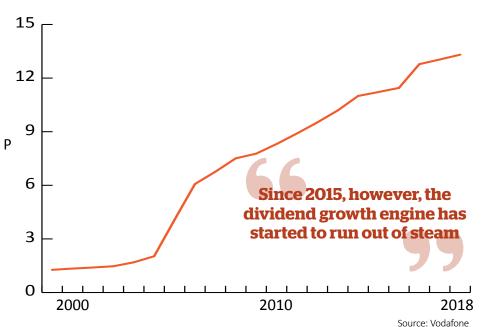
#### THE CASE FOR A PAYOUT CUT

Question marks over Vodafone's future dividends centre around huge borrowings, biting competition and potentially significant investment needed in new radio wave spectrum for 5G services, or fifth generation mobile networks that will allow users to send more data far faster over the internet.

These are all valid potential trouble spots, but it may be that investors are over-egging the negative mood.

At the end of this year to March Vodafone is forecast to have net debt of around €32bn sat on the balance sheet. That would imply a net debt to earnings before interest, tax, depreciation and

#### **VODAFONE'S DIVIDEND TRACK RECORD**



Source: Vodafone 2016-2018 dividends conerted from euros



amortisation of 2.2 times based on consensus forecasts.

Typically lenders and bond holders start getting nervous when this metric tips the scales at more than three-times.

On the competition front, it's been a bit of a blood bath in both Spain and Italy (where roughly 25% of revenue stem from), while the UK has stubbornly refused to growth for a while now. Yet those pressures seem to be abating bit by bit, particularly in Italy where prices are starting to rebound after aggressive promotions by local rival Iliad.

> A change at the top is typically a prime time to rethink strategy and any dividend commitment to investors

These issues have also masked Vodafone's success elsewhere in Europe, and in emerging economies in Africa, the Middle East and Asia Pacific (AMAP).

If these trends continue it could relieve substantial pressure on the balance sheet.

#### **GO FASTER INTERNET**

The final point is capital expenditure. Multiple 5G spectrum auctions are due over the next couple of years – the UK, Germany, Spain, South Africa the main ones.

Vodafone estimates €1.2bn a year will be needed to fund this investment and while there is the chance that one-off auctions prove more expensive than budgeted, the company's has gone on record to express its confidence that its crunched numbers are right.

All of this should mean that estimated free cash flow will remain in the €5.1bn to €5.3bn range for the foreseeable future, versus the annual €3.92bn cost of the dividend.

One hint towards a brighter outlook for Vodafone might be the absence of a cut so far despite the glaringly obvious opportunity to do just that.

When Vittorio Colao stood

down as chief executive officer (CEO) after 10 years of running the show there was the readymade replacement of Nick Read to take the top job (since 1 October 2018). He had previously been the chief financial officer so was already well known in City and investment circles.

A change at the top is typically a prime time to rethink strategy and any dividend commitment to investors. Half year results announced on 13 November was that opportunity for Vodafone to rebase its payout promises, yet the company chose not to do so.

Vodafone has even laid out plans for a return to dividend growth, this aim is ambitious but will be aided by a new swathe of operational cost cutting being implemented by new CEO Nick Read, and should also be helped by the cable assets being acquired from Liberty Global in Europe.

If all goes well analysts at Numis predict a steep share price re-rating back to 220p over the next year or so. We're not so sure.



By Steven Frazer **News Editor** 



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# Is broking research any use or not?

We look at how often analysts get it right

t just under 3,900, the FTSE 350 index stands about 10% below its mark of a year ago, which may depress some investors, especially those less experienced ones who did not experience the bear markets, of 2000 to 2003 and 2007 to 2009 or – going further back the Asian crisis of 1997-98 or the Black Monday crash of 1987.

But it has still been possible to make healthy gains. Five stocks – Ocado (OCDO), Hikma (HIK), Pearson (PSON), QinetiQ (QQ.) and El Group (EIG) – are all up by 40% or more over the past 12 months and another 18 FTSE 350 firms' shares advanced by 20% to 40%.

Unfortunately it has been easy to lose money as well. Ninety-two FTSE 350 stocks fell by 20% or more, including 15% shed more than 40% of their value. The four worst performers – British American Tobacco (BATS), Intu (INTU), Indivior (INDV) and Superdry (SDRY) – all more than halved.

This begs the question of how investors can find winners – or at least avoid portfoliodamaging losers.

#### **PICK AND CHOOSE**

One possible way is to at least narrow down an index as big as the FTSE 350 could be identify which firms are more and least preferred in the research written by analysts at the leading investment banks and broking firms. Granted, this is primarily intended for institutional investors but websites such as www.uk.webfg.com and the Broker Forecasts section of *Shares'* own website provide a summary of how many analysts cover a stock and how many rate the stock a 'buy' or a 'sell' (or are sat on the fence with a 'hold').

However, a back-test of the data on the most and least popular stocks at the start of 2018 suggests that this research needs to be treated with kid gloves, especially when it comes to the FTSE 350.

As if to reinforce US investor Jim Rogers' view



that 'The more certain something is, the less likely it is to be profitable', the ten FTSE 350 firms which last January attracted the highest percentage of 'buy' ratings among the analysts only just beat the 13% capital loss generated by the FTSE 350 in calendar 2018. Just three of the ten rose in value.

In defence of the analysts at least the stocks that they most actively disliked did worse than the FTSE 350, with an aggregate 18.8% loss of value. Only two of those 10 stocks rose and one – Fidessa – was the subject of a bid, to confound bears of stocks.

#### **WEALTH WARNING**

The following conclusions can be drawn from this data:

 Seeking safety with the crowd by selecting the most-widely tipped FTSE 350 stocks did not work as a strategy. Instead it damaged investors' wealth.

While it is tempting to cut analysts some slack by noting that 2018 was a tough year, this the fourth year in which AJ Bell has conducted this survey - and the analysts' combined top picks fared no better than the benchmark index in 2015, 2016 or 2017.

 The analysts did a better job in avoiding trouble as the stocks with the highest percentage of 'sell' ratings lived down to their billing and did badly.

The temptation to simply blindly do the opposite to the consensus should therefore be resisted. not least as the past is no guide to the future and because if making money in the markets was that simple then every one would already be doing it. Anyone prepared to pick their own stocks rather

#### The most widely avoided stocks did at least fall sharply in value in 2018

FTSE 350 by Sells	Buy	Hold	Sell	Sell	2018
				%	performance
Renishaw	1	2	5	63%	(18.9%)
Sports Direct	1	1	3	60%	(36.9%)
CYBG	1	7	8	50%	(46.7%)
Fidessa	1	2	3	50%	52.7%
PureCircle	1	0	1	50%	(45.2%)
Antofagasta	5	8	12	48%	(22.1%)
Marks & Spencer	8	6	12	46%	(21.5%)
Wetherspoon JD	2	5	6	46%	3.7%
Metro Bank	2	4	5	45%	(52.8%)
Rolls Royce	4	6	8	44%	(0.6%)
Total					(18.8%)
FTSE 350					(13.0%)

Source: Webfg, Broker Forecasts, Refinitiv data

than pay a fund manager or index-tracker fund to do it for them must therefore thoroughly research any company for themselves before they even think about buying it shares.

If this sounds difficult, well, it is but at least investors can follow the lead of successful American investor Charlie Munger – Warren Buffett's vice-chairman at Berkshire Hathaway – who boils it down to four things:

- One, do you understand the business?
- Two, does the business have intrinsic value or durable competitive value?
- Three, does management have integrity?
- Four, does the stock come at a reasonable valuation?

Equally, if an investor likes what they see, they should not be put off just because they are out of step with consensus – they may have unearthed a nugget of value, assuming the stock passes the first three of Munger's tests. Then they may be heeding Warren Buffett's maxim that 'you can't buy what is popular and do well.'

#### THE YEAR AHEAD

With this year in mind, investors might like to know which stocks are most liked - and disliked by analysts. The two tables below list the names which investors may wish to research - or avoid like the plague – depending upon their view of the value of the research provided.

#### The ten stocks most popular with analysts at the start of 2019

FTSE 350 by Buys	Buy	Hold	Sell	Buy
Avast	9	0	0	100%
Polypipe	6	0	0	100%
Coats	5	0	0	100%
BCA Marketplace	4	0	0	100%
Energean Oil & Gas	4	0	0	100%
St. Modwen Properties	4	0	0	100%
Telecom Plus	4	0	0	100%
CLS	3	0	0	100%
Primary Health Properties	3	0	0	100%
Sirius Minerals	3	0	0	100%

Source: Webfg, Broker Forecasts

#### The ten stocks least popular with analysts at the start of 2019

FTSE 350 by Sells	Buy	Hold	Sell	Sell
Pearson	1	7	10	56%
Marks & Spencer	3	7	11	52%
Millennium & Copthorne	1	0	1	50%
Sports Direct	1	1	2	50%
Admiral Group	3	6	9	50%
Royal Mail	1	8	8	47%
Wetherspoon JD	5	3	6	43%
IWG	1	3	3	43%
Hargreaves Lansdown	1	7	6	43%
TalkTalk Telecom	3	6	6	40%

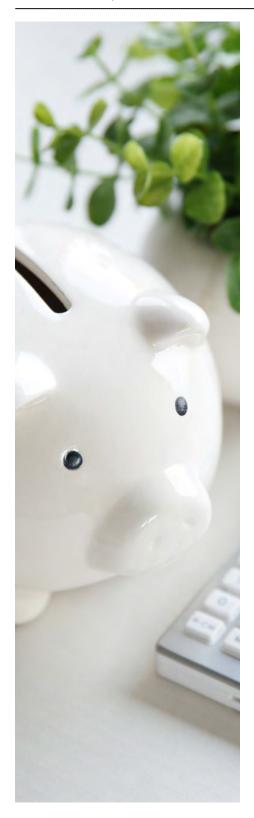
Source: Webfg, Broker Forecasts



By Russ Mould AJ Bell Investment Director

# The case for investing in micro caps through funds

Attractively valued smaller companies could help diversify portfolios



acroeconomic uncertainties, the return of volatility and political turmoil suggest diversification will prove a key investment watchword in 2019.

One way in which investors can diversify portfolios is by allocating funds to UK micro caps, often agile and fastgrowing minnows offering better value relative to larger caps; they fly under the radar of big institutional investors and are generally less well researched than their larger corporate cousins.

#### **'MINI' IS READY TO MOTOR**

Open-ended funds offering specialist exposure to the asset class include Liontrust UK Micro Cap (BDFYHP1), LF Gresham House UK Micro Cap (BV9FYS8) and FP Octopus UK Micro Cap Growth (BYQ7HN4).

In the investment trusts (closed-ended) universe, Shares recently enjoyed a briefing with smaller companies guru Gervais Williams, who co-manages **Miton UK Microcap Trust (MINI)** alongside Martin Turner, a collective currently trading at a 4.2% discount to net asset value (NAV).

For the half year to 31 October, Miton UK Microcap Trust's NAV fell 12.4%, reflecting the general move in markets but not helped by a plunge in the share price of business

energy services play Yu Group (YU.AIM), pummelled by an accounting bolt from the blue.

Yet Williams insists this is a moment when the characteristics of the trust's micro cap approach, with a strong valuation discipline and a focus on financial robustness, could come to the fore.

Smaller companies are more prone to share price volatility and smaller balance sheets can make them more vulnerable to financial shocks. This makes packing the right companies important and that's where the expertise of a fund manager can be an advantage.

Williams points out micro caps operate across a wider range of industry sectors than those companies contained in the mainstream indices, which are increasingly dominated by giant global companies in a narrow band of sectors.

Consequently, micro cap returns aren't usually correlated with the daily or monthly moves of larger quoted companies, thereby offering diversification for investors.

#### **MARVELLOUS MICROS**

Referring to globalisation of trade and then the asset pricedistorting impact of QE, Williams says: 'You've had 30 years where basically returns have been very satisfactory and being entirely truthful, you didn't need any

micro caps in your portfolio because you would have made money with a dartboard. Housing, bonds, equities, it all went up.'

Yet with globalisation in retreat and QE being unwound, global growth is slowing, reality is hitting home and valuations matter.

Williams believes 'one of the key drivers of premium return going forward will be that most asset allocators willingly, or dragged by their investors, will increase their participation outside the FTSE 350.

'Specifically into small caps and specifically into small and micro caps. That is a sensationally exciting moment because the UK market is one of the few international markets where we've still got a vibrant community of small micro caps. We believe that small micro is on the verge of a long term secular period of outperformance.'

Williams generally looks for 'recovery, overlooked, more value' situations rather than stratospherically rated go-gogrowth stocks that can fall back to earth.

'We're very keen on doing a large number of meetings to try and pick up on those kinds of opportunities, so that if we believe the recovery is coming, our entry price is very low and the risk/reward can be very attractive.'

#### **MINIS AND MICROS**

Yu Group had been 'overaccruing profit and sales in some cases' laments Williams who is nonetheless sticking with this longer-term portfolio holding and reassured by 'a very strong



Judith MacKenzie

balance sheet'.

Williams is excited by unloved cybersecurity and intelligence firm Falanx (FLX:AIM), whose transformational partnership with US-based software company SolarWinds means 'the share price could be a multiple of what it is now'.

The trust has also been building up a position in **Mercantile Ports & Logistics** (MPL:AIM), investing tens of millions into a new port facility in Mumbai.

And the micros maestro also sees value in overlooked **Conygar Investment Company** (CIC:AIM), a property play that is 'going to be surprising on the upside' and is trading at 'below its tangible asset value', not to mention Cerillion (CER:AIM), 'brilliant at helping mobile companies to deal with software solutions on billing in particular'.

#### **DOWNING'S DIAMONDS**

Another way to gain exposure in the investment trusts space is via Downing Strategic Micro-Cap Investment Trust (DSM), a concentrated portfolio of 12 to

18 holdings aiming to generate a 15% per annum compound return through a value approach that includes exerting influence through strategic stakes.

'We are value investors in the micro cap space,' says lead investment manager Judith MacKenzie. 'We get the catalysts in place, we get the companies to be a bit more marketable and we're pretty much the dominant shareholder in every position.'

Portfolio positions include recovery situation Real Good Food (RGD:AIM), refocused on cake decoration and food ingredients, refinanced and under new management and with 'upside value to come from the turnaround' according to MacKenzie, who sits on the board as a nonexecutive director.

The fund also has a stake in private company financing specialist Duke Royalty (DUKE:AIM).

There is also endurance sports nutrition tiddler Science in **Sport (SIS:AIM)**, which recently acquired premium performance nutrition brand PhD Nutrition for f32m.

Another under-the-radar outfit held is FireAngel Safety Technology (FA.:AIM), the smoke alarms and CO alarms supplier benefiting from some 'great regulatory drivers' and generating 'decent margins. It has had growing pains, but FireAngel is on the block for change over the next 6-12 months', insists MacKenzie.



By James Crux **Funds and Investment Trusts Editor** 

# Can the sun rise on Japanese stocks?

After a stormy end to 2018 fund managers spy opportunities but there are clouds on the horizon

poor end to the year saw Japanese funds rank among the worst performers of 2018 – but could this year see a turnaround?

Japan's TOPIX index hit levels not seen since the early 90s in the first part of 2018, while the Nikkei index broke the 24,000 barrier for the first time in years.

Yet by the end of the year the indices had plunged and the average Japan fund lost 11.3% in the year.

#### WHO PERFORMED WORST?

The worst performers in the sector over the past 12 months are the Neptune Japan Opportunities (B3Z0Y81) and Fidelity Japan Smaller Companies (B73VMD5) funds, down 25.9% and 22.2% respectively. Just one fund, Lindsell Train Japanese Equity (B3MSSB9), is in the black over the past year, up just 1.7%.

But experts say the outlook for the region is still strong: companies are more shareholder friendly than ever before, the stock market is great value and the economy is in decent shape. So, what has caused the poor performance? Largely to blame is the strength of the yen – it climbed around 8% against sterling in recent months.

The Japanese yen is seen as a safe haven currency so tends



to rally at times of uncertainty; that is why the strengthening of the currency and the fall in the stock markets were particularly noticeable in October, when there was a global sell-off.

But that's bad news for corporates: Japan is a big exporter of goods such as cars and electronics, and these products become more expensive when the yen strengthens, which makes them less attractive to overseas buyers – also not helped by ongoing trade war concerns.

## POLITICAL STABILITY (UNLIKE THE WEST)

While the country's economic growth is largely uninspiring – around 1% to 2% a year – Japan has something going for it that much of the West does not currently: a stable political

backdrop, reinforced by the re-election of prime minister Shinzo Abe in September 2018.

Michael Stanes, investment director at Heartwood Investment Management, says: 'The profit picture in Japan is actually very positive. The return on equity of the largest companies is expected to exceed 10% - a record high – as a result of various government measures to encourage companies to boost returns.'

As well as that, firms are more keenly using share buybacks and dividends to reward their shareholders, where previously they have preferred to hoard cash on their balance sheets. Interest rates in the country are currently -0.1%, and likely to stay that way until at least 2020, which helps to encourage spending and investment among

#### **FEATURE**

both companies and consumers.

But there are still clouds on the horizon. This year will see the abdication of the current Emperor, local elections and the raising of consumption tax from 8% to 10%. Still, experts focusing on the region are finding opportunities, particularly amid the recent market falls.

#### ON THE HUNT FOR **OPPORTUNITIES**

Tsunori Kitakura, lead strategist at Sumitomo Mitsui Trust Asset Management is forecasting that GDP will only rise 0.9% in real terms this year but thinks household incomes are likely to rise as the labour market tightens, which should boost consumption.

The service economy [in Japan] is quite under-developed and many highgrowth niches are there to be exploited by companies with the right skills and insights

Eiji Saito, manager of JPMorgan Japan Smaller Companies (JPS) is particularly excited by innovative tech stocks in the region. 'Japanese small-caps remain attractive as technological innovation takes hold,' he says.

Saito looks for companies



benefitting from technological innovation, such as those in the retail and autos industries where there is a growing use of online services, as well as those which are not afraid to adapt and modernise.

Top holdings include Bengo4. com, an online service which connects lawyers with people who need legal advice, and payments services firm GMO Payment Gateway.

He adds: 'The service economy [in Japan] is quite under-developed and many high-growth niches are there to be exploited by companies with the right skills and insights.' The trust is down 18.9% over the past 12 months, but up 41% over three years.

Kitakura likes businesses in the automation, technology and healthcare industries and believes strong earnings growth could push the Nikkei to 25,000 in the coming year.

#### 'INNOVATIVE BUSINESSES'

He says: 'There are many innovative businesses in these areas which offer solutions to Japan's social problems and will be key contributors to issues such as labour shortages and

the country's growing ageing population.'

He is invested in Keyence, which makes automated equipment to help improve productivity in factories, and Daifuku, which provides e-commerce logistics solutions. Another holding is pharma giant Daiichi Sankyo, which has had successful clinical trials with cancer treatments.

Joël Le Saux, manager of the **Oyster Japan Opportunities** (B09DHP3) fund, is focusing on undervalued mega-cap stocks because they have underperformed in recent years and look to be good value. He likes service firms, which are becoming a more important part of the stock market while cyclical business and exporters have seen their weightings decrease.

Top holdings in his portfolio include Mitsubishi Financial Group, Japan Electric Railway and Japan Post Bank. The fund is up 17.4% over the past 12 months and up 9.3% over three years.



By **Holly Black** 

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#### **Trading Statements**

25 Jan: AG Barr, Vodafone. 28 Jan: Paragon Banking. 29 Jan: Domino's, Royal Mail, UDG Healthcare, Greencore, DP Poland. 30 Jan: Wizz Air. 31 Jan: Dairy Crest, PPHE Hotel.

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