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WOODFORD MAY GAUGE HOW MANY **INVESTORS WANT TO SELL OUT**

MOOTED CHANGES TO 'FLAWED' INFLATION MEASURE **COULD HURT INVESTORS**

Alarming statistics show severity of profit warnings

New research shows why you shouldn't ignore an earnings alert from something in your portfolio

Profit warnings are one of investors' worst nightmares and it seems we should be paying close attention to what's going on, rather than clinging on in hope of a recovery.

These warnings occur when a company admits it will no longer meet previous earnings expectations. They tend to result in a large share price fall, often more than 20% in a single day and sometimes as much as 50%.

A new study by accountant EY finds that over the past two decades 10% of UK publicly-listed companies have gone bust within a year of issuing three of more successive warnings.

That is quite alarming, particularly as there is a well-used phrase that 'profit warnings come in threes'. Profit warnings are rarely one-off items because the first alert often highlights a new problem, the second alert typically tells of the struggles dealing with the problem, and the third covers the big decisions a company makes as it makes significant changes to fight back.

So to see evidence that a fair-sized chunk actually go bust would suggest that investors need to be more disciplined when it comes to keeping or chopping profit-warning stocks from their portfolio.

Nearly two fifths (18%) of companies issuing a profit warning in the past 20 years have warned three or more times within a year, finds EY. Of these companies, a fifth delisted over the following 12 months.

By the morning of the third warning, a quarter of chief executives and a fifth of finance directors had left their companies. And within a month of the third warning, more than 10% breached their banking covenants, finds EY. The latter means exceeding a specific ratio of net debt-to-earnings – usually a maximum of 3.5-times.

An optimist would suggest that plenty of companies bounce back after profit warnings, yet EY's research illustrates the severity of many profit warnings and how they impact companies and investors.

So should you simply get out of a stock upon the first profit warning? It is always important to weigh up the facts in the face of negative news and not hastily sell without reason. However, we would suggest that many factors linked to profit warnings don't become fully apparent until a company has had time to investigate following the first warning.

If you think the profit warning-related news hasn't changed the investment case then there could be merit in sticking with a stock. Should there be more serious changes to the way it does business, such as having to adopt a new pricing model, then the investment case may no longer be worth backing.

If you cannot stomach the worries associated with a stock that issued a profit warning then get out as soon as that first set of bad news is issued.

By **Daniel Coatsworth** Editor

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Contents

CFA UK Publication of the Year
CFA UK Journalism Awards 2019

02 EDITOR'S VIEW — Alarming statistics show severity of profit warnings

06 BIG NEWS — Last-minute dash for PPI claims / Woodford / Centrica / European airline sector

10 GREAT IDEAS — **New:** Synthomer / Fidelity Special Values **Updates:** AstraZeneca / 888

16 TALKING POINT — Mooted changes to 'flawed' inflation measure could hurt investors

19 UNDER THE BONNET — How retailer Next is radically transforming its business

26 MAIN FEATURE — British stocks ripe for a foreign takeover

32 AEQUITAS — Donald Trump is trying to reverse 48 years of economic history

34 CASE STUDY — How I invest: aspiring to become an ISA millionaire

37 ASK TOM — 'Should I reduce risk in my pension because of Brexit?'

39 FUNDS — Understanding two well-known fund rating systems

41 EDUCATION — Why you should choose ETFs over traditional tracker funds

44 INVESTMENT TRUSTS — Is there more risk lurking in your portfolio than you think?

47 INDEX — Shares, funds, ETFs and investment trusts in this issue

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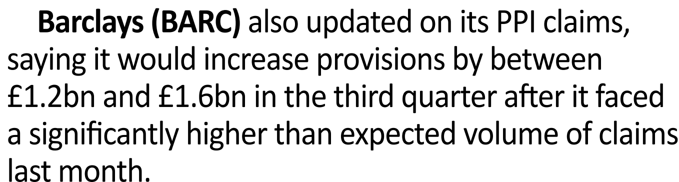
Shares in banks hit by last-minute dash for PPI claims

Investors are now worried about the impact PPI claims will have on dividends



Investors holding shares in the banking sector have been dealt another blow after a last-minute rush of compensation claims for mis-sold payment protection insurance (PPI). This has pulled down shares in the sector and raised concerns that UK banks may not be able to afford such generous dividends in the near-term.

A 'significant spike' in compensation claims for PPI ahead of the 29 August deadline has forced **Lloyds Banking Group (LLOY)** to suspend its share buyback plan in order to preserve cash.

Having already put aside £21bn of provisions for PPI mis-selling, more than any other UK bank by some way, Lloyds announced that it would take an incremental charge of between £1.2bn and £1.8bn in the third quarter. It blamed the volume of PPI enquiries spiking from 190,000 per week in the first half to 600,000 to 800,000 per week in August.

Given the uncertainty around the final figure the bank suspended the remainder of its £1.75bn buyback with £600m still unspent.

It also ditched its target to raise its capital reserves by 1.7% to 2% a year and warned that its return on tangible equity would be below its 12% target. Investors will have to hope that Lloyds can still honour its dividend commitments come the end of the year.

PPI CONTINUES TO BITE

Bank	Latest PPI Provision	Total Provisions To Date
Lloyds Banking	£1.2-1.8bn	£22.2-£22.8bn
Barclays	£1.2-1.6bn	£11.2-£11.6bn
Royal Bank of Scotland	£0.6-0.9bn	£5.9-£6.2bn
HSBC	n/a	£4.3bn
CYBG	£0.3-0.45bn	£3.1-£3.25bn
Santander	n/a	£1.7bn
Co-operative Bank	n/a	£0.5bn

Source: Company announcements, Shares

Barclays (BARC) also updated on its PPI claims, saying it would increase provisions by between £1.2bn and £1.6bn in the third quarter after it faced a significantly higher than expected volume of claims last month.

This comes on top of almost £10bn of provisions up to the end of June, the bulk of which have already been used.

Royal Bank of Scotland (RBS) recently said it faced an extra £600m to £900m in charges this quarter, again due to 'significantly higher than expected' claims. Like its rivals, it cautioned that the ultimate provision could be higher depending on the quality of the claims.

Curiously **HSBC (HSBA)** hasn't updated the market on its PPI situation since publishing its half-year results, nor has Santander or the Co-operative Bank, but none of them are likely to have escaped the industry-wide spike in claims ahead of last month's deadline.

In terms of stocks poised to benefit from PPI mis-selling, technology and services firm **Equiniti (EQN)** may potentially see additional revenue from its 'reparations' business which will be busy for some time helping the banks plough through the extra volume of compensation claims.

By **Ian Conway** Senior Reporter

Woodford may gauge how many investors want to sell out

The administrator of the troubled income fund is understood to be weighing up a 14 day pre-dealing period

Investors with money stuck in **Woodford Equity Income Fund (BLRZQ73)** may be able to place an order to sell up to two weeks before the official reopening date earmarked for December.

Shares understands that Link Fund Solutions, the fund's administrator, is considering a 14 day period in which investors can say how much they want to transact in the fund. These instructions would only be enacted once the fund's suspension is lifted.

This would give Woodford Investment Management up to a fortnight to gauge demand from investors looking to cash out of the fund.

Theoretically it would provide a short period of time to sell enough stock to meet redemptions as soon as trading recommences rather than the fund reopening and the manager having to rush to sell holdings to immediately raise cash.

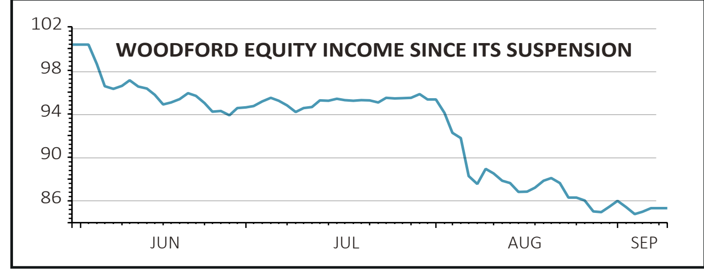
WHAT'S HAPPENED SINCE THE SUSPENSION?

Trading in the fund has been suspended since 3 June while fund manager Neil Woodford restructures the portfolio, sells smaller holdings and uses the proceeds to invest in larger stocks. The value of the fund has fallen by 15% since the dealing suspension began.

Woodford Investment Management last month reduced its stake in one of the income fund's holdings, **Non-Standard Finance (NSF)** from 23.9% to below 5%. Private equity group Alchemy bought a 19.25% stake from Woodford and may be interested in owning the whole company according to analysts.

Another holding in the income fund has also been reduced, a 13.17% stake in Russian warehouse investor **Raven Property (RAV)** where Woodford Investment Management recently went below 5%.

This ongoing portfolio restructuring is a key reason why the asset manager has refused to waive



the fees charged to investors locked in the income fund. It means that investors have incurred fees for more than 100 days with no way of withdrawing their money.

Eddie Stobart Logistics (ESL:AIM), another holding in the fund, last month saw its own shares suspended following various accounting issues. On 9 September it revealed that investment group DBAY had expressed interest in buying the company.

LATEST NEWS ON THE FUND SUSPENSION

'Link previously indicated that it was anticipated that the suspension of dealing is likely to last until early December 2019 while the portfolio of assets held by the fund is re-positioned,' said Woodford Investment Management on 23 August.

'Based on the progress made to date, they remain of the view that this is a realistic timeframe and therefore have decided that it remains in the interests of all investors for the suspension of dealings to continue.'

Investors are expected to get at least four weeks' notice of the date when the suspension will be lifted.

By **Daniel Coatsworth** Editor

Weighing up the future for Centrica

Analysts consider the potential price tag for mooted asset sales and whether it could be a takeover target

Britain's biggest energy company **Centrica (CNA)** has been through a rough few years, culminating on 30 July when it reported a 49% fall in operating profit, slashed its dividend by more than half, announced plans to exit its oil and gas business and said that chief executive Iain Conn would leave the business.

The focus now shifts to the potential shape and size of Centrica going forward – and whether it could be bought by someone else given its shares are cheap and it is about to become a more streamlined business.

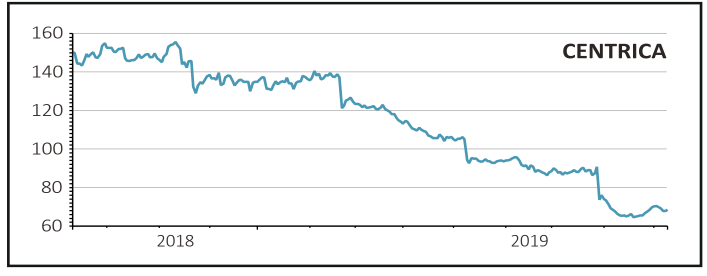
In the UK, Centrica will further reduce its cost base and improve its proposition centred on home energy management.

The company is targeting £1bn of annualised efficiencies over the 2019 to 2022 period, a third higher than its prior target. It estimates these savings will cost £1.25bn to deliver.

The aim is to become the most competitive provider in all markets where the company operates, with hopes to reignite customer growth and rebuild margins.

The planned disposals of oil and gas business Spirit Energy and an interest in nuclear generation – expected to happen by the end of 2020 – could net the company around £2.7bn according to analysts at Berenberg. This would slash net debt by close to 80% from £3.37bn to £0.67bn.

The analysts are sceptical of the cost cutting efforts, especially given past experience where the original £1.1bn of savings envisaged over the 2015 to 2018 period were overwhelmed by



pricing pressures in the retail business, effectively being nullified.

However, the current plans build on pervious improvement and according to management the new initiatives should deliver around £20 of savings per dual fuel customer, in real terms, which would propel Centrica into a top quartile cost position.

There is a chance that the customer base will stabilise and, combined with a strong brand, may even see some growth.

Having rebased the dividend to 5p per share, the plan is to progressively grow it in line with the long-term growth in earnings and cash flow, targeting a dividend cover of 1.5 to 2-times.

The company is targeting a strong investment grade credit rating and anticipates retaining asset divestment proceeds to reduce debts.

Centrica shares currently offer a dividend yield of 7.6%, and trade on eight times forecast December 2020 earnings per share. It is the cheapest company in the sector, looking at enterprise value-to-revenue and enterprise value-to-earnings before interest, tax, depreciation and amortisation.

Berenberg believes Centrica could be a future takeover target for oil majors pursuing climate change goals. The idea that big oil and gas companies could see M&A as a way to 'dilute' their carbon footprints by increasing their exposure to low-carbon energy.

By **Martin Gamble** Senior Reporter

European airline sector is not grounded, says broker

Can the likes of International Consolidated Airlines and Ryanair win back the market's favour?

British Airways reached 100 years old at the end of last month, but its centenary celebrations haven't exactly gone to plan.

A two-day pilots' strike this week, combined with stranded passengers and recent IT failures, as well as a data breach, has whacked the airline's reputation.

Shares in its owner **International Consolidated Airlines (IAG)** fell over 2% to 417p as the strike started, and with its crown jewel British Airways hit by multiple issues its shares are a long way down on the 700p mark they stood at in summer last year.

Ryanair (RYA) has also been subject to pilot strikes and its share price has almost halved in the last two years.

EasyJet (EZJ), as well as European giants Lufthansa and Air France KLM, has also struggled as the airline sector in general faces several headwinds.

Both short-haul carriers like Ryanair and EasyJet and full service ones like British Airways have struggled in the past few years, as price wars, rising fuel costs, industrial action from crews and an increasing number of Brits 'staycationing' over Brexit uncertainty all take their toll on airlines.

But analysts at Irish stockbroker Davy say that, while it may not feel like it, 'structural underpinnings' of the European airline sector continue to improve.

They argue that for the five aforementioned airlines, and **Wizz Air (WIZZ)**, the strength of their brands mean the majority of them should continue to grow their earnings and operating margins.

That's even the case for British Airways, despite a report by reputation management company Alva placing it 55th out of 65 airlines in terms of reputation.

According to Davy, International Consolidated Airlines has a portfolio of airline brands better prepared for any downturn and is 'well positioned for sustainable returns and far more resilient' than before the last global recession in 2008, with its return on invested capital around 15%.

'Even a global financial crisis scenario, assuming a lower fuel price and corrective actions (as in the year post Lehman), would see the dividend being maintained,' it adds.

As for Ryanair, despite its share price decline Davy calls it the industry's 'structural winner', thanks to it having one of the 'best balance sheets in the industry', as well as the lowest cost base and best structures put in place.

Analysts at the stockbroker also believe EasyJet could become a takeover target, given the consolidation happening in the sector and the lack of opportunities the airline has to grow in the near-term.

By **Yoosof Farah** Reporter

The outlook is looking brighter for Synthomer

The company should benefit from capacity expansion and a deal to boost its position in the US and Europe

Chemicals firm **Synthomer (SYNT)** looks very tempting at the current price following a big sell-off over the past year.

The firm's share price dropped from around 530p a year ago to 280p last month and saw the stock trade on nearly its lowest rating in a decade, while its level of debt compared to how much it's earning is expected to double.

But with the business on the cusp of global expansion as it aims to keep up with soaring demand for its products, investors with a long-term view may want to take advantage of the firm's cheap valuation.

The chemicals sector has historically been a good place to invest with significant share price gains over the past decade and occasionally generous dividends.

But chemicals companies have been caught up by concerns over a global economic slowdown in the past year, and some in the market think this may feed into weaker demand for chemicals products.

Synthomer has tried to expand significantly to keep up with demand for its speciality products, sought after due to many factors such as urbanisation, ageing demographics and stricter legislation.

The firm supplies aqueous polymers to companies, which help create new products and boost the performance of existing ones, such as footwear insoles, condoms, packaging tapes, carpets and waterproofing products.

While strong on the consumer side, investors had questioned Synthomer's growth prospects given its lack of real penetration into the industrial market.

But the proposed deal to acquire Omnova Solutions, an American speciality chemicals business operating in sectors like construction and oil and gas, could make the market reappraise Synthomer.

As well as the US, Omnova has manufacturing and technical facilities in Europe, Thailand and China.

Analysts at UBS believe the acquisition will help Synthomer sell more products in the US, and help it expand its facilities in Europe.

Synthomer is also forecast by analysts at Canaccord and Numis to have a much stronger second half of this year as market conditions are set to improve.

That combined with its completed upgrades to facilities in Germany and Malaysia means the firm will have greater capacity to meet demand for its products.

Its net debt-to-earnings ratio is expected to increase next year to between 2.2 and 3-times as the Omnova deal is completed.

But Synthomer has a clear plan to get this down below 2-times by the end of 2021.

Its management team has a disciplined approach to M&A, with a 'conservative capital' policy meaning it's unlikely to ever be reckless in the pursuit of growth.

By Yoosof Farah
Reporter

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Bagging bargains with Fidelity Special Values

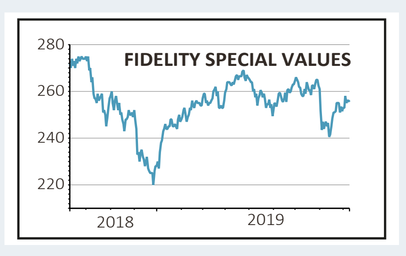
Contrarian investment trust targets beaten down stocks with the potential to rebound

Cautious investors concerned about future stock market corrections might consider seeking shelter in a portfolio of domestic stocks that are already dirt cheap and primed for recovery.

Fidelity Special Values (FSV) pursues such an approach. Managed by Alex Wright, this fund should provide a margin of safety, as it aims to buy shares for less than their intrinsic worth, and also offers a compelling play on the re-rating potential of a deeply unloved UK market.

FIDELITY SPECIAL VALUES ↗ BUY
(FSV) 255.5p
Stop loss: 200p

Total assets: £816m



WHAT DOES FIDELITY SPECIAL VALUES DO?

Fidelity Special Values is an all-cap investment trust with a value-contrarian philosophy managed by the well-followed Wright. It seeks to achieve long term capital growth through investment in special situations, i.e. UK companies that Wright believes are undervalued or where the potential has not been recognised by the market.

He invests in unloved companies in out of favour sectors, but with the caveat that he wants to see a balance sheet that can withstand economic weakness and a valuation providing a margin of safety, which are held until their potential value is recognised by the wider market. A book of between 80 and 120 stocks provides both diversification and liquidity.

WHAT'S IN THE PORTFOLIO

Wright's day job entails researching companies that offer some degree of downside protection but also 'potential for a positive change to show them in a new light'. By investing when all the bad news is 'in the price', and no good news is expected, he looks to stack the odds in his favour.

With Wright willing to go against the grain, Fidelity Special Values offers exposure to two heavily-shorted stocks, defence equipment company **Ultra Electronics (ULE)** and educational publisher **Pearson (PSON)**, firms with have had major issues in the past but, Wright believes, have more positive futures ahead of them.

Pearson's profit warnings between 2015 and 2017 left many believing the company is in a prolonged structural downturn, yet Wright argues they are missing the enormous investment it has been making into digital education services and the positive effect this could have on the company.

Short-sellers have argued Ultra Electronics pursued aggressive accounting policies under its previous CEO, thus exaggerating profitability, and that the company can't grow organically.

However, Wright likes its high-quality portfolio of defence assets and the shares have rallied since first half results which suggested these accounting policies can be unwound, key markets are improving and organic growth is returning.

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

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ALTs by J.P.Morgan Asset Management

ASTRAZENECA (AZN) £68.57

Gain to date: 8.9%

Original entry point:

Buy at £63.00, 15 November 2018

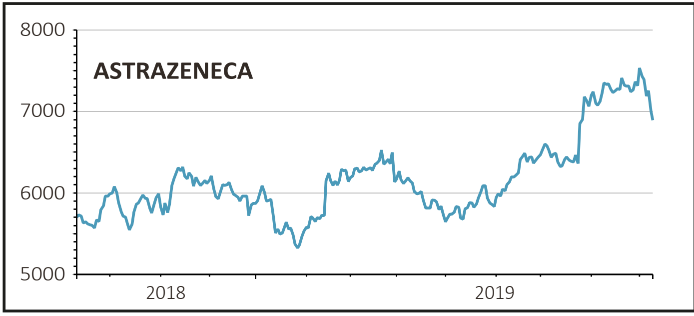
OUR POSITIVE CALL on pharmaceutical giant **AstraZeneca (AZN)** has performed solidly. However, having reached a record high on 2 September, boosted by positive news on drug trials, the shares have since lost some momentum and we think now would be a good time to take profit as sentiment towards names on lofty valuations sours.

Based on 2020 forecasts the shares trade on a price-to-earnings ratio upwards of 20-times and as broker Shore Capital recently noted, 'the shares are priced to perform and (we) would anticipate a pullback on any minor setback'.

This setback came in the form of reports that US lawmakers are planning a legislative crackdown on prescription drug prices. Our ultimate 9% gain might not look much but you would have also enjoyed dividends in the interim, which was part of our rationale for flagging the company.

Fundamentally this remains a good business, and the firm's oncology or cancer portfolio is continuing to perform well.

On 9 September it reported that results from a clinical trial showed its lung cancer drug reduced the risk of death by more than a fifth in patients with previously-untreated extensive-stage small cell lung cancer.



SHARES SAYS:

We still like AstraZeneca just not at this price.

888 (888) 157.3p

Gain to date: 2.1%

Original entry point:

Buy at 154p, 20 June 2019

HALF-YEAR RESULTS from **888 (888)** showed like-for-like revenue growth of 7% to $277m, with the UK casino and sports betting business the standout performers, up 23% and 50% respectively, driving a 23% growth in UK revenue.

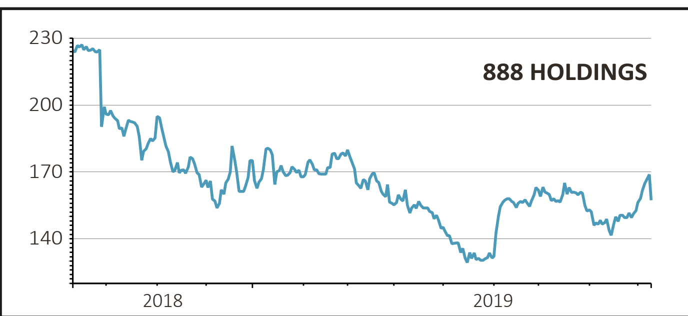
However, earnings before interest, tax, depreciation and amortisation fell 20% to $41.8m, largely driven by higher taxes in the UK where remote gaming duty increased from 15% to 21% as well as an increase in the rate of tax paid in Romania and Italy.

Poker was particularly disappointing, where revenue fell by 24% to $23.1m, due to increased competitor marketing activity.

Consensus expectations for profit has been revised down consistently since our 'buy' recommendation in June and the interim results will likely lead to more downward adjustments.

We knew that the legacy poker business-to-business interests were expected to drag on earnings for 2019, but the focus on consumer operations, particularly in casino, was expected to show rapid growth, as indicated at the capital markets day on 4 June.

Casino (63% of revenue) saw 14% constant currency growth in the first half, well short of the 45% we were expecting.



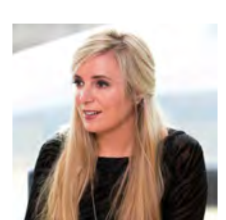
SHARES SAYS:

Despite signs of improving operational performance and a maintained focus on efficiencies and cost control, the company has yet to convince investors that it can deliver on its strategic objectives.

We recommend taking profit and waiting for stronger evidence that 888 is on a sustainable growth path.

PUTTING FUNDAMENTALS FIRST

Lucy Isles, joint-manager of the High Yield Bond Fund, explains how the fund's genesis has resulted in a forward-looking research approach, focusing on fundamentals first. The focus on fundamentals before valuation allows us to achieve the right balance of risk and reward and helps us to avoid costly mistakes. Our approach to high yield has been born out of our roots as a long-term equity house, which is unique within the market.



The value of an investment in the fund, and any income from it, can fall as well as rise and investors may not get back the amount invested.

We seek to identify a diverse range of under-appreciated resilient businesses that will adapt to our changing world. We define resilience as comprising three factors – a durable competitive position, good governance and a sustainable approach (synonymous with Environmental, Social & Governance) and an appropriate capital structure. Resilience, however, is not static, so we have developed rigorous monitoring tools to inform position sizing and our sell discipline. We think about risk differently, taking active positions in companies who face very different risk profiles. Knowing our holdings well is our first risk control, diversity is our second. We currently lend to 73 issuers from 15 countries in 18 sectors.

The combination of all these factors allows us to invest for the long term, with a three to five-year investment horizon, resulting in low turnover – a further differentiating characteristic of the fund. We allow time for fundamentals to assert themselves over fluctuating market sentiment and avoid unnecessary trading in what is a costly asset class. In doing so, we believe our investments are better placed to capture the opportunities of today and the future, to deliver long-term income, not short-term yield.

The result is top quartile performance in all timeframes, one, three, five and ten-year and since inception, 18 years ago. We deliver this outperformance by investing in bonds we consider to be resilient and then rigorously monitoring our holdings. This allows us to determine how the businesses are responding to our capricious world, and whether the initially identified resilience remains or we need to consider selling the bonds. We have delivered this top quartile performance with an 18-year track record for some of the lowest, if not the most competitively priced fees in the industry, with total charges for the fund of 0.37 per cent, with no entry or exit fee.

In doing so, we believe we remain true to Baillie Gifford's principal goals - to add value to clients, support companies and benefit society through thoughtful long-term investment.

SHARES

Lucy Isles
Investment Manager

Baillie Gifford High Yield Bond

ANNUAL PAST PERFORMANCE TO 30 JUNE EACH YEAR (%)

	2015	2016	2017	2018	2019
Baillie Gifford High Yield Bond Fund (B Inc Shares)	-0.7	0.9	12.6	1.7	6.7
Investment Association Sterling High Yield TR	-0.7	0.7	10.4	1.0	5.1

Past performance is not a guide to future returns

Source: FE. Single pricing basis, total returns. Sterling.
The manager believes this is an appropriate comparison for this fund given the investment policy of the fund and the approach taken by the manager when investing.

The views expressed in this article should not be considered as advice or a recommendation to buy, sell or hold a particular investment and it does not in any way constitute investment advice. This blog contains information on investments which does not constitute independent investment research. Accordingly, it is not subject to the protections afforded to independent research and Baillie Gifford and its staff may have dealt in the investments concerned. Bonds issued by companies and governments may be adversely affected by changes in interest rates, expectations of inflation and a decline in the creditworthiness of the bond issuer. The issuers of bonds in which the fund invests may not be able to pay the bond income as promised or could fail to repay the capital amount. Issued by Baillie Gifford & Co Limited which is authorised and regulated by the Financial Conduct Authority (FCA).

Mooted changes to 'flawed' inflation measure could hurt investors

Dropping RPI inflation could have a negative effect for pensioners and investors

The Chancellor has refused to review a decision on whether to scrap the controversial Retail Prices Index (RPI) measure of inflation in the short-term, despite reputable statisticians saying it is a flawed measure of price increases.

However, an indication that it will be reviewed from 2025 has sent shockwaves through the RPI inflation-linked UK Government debt market, causing the price of some longer-duration bonds to fall by 10%.

> "The Government's reticence to abandon RPI is likely in part driven by the fact it has been used as a money-making machine in recent years."

Investors were caught off-guard and many were unaware of how changes to inflation measures would impact certain investment products.

Switching away from RPI could see inflation-linked government bonds, also known as 'linkers', produce lower returns.

WHAT IS THE DIFFERENCE BETWEEN RPI AND CPI?

The RPI measure of inflation was introduced in 1947, but was usurped by the Consumer Prices Index (CPI) measure of inflation, introduced in 2003 and thought to be more reliable.

The two differ in how they calculate inflation, with RPI typically running around one percentage point higher than CPI. More recently the CPIH measure was introduced, which charts inflation including housing costs.

However, a number of parts of our everyday life are still linked to RPI, from student loans to pensions and train fares.

WHAT'S HAPPENED?

The Bank of England, which produces the figure each month, has already said the RPI measure is not fit for purpose, with Governor Mark Carney saying it is 'of no merit' and should be scrapped. He's not alone – the Office for National Statistics has branded the RPI measure of inflation as 'flawed' with 'serious shortcomings' and does not recommend it being used.

More recently the UK Statistics Authority said that RPI should be scrapped and merged with the CPIH measure of inflation. However, Chancellor Sajid Javid has delayed making any decision, saying any change will be consulted on between 2025 and 2030 – effectively kicking the can down the road.

David Norgrove, chair of the UK Statistics Authority, says: 'We continue to urge the Government and others to cease to use the RPI. It would be wrong for the Government to continue to use a measure of inflation which it itself accepts is flawed, where it has the opportunity to change.'

WHY DOES IT MATTER?

Despite being discredited, some big price rises in our lives are determined by RPI, rather than CPI, meaning it likely affects most people in one way or another.

The Government has been accused of cherry-picking which measure of inflation is used. CPI is often used for hikes that benefit the public, such as state pension increases, tax credits or public sector final salary schemes, while RPI is used for things that cost them, such as price hikes on rail fares and setting interest rates for student loans.

Tom Selby, senior analyst at AJ Bell, says: 'The Government's reticence to abandon RPI is likely in part driven by the fact it has been used as a money-making machine in recent years. For example, back in 2011 the Government chose to switch the inflation measure used for public sector pension increases from RPI to CPI, saving the Treasury tens of billions of pounds in the process.'

WHO IS HIT IF RPI'S USE IS EXTENDED?

One of the biggest hits is for graduates as student loan interest rates are linked to RPI rather than CPI. This means they pay more interest on their loan than if it was linked to CPI.

Commuters are hit with an RPI increase to their train fares and season tickets each year

The rate is based on the inflation figure from March the previous year. This year RPI inflation in March was 2.4% compared to 1.9% for CPI.

For someone with the average student loan debt of £50,000, this equates to an extra £300 in interest a year. It's also worth noting that the difference between CPI and RPI is usually larger, so the difference would usually be greater.

Commuters are also hit with an RPI increase to their train fares and season tickets each year. People have long called for this to be changed, but the train companies argue that its workers' wages are linked to RPI increases each year. July's figure for RPI is used for rail fare increases in the following year – this July the figure for RPI was 2.8%, while CPI was 2.1%.

WHO BENEFITS IF RPI ISN'T SCRAPPED IMMEDIATELY?

Pensioners and investors will likely benefit from RPI still being in place until at least 2025. Some private sector defined benefit pension schemes have RPI-linked increases baked into their scheme rules, which means that each year the rise is higher than if it was linked to CPI.

Some pension schemes have already tried to switch to the lower CPI measure, but have been defeated in their attempts – as it would effectively equate to a pay cut for pensioners.

Another area where many pensioners benefit is the millions of people who have bought annuities that rise in line with RPI. Investors also enjoy RPI-linking, as those who have purchased index-linked Government gilts from the Bank of England see the value of their coupon or yield increase in line with RPI.

If RPI is eventually scrapped, the Government will have to figure out what to do about the existing stock of products and benefits where the inflation measure is used. It might be that the measure is continued for existing contracts, but all new contracts are switched to CPI. What seems certain is that many investors will lose out should RPI go.

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

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How retailer Next is radically transforming its business

The FTSE 100 stock is one of our favourite companies on the London Stock Exchange

Leicester-based **Next (NXT)** has navigated through the tough retail environment by radically changing the shape of its business while maintaining a disciplined financial performance. The company has indicated that it expects more of the same over the next decade.

Rather like a swan gracefully gliding on top of the water masking the frantic paddling going on beneath the surface, Next has presented a surprisingly smooth profit trajectory over the last 10 years, despite lots of change going on behind the scenes.

The company has navigated the move to online with relative ease because it had an existing mail order catalogue which it has migrated into a full online offering.

Online revenue has increased from 25% of group sales in 2010 to 45% today, while the land-based stores have seen their share fall from almost two-thirds to 46% over the same period.

The trend at the pre-tax profit level has been even starker, with online profit now dwarfing earnings made from the physical stores, representing 49% of total profit compared with 29% in 2010. That isn't to imply that profit has suffered, it has grown at 4% a year over the last nine years.

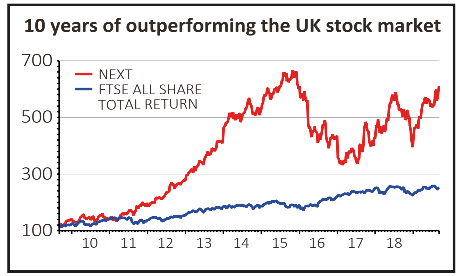
Next has purchased and cancelled 37% of the shares outstanding over the last nine years which has had a very positive effect on earnings per share growth, with a compound annual growth rate (CAGR) of close to 10%.

The eagle-eyed reader will have noticed that adding up the online and physical stores' share of revenue falls well short of 100%, and that is because Next has been developing other profit streams in recent years.

THE NEW SHAPE OF THE GROUP

Not only has the company moved more business online, it has also increased the proportion of business done overseas and developed from a single brand to a full multi-brand offering.

Today, 10% of Next's revenue comes from selling third party brands, 9% of revenue is generated outside the UK and



NEXT'S FINANCIAL PROFILE

		2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue (£M)	RETAIL	2274	2222	2191	2191	2241	2348	2406	2305	2123	1955
	ONLINE	873	936	1089	1193	1374	1541	1688	1728	1672	1919
	FINANCE	250	223	n/a	n/a	n/a	n/a	n/a	n/a	223	250
	TOTAL	**3406**	**3293**	**3441**	**3548**	**3758**	**4028**	**4214**	**4137**	**4118**	**4221**
	RETAIL	66.8%	67.5%	63.7%	61.8%	59.6%	58.3%	57.1%	55.7%	51.6%	46.3%
	ONLINE	25.6%	28.4%	31.6%	33.6%	36.6%	38.3%	40.1%	41.8%	40.6%	45.5%

		2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Profit (£M)	RETAIL	324	329	324	331	348	384	408	353	269	212
	ONLINE	184	222	263	302	359	377	413	430	310	353
	FINANCE	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	112	121
	TOTAL	**505**	**543**	**570**	**622**	**695**	**782**	**836**	**790**	**726**	**723**
	RETAIL	64.2%	60.6%	56.8%	53.2%	50.1%	49.1%	48.8%	44.7%	37.1%	29.3%
	ONLINE	36.4%	40.9%	46.1%	48.6%	51.7%	48.2%	49.4%	54.4%	42.7%	48.8%

Source: Company reports, Shares

6% comes from selling credit to customers.

The financing arm earns more profit than its size suggests, although with over £1bn of credit to its customers, it isn't small either. Profit after financing costs represents 17% of the company's total profit.

Although lots of high street firms have been suffering from the move to online and onerous rents, Next sees its stores as an asset to be optimised rather than a millstone around its corporate neck.

Of the 45% of online orders, half are delivered to a Next store for free collection as opposed to delivering to a customers' home, which incurs a £3.99 charge. It can be more convenient as well as cheaper to collect from an existing store and these orders represent around a third of all orders by volume.

Shops are even more important in facilitating online

returns, with over 80% of all returns going through them.

At the same time the company has been renegotiating more competitive rents when they come up for renewal. In 2018 it saw a 29% reduction on the leases that it decided to renew.

The average lease term is around six years. Management have conducted an in-house study to glimpse at the future and they believe that in 15 years' time there will be fewer stores and much lower rent.

The way that management looks at the industry, it's not a question of how much physical space they need, it's a question of reducing rent and rates so that an adequate return can be made from each store.

AGGREGATION PLATFORM

The internet has drastically lowered barriers to entry in the retail industry. Challenger firms like **Sosandar (SOS:AIM)** do not need to own any stores, warehouses or distribution networks to launch and develop their brand.

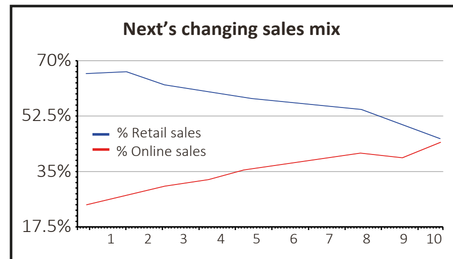
Seeing opportunity rather

than threat, Next is leveraging its assets to build an aggregation platform by offering clients access to its 8m square feet of mechanised warehousing with its capability of handling flat-packed, hanging, palletised and furniture items.

In addition to offering a flexible distribution infrastructure, the company can offer third parties other services such as digital marketing, access to 4m UK customers, finance and credit services as well as access to 1.3m overseas customers.

LABEL is the company's third party business and it makes over £400m of revenue and delivers £66m of profit. Management are consciously taking a long-term view in developing this business, implicitly accepting that in the brave new internet world, power lies with originators of products who can choose their route to market.

> "Next has been advancing credit to customers for a number of years"



LABEL grew its revenue by 29% last year and its partners now include All Saints and River Island. Over the last five years the compound annual growth rate of sales has been close to 30% per year.

Half of the third party branded sales is sold on a commission basis, which has lower margins, but encourages its partners to generate higher revenue growth. The next step is to offer third party brands that are only available in partners' own warehouses.

OVERSEAS STRATEGY

In overseas markets Next is a challenger brand and offers its whole UK range at similar prices to the home market.

It benefits from low barriers to entry, allowing Next to expand quickly and efficiently through third party platforms. The online overseas business generates £360m of sales and delivers £59m of profit per year.

Overseas revenue has grown at a 23% CAGR over the last three years, while the customer base has increased by 25% over the past 12 months to 1.3m.

THE FINANCING ARM

Next has been advancing credit to customers for a number of years and today the activity represents a significant 17% slice of the company's total profit.

In the year to 31 January 2019, the average value of outstanding debtors was £1.14bn which generated £250m of interest income and £121.2m of net profit.

This is a very credible result and management estimates that the business earns a 10% to 11% return on capital.

Bad debts ran as high as 8.5% of average debtors back in 2010 but have only averaged 3.6% in the past five years. At the same time the number of active customers has been on a positive trend since 2016.

Recently the company introduced next3step, which allows customers to spread payment over three months. It is currently recruiting 2,000 new customers a week.

Nextpay app allows credit customers to pay for goods in the retail stores the same way as a physical payment card and has been downloaded over 1,400 times a week, mainly by existing customers.

OTHER BUSINESSES

The company has franchise partners that operate in 32 countries through 199 stores, and which generate £52.2m of income, most of which is pure

profit. Next also directly owns six stores in Czech Republic, Slovakia and Sweden which generate £10m of revenue a year.

Lipsy is a wholly owned subsidiary with its own independent management team, based in London. It sells product through a number of different channels, including Next online and retail. Although small, the unit grew its operating profit to £11m last year, an increase of 129%. Management forecasts an increase of 40% in the current year.

ACCELERATING CHANGE, MORE TO COME

Helpfully Next's management provide what they call their 15-year stress test, which attempts to outline the future shape of the business. The company assumes that the physical stores will continue to see 10% like-for-like sales decline a year and that wages will fall at the same pace.

Rents are assumed to fall by 5% a year after 2022, and the company has also assumed it will keep some of the loss-making stores so that they can continue to facilitate the collection of online orders and returns.

Next online is projected to grow by a CAGR of 4.8%, while UK LABEL is expected to grow at a CAGR of 8.4% and overseas is expected to grow at a CAGR of 12.2%. The finance arm is expected to grow at a CAGR of 4.7%.

If the projections work out as planned the online business will be generating almost £4bn of revenue, while the number of stores will fall from 509 to 270 across the UK.

The third party LABEL business will almost be as big as the current Next retail business and the revenue from overseas will be close to £2bn, larger than the online revenue generated in the UK today.

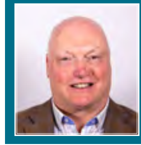
As management points out, it's highly likely that many of the assumptions about sales and costs will prove to be incorrect.

Nevertheless, the exercise demonstrates that a radical restructuring of the company's cost base is possible over time, while continuing to produce significant cash flow. The company expects the business to generate an additional £12bn of cash over the next 15 years.

SHARES SAYS:

Next is one of our top picks for 2019 and we rate it as one of the best stocks to own on the London market.

At £61.34 it trades on 13 times forecast earnings for the year ending January 2021. It is forecast to pay 175.07p in dividends that financial year, meaning the shares offer a 2.9% prospective yield.



By **Martin Gamble**
Senior Reporter

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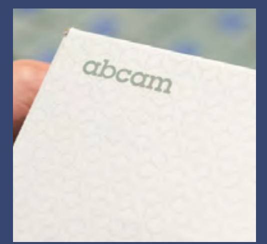

ANTIBODY GROUP ABCAM DISAPPOINTS WITH GROWTH PLAN

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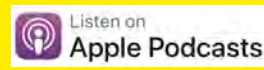
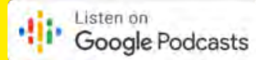


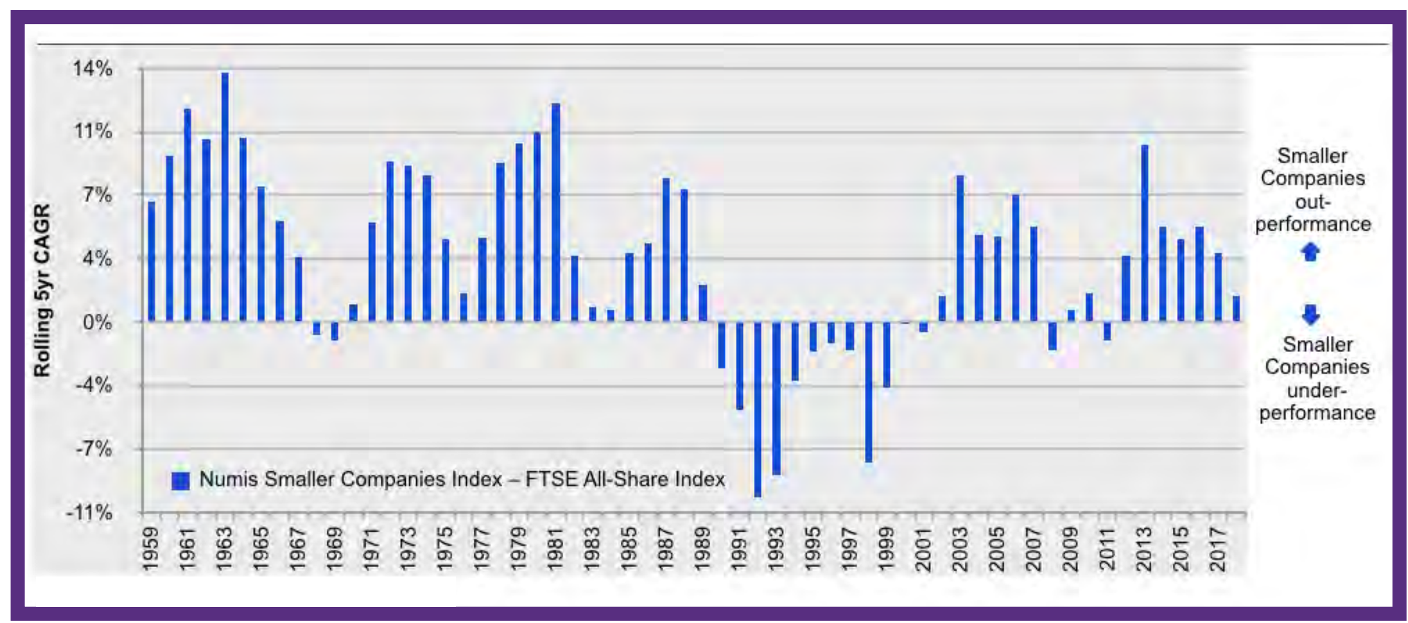


GREATEST INVESTING HITS - REALISING POTENTIAL ON THE FINANCIAL FRONT LINE

Jonathan Brown & Robin West, UK Equities Fund Managers, Invesco Perpetual UK Smaller Companies Investment Trust plc

The UK equity market is one of the most diverse stock markets in the world. Historically smaller companies have tended to outperform their larger brethren, particularly when taking a medium-term investment horizon (see chart below). We see a number of reasons for this. Smaller businesses tend to be less well researched by the market, leaving room to discover genuinely undervalued stocks. Small-caps also often have a high proportion of founder ownership, which encourages management to focus on long-term shareholder value creation. And, smaller companies are typically more nimble, allowing them to exploit niches in existing industries and generate organic growth.

UK Smaller Company excellent historic long term performance



Past performance is not a guide to future returns. CAGR = compound annual growth rate.
Source: Numis and Invesco as at 31 December 2018 (latest available).

Within the Invesco Perpetual UK Smaller Companies Investment Trust plc (the trust) we concentrate on bottom-up stock selection, believing that company fundamentals are the most important factor in generating long-term outperformance. We seek growing businesses, which have the potential to be significantly larger in the medium term. These tend to be companies that either have great products or services, that can enable them to take market share from their competitors, or companies that are exposed to higher growth niches within the UK economy or overseas.

We favour stocks with "self-help" characteristics that enable them to grow independently of the economy. This can include the restructuring of underperforming businesses, pursuing a strategy of acquisitions, or market

share gains led by innovation. These characteristics, we believe, allow companies to flourish, even against a volatile macroeconomic picture. Three stocks that have performed well for the trust over the past few years include:

Future:
Media business Future has been one of the trust's most successful investments in recent years. A change of company management team has seen the firm's content move online, transitioning the business from a traditional magazine publisher to digital media company. The company also employs innovative methods of monetising its content, capitalising on the structural shift away from traditional print to online media.

4imprint:
The firm is the leading supplier of promotional products in the highly fragmented US market. 4imprint benefits from a large customer database, strong market position and supplier network. The business has transitioned from a catalogue to internet driven model, delivering organic growth of the business through existing and new customers.

Young & Co.'s Brewery (Youngs):
Youngs operates a portfolio of premium quality pubs within London and the South-East. Their wet-led focus has enabled them to withstand the proliferation of high-street casual dining. They have an entrepreneurial management team and have been early to spot trends such as craft ales and the growth of gin. Youngs has low gearing relative to peers and benefits from significant asset ownership; it owns most of its pub estate and 84% is freehold. Organic growth has been boosted through acquisitions that have enhanced earnings.

As active investors we are always seeking companies with the potential to outperform the wider market over time. Given the breadth and depth of the UK Equity market, we believe that there are plenty of exciting investment opportunities for the patient, long-term, fundamentals focussed investor. Particularly at the small-cap end of the spectrum.

Investment risks
The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

When making an investment in an investment trust you are buying shares in a company that is listed on a stock exchange. The price of the shares will be determined by supply and demand. Consequently, the share price of an investment trust may be higher or lower than the underlying net asset value of the investments in its portfolio and there can be no certainty that there will be liquidity in the shares.

The Invesco Perpetual UK Smaller Companies Investment Trust plc invests in smaller companies which may result in a higher level of risk than a product that invests in larger companies. Securities of smaller companies may be subject to abrupt price movements and may be less liquid, which may mean they are not easy to buy or sell.

The product uses derivatives for efficient portfolio management which may result in increased volatility in the NAV.

The use of borrowings may increase the volatility of the NAV and may reduce returns when asset values fall.

STANDARDISED ROLLING 12-MONTH PERFORMANCE (% GROWTH) *

	30.06.14 30.06.15	30.06.15 30.06.16	30.06.16 30.06.17	30.06.17 30.06.18	30.06.18 30.06.19
Numis Smaller Companies Index	10.4	-6.6	29.1	7.6	-5.4
FTSE All-Share index	2.6	2.2	18.1	9.0	0.6
Invesco Perpetual UK Smaller Companies Investment trust plc (NAV)	15.5	-4.1	38.8	14.1	2.4
Invesco Perpetual UK Smaller Companies Investment trust plc (share price)	26.0	-4.8	40.2	13.6	10.1

Past performance is not a guide to future returns. * All performance figures are in sterling as at 30 June 2019 except where otherwise stated. Ordinary share price performance figures have been calculated using daily closing prices with dividends reinvested. NAV performance figures have been calculated using daily NAV with dividends reinvested. The NAV used includes current period revenue and values debt at fair. Source: Morningstar. Index performance shown is total return, sterling, Datastream.

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For more information on our products, please refer to the relevant Key Information Document (KID), Alternative Investment Fund Managers Directive document (AIFMD), and the latest Annual or Half-Yearly Financial Reports. This information is available using the contact details shown.

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BRITISH STOCKS RIPE FOR A FOREIGN TAKEOVER

By **Ian Conway**
Senior Reporter

A weak currency and cheap valuations make the UK a happy hunting ground for deal-makers

Last year was a vintage one for mergers and acquisitions (M&A) with deals totalling more than $4trn, the highest figure since 2007 and the onset of the global financial crisis. This year is shaping up to also be a historic period for takeovers and we believe UK-listed companies are prime targets for foreign companies, such as Hong Kong's HKEX making a £31.6bn offer for **London Stock Exchange (LSE)** on 10 September.

In 2018 mega deals worth $10bn or more grabbed the headlines. According to the MAN Institute, 30 transactions were announced in the first half of the year alone while mid-sized deals between $1bn and $5bn accounted for more than half of all transactions.

The low cost of debt, improving cash flows, high levels of cash both on corporate balance sheets and at private equity firms (which raised record amounts of funding in 2017), and a favourable tax regime in the US were all big factors.

M&A activity in the UK hit a record last year with more than 600 deals involving foreign companies buying UK companies according to figures from the Office for National Statistics.

Of a total of £78.8bn of foreign investment, £52.7bn or two thirds came from the US, while £17.8bn or just under a quarter came from Europe.

Domestic M&A hit an all-time record last year with 960 deals done worth a total of £27.7bn.

OPTIMUM CONDITIONS FOR UK M&A

Conditions in the UK stock market are currently ideal for more corporate M&A activity.

The continued weakness of sterling makes UK assets relatively more attractive for foreign buyers as their purchasing power is increased.

Meanwhile UK companies have high levels of cash on their balance sheets, interest rates are still low should suitors want to borrow to do a deal, and valuations are low thanks to political uncertainty.

Most of this year's domestic M&A has been small deals as companies look to bolt on small acquisitions to make up for lack of organic growth. Therefore although the number of transactions in

TEN MAJOR UK M&A DEALS STRUCK IN THE FIRST HALF OF 2019

- **Marsh & McLennan** (US) buying **JLT** for **£4.6bn**
- **Berry Global** (US) buying **RPC** for **£3.3bn**
- **Vinci** (FR) buying majority stake in **Gatwick airport** for **£2.9bn**
- **City Developments** (Singapore) buying the rest of **Millennium & Copthorne** it didn't already own for **£2.2bn**
- **TDR Capital** (UK) buying **BCA Marketplace** for **£1.9bn**
- **Saputo** (Canada) buying **Dairy Crest** for **£975m**
- **Charter Court** (UK) buying **One Savings Bank** for **£800m**
- **Macquarie Infrastucture** (Australia) buying **Kcom** for **£627m**
- **Roper** (US) buying **Foundry** for **£451m**
- **Asahi** (Japan) buying a division of **Fuller, Smith & Turner** for **£250m**

the first half hit 460, the total amount spent was just £4.6bn.

Finally non-trade buyers like private equity firms have huge amounts of 'dry powder' in the form of funding for deals. According to research by financial data group Prequin, the amount of unspent cash available to private equity firms is close to $2.5trn, of which roughly a third was raised last year.

An interesting feature of last year's M&A bonanza was the domino effect where one mega deal lead to another. For example, Barrick's merger with Randgold, which created the world's largest gold producer, spurred rival Newmont to bid for Goldcorp and reclaim the title shortly afterwards.

GLOBAL EARNINGS GOING CHEAP

It's standard practice nowadays for managers of UK funds to flag up the fact that many FTSE 100 stocks are global players, with substantial overseas earnings, yet they are trading at a discount to their overseas rivals because they are quoted in sterling.

A case in point is **British American Tobacco (BATS)**, the seventh-largest stock on London's Main Market, which makes more than 90% of its sales outside the UK yet trades on just nine times this year's forecast earnings.

By contrast US rivals Philip Morris and Altria – who also sell tobacco products worldwide – are trading on 14 times and 12 times this year's earnings respectively.

While selling tobacco may not be a great business, which is one reason why we haven't included British American Tobacco on our M&A target list, it's probably fair to say that at least part of the 'valuation gap' is down to the stock being London-listed.

On the other hand **AstraZeneca (AZN)** generates more than 90% of its revenue outside of the UK, and it reports in US dollars, but it trades on 25 times current-year forecast earnings according to Sharepad, while US rival Pfizer trades on 15-times and Switzerland's Roche trades on 16-times.

Selling prescription drugs is undoubtedly a better business than selling tobacco, hence AstraZeneca has better revenue growth and better operating margins than British American Tobacco, but the shares could hardly be said to be trading at a discount either to their historic valuations or to those of their peers regardless of the level of the pound.

FOR A FEW DOLLARS (OR EUROS) MORE

Moves in the exchange rate can make a big difference for corporate buyers in terms of their appetite for M&A. The sharp drop in sterling following the 2016 Brexit vote spurred a huge influx of M&A spending as the buying power of every dollar and euro was suddenly boosted.

If a company can move in and scoop up a rival or complementary business at a low price and then see a benefit as the target company rises in value in tandem with the currency it's a win-win situation.

So any investor seeking stocks to buy as potential

MAJOR UK DEALS RECENTLY ANNOUNCED

Cobham (£4bn, buyer **Advent**, US private equity)

EI Group (£1.3bn, **TDR Capital**, UK private equity)

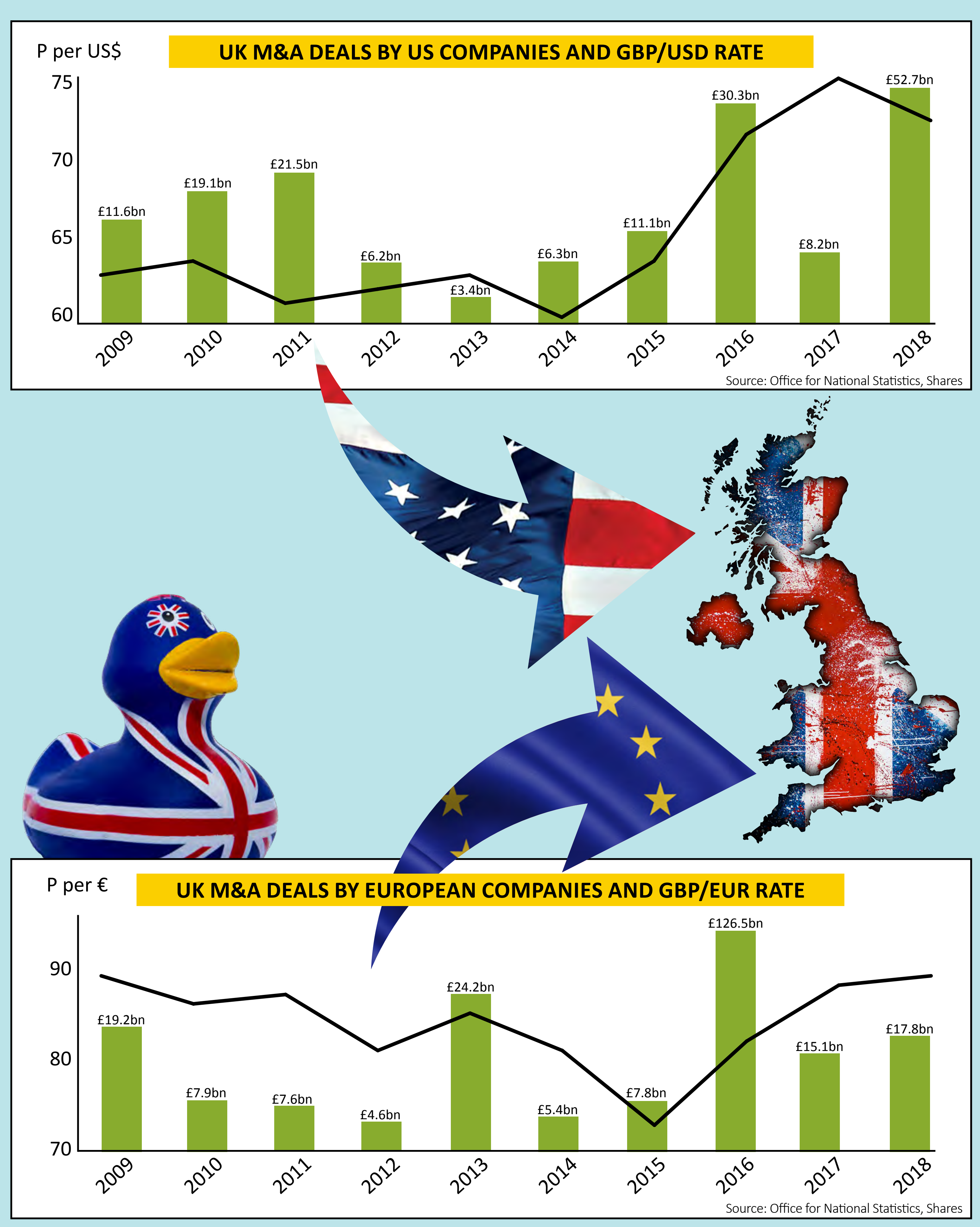
Entertainment One (£3.3bn, **Hasbro**, US industrial)

Greene King (£2.7bn, **CKA**, Hong Kong property investor)

Just Eat (£5bn, **Takeaway.com**, Dutch fast-food rival)

Merlin (£4.8bn, **Kirkbi**, Danish Lego owner)

FOREIGN COMPANIES BUYING IN THE UK



takeover targets, the goal is to find solid businesses with at least three quarters of their sales overseas, which thanks to the weakness of sterling or a short-term hiccup in trading are sitting at relatively attractive valuations for trade or financial buyers.

However, given the amount of money already chasing these kind of companies and the number which have already been snapped up, compiling the list isn't easy.

WHICH COMPANIES ARE FLOATING OUR BOAT?

Rather than just looking for companies which look cheap, we have screened the FTSE 350 for what we consider to be good companies which are either cheap due to the weak pound, or are trading at depressed levels due to temporary factors like a cyclical downturn or a company-specific problem which can be solved without too much drama.

We have also identified a group of companies which look cheap relative to the value of their assets and which could appeal to non-trade buyers looking for a purely financial return over the medium term.

A couple are turnaround stories and some have net cash on their balance sheets – which makes them even cheaper for a buyer as they can pocket the money.

THE FTSE 250 PERFORMANCE LOOKS A LOT DIFFERENT IN DOLLAR TERMS

Performance since start of 2016:

In sterling: **+11.7%**

In dollars: **-8.4%**

About half of the FTSE 250 index contains UK-focused companies. The data shows that the index has become 8.4% cheaper in dollar terms, raising the prospect of good firms being taken over by foreign entities.

FIVE TAKEOVER TARGETS TO BUY NOW

BUY **AGGREKO 790.4P** BUY

MARKET VALUE: £2BN/$2.5BN NET DEBT: £784M/$964M

Power-equipment rental firm **Aggreko (AGK)** is a truly global operation, doing business in weird and wonderful places across the globe from Bangladesh to Burkina Faso.

Its core business is providing power where it's needed, when it's needed, to keep the lights on. It has large exposure to the US, especially the energy sector, and is always busy during hurricane season when traditional power sources are knocked out.

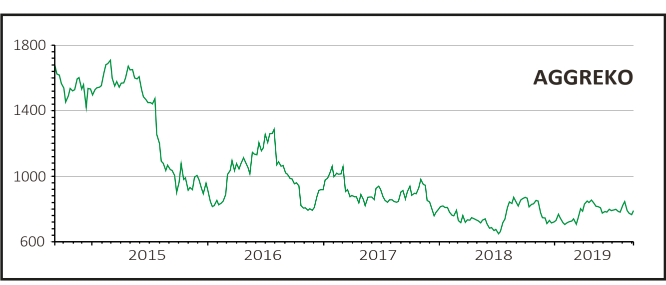
In its heyday it enjoyed returns on capital employed (ROCE) of over 20%. Today returns are more like 10%, but thanks to cost-cutting and a dwindling proportion of sales to the utility sector – which is low-margin and where some of its customers are cash-strapped – it is targeting a mid-teens ROCE in 2020.

The balance sheet is better than it was, although net debt is close to £800m, and it is a capital-intensive business with new projects typically requiring an upfront investment.

It has invested heavily in more eco-friendly

equipment, and the trend towards greener energy in emerging markets, where there is large structural power deficit, means there is still significant growth potential.

This looks like a classic takeover target for a foreign entity – a solid business going cheap.



BUY — RENISHAW £36.64

MARKET VALUE: £2.6BN/$3.2BN NET CASH: £105M/$130M

Precision-measurement manufacturer **Renishaw (RSW)** earns 95% of its revenue outside the UK, operating across 81 locations in 36 countries.

Its tools are used in a range of industries from electronics and healthcare to transport, contributing to the development of products from smart phones to dental implants and jet engines.

Headwinds in the Asia-Pacific region (43% of sales), especially smart phones, led to a profit warning in late March since when the company has lost over 10% of its market value.

Renishaw has been through similar 'bumps in the road' before and the quality of the business usually shines through. Return on capital employed is currently 15% but has averaged more than 20% over the last five years.

The weakness of sterling means that a US buyer could acquire the company for 50% below the peak price seen in January 2018. Meanwhile earnings per share are slated to grow by 11%

and 15% for the next two years according to analyst forecasts compiled by Reuters.

The firm is majority-owned by its two founders, both in their late 70's with no family members involved in the senior management, so a bid at the right level could succeed.

BUY — A.G. BARR 570.3P

MARKET VALUE: £650M/$800M NET CASH: £22M/$27M

Shares in Scotland-headquartered soft drinks group **A.G. Barr (BAG)** have fallen by a third since a mid-July profit warning, leaving the maker of iconic tipple IRN-BRU, Strathmore, Rubicon and cocktail mixers name Funkin looking vulnerable to a takeover bid.

Beverages industry watchers may recall that a £1.8bn merger with rival **Britvic (BVIC)** was announced in 2012, but the deal fell apart a year later.

The key takeaway is that big-time consolidation can happen in this sector and a bid for A.G. Barr is not beyond the realms of possibility given the current weak share price.

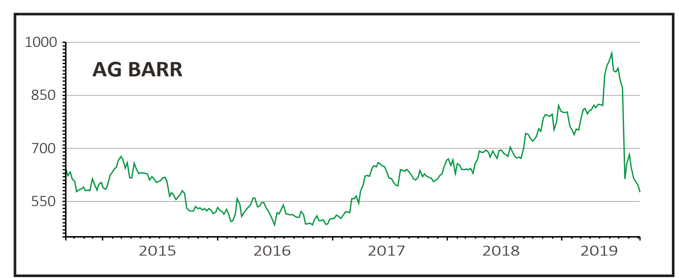
This is a business that could well be on the watch list of overseas acquirers with a liking for quality.

A.G. Barr's shares lost their fizz following a punishing earnings alert this summer, which was blamed on a strategy shift from a heavy focus on driving volume last year to prioritising value now.

Also at play were disappointing spring and early summer weather, most notably in Scotland and the north of England, and short-

term challenges around its Rockstar energy and Rubicon juice drinks.

Yet *Shares* remains bullish on the long-term earnings potential of A.G. Barr, whose competitive advantage lies in a portfolio of differentiated soft drinks brands, well-invested manufacturing assets and strong cash generation, the latter enabling the company to fund a progressive dividend and supportive share buybacks.



BUY JOHNSON MATTHEY £30.78

MARKET VALUE: £6BN/$7.4BN NET DEBT: £866M/$1.1BN

Investors have a love-hate relationship with catalytic converter-supplier **Johnson Matthey (JMAT)**, piling into the stock when it's in vogue and piling out when it fails to meet expectations.

Right now sentiment is at a low ebb after the company disappointed the market with its full-year results in May despite a big increase in revenue and earnings.

The big story isn't so much catalysts any more as the New Markets division which is working on a new type of battery technology for electric vehicles.

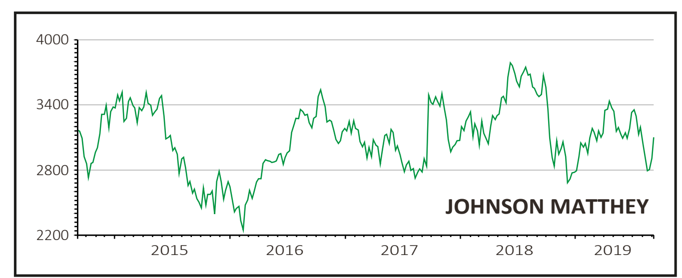
ELNO, or enhanced lithium nickel-oxide, could transform the firm's fortunes if it can get it into commercial production and ready for the market by 2022 as planned.

Sales of electric vehicles are estimated to hit over $550bn by 2025 compared with $55bn this year which means the opportunity set is huge.

The July trading update said that this year's results will be 'second half-weighted', which

didn't go down well with investors, but given the ups and downs of the last five years and the current rating of 13 times earnings it's hard to see the shares falling much further.

For a car-maker seeking next-generation battery technology, or even a rival supplier, Johnson Matthey looks ripe for the taking.



BUY KELLER 665.76P

MARKET VALUE: £475M/$585M NET DEBT: £420M/$517M

Ground works engineering specialist **Keller Group (KLR)** is the world's largest player in a fragmented market, with around a 5% of the share. It operates in over 40 countries through 22 business units, and generates only 3% of its revenue from the UK.

Just over half of group revenue comes from the US market, another third from Europe, and the rest from Asia. Late last year the company saw its shares crash 30% on news that it was reviewing its Asian business, citing deteriorating conditions, notably in Malaysia.

The company decided to start restructuring the troubled Asian business as well as the reorganising the US business, integrating seven individually branded businesses into one Keller brand.

The underlying drivers of the business, growing urbanisation and infrastructure spending, continues to provide growth opportunities for the group.

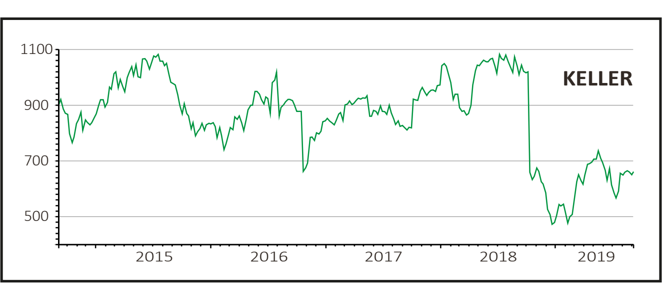
At the first half results reported on 29 July, the company reported an increased momentum during the second quarter, offsetting the weak

start to the year.

For the full year Keller expects revenue to be broadly flat and an improvement in margin to drive growth in profits.

Current analyst expectations pencil in 12% growth in operating profit to £108.4m and 15% growth in earnings per share to 91.12p.

Keller ticks the box on several levels in terms of our search for potential takeover targets. It earns a lot of earnings overseas, which are more attractive due to the weakness of sterling and the company suffered a one-off earnings hiccup, cheapening the shares further.



Donald Trump is trying to reverse 48 years of economic history

His actions have put the spotlight back on something called 'the Triffin dilemma'

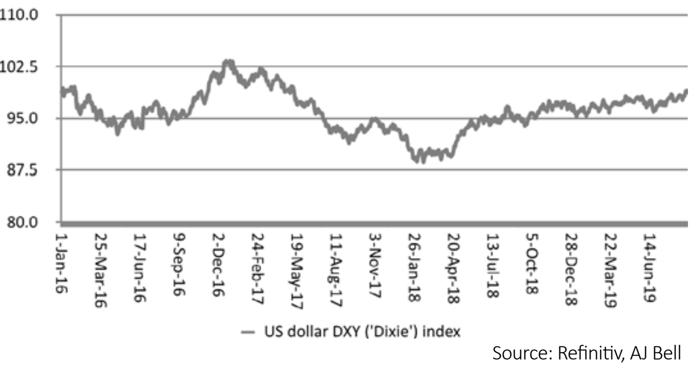
When the latest meeting of the US Federal Open Markets Committee concludes on 18 September chair Jay Powell is widely expected to announce an interest rate cut, according to the CME Fedwatch tool.

The only debate concerns whether it will be a quarter-point or half-point reduction from the current level of 2.25%.

And yet the US dollar continues to rise despite the huge U-turn in Fed monetary policy and President Trump's attempts to lean on the central bank for more action to talk the dollar down.

Using the trade-weighted DXY (or 'Dixie') index as a benchmark, the dollar stands at a 2.5 year high, around the 99 mark.

THE DOLLAR CONTINUES TO GAIN GROUND



Source: Refinitiv, AJ Bell

This takes us back to a topic called the Triffin dilemma, whose influence should be followed by investors in the coming months.

TRIFFIN EXPLAINED

When then-US President Richard Nixon took America off the gold standard in 1971 the dollar effectively became the world's reserve currency. Yet Professor Robert Triffin had already seen the catch in a book he produced in 1960 called *Gold and The Dollar Crisis: The Future of Convertibility.*

He argued that the greenback's global reserve currency status would come at a cost – either to America or the world.

Triffin asserted that to provide the world with enough dollars, America would always have to run a trade deficit and import more than it exported, paying out more in dollars than it received, and run an ever-growing budget deficit for good measure.

This is all well and good while confidence in the dollar remains, lenders are happy to hold US Treasuries and the US is happy to run a trade deficit. But it becomes a problem if lenders lose faith (as they did briefly in 2008) or America's trade policy is changed.

This is where President Trump enters the equation. While he is happy to run ever-bigger budget deficits his policy to put 'America first' means he is trying to reverse 48 years of economic history and reduce the US trade deficit.

If Trump succeeds, dollars would flow back to America and drain the global economy of the greenbacks upon which it is reliant.

The President has only made little, if any, progress with the US trade deficit so far but the dollar has gained during this period and the world's economy and financial markets have already started to feel the effects.

THE US TRADE DEFICIT IS SHRINKING (A LITTLE)

65.0
55.0
45.0
35.0
1-Jan-17 1-May-17 1-Sep-17 1-Jan-18 1-May-18 1-Sep-18 1-Jan-19 1-May-19
— US trade deficit ($ billion)

Source: FRED – St. Louis US Federal Reserve database, AJ Bell

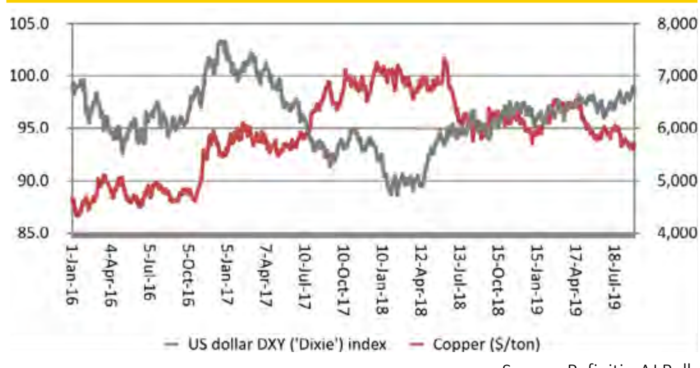
ARGENTINA CRIES AGAIN

A strong buck is traditionally seen as deflationary – it increases both the costs of dollar-priced commodities and the interest costs of those nations who borrow in dollars and not their own currency, a particular facet of emerging markets.

Increased raw material costs eat into corporate profit margins and cash flows (and potentially dividends) while coupon payments to bondholders crimp governments' scope to invest and potentially economic growth.

We are already seeing early signs of strain. First, the copper price, a traditional proxy for global economic health thanks to the industrial metal's widespread use, is languishing at a 2.5-year low of around $5,500 a tonne.

COPPER PRICE WEAKNESS IS A CONCERN



Source: Refinitiv, AJ Bell

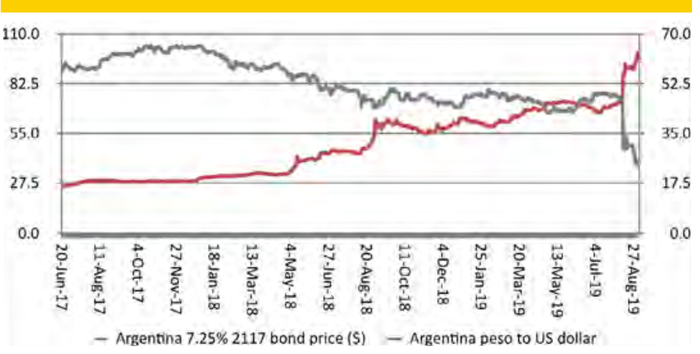
Second, Argentina, a huge borrower in dollars, is suffering a collapse in confidence and its currency after President Mauricio Macri's unexpected defeat in an early poll ahead of October's election.

That has forced him to postpone repayment of $7bn in debt, talk about 'reprofiling' the nation's $101bn in liabilities and impose capital controls to support the peso.

Those brave souls who bought Argentina's 100-

year (or so-called 'century') bond in 2017 may now be feeling pretty sick, though they really should have known better given Buenos Aires' history of eight defaults since the early 1800s.

ARGENTINA'S CENTURY BOND AND CURRENCY HAVE COLLAPSE



Source: Refinitiv, AJ Bell

CRACKS IN THE WALL

It remains to be seen whether these cracks become a major fissure in financial markets or whether central bank interest rate cuts can paper over them.

Currency controls have helped the Argentina peso to rally a little. But they did not work in Malaysia in 1997 and the ripple effects then were huge, even if it took until mid-1998 for them to knock global markets.

Investors are used to (relatively) easy access to markets and assets. Capital controls stop that, just like the gating of a fund – and we all know how badly that has gone down this year in the case of Woodford.

It is to be hoped that the Triffin dilemma does not become more acute and claim more victims and investors need to keep an eye on emerging markets to check for any more market stresses – Turkey, for one, may not be out of the woods yet.

By **Russ Mould**
AJ Bell Investment Director

HOW I INVEST:

Aspiring to become an ISA millionaire

Mark from Edinburgh is taking higher risks in an effort to hit a number of goals

Twenty eight year-old Mark has made 14% average annual return from his equity, derivative and loan investments over the past five years. He comes across as someone with a high appetite for risk and is prepared to try many different strategies in order to make money.

The financial gains exclude additional investments which are spread across buy-to-let property, crowdfunding (including investments linked to beer group Brewdog and financial services group Nutmeg) and bitcoin.

'I'm active in so many parts of the market because of diversity and curiosity,' he says. 'I could put everything into index funds and hopefully achieve an average of 10% a year, but frankly it's boring and I see it as a challenge to achieve above-average returns.'

Mark works as a chemical engineer in Edinburgh and started investing when he was aged 20. His job has taken him to the North Sea, the Middle East and Azerbaijan and provided insight into the commodities market.

Having started his investment journey with low cost tracker funds, he now invests in stocks, passive and actively-managed funds and has had some experience with derivatives such as trading the oil price as well as peer-to-peer lending.

The very high-risk investments are ring-fenced from his core portfolio by being held in a separate account. The bulk of his money is held in Vanguard tracker funds, shares in companies including Apple, Microsoft and Amazon, and various investment trusts including **City of London (CTY)**, **Scottish Mortgage (SMT)** and **F&C (FCIT)**.

His best performing stocks have been software group **Blue Prism (PRSM:AIM)** and Chinese giants Alibaba and Tencent. The biggest losses have come from **Woodford Equity Income Fund (BLRZQ62)** and **Woodford Patient Capital Trust (WPCT)**.

He makes regular contributions into an ISA and tries to use the entire £20,000 allowance each year. 'I purchase funds on a monthly basis so that I pay the average price,' explains the enthusiastic investor. 'This only takes an hour or two a month as I reflect on my decisions and strategy.'

Earlier in his investment journey, Mark spent more time trading the markets and found this took up more of his time, often consuming an hour or two a day.

'I was making about £400 net earnings a month, but it was high risk, time consuming and to make any money I had to sustain a high success rate,' he says.

'I now have limited time to dedicate to day trading so my frequency has reduced and I

take a more cautious approach to investments. I try to understand a company and how it might perform over a six to 12 month period rather than my old time period of a week and where I might have sold hours after buying. This change in approach has resulted in less time spent on the markets, lower fees and smoother returns.'

"I was making about £400 net earnings a month from day trading, but it was high risk"

Mark initially started investing as a way of making money to buy a house. Now that's been achieved, his future goals include making enough returns to pay for his wedding and buy a McLaren sports car. 'The long term goal is to design and build an environmentally-friendly house which is as self-sufficient as possible.'

Clearly an ambitious person, Mark has worked out how and when he could become an ISA millionaire, saving enough in his tax-efficient investment wrapper and calculating the necessary returns to hit the seven-figure number. On paper that's 25 years of saving £20,000 a year and achieving 5% annual return.

Mark says he tends to avoid talking about the higher risk investments he makes – because it worries his mum.

He adds that friends and family don't really share his passion for investing and understanding the opportunities.

'Most of my family and friends wish to discuss investments purely to benefit financially, not out of interest, hence why I find solace in reading *Shares* magazine on a weekly basis.'

By **Daniel Coatsworth**
Editor

GETTING LUCKY WITH CRYPTOCURRENCY

Mark took a punt on the price of Bitcoin with a £1,000 investment in 2014. The cryptocurrency saw its price soar in 2017 to just shy of $19,800 (c£14,780) in December that year. He timed the exit well, selling down progressively during 2017 before the bubble burst.

'I would consider it my luckiest investment to date and have not since invested in cryptocurrencies. I don't ever anticipate achieving returns of the same magnitude again.'

WOULD YOU LIKE TO FEATURE AS A CASE STUDY IN SHARES?

We are looking for individuals or couples who can discuss their experience with investing and some details about their portfolios.

Anyone interested should email **editorial@sharesmagazine.co.uk** with 'case study' in the subject line.

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.

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'Should I reduce risk in my pension because of Brexit?'

A reader approaching retirement asks if they should bring forward their de-risking plans

I'm 57 and currently have my SIPP invested mainly in equities. I plan to start taking an income via drawdown when I turn 65 and so was planning to take a bit less risk from my 60th birthday. However, given everything that's going on in the UK at the moment I'm wondering if I should bring forward my plans?
Clive

Tom Selby
AJ Bell
Senior Analyst says:

Lots of investors are concerned about Brexit and what it might mean for their investments.

While it might be tempting to radically alter your retirement strategy based on whether or not the UK leaves the EU with a deal, remember this is just one political event whose impact is far from certain. One of the biggest mistakes investors can make is dramatically shifting their portfolios based on short-term events such as Brexit.

The pound has recently been falling in value which could hurt UK-focused companies while potentially giving a boost to exporters whose goods will become cheaper to foreign buyers. If the Prime Minister salvages a Brexit deal and sterling rebounds, the opposite will likely occur.

The extent to which either scenario will play out is entirely

unclear at this stage. There are also many other factors at play, including UK economic performance and the Bank of England, which sets interest rates independently of Government.

Something like Brexit should be seen as an opportunity to review your portfolio and strategy to make sure you aren't overly exposed to one outcome or another.

It is good sense not to put all your eggs in one basket by investing in a single or even handful of shares which may be overly exposed to the fortunes of a particular factor or country's fortunes.

This does not necessarily mean having to choose lots of shares or funds – a single global equity or multi-asset fund might be satisfactory, as long as it is widely diversified.

When it comes to reviewing and potentially reducing your exposure to equities – and hence the risk – in your portfolio as you approach retirement, you should weigh the pros and cons first.

Broadly, reducing risks in a diversified portfolio, perhaps by holding more bonds and cash in place of equities, should dampen the volatility of your investments. It will also limit the extent to which they can grow, meaning your outcome becomes more certain. This is a common strategy for people approaching retirement, particularly when they plan to buy an annuity.

While there is nothing wrong with holding cash or cash-like investments as part of your portfolio, having the majority of your fund in cash leaves you exposed to the ravages of inflation. This might not be a problem for a year or two, but over longer time periods it risks seriously eroding your fund value.

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.

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Understanding two well-known fund rating systems

Independent ratings systems are a vital tool in your armoury when it comes to assessing funds

Picking the best funds for your portfolio can be complicated given the vast amounts of data and opinion in the market. Private investors often find it difficult to discern which funds are most suitable for portfolio inclusion, or which stock pickers are the real deal.

There are best buy lists out there, but their reputations have been slightly tainted by the Neil Woodford debacle, with **Hargreaves Lansdown (HL.)** in the doghouse for retaining the **LF Woodford Equity Income Fund (BLRZQ73)** on its 'Wealth 50' list right up until the money manager gated the fund in June.

Nevertheless, you certainly shouldn't discount some very informative independent fund rating systems that investors can lean on for ideas. In this article, we examine the mechanics of two ratings systems and flag some of the funds that stand up to scrutiny.

EXAMPLES OF FUNDS WITH MORNINGSTAR 5-STAR AND GOLD RATINGS

- JPMorgan US Equity Income
- Vanguard LifeStrategy 20%/40%/60%/80% Equity Funds

EXAMPLES OF FUNDS WITH MORNINGSTAR 5-STAR AND SILVER RATINGS

- Jupiter Strategic Bond
- M&G Global Macro Bond

EXAMPLES OF FUNDS WITH MORNINGSTAR 5-STAR AND BRONZE RATINGS

- Investec UK Alpha
- Merian UK Smaller Companies

GOING FOR GOLD

Independent investment research provider Morningstar's fund ratings offer a powerful fund assessment tool. They include the Morningstar 'star rating', which is an assessment of a fund's track record relative to peers and offers investors a first port of call in the fund evaluation process.

The star rating shows how well a fund's past returns have compensated shareholders for the amount of risk it has taken on, with the star ratings calculated at the end of every month. Importantly, to receive a Morningstar rating, a fund must have a track record of at least three years.

Helpfully, funds are given a Morningstar analyst rating of Gold, Silver, Bronze, Neutral or Negative, reflecting a Morningstar analyst's conviction in the prospects for outperformance.

This Morningstar analyst rating provides a forward-looking assessment of the fund's ability to outperform its peer group or benchmark on a risk-adjusted basis over a full market cycle.

Continuously monitored and re-evaluated at least every 14 months, the Morningstar analyst ratings are assigned to funds that

have attracted the most assets and investor interest.

From an investor's perspective, these analyst ratings, based on five key pillars – people, parent, process, performance and price – and face-to-face meetings, can be used to unearth funds the analysts believe will perform better than similar investments over a full market cycle.

Among the open-ended elite boasting a five-star Morningstar rating combined with a Gold Morningstar analyst rating is the Terry Smith-steered **Fundsmith Equity (B41YBW7)**, which puts money to work with high-quality, cash generative businesses that will compound in value over time.

Morningstar analyst Peter Brunt dubs Fundsmith Equity 'one of the strongest options for investors seeking exposure to high-quality global equities'. Smith is described as 'an original thinker' who has 'often demonstrated his willingness to bet against the crowd by taking a longer-term view'.

CROWNING GLORY

Financial data provider FE Trustnet also offers ratings that can help investors to identify the best funds. Its FE Crown fund ratings identify the best performing and most consistent funds over the long term. Crucially, the fund providers are not charged for a rating, which means, like Morningstar's ratings, they are entirely independent.

FE Crown fund ratings are updated twice a year (during January and July) and enable investors to separate the benchmark-beating wheat from the underperforming chaff among unit trusts, open-ended investment companies (OEICs) and investment trusts.

EXAMPLES OF FUNDS WITH A FIVE-CROWN RATING FROM FE TRUSTNET

- AXA World Funds Framlington UK
- BlackRock Sterling Strategic Bond
- Liontrust UK Micro Cap

Since they focus on a fund's outperformance (or not) of an index, the FE Crown fund ratings are aimed at active funds, while tracker-type funds are rated using FE's Passive Crown rating methodology.

Quantitative ratings range from one to five. These ratings are designed to help investors to spot funds which have exhibited superior performance in terms of stock picking, consistency of outperformance versus a credible benchmark and the generation of results at a relatively low risk.

The top 10% of funds are awarded five FE Crowns. Among this highest tier are the likes of **LF Ruffer Gold (B8510Q9)**, the Robin Geffen-guided **Neptune Russia (B86WB79)** and **Lindsell Train Global Equity (B3NS4D2)**, not to mention private investor favourite **Scottish Mortgage (SMT)** from the investment trusts sector.

The next 15% receive four FE Crowns and each of the remaining three quartiles are given three, two and one FE Crown(s) respectively.

FE Crown's ratings are purely quantitative and backward looking and are therefore no guide to the future. They are not fund recommendations either and shouldn't be regarded as specific advice.

Investors still need to consider qualitative measurements, the track record of the fund managers running the portfolio and the expertise of the asset management group behind the fund in the sector in which the portfolio is allocating capital.

A RECENT AWARD WINNER

Unicorn UK Ethical Income (BYP2Y51) recently won a five-Crown rating from FE Trustnet, having just become eligible for the first time to be considered for an award.

The fund was launched in May 2016 and invests in companies which meet certain ethical guidelines. It is essentially an ethically screen version of **Unicorn UK Income Fund (B00Z1R8)** and it outperformed this fund by 3.1% in the year to 30 September 2018.

The top holdings currently include cinema operator **Cineworld (CINE)**, financial services group **Secure Trust Bank (STB)** and promotional products specialist **4imprint (FOUR)**. It has achieved 5.59% annualised total return over three years.

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

Why you should choose ETFs over traditional tracker funds

There are tax advantages for choosing ETFs over traditional tracker funds

When it comes to passive investing, there are two main options – exchange-traded funds (ETFs) and index funds, the latter perhaps better known as the traditional tracker funds offered by the large life insurers and banks.

Both do practically the same thing; they buy shares in companies that feature in a specific index, such as the FTSE 100, so they can mirror its returns.

But there are differences between them. ETFs are listed like normal shares on places like the London Stock Exchange and you buy them via an investment platform provider, such as the company with whom you hold an ISA or SIPP.

Index funds on the other hand are mutual funds, and when you buy units in the fund you're buying them straight from the fund company.

They both perform the same function in an investor's portfolio, simply following an index and its accompanying returns both positive and negative, and both should have low fees compared to actively-managed funds.

THE STAMP DUTY FACTOR

So all being equal – the same index followed, the same fee advertised, which would be better, the ETF or the index fund?

Partly because of something called Stamp Duty Reserve Tax (SDRT), or just 'stamp duty' if undertaken in certificated form, the ETF would most likely be the better option if investing in UK-listed companies, like those in the FTSE 100 or FTSE 250.

Taxed on UK equity investments, stamp duty is charged at 0.5% of the value of any purchases of UK-listed shares.

The exceptions are companies quoted on AIM, as well as the purchase of shares under £1,000 which are undertaken non-electronically.

So when making a purchase of £20,000 worth of **Vodafone (VOD)** shares, for example, £100 in stamp duty is payable, bringing the total cost of the transaction to £20,100.

WHEN IS THE TAX PAID?

For an investor directly investing in UK shares, the tax is paid on purchase. It is also usually paid by investors in a UK equity fund, although in this case indirectly.

When the manager of the fund puts money received from investors into shares, they are subject to stamp duty.

This is passed on to the investor through what's called a dilution levy, a charge that is applied by the fund manager to

mitigate the impact of the fund's dealing costs when investors put money in or take money out.

But if this is not the policy of the fund, then stamp duty is borne by all investors in the fund.

This is also the case for UK index tracking funds. As passive funds look to minimise the tracking against the benchmark, they almost always pass stamp duty charges straight to the investor through something like a dilution levy.

But ETFs don't pay this tax because ETFs are traded on the secondary market.

WHY ARE ETFS DIFFERENT?

When a company launches an ETF, it's put onto an exchange, and once on that exchange, shares in it are traded between investors, not the company that created the fund.

That means when you buy shares in an ETF, you're buying them from another investor and not the ETF provider, so there is no extra money put into the fund from the transactions.

Because the transaction has occurred independently of the ETF itself – which is called secondary trading – this means it is exempt from stamp duty.

When you're buying shares in a traditional index fund, you're buying from the fund itself, meaning the tax is payable.

But according to Matt Brennan, head of passive portfolios at AJ Bell, it's important to note that an ETF does trade at a slight premium or discount to the underlying value of the holdings. This is to prevent investors from exploiting this tax advantage.

In normal market conditions the premium or discount is fairly steady, meaning an ETF can be sold at the same premium or discount it was purchased at.

Brennan adds: 'UK equity ETFs tend to trade at a slight premium to account for stamp duty, but can also very likely be sold at this premium later.

'This effectively means that whilst stamp duty is temporarily suffered on purchase due to the premium, it is in effect recouped by the investor on selling the holding, due to the persistent premium.'

THE LITTLE NUMBERS ADD UP

When the performance of an ETF or index tracker fund is reported, often just the change in the value of the underlying holdings is included, with the costs impacting investors like taxes and trading costs mostly excluded.

So when investors see the overall return figure from their fund, it's likely they won't realise that taxes and other charges have made a dent into those returns.

Going back to the earlier example of investing £20,000 in Vodafone shares (which came with a £100 stamp duty fee), if 10 years later they have increased by 50% in value and you decide to sell, you'd get £30,000 back.

But say the full £20,100 you originally paid in total was all invested in its shares and you didn't have the £100 stamp duty fee as part of the overall transaction, you'd get £30,150 back.

That might not sound a big difference over 10 years, but multiply that across several holdings in a portfolio and it can soon add up.

By **Yoosof Farah**
Reporter

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Equals Group (EQLS)

Ian explains Equals' plans and how the e-banking and payments group (previously known as FairFX) is growing

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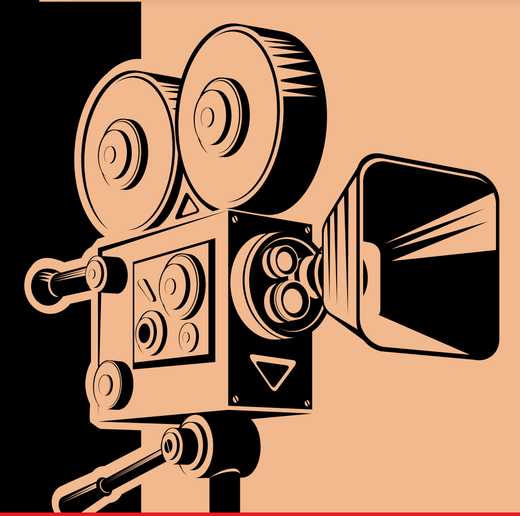
Dorian speaks to *Shares'* editor Daniel Coatsworth about the UK property market and how Belvoir Group is coping with various business challenges.

Alex Savvides, Senior Fund Manager
JO Hambro UK Dynamic Fund

Alex explains the main distinguishing features of JO Hambro UK Dynamic Fund and how he searches for companies that are going through a process of management and strategic change.



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Is there more risk lurking in your portfolio than you think?

Trusts using debt to supercharge returns can incur problems in a market downturn

Investors are concerned about what Brexit means for their portfolios and how to navigate the current tricky markets. There's no magic bullet, but investors should make sure there aren't any risks lurking in their portfolios that they aren't aware of. One step they can take is to check the level of gearing in any investment trusts they own.

Borrowing to invest is also known as gearing, or in other words increasing the proportion of debt to equity in an investment trust. Gearing works to effectively amplify any rise or fall in the trust's value. This means that if the investments within a trust rise, gearing will boost those returns, while if the investments fall gearing will lead to an even larger fall.

> A total of eight UK-focused investment trusts have gearing of 20% of more

This is particularly important for UK-focused trusts at the moment, as they are exposed to the risk of Brexit negotiations causing more volatile market movements.

IS THERE BENEFIT OF HAVING HIGHER GEARING NOW?

Gearing in these UK-focused investment trusts could pay off if the UK sees a much-anticipated 'Brexit bounce' following the conclusion of any deal. Likewise, it means these investors could face a shock fall in their investments if the market sees a slide downwards on a shock outcome that spooks markets.

The ability to use debt is one of the ways that investment trusts have on average managed to outperform their fund peers over the long-term, but it does mean that investors need to buckle up for more of a rollercoaster ride. Above all investors need to know what level of gearing the trusts they own have, so they can be prepared for this higher risk.

HOW MANY UK TRUSTS HAVE HIGH GEARING?

A total of eight UK-focused investment trusts have gearing of 20% of more, meaning investors in these funds are exposed to more risk.

For example, **Acorn Income (AIF)** currently has gearing of 47%, so equivalent to almost half the value of its assets, adding in a hefty level of risk for investors. Larger trusts, such as **Perpetual Income & Growth (PLI)**, **Law Debenture (LWDB)** and **Merchants (MRCH)** all have gearing of 15% or higher, ratcheting up the risk for investors.

However, investors shouldn't just check the level of gearing but also how it's structured and how much it's costing

TOP 20 UK-FOCUSED INVESTMENT TRUSTS BY LEVEL OF GEARING						
Company	Gearing	One year return*	Three year return*	Five year return*	Discount/ premium to NAV	Dividend yield
Acorn Income	47%	-16.9%	7.7%	22.6%	-16.4%	6.2%
Chelverton UK Dividend	37%	-20.3%	-2.4%	20.3%	-11.9%	5.5%
Aberforth Split Level Income	32%	-17.2%	NA	NA	-10.9%	5.8%
British & American	30%	-46.8%	-36.2%	-26.5%	34.1%	24.5%
Value and Income	29%	-4.1%	14.0%	14.3%	-18.9%	4.7%
Henderson High Income	26%	0.9%	7.6%	23.5%	-5.6%	5.7%
Shires Income	24%	6.0%	32.5%	35.3%	-1.1%	5.1%
BlackRock Throgmorton Trust	20%	5.3%	86.9%	120.2%	-2.3%	1.7%
Merchants	17%	-4.6%	26.7%	19.0%	-1.1%	5.8%
Law Debenture	15%	-3.0%	28.7%	25.9%	-8.5%	3.4%
Perpetual Income & Growth	15%	-15.6%	-14.8%	-5.8%	-12.2%	4.9%
Henderson Opportunities	14%	-17.2%	15.7%	1.5%	-21.5%	2.4%
Lowland	14%	-14.0%	9.1%	9.1%	-7.6%	4.8%
Schroder Income Growth	13%	-5.2%	19.3%	24.6%	-7.5%	4.2%
Aberdeen Standard Equity Income	11%	-23.9%	-2.6%	5.2%	-11.0%	5.8%
City of London	10%	1.1%	13.7%	32.1%	2.3%	4.5%
JPMorgan Claverhouse	10%	-4.9%	37.5%	36.6%	-3.5%	4.0%
Henderson Smaller Companies	9%	-6.5%	39.2%	72.1%	-10.5%	2.8%
JPMorgan Smaller Companies	9%	-5.1%	52.0%	62.5%	-15.3%	2.4%
Montanaro UK Smaller Companies	9%	-8.5%	23.5%	27.0%	-18.7%	3.6%

Source: AIC/AJ Bell. Data accurate to 3rd September. * on a total return basis

the trust. This information is available in the trust's annual report and accounts.

WHAT RATES DO TRUSTS PAY ON DEBT?

Some trusts will have secured their borrowing years ago when interest rates were higher and so will be paying high interest rates on the loans.

This means they face a strong headwind and must earn a decent return on any gearing just to break even. Trusts that have managed to refinance this lending recently, when rates have been lower, will have an advantage as they can invest in relatively low yielding assets and still generate a return.

For example, **City of London (CTY)** currently has expensive

long-term borrowing that it secured in the 1980s and 1990s, with interest rates of 10.25% and 8.5%. However, in the past few years it took advantage of lower interest rates and secured cheaper borrowing at around 3%. Perpetual Income & Growth is another trust that has made use of low borrowing costs, with a chunk of its borrowing having an interest rate of 0.7% over the Bank of England's base rate.

Investors also need to understand how the gearing is arranged. Some trusts shun bank lending or other corporate borrowing in favour of issuing new 'preference' shares in the trusts in order to borrow.

These zero-dividend preference shares have a fixed rate of return, much like bank interest, but usually will get their capital returned before other shareholders. Acorn Income, which has the highest level of gearing of the trusts, uses this funding method, as does **Aberforth Split Level Income (ASIT)** and **Chelverton UK Dividend (SDV)**, among others.

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

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Belvoir Lettings

Speaker – Dorian Gonsalves, CEO

Belvoir Lettings (BLV) is uniquely positioned within the property sector, benefiting from the agility of a franchise business model compared with the larger corporate players.

Open Orphan

Speaker – Cathal Friel, CEO

Open Orphan (ORPH) is a European-focussed, rare and orphan drug consulting services platform. The Company targets the orphan drug services market in Europe.

ReNeuron Group

Speaker – Michael Hunt, CFO

ReNeuron Group (RENE) is a leading, clinical-stage stem cell business. Our primary objective is the development of novel stem cell therapies targeting areas of significant unmet or poorly met medical need.

SkinBioTherapeutics

Speaker – Stuart Ashman, Chief Executive

SkinBioTherapeutics (SBTX) is a life science company focused on skin health. The Company's proprietary platform technology, SkinBiotix®, is based upon discoveries made at The University of Manchester.

VolitionRx

Speaker – Cameron Reynolds, President and CEO

VolitionRx (VNRX) is a multi-national life sciences company developing simple, easy to use blood-based cancer tests to accurately diagnose a range of cancers.

During the event and afterwards over drinks, investors will have the chance to:

- Discover new investment opportunities
- Get to know the companies better
- Talk with the company directors and other investors

Event details

Registration 18:00
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KEY

- **Main Market**
- **AIM**
- **Investment Trust**
- **Fund**

4imprint (FOUR)	40
888 (888)	14
A.G. Barr (BAG)	30
Aberforth Split Level Income (ASIT)	45
Acorn Income (AIF)	44
Aggreko (AGK)	29
AstraZeneca (AZN)	14, 26
Barclays (BARC)	6
Blue Prism (PRSM:AIM)	34

British American Tobacco (BATS)	26
Britvic (BVIC)	30
Centrica (CNA)	8
Chelverton UK Dividend (SDV)	45
Cineworld (CINE)	40
City of London (CTY)	34, 45
EasyJet (EZJ)	9
Eddie Stobart Logistics (ESL:AIM)	7
Equiniti (EQN)	6
F&C (FCIT)	34
Fidelity Special Values (FSV)	12
Fundsmith Equity (B41YBW7)	40
Hargreaves Lansdown (HL.)	39
HSBC (HSBA)	6
International Consolidated Airlines (IAG)	9
Johnson Matthey (JMAT)	31
Keller (KLR)	31
Law Debenture (LWDB)	44
LF Ruffer Gold (B8510Q9)	40
Lindsell Train Global Equity (B3NS4D2)	40
Lloyds Banking Group (LLOY)	6
London Stock Exchange (LSE)	26
Merchants (MRCH)	44
Neptune Russia (B86WB79)	40

Next (NXT)	19
Non-Standard Finance (NSF)	7
Pearson (PSON)	12
Perpetual Income & Growth (PLI)	44
Raven Property (RAV)	7
Renishaw (RSW)	30
Royal Bank of Scotland (RBS)	6
Ryanair (RYA)	9
Scottish Mortgage (SMT)	34, 40
Secure Trust Bank (STB)	40
Sosandar (SOS:AIM)	20
Synthomer (SYNT)	10
Ultra Electronics (ULE)	12
Unicorn UK Ethical Income (BYP2Y51)	40
Unicorn UK Income Fund (B00Z1R8)	40
Vodafone (VOD)	41
Wizz Air (WIZZ)	9
Woodford Equity Income Fund (BLRZQ73)	7, 34, 39
Woodford Patient Capital Trust (WPCT)	34

KEY ANNOUNCEMENTS OVER THE NEXT WEEK

Full year results

16 September: City of London Investment Group, Petra Diamonds. **18 September:** Avingtrans, Pan African Resources. **19 September:** Bluefield Solar Income, Clinigen, Kier, Smiths, Wilmington.

Half year results

16 September: MP Evans, Ocean Outdoor, Science in Sport, Spire Healthcare. **17 September:** Aquis Exchange, Central Asia Metals, French Connection, Hydrogen, Personal Group, Smart Metering Systems, Uniphar. **18 September:** Accesso, Bonhill, Cello, Clearstar, Kingfisher, Keywords Studios, MaxCyte, Pendragon, Surgical Innovations. **19 September:** Allied Minds, Cambridge Cognition, Next, Xeros.

Trading statements

13 September: JD Wetherspoon.
17 September: Ocado. **19 September:** IG Group.

WHO WE ARE

EDITOR: Daniel Coatsworth @Dan_Coatsworth

DEPUTY EDITOR: Tom Sieber @SharesMagTom

NEWS EDITOR: Steven Frazer @SharesMagSteve

FUNDS AND INVESTMENT TRUSTS EDITOR: James Crux @SharesMagJames

SENIOR REPORTERS: Martin Gamble; Ian Conway @SharesMagIan

REPORTER: Yoosof Farah @YoosofShares

CONTRIBUTORS Russ Mould, Tom Selby, Laura Suter

ADVERTISING
Senior Sales Executive Nick Frankland
020 7378 4592
nick.frankland@sharesmagazine.co.uk

CONTACT US:
support@sharesmagazine.co.uk

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Head of Design Darren Rapley
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