STOCKS | FUNDS | INVESTMENT TRUSTS | PENSIONS AND SAVINGS

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# SHARES

WE MAKE INVESTING EASIER

# GETTING STARTED WITH INVESTING

## WHAT TO THINK ABOUT AND HOW TO DO IT

**PLUS**

**CAN TESLA KEEP MOTORING?** WE LOOK UNDER THE BONNET OF THE ELECTRIC CAR PLAY

FEARS OVER **CORONAVIRUS** SUPPLY CHAIN IMPACT

**FUNDSMITH'S BIG NUMBER** WHY IS TERRY SMITH TALKING ABOUT THE SORTINO RATIO?

# What your weekly shop can tell you about Unilever and Reckitt

The consumer goods giants are struggling to get back on a path to growth

When you go to the supermarket or go online to shop for household essentials, just how much do brands matter to you?

Will you pay more for a brand you know and have an attachment to, or are you prepared to pay less for a cheaper non-branded alternative? And if you're happy to pay up, perhaps you'll be looking for a more niche, artisan product.

These everyday questions of domestic life are central to the dilemma facing two of the UK's largest listed companies – consumer goods giants **Reckitt Benckiser (RB.)** and **Unilever (ULVR)**.

Historically both companies were popular with investors due to their reliable dividends, the robust margins protected by a strong portfolio of brands, and steady growth. Of late that growth has started to evaporate leading to strategy shake-ups and management change at both firms.

We took a detailed look at Unilever in a recent issue after it warned on sales growth in December 2019. Now Morgan Stanley analysts have been running the rule over Reckitt Benckiser ahead of its full year results on 27 February when a relatively new-look management team, including ex-Pepsi man Laxman Narasimhan at CEO, will outline their plans for the business.

The investment bank observes that in 13 of the last 14 quarters the company has fallen short of expectations. Its analysis further suggests that just two out of its top 23 brands (which combined account for 83% of sales) delivered high single digit growth in the period between 2017 and 2019.

These standout names are toilet cleaner Harpic (likely familiar to UK shoppers) and surface cleaner Veja (likely not as it is sold in Brazil).

Improving the growth prospects of the underperformers in the portfolio, which include the Cillit Bang range and antibacterial brand Dettol, appears as if it would involve sacrificing profitability.

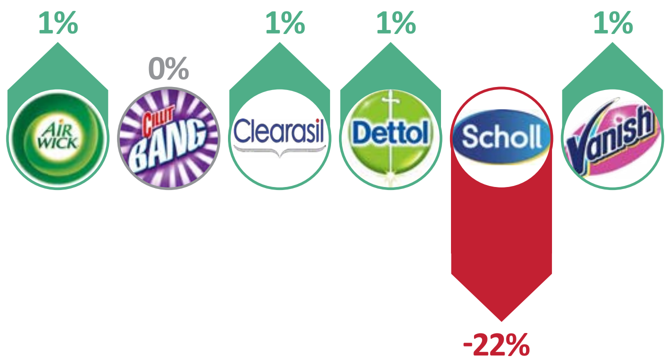
Morgan Stanley says: 'If we assume for illustration that the investment level in the underperforming brands is raised to 20% to drive growth back to in-line or above market growth, this could drive an additional 150 to 200 basis points to group top-line growth. Our framework suggests that this could cost 80 to 240 basis points at the group margin level.'

With both Unilever and Reckitt, you need to think whether investing in the underperformers in their portfolios can make a difference or if we just aren't as loyal to those brands specifically or more significantly to big brands in general any more.

Given their substantial weighting in the FTSE 100 and the big contribution they make to the overall dividends on offer from UK stocks, these considerations are relevant to most investors. It's something to consider next time you do the weekly shop.

**DO YOU HAVE ANY OF RECKITT'S UNDERPERFORMERS IN THE CUPBOARD?**

Average growth 1 Jan 2017-30 Sep 2019




Source: Reckitt Benckiser, Morgan Stanley

By **Tom Sieber** Deputy Editor

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CLICK ON PAGE NUMBERS TO JUMP TO THE START OF THE RELEVANT SECTION



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Since launch, The Diverse Income Trust plc has increased its income payable year-on-year by 8.8%.

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INVESTMENT WEEK INVESTMENT COMPANY OF THE YEAR AWARDS 2018 WINNER UK INCOME

MONEYOBSERVER RATED FUND 2019

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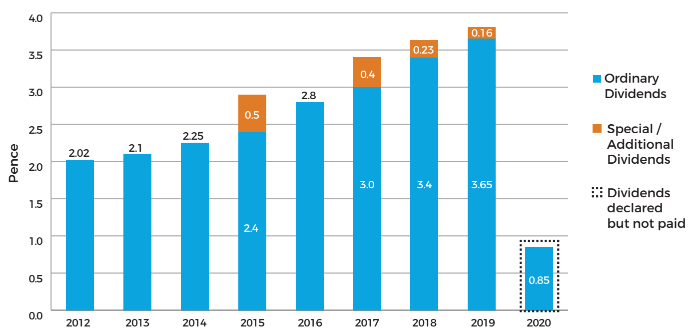


Note: The dividend for the period to 31 May 2012 covered 13 months, and the annualised dividend was 2.02p. Therefore, the underlying growth of the dividend in the year to 31 May 2013 was 4%. Only the four interim dividends at 31 May 2015 have been included for comparative purposes. The final dividend that was paid that year was excluded because it was merely the first interim dividend for the fourthcoming year that was redesignated.

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MFP20/034

# Investigating the China supply chain risk facing UK firms

Shares are already being sold off as investors switch on to the issue

The number of deaths from China's coronavirus has exceeded those from the 2003 SARS outbreak and the restrictions imposed in the country are already wreaking havoc with the domestic economy as well as the supply chains of businesses based outside China.

*Shares* has done some digging to discover to what extent UK-listed companies have been affected by the escalating crisis.

## IT'S BIG (IN EVERY SENSE)

China accounts for a quarter of global value-added manufacturing according to research from Bank of America and is the world's second largest economy, making the current disruption a big event. Yet, so far, not many companies have given a clear picture of how it affects them.

**Coronavirus: how selected firms with supply chains in China have performed**

| Company | Performance since close 17 Jan (%) |
|---|---|
| IG Design | 6.4 |
| TI Fluid Systems | -2.5 |
| Strix | -2.9 |
| Luceco | -13.5 |
| Volex | -14.8 |
| UP Global Sourcing | -32.7 |

Source: SharePad, 10 February 2020

Ground zero for the coronavirus is Wuhan, a city of around 11m in the province of Hubei in the mid-west of China. It is known as the 'Chicago of the east' a reference to the 'windy' city's industrial importance to the US economy.

Wuhan has become an economic powerhouse, producing a tenth of all cars made in China and is home to the second largest steel company in the world. It is also a very important high-tech hub.

The effects of virus outbreak reach beyond the immediate environs of Wuhan as the profit warning from **Burberry (BRBY)** demonstrated last week.

The trench coats-to-handbags seller said 24 of its 64 stores in mainland China are currently closed, while the remaining stores are operating with reduced hours and seeing 'significant' footfall declines and dwindling sales.

Global household names such as McDonalds, Pfizer, Walmart, Hennes and Mauritz and IKEA have operations cross China which will be seeing some sort of disruption from the current virus outbreak.

Hubei produces over 2.4m cars a year while there are also over 500 auto-parts manufacturers in the region. Italian manufacturer Fiat announced recently it was considering the closure of some Italian factories because it couldn't source the


required Chinese parts.

General Motors sold over 3.1m cars in China last year and has a Shanghai-based joint-venture with SAIC Motor Corp. It announced on 10 February it would re-start production over the next two weeks depending on the 'readiness of the supply-chain'.

## SHOOT FIRST APPROACH

In the absence of direct guidance from companies, investors have in some cases voted with their feet and begun to mark-down shares where there is suspicion of a direct impact from the virus.

For example, Telford-based electronics components and LED firm **Luceco (LUCE)** said as recently as 28 January that it is trading ahead of expectations and will beat market forecasts for adjusted operating profits for both 2019 and 2020, pushing the shares up on the day of the announcement.

However, since the positive update the shares have fallen 19% to 120.1p on worries that protracted Chinese Lunar holidays will hurt the recent trading momentum.

In the same sector electronic assemblies and power supplies company **Volex (VLX)** said on 10 February, 'as a result of the outbreak of coronavirus in Wuhan, all major operations in China have been subject to an extended and mandatory closure over the Chinese New Year holiday period.' The shares fell 2% in response.

Affordable homeware brands company **UP Global Sourcing (UPGS)**, better known as Ultimate Products saw its shares fall more than 8% after it warned (10 Feb) that it is closely monitoring developments of coronavirus in China, where the majority of its manufacturing is based.

To be fair it must be difficult for companies to make an assessment so soon after the New Year holidays, when trading is traditionally light, but those firms providing clear guidance will surely get a better 'hearing' from investors than those refusing to say anything.

*Shares* contacted some companies with known operations in the Hubei province and those relying on Chinese supply chains.

Gift packaging and greeting card company **IG Design (IGR:AIM)** falls into the 'it's too early' camp.

A spokesperson told *Shares* that 'due to the nature of operations around Chinese New Year, the immediate effects are negligible as vendor manufacturing and despatches will ordinarily be minimal in the couple of weeks immediately following Chinese new year. Naturally the company is monitoring developments closely.'

The shares have been stable around 750p over the last couple of weeks.

Thermostatic kettle controls company **Strix (KETL:AIM)** which has a large presence in China declined to make a comment at such an early stage as did auto specialist **TI Fluid Systems (TIFS)**. Strix shares are off 10% in the last two weeks while TI Fluid Systems are flat.

## MORE CLARITY REQUIRED

There will be winners and losers from the current disruption hitting the Chinese economy and worldwide supply chains. Some companies will be able to make alternative arrangements and navigate the choppy waters successfully. In such cases a falling share price might ultimately represent a buying opportunity.

History suggests previous outbreaks like SARS ultimately had a one-off impact and business soon got back to normal, but until a greater number of companies give more details about the current situation, investors remain in the dark.

# Infrastructure stocks diverge on HS2 hopes and energy price fears

Construction stocks soared on high speed rail approval while renewable funds plunged on fears about future income

There was good and bad news for infrastructure investors over the past week, depending on where in the sector they invested.

On the plus side, an infrastructure boom could be about to hit the UK after the government gave the green light to build the £106bn High Speed 2 (HS2) rail project, spelling good news for stocks in the space.

But for those investing in renewable energy, another area tipped for significant capital expenditure going forward, the outlook looks bleaker as falling energy prices led shares in renewable energy funds  to plunge.

The go-ahead for HS2 comes after chancellor Sajid Javid promised an 'infrastructure revolution' in March's Budget, while a recent report from PwC estimated total UK infrastructure spending to 2025 could reach £110bn.

Some of the stocks that stand to benefit in some way include construction companies **Balfour Beatty (BBY)**, **Kier (KIE)** and **Costain (COST)**, which have had doubts over big parts of their future income lifted.

Shares in Kier jumped around 10% to 116p on the morning of 11 February as news broke of the HS2 go-ahead while Costain shares traded 5.7% higher at 205p and Balfour shares were up 2.7% to 280p.

Several big money contracts have already been handed out for work on HS2, but question marks over whether the project would go ahead meant many firms didn't count on the contracts on their order books, significantly denting their future growth outlooks.

In the case of Kier for example, which has been struggling with higher debt and lower profit, HS2 accounts for £1.5bn, or almost 16%, of all the contracted money it expects to earn in future.

Other companies which stand to indirectly benefit for similar reasons could include engineering services providers like **Hill & Smith (HILS)** and **Renew Holdings (RNWH:AIM)**.

But for those who invest in renewable energy, confidence was dented after **John Laing Environmental Assets (JLEN)** shocked the market by lowering expectations on future energy prices by 7.5%.

A cut in future prices would be great for consumers but not the many investors who use renewable funds to diversify their portfolios.

Shares in rival investment trusts also dropped sharply on JLEN's announcement, with the market having already been rattled by a hard-hitting report from analysts at JPMorgan Cazenove. The investment bank predicted a potential 40% slide in the shares of listed renewables funds due to the big premiums on which they trade and falling revenue from energy sales.

**Testing times for infrastructure trusts**

| Trust | Performance since 21 Jan 2020 |
|---|---|
| Bluefield Solar Income | -8.0% |
| JLEN Environmental Assets | -6.2% |
| US Solar | -5.2% |
| Foresight Solar | -3.7% |
| NextEnergy Solar | -3.4% |
| Greencoat UK Wind | -2.6% |
| Greencoat Renewables | -1.6% |
| Gresham House Energy Storage | -0.5% |
| Aquila European Renewables | -0.2% |
| SDCL Energy Efficiency Income | 0.5% |
| Renewables Infrastructure Group | 1.0% |
| Gore Street Energy Storage | 3.6% |

Source: Sharepad, 11 February 2020

# Why the Lindsell Train funds sell-off is continuing

Manager Nick Train suggests negativity about two key holdings is unwarranted

Two Lindsell Train funds were among the most sold by investors in January as the fallout from a ratings downgrade continues.

Around £225m was pulled in January from **LF Lindsell Train Global Equity (B3NS4D2)** and **LF Lindsell Train UK Equity (B18B9X7)**, according to estimates by Morningstar.

This followed the financial information provider's decision to downgrade the UK equity fund the previous month from 'gold' to 'bronze' over liquidity concerns.

However, most of the outflows, around £162m, came from the global equity fund, which wasn't directly affected by the downgrade.

Both funds were in the top three most sold by AJ Bell Youinvest customers over the past month.

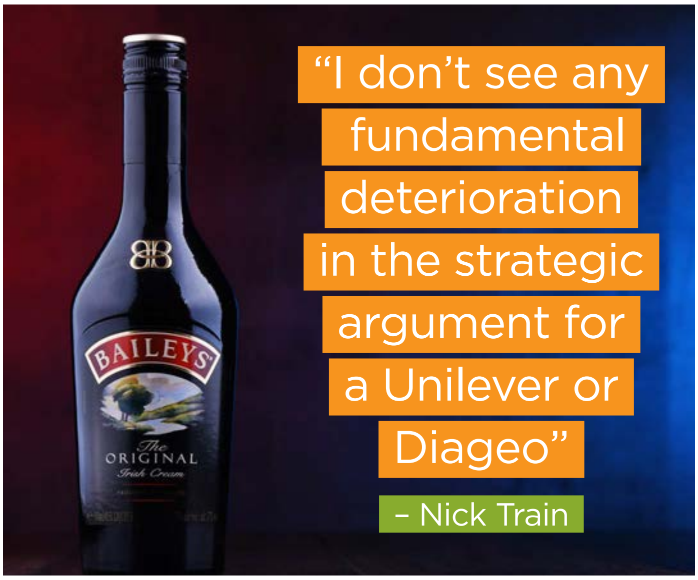
In its decision to downgrade the UK equity fund in December, Morningstar also highlighted concerns that the highly concentrated approach taken by Lindsell Train – the number of stocks ranges from 20 to 30 in both funds – can make it 'vulnerable to any change in fortune' in the companies it owns.

Both the UK and global funds have struggled performance-wise in the past few months, with concerns over growth rates at a number of stocks which make up the top 10 holdings of both portfolios.

Two of the biggest holdings in both funds are consumer goods giant **Unilever (ULVR)** and alcoholic drinks maker **Diageo (DGE)**, which have struggled with slowing growth in sales and seen their share prices fall accordingly.

While Lindsell Train UK Equity beat its FTSE All Share benchmark by 3.6% in 2019, the global equity fund lagged 3.3% behind its MSCI World benchmark.

Though investors are always encouraged to look long-term, both funds also significantly lagged their benchmarks in the last three months of 2019, dented by double-digit drops in the Unilever and Diageo share prices.




But speaking on *Shares' Money & Markets* podcast, Nick Train remained bullish on the prospects for both companies.

Well known as a buy and hold investor, he reminded investors to look at the 'absolutely fantastic' multi-decade share price charts for both businesses.

Train said: 'I don't see any fundamental deterioration in the strategic argument for a Unilever or Diageo.

'Growth rates can be a little volatile, but one of the things that really strikes us about markets, the world we're living in today, is that there ain't any inflation.

'Tech is whipping away pricing power for so many industries. So if Unilever's growth rate goes from 3.5% per annum to 3%, which is what people are complaining about at this most recent period, maybe that's still accelerating real growth, because inflation is so low.

'Maybe a decade ago Unilever was growing at 7%, maybe 4% to 5% of that was inflation, which isn't as valuable. So I don't think the real growth rates of these businesses that own truly resonant global consumer brands have actually slowed, if anything they've picked up.'

# Micro Focus rethink could scupper takeover hopes

Company plans change in sales approach after strategic review

Infrastructure software company **Micro Focus (MCRO)** has abandoned plans to sell off parts of the business and return to cash to shareholders, a move that may scupper any hopes of a possible takeover of the whole business.

Micro Focus has effectively been in play since its latest profit warning in August 2019 sparked a strategic review of the business by the board. Many analysts felt that the rethink was a euphemism for raising the 'for sale' sign over the entire company.

Takeover speculation has swirled around the £2.5bn business for even longer, when reports emerged that activist investor Elliott had built a stake in the company back in April 2018. More recently Canadian enterprise management software firm **OpenText** had been linked to a possible buyout, while Micro Focus is still seen as a prospective target for private equity buyers.

The new strategy will see the company change its sales approach, accelerate recurring service revenues, and target product portfolio improvement, the latter likely to include bolt-on acquisitions. Executive chairman Kevin Loosemore will also end a 15 year career with the company by standing down.

'We don't expect OpenText, another trade or PE buyer will be making an approach until Micro Focus gets its house in order,' says Megabuyte analyst Devun Mistry.

## FTSE 350 MOVERS OVER THE PAST WEEK

**BEST PERFORMERS**

| STOCK | SHARE PRICE RISE | REASON |
|---|---|---|
| **TUI** | 13.6% | First quarter results reveal strong growth, summer bookings up |
| **William Hill** | 10.7% | Announces US betting tie-up |
| **Beazley** | 10.0% | Full year profit increases on rising premiums, investment returns |

**WORST PERFORMERS**

| STOCK | SHARE PRICE FALL | REASON |
|---|---|---|
| **NMC Health** | -19.4% | Possible private equity suitor KKR rules out bid for troubled business |
| **Tullow Oil** | -14.3% | Hit by volatile oil prices |
| **Hargreaves Lansdown** | -6.5% | Co-founder Peter Hargreaves sells £550m of shares |

Source: Shares, SharePad. Data to 11 Feb 2020

# Why Rank Group has some serious momentum

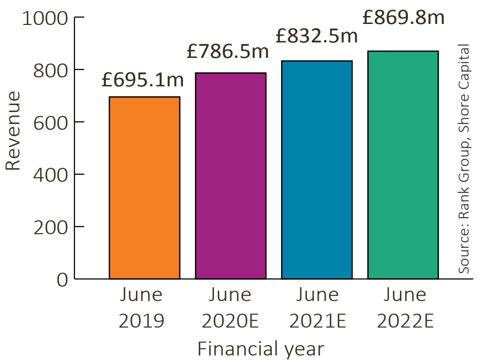
Analysts' earnings expectations have increased more than 20% over the last six months

We think the transformation afoot at casino to bingo operator **Rank Group (RNK)** can continue to benefit the company and its share price.

This shift is not just about cutting costs, but changing the culture of the whole organisation, making it more dynamic in a bid to boost growth and achieve £1bn of revenue by 2023. For reference, last year to 30 June 2019 the company generated revenue of £695m.

Since July 2019 analysts have been busily upgrading their 30 June 2021 earnings per share estimates from 16.9p to the current 20.4p, up 21%. This puts the shares on a forward price-to-earnings ratio of 14.7 times, attractive given the growth potential

Rising expectations were not disappointed at the half year stage to 31 December 2019 when the company reported a 70% improvement in like-for-like operating profit to £55m, generated from a 10% increase in gaming revenue to £377.5m.




**RANK GROUP BUY**
(RNK) 301.5p
Stop loss: 241.2p

Market value: £1.2bn

The Grosvenor and international venues were the key drivers, showing operating profit up 137% and 29% respectively.

Digital is a key part of the company's growth ambitions and the acquisition of Stride Gaming, (online bingo) brought a unique digital platform to the business that can be exploited in future.

Within the digital arm, Grosvenor and Mecca saw strong growth which reflects continued improvements in the customer experience with a highlight being the roughly 33% of Grosvenor revenues coming from multi-channel players. These players tend to have higher lifetime values and lower acquisition costs, making them more profitable.

## CASH IS KING

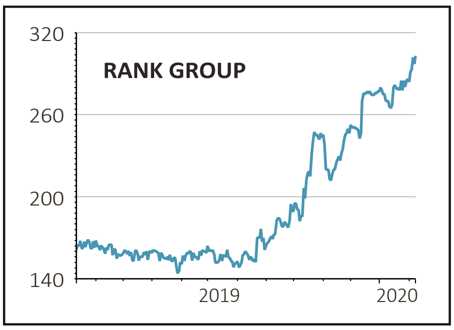
Broker Shore Capital believes the digital division holds to the key to delivering future shareholder value and it is forecasting cumulative net cash inflow after dividends of around £200m by June 2023.

If achieved, it will provide the financial muscle to make

acquisitions or return a decent chunk of capital (Shore Capital see a surplus of £450m) to shareholders.

Targeted investment in marketing is expected to see a return to revenue growth at Stride, propelling the digital division to an operating profit of around £50m over the medium-term, according to Shore Capital, more than doubling last year's contribution.

While cost cutting represents low-hanging fruit and provides one-off gains, the fact that the business is also generating strong increases in revenue suggests the organisational changes have set the company on a sustainable growth trajectory.



# The asset manager in hot demand for income and ESG funds

Liontrust's shares are soaring and we think there is a lot more to come as its reputation grows

Asset management **Liontrust (LIO)** has outstanding prospects thanks to soaring demand for ESG-related investment products and a cracking reputation of running successful funds. Don't be put off by its share price having already enjoyed a good run. We think it is only in the early stages of a massive re-rating.

Liontrust is forecast to grow earnings per share by more than 20% a year for the next three years. This is even after earnings have been upgraded many times over the past few years.

Its shares may seem pricey based on estimates for the current financial year ending 31 March, trading on a price-to-earnings multiple of 22. However, this is a classic growth stock whereby the rating quickly falls to 17-times for the forthcoming financial year and 14-times for the period ending March 2022.

Investors are getting a decent dividend which you tend not to associate with fast growth stocks. Numis forecasts 45p in dividends for the year ending March 2021, equating to a 3.4% yield.

One of key things we like about Liontrust is the clarity of its investment processes. The fund managers are extremely clear about what they desire from

**LIONTRUST ASSET MANAGEMENT BUY**
**(LIO) £13.14**
**Stop loss: £10.50**

**Market value: £728m**

companies in order to make an investment. The asset manager also has high conviction with fairly concentrated portfolios which looks very different to the benchmark indices.

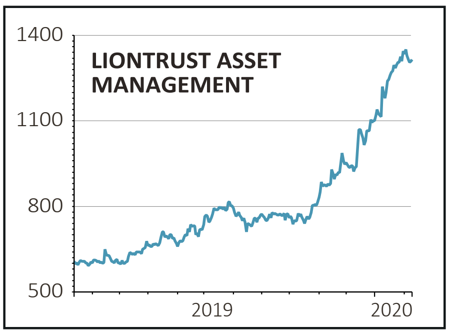
Following a meeting with some of the management, Numis said they believe most of the Liontrust funds are 'highly scalable' because they generally contain larger businesses.

Its **Liontrust Income Fund (B8L7B35)** is seen as having the biggest potential in its product range to attract more investor money in the short-term. This is thanks to a good performance track record and investors eager to find replacement income products after being let down by Woodford's two income funds.

A big emphasis on sustainability is also working in its favour, with investors hungry to put their money into funds that provide exposure to companies helping the world to be a better place. It has funds with both 'sustainable' and 'ethical' badges.

Retail investors have driven demand for these products from Liontrust, yet the asset manager now says there is growing interest from institutional investors and it is optimistic about increasing flows from non-UK investors.

Liontrust ended 2019 with £19.1bn of assets under management and enjoyed £836m of net inflows in the final three months of the year. While equity markets can be unpredictable and there is no guarantee that Liontrust will continue its current level of success, it certainly seems to have the right ingredients to flourish in 2020 and beyond.




## 10 March | Guildhall London, 2:30pm

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**Alastair Fothergill**, Series Producer of BBC's The Blue Planet, and creator of Our Planet, a landmark series for Netflix

**Hannah Fry**, Popular mathematician, TED speaker, author and co-host of The Curious Cases of Rutherford & Fry on BBC Radio 4

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## TATE & LYLE
(TATE) 786.6p

**Gain to date: 8.2%**
**Original entry point:**
**Buy at 727.2p,** 15 August 2019

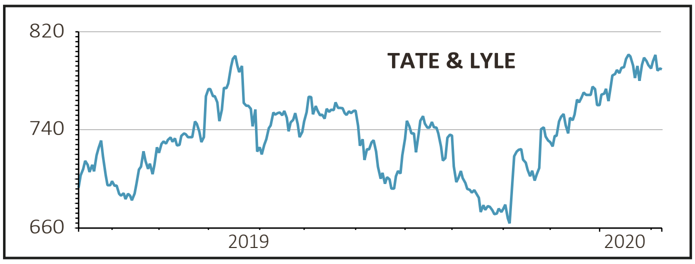
OUR BULLISH CALL on cash generative food producer **Tate & Lyle (TATE)** is a respectable 8.2% in the money, yet we are holding on for additional upside.

We see Tate & Lyle as well positioned to grow with large food and beverage customers.

It is also well aligned with current trends given its provision of plant-based ingredients and solutions to customers, enabling it to profit from the boom in demand for plant-based proteins.

As outlined in our original story, Tate & Lyle is a global provider of corn-based sweeteners and starch ingredients as well as sucralose zero-calorie sweetener that has transformed itself into a higher margin and more stable speciality ingredients supplier.

In its latest trading update (6 Feb), Tate & Lyle left guidance for the year to March 2020 unchanged, continuing to expect 'broadly flat to low-single digit' earnings per share growth. This followed a robust third quarter of operational progress in which Tate & Lyle's underlying performance was 'consistent' with the first half, implying organic growth of around 5%.


**SHARES SAYS:**
**We're staying sweet on Tate & Lyle for its global growth potential and an attractive 3.8% yield, based on Berenberg's full year dividend per share estimate of 30.3p.**

## OCADO
(OCDO) £12.52

**Gain to date: 5.5%**
**Original entry point:**
**Buy at £11.87,** 25 July 2019

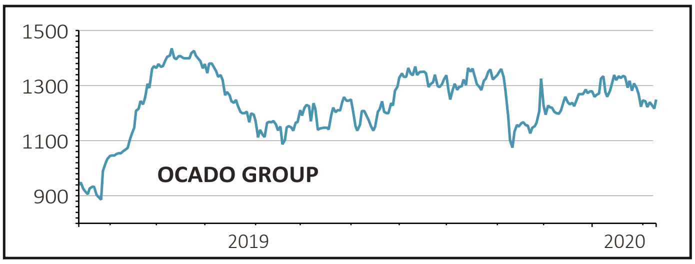
SHARES IN ONLINE retailer **Ocado (OCDO)** rose this week despite revenue for the year to 1 December just meeting estimates and losses widening further as it continues to invest overseas.

Sales in the UK Retail division grew by more than 10% while the Solutions & Logistics business grew turnover by 7.8%. However pre-tax losses ballooned to £214.5m from £44.4m after accounting for the costs of a fire at its Andover warehouse and heavy investment in its international business.

Ocado signed up more overseas retailers to its Smart Platform last year and plans to open two state-of-the-art warehouses, in France and Canada, in the next six months. Two more openings are planned in Australia within the next three years and more openings are scheduled in Japan in coming years.

For shareholders this means no profit for the foreseeable future and potentially further dilution as the firm raises more capital to fund growth.

However analysts at Morningstar estimate the global online grocery market to be worth over £700bn within two decades and they also believe Ocado's Smart Platform is 'years ahead of the competition' so the opportunity is huge provided the company continues to execute well.




**SHARES SAYS:**
**We remain buyers for now.**

SHARES AJBell

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**The property debate: who had it easier between baby boomers and millennials? And a top fund manager on the outlook for UK stocks**

MONEY & MARKETS

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# LOK'N STORE

(LOK:AIM) 730p

**Gain to date: 28.7%**

**Original entry point:**

**Buy at 574p,** 7 November 2019

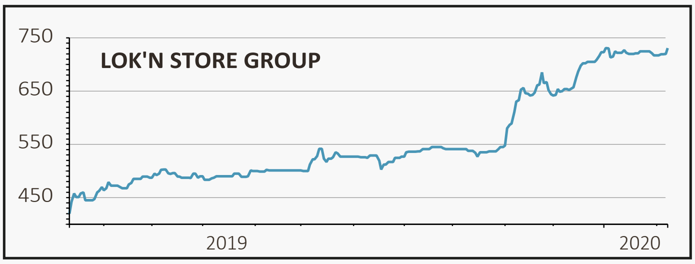
SELF-STORAGE PLAY **Lok'n Store (LOK:AIM)** is rewarding our faith with the latest trading update for the six months to 31 January 2020 revealing decent momentum in the business (10 Feb).

Like-for-like revenue was up 7%, with occupancy also increasing and the price let per square foot unchanged year-on-year.

The company is planning to fit out a property in Salford to open later in 2020.

CEO Andrew Jacobs neatly summed up why we like the stock: 'Using our strong balance sheet and low gearing, we have the capacity and will continue to build more landmark stores in an undersupplied market, adding considerable momentum to sales and earnings growth in the coming years which will allow us to continue to increase the dividend.'

Broker FinnCap notes the shares continue to trade at a discount to peers **Big Yellow (BYG)** and **Safestore (SAFE)** despite its forecasts implying Lok'n Store's earnings will grow twice as fast in the next two years. Half-year results will be announced in full on 27 April.




**SHARES SAYS:**
**We remain positive on the story.**

# SMART METERING SYSTEMS

(SMS) 525.5p

**Gain to date: 11.8%**

**Original entry point:**

**Buy at 470p,** 24 October 2019

ONE OF **SMART Metering Systems' (SMS)** larger rivals has joined the UK stock market and has a less appealing investment proposition. **Calisen (CLSN)**, valued at £1.3bn versus £582m for SMS, has the same approach of owning and installing smart meters and collecting rent from utility providers.

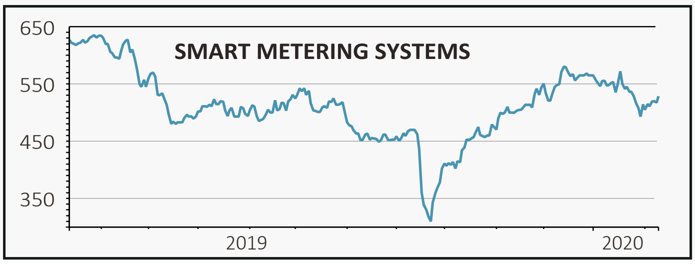
Where the two companies differ is in the capacity of the installation team and customer base.

SMS has 500 in-house engineers and a training programme. In contrast, Calisen only recently acquired in-house installation capacity and it will have to invest heavily to expand its installation team.

Fund manager Oliver Brown of **MFM UK Primary Opportunities (B905T77)** says he didn't take part in Calisen's IPO offer because of concerns about it not being able to meet demand for installations and that its valuation was too high.

On the customer side, SMS has a bigger presence among independent utility providers, a part of the market rapidly picking up business from customers disgruntled with the service from the big energy companies.

'The shares were weak in mid-2019 partly due to a large seller, but have since recovered,' says Joe Brent at Liberum. 'Negative real gilt yields (-2%) makes SMS's index-linked recurring revenues an attractive proposition,' adding that Calisen's portfolio is a fixed annual rental per meter.




**SHARES SAYS:**
**Having a quoted peer is good for comparison purposes but it doesn't alter our positive stance on SMS.**


# EPIC for income

IF YOU'RE looking for monthly income, you want it to be built on firm foundations. At Ediston, we take that seriously – and literally. All of our investments are in properties we know inside out and from top to bottom.

This in-depth understanding of our investments assures us that the income we provide to our investors is as solid and secure as it can be. That's why we're able to pay a highly competitive dividend in monthly instalments – allowing our investors to rely on a steady income stream to cover everyday expenses.

## A GROWING DIVIDEND

Ediston currently offers a 6.4%* annual yield. Our income payments stem from a diversified portfolio of properties, helping the sustainability of the overall dividend. We have maintained the dividend since the inception of the fund, and we expect it to grow in future. The dividend is also well covered – meaning there's something in reserve if underlying earnings fluctuate.

*as at 31 December 2019

## A WEALTH OF EXPERIENCE

The strongest support for our dividend comes from the expertise of our team. We live and breathe property. While the Ediston Property Investment Company listed on the London Stock Exchange (LSE: EPIC) in 2014, the broader Ediston business has been operating in the UK market since 2004. On average, each member of our team has more than 20 years' experience in property investment and development.

## BEYOND BRICKS AND MORTAR

When we consider any investment, our focus is always on cash flow. We want to be sure that our properties are not just paying for themselves but also paying out sustainable income for our investors.

To do this, we look well beyond the physical buildings themselves to understand how the properties 'live and breathe' – how they fit into their location and their economic environment. We go to great lengths to ensure that risks to the cash flow are minimised and that occupancy rates and tenant satisfaction are maximised.

We have a profound understanding of all aspects of managing real estate for the benefit of our tenants and investors. This spans the range from change-of-use applications, through to refurbishment and redevelopment, to tenant liaison, lease negotiations and rent reviews. Each of these aspects offers opportunities for improving the income stream available from property.

## INTENSIVE, ENTREPRENEURIAL AND UNCONSTRAINED

Our approach to property investment is intensive and entrepreneurial. No holding in our portfolio is left to look after itself. We sweat the small stuff, and we do it at every level of the process – from developing new properties to ensuring that existing tenants are satisfied and that no potential for improvement is missed. And with no benchmark, we're free to focus on the areas where we see the greatest potential for sustainable income and capital growth.

We're confident that our record of steady income is compelling. So, if you need a regular income stream from actively managed investments, we've got you (and your dividend) covered.

The contents of this article should not be construed as legal, tax, investment or other advice. Each prospective investor should make its own enquiries and consult its professional advisers as to the legal, tax, financial and other relevant matters and risks concerning any investment opportunity.

Past performance is not a reliable indicator of future performance – the value of a stock market investment and any income from it can fall as well as rise and investors may not get back the amount invested.

Whilst information contained in this article is believed to be accurate at the date of publication, it is subject to change and does not purport to provide a complete description of Ediston Property Investment Company Plc (the "Company") or its future prospects or performance. Any forecast, projection or target is indicative only and not guaranteed. In particular, the payment of dividends and the repayment of capital are not guaranteed.

The Company invests in property assets which can be highly illiquid, typically do not grow at an even rate of return and may decline in value, all of which may have a negative impact on the value of the Company.

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# Why Tesla shares can't continue to motor

Valuation of electric car maker has soared beyond reasonable metrics

There's been only one share on the lips of investors over the past week or two; **Tesla**. The electric car maker seemed to turn a corner with its latest fourth quarter trading update, opening the floodgates on an almighty short squeeze that sent the stock soaring.

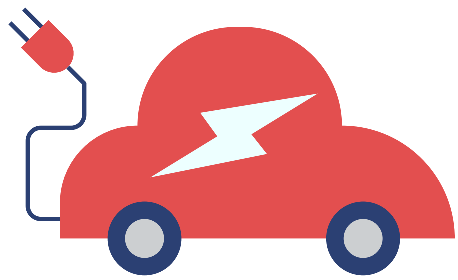
Just eight months ago Tesla's shares were trading below $180, with analysts and investors gripped by serious doubts about the car maker's future. The most sceptical suggested that it might run out of money altogether and go bust. But Tesla has never been short of supporters and, for many shareholder fans, being part of the Tesla story is more of a cult than a cold-eyed investment.

Now on a staggering market value of $135bn, and a 2020 price to earnings (PE) valuation of 185, we believe investors should resist the temptation to follow the crowd and invest in company.

To put that market valuation into perspective, Tesla is now valued at $20bn more than the market caps of Ford, General Motors and BMW put together.

## TESLA IN NUMBERS:

**$135bn**
market cap



**367,500**
vehicles delivered in 2019

### WHAT HAS CHANGED?

A year ago chief executive Elon Musk predicted Tesla would deliver between 360,000 and 400,000 electric vehicles to customers in 2019. Ultimately, according to the company, it delivered around 367,500 vehicles, an impressive 50% jump from 2018. (Though for perspective Toyota produced almost 9m motor vehicles in the year to 31 March 2019.)

Tesla also delivered a record 112,000 vehicles globally during the fourth quarter, significantly topping Wall Street estimates.

What this meant was back-to-back quarters of profit and positive cash flow.

**GROSS PROFIT AND GROSS MARGIN TREND ($M, %)**


Source: UBS

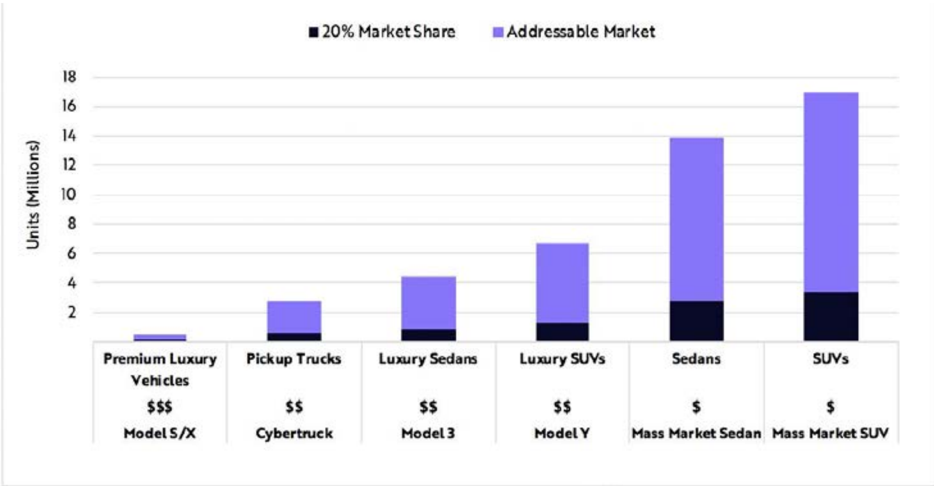
Fourth quarter to end December revenue were $7.38bn from which it made a $105m profit. Adjusted earnings per share of $0.58 beat expectations, although that strips out stock based compensation, not always popular with analysts or investors.

'While the valuation remains unjustifiable, I think my very long-term view that Tesla won't survive needs a revisit,' admitted analyst Richard Windsor in an update on his Radio Free Mobile website.

'Tesla genuinely fared better than expected on the top line and crucially, continued to generate cash.'

The soaring share price marks something of a victory in Elon Musk's ongoing battle with short sellers and sceptical analysts who have always fretted over Tesla financial health.

## TESLA'S ADDRESSABLE MARKET BY VEHICLE TYPE




Forecasts are inherently limited and cannot be relied upon. Source: ARK Investment Management LLC, 2020 | ark-invest.com. Data: Evercore ISI.

Source: ARK

The company is among the most shorted on Wall Street and even if many cynics have been forced to close short positions in recent days to cover themselves, there is still nearly 14% of the firm's 180.25m shares issued in the hands of short sellers.

Toby Clothier of Mirabaud Securities is among the sceptics. His continues to base his expectations on hard financial data, and it is difficult to objectively disagree that Tesla share price has detached from reality.

He points to weakening market share in Europe and concerns that fourth quarter profit will drift into 2020.

Patrick Hummel of UBS shares Clothier's view on valuation, but sees little to cap enormous growth for Tesla in the years ahead.

### MOST PROFITABLE CAR MAKER

With volumes expected to double by 2022, Tesla can become the most profitable car maker in the world, reckons the UBS analyst.

'We expect approximately 300 basis points auto gross margin accretion from the localized Model 3 in China and Model Y on likely strong commercial success,' he said. Part of the reasoning is Tesla's sustained technological lead. Tesla cars are stuffed full of software and hardware ad it leads the electric car industry in batteries and power train engineering.

Volkswagen has committed to a €40bn investment into its new electric fleet over the next five years and most established car manufacturers acknowledge the enormous cost to get close to Tesla. Perhaps some of these will

"Tesla genuinely fared better than expected on the top line and crucially, continued to generate cash"

catch up eventually, but it looks likely to take years.

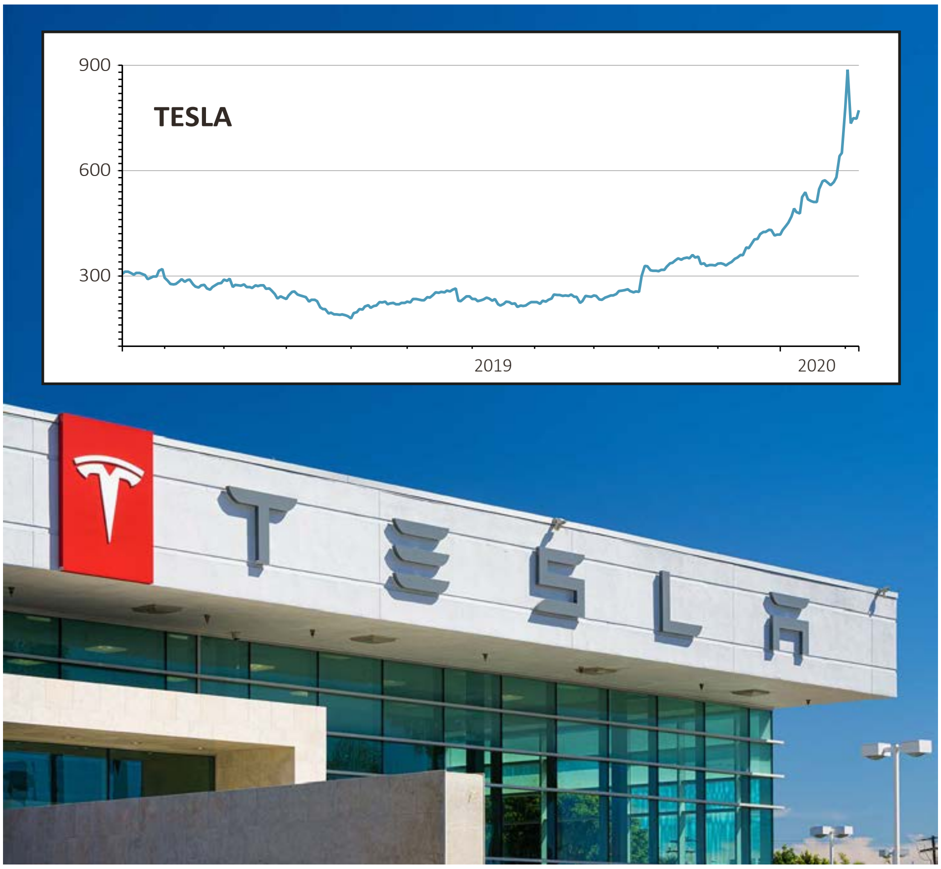
'Tesla's sustained technology lead and mix boost from Model Y and the Cybertruck enable a stable $54,000 ASP trend at the top end of the premium segment,' said Hummel. ASP stands for average selling price, the per unit price tag of a Tesla car averaged across the range.

Interestingly, Tesla's key performance indicators, or KPIs, show much higher efficiency than incumbent car makers as there is no drag from any legacy business. 'Tesla should meet and exceed margins and cash generation the premium manufacturers enjoyed in their best days,' said Hummel.

He calculates that at between $3bn and $5bn of annual free cash flow on an 8% to 10% operating profit margin, yet Hummel believes that all of the above and more are taken for granted at the current share price.

Tesla shares now discount 1.6m vehicles being sold in 2025 versus the 367,500 in 2019, on an 11% operating margin, calculates the UBS analyst.

> "That would put Tesla behind only Apple and Microsoft (both $1.4trn) among the world's biggest companies"




## VALUING TESLA AS A CAR MANUFACTURER, OR NOT

The biggest challenge for more sober investors is coming to terms with the idea that Tesla should not be valued as a car company at all, but a manufacturer of highly advanced bits of mobile technology.

This is how New York-based researcher Ark Invest sees the story, one of Tesla's biggest and most bullish fans. In a note to clients on 31 January 2020 Ark put forward its case for the share price to hit a staggering $7,000 by 2024, which would give the firm a market value of $1.3trn.

That would put Tesla behind only Apple and Microsoft (both $1.4trn) among the world's biggest companies.

That's Ark's base case valuation forecast. The analyst's bear scenario still sees Tesla stock roughly doubling to $1,500 by 2024, with $15,000 its bull case play.

Those sort of wild predictions make great headlines but sensible investors should not invest in Tesla because of them. This is a company that has endured many production and delivery problems in the past and missed forecast targets because of them.

With the coronavirus creating plenty of global supply chain uncertainty, there is a very good chance that a hefty chunk of the Tesla fluff will get blown off the shares over the coming months. Reassessing the valuation story then would be more sensible.

By **Steven Frazer**
News Editor

by IAN CONWAY
Senior Reporter

# GETTING STARTED WITH INVESTING

## WHAT TO THINK ABOUT AND HOW TO DO IT

Just as the way we work has changed over the last decade, with more of us working 'remotely' or in temporary jobs, so the world of saving for our financial future has changed hugely.

We all know we have to save and invest ourselves these days, but many of us just don't know how to do it or even where to begin.

With our weekly **First Time Investor** series we will take you through the basics of how to start thinking about long-term investing, how to get the most out of your investments and how to secure your financial future.

### INVESTING CAN BE FOR EVERYONE

Lots of people assume investing isn't for them, that it is somehow the preserve of the incredibly wealthy or people at a certain stage of life. That simply isn't true, investing can be a good option for almost anyone given the range of options available.

Don't be put off by the fear of looking foolish and by the often needless and confounding jargon, even the most experienced investor was once sat where you are now – everybody has to start somewhere.

For an investor the markets are simply a tool with two main uses: to protect and increase your wealth. If you can train yourself to think in these terms, then any fears you have about investing should diminish.

### DIY INVESTING

Today most firms have stopped offering new employees a defined benefit pension scheme – funded by a company and paying out a secure income for life when you retire.

Instead they offer a defined contribution scheme, which pays an income depending on the amount you yourself pay in, the performance of your investment 'pot' and the choices you make when you finish working.

On top of this, the high street banks have pulled back from offering advice on how to invest your money – mainly because they have been so bad at doing it, as shown by various mis-selling scandals.

The result is we are all now responsible for planning our long-term financial future in a way we weren't even a few short years ago.

What has also become clear is that many of us aren't saving or investing enough to provide a reasonable standard of living in retirement.

This is where *Shares* can help. Over the next few weeks and months we will explain the basics of investing, why investing can be better than saving and why starting early matters.

We'll also look at how to invest for specific goals like saving for a first home or a first child, or for longer-term goals like university fees.

Even with a small amount of time and money, following our step-by-step guide will help you to start planning for the future.

## SAVING IS A GOOD START

Most of us have a savings account as well as a current account, and these days with the range of accounts available from smaller disruptors like Monzo and Revolut some of us have more than one 'secondary' account.

However the rates of interest on most savings accounts are typically below the rate of inflation, meaning that in real terms your savings aren't keeping up with the cost of living.

For example, according to Moneysavingexpert.com, the best easy-access online savings accounts currently pay an annual rate of interest of between 1.3% and 1.35%. So for every £1,000 saved you would only earn between £13 and £13.50 over the course of a year.

Interest on savings accounts is tax-free for most people. Basic-rate tax-payers can earn £1,000 in interest a year free of tax while for higher-rate tax-payers the limit is £500, so only people with large amounts of savings would need to worry about paying tax on interest earned.

However, the official rate of inflation as measured by the consumer price index (CPI) is 1.4% as costs for housing, water, electricity and gas aren't going down. With the economy starting to pick up after the general election, prices might even rise further this year.

If you want a higher rate of interest you'll have to stick your money away for a fixed period, say up to three years. For that you get 2% interest but you can't access your money in the meantime. Also, 2% is lower than some banks were offering a year ago for just a one-year fixed deposit of £1,000 or more which shows how far interest rates have fallen.

A savings account is probably most appropriate as a place to keep money to cover unexpected expenses like a replacement washing machine or periods out of employment.

**FOR AN INVESTOR THE MARKETS ARE SIMPLY A TOOL WITH TWO MAIN USES: TO PROTECT AND INCREASE YOUR WEALTH. IF YOU CAN TRAIN YOURSELF TO THINK IN THESE TERMS, THEN ANY FEARS YOU HAVE ABOUT INVESTING SHOULD DIMINISH.**

## INVESTING IS BETTER

If you've already built up these emergency funds and you want your money to earn a better return than it will in the bank, the case for investing is compelling. Over the very long term – more than 100 years – annual returns from the UK stock market have been roughly 5% above the average rate of inflation according to the Equity Gilt Study published every year by **Barclays (BARC)**.

Over the same period the annual return on UK government bonds, also known as gilts, has been 1.3% above the rate of inflation while the return on cash has been just 0.7% above inflation on average.

On a 10 year view the returns on stocks and bonds have been even better at 5.8% and 2.7% above inflation, but the returns on cash have been much worse at 2.5% *below* the rate of inflation. This shows that leaving your cash in your savings account isn't going to help fund your old age or any big life goals as it will just lose value in real terms.

## COMPOUND INTEREST

Let us assume that, instead of your money earning 1.3% or even 2% in a savings account, you invested £1,000, which at around £80 per month is not too far away from the cost of a gym membership or TV subscription.

On the reasonable assumption that you were were earning 5.8% more than the inflation rate over 10 years – let's say 7.3% a year, assuming inflation averaged 1.5% a year – you would have ended up with £73 in returns after the first year.

What's more, if you kept that £73 in the markets so you now had £1,073 in capital, a year later your return at 7.3% would be £78 because your starting capital was higher. Adding that £78 to the £1,073 means you start the third year with £1,151 and your return rises to £84.

This is called compounding, because each year you are earning returns on what you got last year as well as your initial capital, your money is working harder for you. The higher the rate of return, the faster your investment compounds and the harder your money is working.

The table below shows how your money would compound over 10 years assuming an annual return of 7.3%.

What the table shows is that by leaving your capital and returns invested, the amount you make annually on your money goes from £73 to start with to more than £500 by the end of six years and more than £1,000 over the full 10 years.

Also, by adding the returns to the capital each year and letting it compound, £1,000 a year turns into more than £6,000 after just five years, getting on for £10,000 after just seven years and more than £15,000 over the full 10 years. Potentially providing a good starting point for a deposit on a house, for example.

This is just an indicative example and doesn't take into account investment fees, which will affect your returns, although shares offer not just the potential for capital appreciation from price increases but also regular income from dividend payments. By reinvesting these regular payments in more shares you can super charge your returns because, as you increase your holdings of a particular stock or fund, you also boost the amount of dividend income you receive, with the level of payment dependent on the number of shares or fund units you own.

We will cover dividend reinvestment in more detail in a future article in this series.

Overall it is little wonder Albert Einstein described the effect of compounding as 'the most powerful force in the universe', and it's a crucial first lesson on the way to long-term investing.

### How your money could compound over 10 years:

| | Amount you invest each year | Amount you've now got | 7.3% return in pounds | Amount you end up with |
|---|---|---|---|---|
| Year 1 | £1,000 | £1,000 | £73 | £1,073 |
| Year 2 | £1,000 | £2,073 | £151 | £2,224 |
| Year 3 | £1,000 | £3,224 | £235 | £3,459 |
| Year 4 | £1,000 | £4,459 | £326 | £4,785 |
| Year 5 | £1,000 | £5,785 | £422 | £6,207 |
| Year 6 | £1,000 | £7,207 | £526 | £7,733 |
| Year 7 | £1,000 | £8,733 | £638 | £9,371 |
| Year 8 | £1,000 | £10,371 | £757 | £11,128 |
| Year 9 | £1,000 | £12,128 | £885 | £13,013 |
| Year 10 | £1,000 | £14,013 | £1,023 | £15,036 |

Source: Shares, figures rounded to nearest whole number. Indicative example, does not include fees.

by YOOSOF FARAH
Reporter

# YOU DON'T NEED A LOT OF MONEY TO START INVESTING

It is possible to start saving as little as £50 a month and soon have an investment portfolio but just watch those charges

Getting started with investing can seem quite daunting with the perception being that thousands of pounds are needed before you can kick off.

In reality, that's not the case at all and technically you could start by buying a share in a company for 1p for example, although this would not be advisable as dealing fees and other charges mean you'll most likely never recoup that investment.

We think £150 a month is more realistic as the minimum you could invest without fees representing too big a proportion of the overall transaction. Read on and we'll explain the different options.

Some experts suggest a £1,000 lump sum could be a good starting point for shares, investment trusts or exchange-traded funds (ETFs) or £500 if investing just in traditional funds as their transaction fee is much lower.

Based on a rough average from the main investment platforms, you would expect to pay about £10 to buy or sell shares, investment trusts and ETFs. So if you wanted to invest £200 in a company, your transaction fee of £10 would equate to 5% of your investment. That's quite a large proportion, particularly as you would pay the same again to sell.

Investing £1,000 would bring the transaction fee down to a mere 1% of the money you use to buy the shares, which is much easier to stomach.

Buying funds can be much cheaper, typically £1.50 per transaction. Therefore to get the fee down to 1%, you would be looking at putting a minimum of £150 into funds.

Most investment platforms offer a regular dealing service which only costs £1.50 to buy stocks, investment trusts and ETFs, rather than the £10 fee you'd typically find in the industry. Therefore it is possible to apply the £150 minimum investment across all the main asset types.

The downside of the regular dealing service is that investment platforms take the money and process the transaction on a specific day each month, so you can't buy any time you want. Such services can also be restricted to the FTSE 350 index for shares but still have a fairly

### CAN'T AFFORD TO INVEST £150 A MONTH?

- Put £50 into your ISA
- Do the same in months two and three
- Once you've saved £150, invest the lot in a fund

wide choice for investment trusts and ETFs.

If finding £150 is beyond your means, why not put £50 a month into your ISA and then put the whole lot into a fund at the end of every three months when you've built up £150 of savings.

## OTHER FEES TO CONSIDER

There are additional fees to consider including a custody charge which is the money you would pay your investment platform for holding investments on your behalf.

The amount of fees and how often they are applied varies across the industry. For the purposes of this article, we'll use AJ Bell Youinvest's charging structure to illustrate the range of charges.

For shares, investment trusts and ETFs you would pay £9.95 to buy each one, or £4.95 if you carried out 10 or more online deals in the previous month. You would then pay a quarterly custody charge representing 0.25% of the value of your shares, investment trusts and ETFs each year, up to a maximum of £7.50 per quarter.

There is also stamp duty of 0.5% to consider when buying shares in companies or investment trusts listed on the London Stock Exchange. You don't pay stamp duty on ETFs unless they are domiciled in the UK – but that's very rare.

Funds cost £1.50 to buy and fees are tiered. You pay 0.25% quarterly fee on the first £250,000 worth of funds in your portfolio with AJ Bell Youinvest, dropping to 0.1% on the value between £250,000 and £1m, and then further reductions the bigger the size of your fund portfolio.

Funds, investment trusts and ETFs also come with annual management fees which cover the cost of running the products. You don't pay these through your investment platform provider; instead, the fees are taken within the fund itself.

## ONLINE IS MUCH CHEAPER

All of the costs we've mentioned so far in the article apply to online transactions. Buying shares by telephone is three times the price compared to online at £29.95 while a paper application would cost £100 per transaction.

## WATCH FEES IF YOU ARE REINVESTING DIVIDENDS

You can often reinvest dividends for as little as £1.50.

But such fees can still represent a large amount of your dividend if you only have a small investment.

For example, let's say you received £7.50 in dividends. Reinvestment costs of £1.50 equate to 20% of your dividend payment.

If you had a much bigger stake in the company and received £75 in dividends, the reinvestment fee would only represent 2% of your dividend, so you would only be giving up a small part of your reward.

# Why private equity could boost your portfolio

FOR MANY PRIVATE investors in the UK, it may be worth considering an allocation to private equity. Private equity backed companies typically represent a very different set of companies to those listed on the London Stock Exchange. With investment trusts, private investors can access these opportunities with daily liquidity.

The AIC's Listed Private Equity sector currently constitutes around 15 trusts, which invest in private companies - either directly or through private equity funds run by other managers. Each has its advantages and disadvantages, but **NB Private Equity Partners (NBPE)** bridges both approaches. Uniquely among funds available to individual UK investors, it invests directly into companies alongside a variety of other private equity managers through 'co-investing'.

Investing through co-investments is a key advantage NBPE has, both in being able to put money to work in a timely fashion, but also managing the shape of the portfolio. NBPE currently has a portfolio of over 100 equity investments, balancing the requirement to make meaningful investments in the team's best investment ideas (driving growth) with the benefits of diversifying risks across businesses and sectors (minimising specific risks). And these companies tend to look very different to those available in public markets, operating in new industries or distinct niches.

**Tools for outperforming listed equities**

Alongside having a very different overall portfolio make up, the underlying companies available to private equity investors can be distinct from public companies, in terms of both how they perform and how they are managed.

First, private equity managers actively drive value creation through active ownership, meaning they take a real role in guiding the businesses they invest in. These managers often have detailed knowledge of the competitive landscapes and sectors within which companies operate, which means their advice can be highly valuable to companies and means they have more expertise at their core than many public companies.

And because private equity managers have to live with their investment – for good or for bad – for quite some time, an enormous amount of research (or "due diligence") is undertaken by managers to ensure that the companies they invest in, truly are what they think they are.

This brings us to incentivisation. Another way that private equity investors aim to ensure their investments outperform is by ensuring the management team is highly incentivised to deliver and that the best management teams are therefore attracted to private businesses.

**Private equity delivers results...**

Over time private equity can deliver returns ahead of public equity markets, although it is worth noting that the share price of NBPE may not always directly follow the changes in the trust's net asset value (NAV). Nevertheless, according to Morningstar, over the five years to 30 September 2019, NBPE's NAV total returns in sterling have been 106% compared to the 81.5% total return for the MSCI ACWI Index in sterling.

While past performance is not a guide to future performance, NBPE has proven to be an excellent way to outperform public equity markets in the past. At the same time, private equity offers investors the opportunity to gain access to companies and technologies driving modern economies forward.

**Click here** to find out how NBPE fits into a broader portfolio.

**RUSS MOULD**
AJ Bell Investment Director

Insightful commentary on market issues

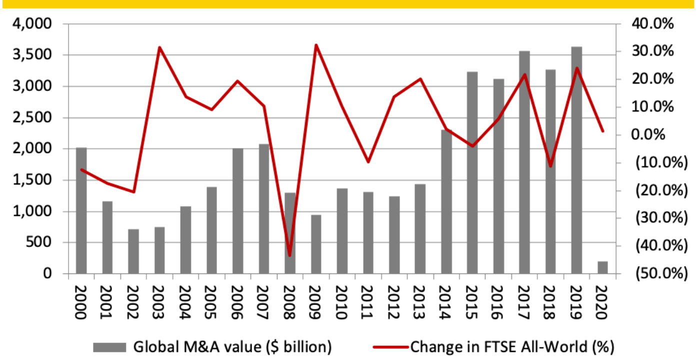
# Will the global M&A love-in end in tears?

Why the 'urge to merge' could be a warning sign for investors

Readers may beg to differ but this column is pretty sure that it was the *Financial Times* newspaper's Barry Riley, in his always-readable *Long View* piece, who coined the phrase 'the urge to merge' when it came to corporate merger and acquisition (M&A) activity. (If anyone disagrees and has proof to the contrary then please let me know).

Judging by statistics generated by Bloomberg that urge, as Riley decorously put it, seems to be burning strongly. In 2019, a record 32,344 M&A deals were struck worldwide, the fourth consecutive all-time high. Last year also witnessed a new peak in transaction values. Completed M&A activity reached $3.6tn, the sixth straight new all-time record.

**GLOBAL M&A ACTIVITY REACHED A RECORD PEAK IN 2019**




Source: Financial Times, Wall Street Journal, Harvard Business Review

This rash of activity is usually seen as a good thing for three reasons:

• Investors will welcome a bid for their holdings. An approach can be the ultimate justification of an investment thesis, as a company buys into their rationale for owning the shares to the ultimate extent of wanting to own them all, with the result that the investor books a healthy profit on their position (or in a worst case is at least spared further misery from one and can emerge with some dignity and money intact).

• While not all deals are paid for solely in cash, with stock frequently involved as an acquisition currency, M&A transactions can provide investors with fresh funds to put into the market, providing additional liquidity.

• Deals usually come at a healthy premium to the target's share price. The valuation paid can potentially make other firms in the same sector or industry look cheap by comparison, stoking interest in them from either financial buyers (such as investors) or other corporations who may start to fear that they are missing out (and then themselves dive in with the next bid to keep the M&A action going).

However, not everyone may be caught up in the urge to merge. Experienced investors will note that global M&A activity peaked in 2000 and 2007, just as equity market bull runs peaked and then collapsed during the bear markets of 2000-03 and 2007-09. There was also a wobble in 2012-13 as the Greek debt crisis reached its zenith and confidence in the global economic outlook wobbled as Athens requested a bail-out.

## PEAKS AND TROUGHS

The same trend can be seen in those deals which

**RUSS MOULD**
AJ Bell Investment Director

involved just UK firms, which also hit a record high in 2019.

This may be why Riley referred to the 'urge to merge,' since it seems that cool and calculated thinking is not always evident when it comes to big M&A deals. After all, investors are taught that they should seek to buy low and sell high (if they feel they should sell at all), yet corporations appear most eager to get stuck into M&A deals when their targets' share prices have already soared and they seem less willing to take the chance when share prices are depressed and there should be more value to be had.

It is not just the sheer number of deals that picks up, either, as equity markets race higher. It appears that the size and scope of bids and mergers becomes more ambitious. But again, note how the biggest deals seem to come near market peaks. Even the $31bn bid from KKR for tobacco-to-food conglomerate RJR Nabisco, perhaps the first mega-deal involving private equity, was struck in 1989, just before a recession hit home and the US and global stock markets slumped.

## BIG DISASTERS

Some investors may therefore view the latest M&A boom with a more jaundiced eye. Recessions and stock market accidents tend to follow M&A booms since ultimately someone, somewhere strikes a bad deal. Money and then confidence are lost with inevitable consequences.

Perhaps the best news about 2019's M&A splurge, therefore, was that there was the absence of a new all-time high for the value of a single deal. This is because the track record of the very biggest deals is spotty. **Vodafone (VOD)** wrote down the value of German mobile telco Mannesmann by almost a quarter within six years, AOL and Time Warner demerged after 10 and the ABN Amro deal helped to bring **Royal Bank of Scotland (RBS)** to its knees.

With the *Financial Times* reporting that January saw record issuance of both junk bonds and emerging market debt, and central banks keeping interest rates at rock bottom and markets nice and liquid, it seems likely that the M&A boom can run a bit further in 2020. But at some stage, there will come the deal that (with the benefit of hindsight) is seen as the one that broke the cycle, because of the price paid, the hubris involved or both, as per AOL-Time Warner and RBS-ABN Amro in the last two cycles.

## Ten largest completed M&A deals of all time

| Year | Buyer | Target | Sector | Transaction value ($ billion) |
|---|---|---|---|---|
| 1999 | Vodafone | Mannesmann | Telecoms | 202 |
| 2000 | AOL | Time Warner | Media | 165 |
| 2013 | Verizon | Verizon Wireless | Telecoms | 130 |
| 2015 | Dow Chemical | DuPont | Industrials | 130 |
| 2019 | United Technologies | Raytheon | Industrials | 121 |
| 2015 | Pfizer | Warner-Lambert | Pharmaceuticals | 112 |
| 2015 | Anheuser-Busch InBev | SAB Miller | Consumer Staples | 107 |
| 2015 | Heinz | Kraft | Consumer Staples | 100 |
| 2007 | RBS-Consortium | ABN Amro | Financials | 98 |
| 2016 | AT&T | Time Warner | Media | 85 |

Source: Financial Times, Wall Street Journal, Harvard Business Review

# Stocks and sectors that move the S&P 500 and Nasdaq

You might be surprised how a handful of stocks have so much influence over an index worth $28tn

When people talk about US stock markets they are usually referring to the Standard and Poors (S&P 500) index. One reason why it's so popular is that it represents around 80% of the whole US stock market.

## S&P 500

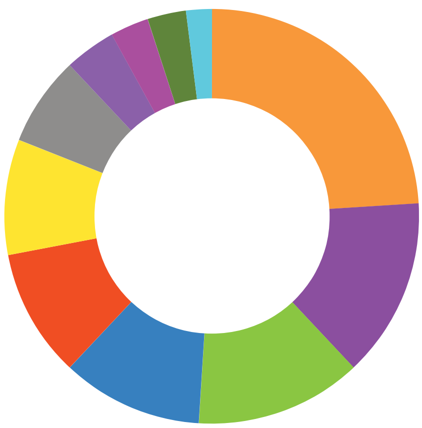
Over $10tn of assets are benchmarked to the index including $3.4tn of indexed products.

It may come as a surprise given the sheer size of the index, but its performance is often determined by just a handful of stocks. Technology names Apple, Alphabet, Amazon, Microsoft and Facebook collectively represent close to 20% of the S&P.

Even a huge business such as Coca-Cola, which has a market capitalization of $252bn, pales into relative insignificance next to Microsoft's £1.3tn market size. To illustrate the effect of this, Coca-Cola shares would need to increase by 5% for every 1% that Microsoft shares increase to have a similar impact on the S&P 500.

Recently Amazon released its fourth quarter numbers, which beat market expectations,

### S&P 500 BY SECTOR



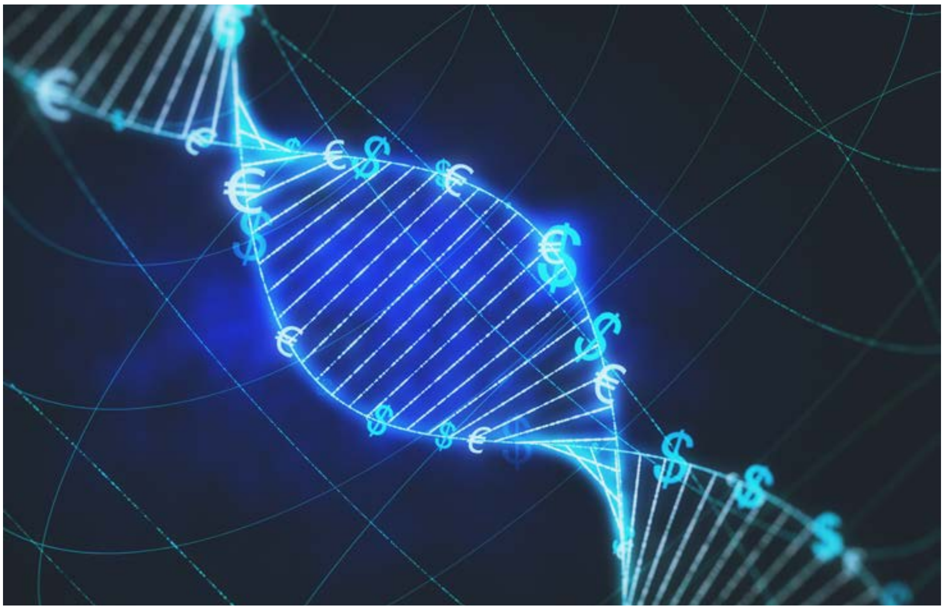
| | |
|---|---|
| Technology | 24.2% |
| Health Care | 13.8% |
| Financials | 12.6% |
| Comms Services | 10.5% |
| Cons Discretionary | 9.8% |
| Industrials | 9.0% |
| Cons Staples | 7.2% |
| Energy | 3.9% |
| Utilities | 3.5% |
| Real Estate | 3.0% |
| Materials | 2.5% |

Source: S&P

### S&P 500 TOP TEN

| Name | Weight % |
|---|---|
| Apple | 4.6 |
| Microsoft | 4.1 |
| Alphabet | 3.3 |
| Amazon.com | 3.1 |
| Facebook | 2.1 |
| Berkshire Hathaway | 1.9 |
| JPMorgan Chase & Co | 1.4 |
| Visa | 1.3 |
| Johnson & Johnson | 1.3 |
| Walmart | 1.1 |

Source: Bloomberg



exciting investors, which pushed its shares up by 10% or $90bn. This lifted the S&P 500 by 0.3% or around 10 points.

The technology sector has the most significant weighting in the index, representing 24%, while healthcare makes up another 14% and financials 13%, these three equating to half of the market.

The largest companies are often global enterprises and therefore receive some revenue and profit from international markets. In aggregate, around 43% of the S&P index's revenues come from outside the US.

The tech sector is the most international, with 57% of its revenues coming from overseas.

The materials and consumer staples sectors also make half of their revenues outside of the US. Good examples are chip maker Intel and 'Ariel to Gillette' consumer brands business Procter and Gamble.

At the other end of the spectrum are the domestically focused sectors like utilities (3% of revenues), real estate (15%) and financials (22%).

Apple tops both the S&P 500 and Nasdaq top 10 lists

What this means is when the US economy struggles relative to global markets the share prices of companies with the greatest international exposure do relatively well and outshine the more domestic players.

And because technology, materials and consumer staples make up around a third of the index, the 'international effect' on the performance of the S&P 500 can be significant.

Related to this effect on the index is the currency tailwind that international companies get from a weak US dollar, which boosts the value of overseas earnings.

That said, some companies protect themselves against financial loss by hedging their non-dollar currency exposure, which also mitigates potential gains.

Over the last five and 10 years respectively, the S&P 500 index has delivered total returns (including dividends) of 79.2% and 269.8% respectively.

You can gain passive exposure to the flagship US index through the **Vanguard S&P 500 ETF (VUSA)**.

## NASDAQ

The Nasdaq Composite index is a broad-based benchmark comprising around 2,700 companies.

Along with the S&P 500 and the Dow Jones Index it is one of the most widely followed indices in the world. Founded in 1971 the name is an acronym of the National Association of Securities Dealers Automated Quotations.

The 10 largest companies comprise 35.5% of the index, dominated by technology businesses which represent half the Nasdaq.

The tech sector itself is comprised of 377 companies, equating to around 14% of the 2,700 companies in the index. This underlines the mega-cap nature of the larger tech names.

Apple and Microsoft dominate the index with weights of 10% and 9% respectively.

While the Nasdaq is broad-based when measured by the number of companies, it is actually very concentrated with the largest 25 (less than 1% of all companies in the index) companies having a combined index weighting of 56%.

Don't be fooled though, just because the companies below the top 25 are small in index weight terms, some are still very large.

For example, online travel booking company Expedia has a market cap of $15.6bn, which makes it bigger than half the companies in the FTSE 100 index.

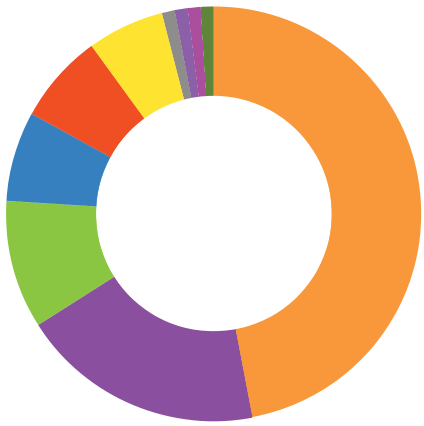
Remarkable as it sounds, even if its' shares were to double, adding another $15.6bn to its value, the impact on the Nasdaq would only be roughly equivalent to a 1% move in the shares of Apple. (market cap $1.4tn)

Outside of the dominant technology sector, consumer services are the next biggest sector with an index weight of 19%. Like tech it is dominated by large cap companies.

By contrast, healthcare is dominated by smaller cap names (think biotech minnows) and the most populous sector with 757 companies or 28% of all the companies in the Nasdaq. It is also the third largest by index weight. (10.2%)

One way of getting passive exposure to the Nasdaq is **iShares Nasdaq 100 UCITS ETF (CNDX)**.

## NASDAQ BY SECTOR



| | |
|---|---|
| Technology | 48.0% |
| Cons Services | 19.4% |
| Health Care | 10.2% |
| Financials | 7.2% |
| Industrials | 6.9% |
| Cons Goods | 5.6% |
| Utilities | 0.8% |
| Telecomms | 0.7% |
| Oil & Gas | 0.6% |
| Basic Materials | 0.3% |

Source: Nasdaq

## NASDAQ TOP TEN

| Name | Weight % |
|---|---|
| Apple | 8.5 |
| Microsoft | 7.7 |
| Alphabet | 6.2 |
| Amazon.com | 5.8 |
| Facebook | 3.9 |
| Intel | 1.6 |
| Comcast | 1.3 |
| Cisco Systems | 1.3 |
| PepsiCo | 1.2 |
| Adobe | 1.0 |

Source: Bloomberg

By **Martin Gamble**
Senior Reporter

# Top tips for picking a current account

Choosing the right place for your day-to-day cash can make a material difference to your finances

Your current account is usually central to your day-to-day money management, so you need one that reflects the way you like to bank and also gives you something back, whether in interest, cashback or a free overdraft.

And by managing your everyday cash sensibly you can free up money to save and invest.

There's a wide world of options out there so, to help you narrow down the choices, here are a few tips from the experts.

## HOW WILL YOU USE YOUR ACCOUNT?

To find your perfect match, think about how you plan to use your current account and what your typical balance will be. Are you someone who travels a lot and would benefit from an account that doesn't charge you to use your card overseas? Are you a big spender who would like to earn rewards or cashback on your spending?


'Current accounts vary from plain vanilla offerings with no perks or interest, to those paying interest and others with perks in exchange for a monthly fee,' says Justin Modray, founder of Candid Money. 'The best choice will depend on your likely average account balance, and if you'll likely stray into overdraft territory each month then overdraft charges are likely to be your key consideration.'

In fact, the rules on overdrafts are about to change so banks are reviewing their fees, making it even more important for customers to shop around, says John Crossley, director of money at Comparethemarket.com. 'Many banks have opted to set their new overdraft interest rate at 39.9% Effective Annual Rate (EAR), but this is not universal, with one high street bank opting for a comparatively cheaper 35% EAR and others opting for a 49.9% EAR,' he explains.

'Interestingly, two of the challenger banks offer overdraft interest rates dependent on your credit rating, likely resulting in those with a poorer credit rating paying more in interest than those with better credit scores.'

## HOW CAN YOU FIND THE BEST DEALS?

Rates change quickly and the best-buy tables are never static, so use comparison sites and shop around once you're ready to switch. Interest rates have plummeted on current accounts as well as savings accounts, with just eight out of 58 standard current accounts paying more than 0.5% interest, says Katie Brain, consumer banking expert at Defaqto. 'Nationwide FlexDirect is the highest paying with a rate of 5% but it comes with restrictions as you can only earn this rate on £2,500, so it does depend on what you will be holding in the account,' she says.

For reward accounts, Modray

points to Santander 123 Lite which offers cashback on some household bills, and First Direct for a good 'plain vanilla' account if you're unlikely to ever have a high balance but also won't run a large overdraft. 'There are no bells and whistles, but First Direct has reputation for good service and tends not to charge interest when overdrawn up to £250,' he says. As an added bonus, it also has a linked regular saver paying 2.75%.

## SWITCHING BONUSES

There used to be a lot of switching incentives on offer as banks battled for your custom, but currently there are only two to choose from. First Direct is consistently one of the top-rated banks for customer service, and it is offering £100 if you switch to it, while parent company HSBC is offering £175. It's now easy to switch thanks to the Current Account Switch Service which should automatically transfer all your incoming payments, direct debits and standing orders within a week. 'A current account is not for life,' says Modray. 'If you receive poor service or spot a better deal, then don't be afraid to switch.' But you'll usually need to pass a credit check to open a new bank account so bear this in mind.

## TRADITIONAL BANKS VS FINTECHS

Aside from the traditional high street banks and building societies, challenger banks are now also offering current accounts with a more fintech feel. Bank with the award-


winning Starling, for example, and you'll do everything via its app.

But while there are perks to digital accounts, such as real-time transactions and tools for budgeting, money management and spending analysis, they won't be suitable for everyone, says Brain. A drawback for some people could be a lack a physical presence on the high street and the facility to pay in cash or cheques over the counter.

'If you are somebody who likes to pay cash or cheques into your account, Monzo charges you to pay in cash, and both Starling and Monzo will only accept cheques by post. These can take up to a week to be credited, whereas with other banks you can take a photo on your phone and it is in there the next day, so those are things to consider,' she adds.

## ARE PACKAGED EXTRAS WORTH THE COST?

If you go for a packaged current account you will usually pay a monthly fee for an account which includes benefits like breakdown cover and various types of insurance. Good if you'll use them all, but they may come with restrictions and high excesses, and you could end up paying for things you don't actually need.

'Accounts with perks such as travel and mobile phone insurance tend to offer poor value, with monthly account fees often outweighing the true value of the perks," says Modray. 'One of the better options tends to be Nationwide FlexPlus, which offers comprehensive family travel insurance, family smartphone cover and UK and European breakdown insurance for £13 per month, potentially good value if you require all these insurances.'


If you're not sure you'll use all the extras, you're probably better going for a free current account and shopping around for cheap standalone insurance that's more tailored to your needs.

By **Hannah Smith**

# 'What do I need to know about the Scottish budget?'

AJ Bell pensions expert discusses what's changed north of the border

*I know everyone is focused on the main UK Budget next month, but is there anything I need to be aware of from the Scottish Budget? I live in Ayrshire and have taxable income of £45,000 a year and pay around £5,000 a year into my ISA. I also receive about £3,000 in dividends via my general investment account.*
***Hamish***

**Tom Selby**
AJ Bell
Senior Analyst says:


The Scottish Budget was published on 6 February, setting out the key spending and tax priorities north of the border for 2020/21.

For savers and investors in Scotland, the event has taken on extra significance since 2017, when former finance minister Derek Mackay – who resigned just before this year's Budget – announced sweeping reforms to income tax bands.

The move was an attempt to make the tax system fairer by placing a greater burden on higher earners and represented the first separation of income tax rates between Scotland and the rest of the UK.

There are now five different tax bands in Scotland – starter-rate (19%), basic-rate (20%), intermediate-rate (21%), higher-rate (41%) and additional-rate (46%).

This compares to the rest of the UK where there are just three tax bands – basic-rate (20%), higher-rate (40%) and additional-rate (45%).

Figure 1 shows the income tax bands rates in Scotland for the current tax year (2019/20), and figure 2 the proposed changes in 2020/21.

So no major shifts, although note the starter and basic-rate bands have increased in line with inflation, while the higher and additional-rate bands have been frozen.

In your case this shouldn't make a material difference, but for those who were close to one of the higher-rate bands who enjoy a pay rise it will push them into paying a bit more tax.

While the product you choose to save in will depend on your goals and personal circumstances, it's worth noting

## Figure 1 - Scottish income tax rates in 2019/20

| Band | Band name | Rate |
|---|---|---|
| Over £12,000-£14,549 | Starter rate | 19% |
| Over £14,549-£24,944 | Scottish basic rate | 20% |
| Over £24,944-£43,430 | Intermediate rate | 21% |
| Over £43,430-£150,000 | Higher rate | 41% |
| Above £150,000 | Additional rate | 46% |

Source: Scottish Budget 2019/20

that higher and additional-rate taxpayers in Scotland can get an extra one percentage point in tax relief boost by saving in a pension versus those in the rest of the UK.

Intermediate-rate taxpayers are also eligible for a bit of extra tax relief, although those in a relief at source scheme such as a SIPP need to claim this back from HMRC.

You should also consider whether your dividend paying investments could be held more tax efficiently in a SIPP or ISA. Both allow you to receive dividends tax-free, whereas outside a tax wrapper any dividends above £2,000 will face a tax charge of either 7.5% (starter, basic or intermediate-rate taxpayers), 32.5% (higher-rate taxpayers) or 38.1% (additional-rate taxpayers).

## Figure 2 - proposed Scottish income tax rates in 2020/21

| Band | Band name | Rate |
|---|---|---|
| £12,501-£14,585 | Starter rate | 19% |
| Over £14,585-£25,158 | Scottish basic rate | 20% |
| Over £25,158-£43,430 | Intermediate rate | 21% |
| Over £43,430-£150,000 | Higher rate | 41% |
| Above £150,000 | Additional rate | 46% |

Source: Scottish Budget 2020/21

## 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.

# What's the catch with investment trusts yielding above 5%?

We explain how certain trusts can generate a high yield and pick two to buy

Little is more satisfying in investing than receiving a dividend payment from one of your holdings and investment trusts have an excellent track record of delivering a regular stream of income.

Some trusts offer very attractive yields too. According to industry body the Association of Investment Companies, the average for all trusts is 3.2% but there are a significant number of trusts which offer dividend yields in excess of 5%.

In this article we will concentrate on the trusts with yields of between 5% and 10%, above which the yield is likely to be an anomaly, quirk of the data or situation where the dividend is almost certain to be on the chopping block.

We will examine the merits of higher yielding trusts in general and identify two which investors should buy today.

### A RED FLAG?

A high yield can attract investors seeking the generous income on offer, but it should also be considered as a red flag as it often means a dividend is considered by the market to be unsustainable and can reflect a falling share price.

**DID YOU KNOW?**

**Managers of investment trusts can retain a bit of cash each year to help smooth out future dividend payments**

**Hadrian's Wall Secured Investments (HWSL)** is a classic example of an investment offering an exceptionally high yield because it has fallen dramatically in value.

The trust launched in June 2016 with a proposition which involved offering secured loans to small businesses at relatively high interest rates. A good chunk of this income was then returned

**Investment trusts yielding more than 5%**

| Investment trust | Yield (%) |
| --- | --- |
| NewRiver REIT | 9.7 |
| VPC Specialty Lending Investments | 9.6 |
| AXA Investment Managers Paris Volta Finance | 9.4 |
| Honeycomb Investment Trust | 8.5 |
| SQN Secured Income | 8.3 |
| AEW UK REIT | 8.2 |
| Premier Global Infrastructure Trust | 7.6 |
| Chenavari Toro Income | 7.6 |
| CQS New City High Yield Fund | 7.5 |
| CEIBA Investments | 7.0 |
| Biopharma Credit | 7.0 |
| Drum Income Plus REIT | 7.0 |
| Real Estate Credit Investments | 7.0 |
| UK Mortgages | 6.9 |
| Tufton Oceanic Assets | 6.7 |
| Henderson High Income Trust | 6.6 |

Source: FE Analytics, 7 February 2020 (includes trusts yielding between 5% to 10% excludes VCTs) to shareholders, once the trust's bills had been paid and some money had been held as a buffer against hard times.

However, the company ran into trouble after loaning money to biomass projects where as broker Winterflood noted 'the security on the (biomass) investments appeared to be worthless'.

In January the company increased its loss provision from £3.27m to £18.1m on these loans and its yield of 12.1% reflects the fact its share price has halved in the last year. A fall in the share price will push the dividend yield up, based on the most recent full year dividend payment.

Looking at some of the other higher yielding collectives in the investment trust universe, several are actually venture capital trusts (VCTs). These are funds that allow investors to claim up to 30% income tax relief on an investment of up to £200,000 a year.

You need to hold the investment for at least five years, but any dividends will be tax free and you will have a capital gains exemption on disposal.

However, VCTs are only suitable for certain investors as they involve high charges and invest in small, often unquoted companies.

Putting these products to one side, there are also some more high-yielding esoteric vehicles which either have complex structures or operate in niche areas like aircraft leasing or asset finance where the risks may not be easy to recognise and understand.

## Best performing high yielding trusts

| Investment trust | Three-year cumulative performance (%) | Yield (%) |
|---|---|---|
| Globalworth Real Estate Investments | 78.5 | 6.5 |
| Bluefield Solar Income | 42.4 | 5.8 |
| Princess Private Equity Holdings | 40.7 | 5.2 |
| VPC Specialty Lending Investments | 38.6 | 9.6 |
| Regional REIT | 37.2 | 5.5 |
| Apax Global Alpha | 34.6 | 5.0 |
| BlackRock Latin American Investment Trust | 32.6 | 5.6 |
| AEW UK REIT | 32.2 | 8.2 |
| JLEN Environmental Assets | 30.8 | 5.5 |
| Real Estate Credit Investments | 29.1 | 7.0 |
| Twentyfour Select Monthly Income Fund | 27.8 | 6.5 |
| Foresight Solar | 27.4 | 5.7 |
| NextEnergy Solar Fund | 26.9 | 5.6 |
| Pollen Street Secured Lending | 26.8 | 5.8 |
| Acorn Income | 25.0 | 5.1 |
| Schroder European Real Estate Investment Trust | 23.3 | 5.8 |

Source: FE Analytics, 7 February 2020 (includes trusts yielding between 5% to 10% excludes VCTs)

### RUNNING HARD

The FTSE All-Share is often used as the benchmark for the UK stock market. It is currently yielding 4.2%.

QuotedData analyst James Carthew says: 'For an equity fund to achieve a yield a quarter higher than the market yield it would have to be running quite hard.

'A trust probably has two ways to achieve that; it can invest in high yielding, value type situations, potentially at the expense of some capital growth, or it can use some engineering to avoid buying really high yielding stuff.

'You need to think about diversity of income. If a trust is relying on just a handful of holdings to generate income then that can easily go wrong.'

The 'engineering' referenced by Carthew can include the use of options or purchasing different classes of share which offer higher income. He adds this is 'not necessarily a bad thing'.

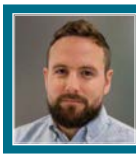
He cites the example of **Shires Income (SHRS)** which uses lower cost debt to buy a portfolio of higher yielding preference shares. It trades on an historic yield of 4.6%. Another popular income-focused trust offering a yield just below the 5% threshold is **Merchants (MRCH)**, on a yield of 4.9%.

## RENEWABLES TRUSTS 'EXPENSIVE'

Several infrastructure-focused trusts, including some in the renewables sector, offer generous yields. As Stifel points out, the high valuations of these increasingly fashionable trusts is a risk to note.

'Renewable sector valuations are at all-time highs, reflecting investor enthusiasm and flows into the asset class. However, headwinds continue to increase with: 1) weak power prices, 2) a corporation tax 'increase' and 3) UK inflation being below assumptions.'

Ultimately investors should understand that, in general, higher yields come with higher risks. Don't simply chase the generous income without understanding how the trust can pay that money to you.



By **Tom Sieber**
Deputy Editor

## Two high-yielding trusts to buy

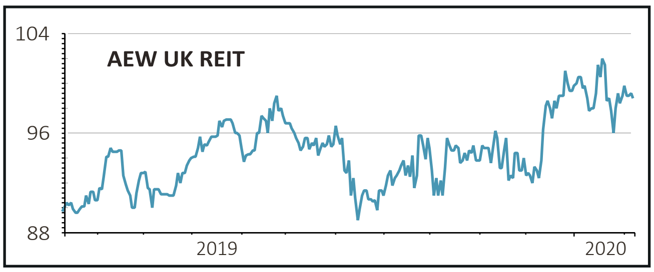
### AEW UK REIT (AEWU) 99p

**Dividend yield:** 8.2%
**Frequency of dividends:** Quarterly
**Premium to net asset value:** 6.2%
(Source: FE Analytics, AIC)

Steered by Alex Short, the trust aims to pay a covered dividend of 8%, with income generated from a portfolio of UK regional property assets.

It has a 50% weighting to the industrial sector, targeting good quality, second hand, well-located assets – distinct from prime logistics units which are more expensive and therefore offer lower yields.

It works hard on asset management to grow rent and capital values. The trust is targeting a pipeline of assets valued at £100m, including some select retail assets, so may be raising new cash soon.



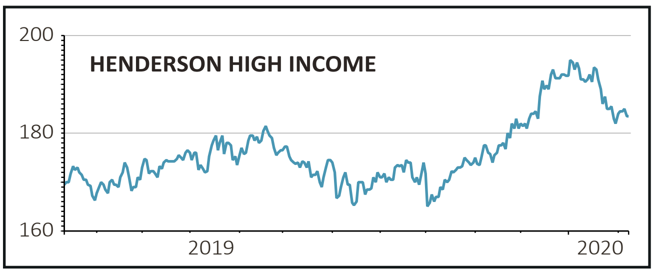

### Henderson High Income (HHI)

**Dividend yield:** 6.6%
**Frequency of dividends:** Quarterly
**Discount to net asset value:** 2.2%
(Source: FE Analytics, AIC)

Launched in November 1989, according to QuotedData since inception it has achieved a total return of 14 times the value of an initial investment, compared with 9.4 times for the MSCI UK benchmark.

Like many trusts the company uses gearing which involves borrowing money to access a greater pool of cash for investments. This enables it to enhance and underpin income with some of this money used to buy fixed-interest securities, typically split 20% to 80% between bonds and equities respectively.

There is a focus on quality and manager David Smith sees a sweet spot investing in stocks which yield between 2% and 6%.



# Sortino ratio: a smart way to measure performance

This method of judging risk against return is employed by top fund manager Terry Smith

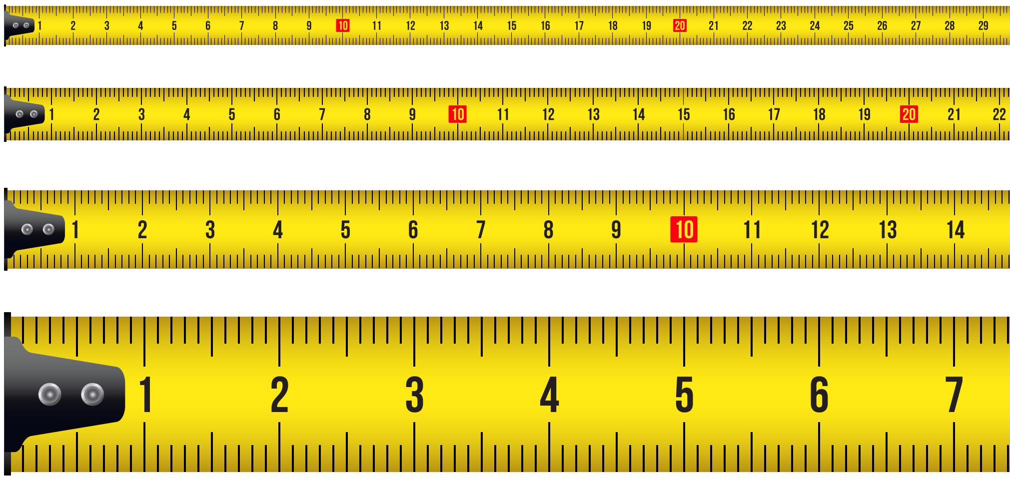
A little known but potentially very useful way to measure the return on an investment received its moment in the spotlight in January 2020 after getting name checked by star fund manager Terry Smith.

In his his annual letter to shareholders in **Fundsmith Equity (B41YBW7)**, Smith included something called the 'Sortino ratio' for the first time when looking at the fund's performance.

It is an adaption of the commonly used Sharpe ratio, a measure developed by Nobel laureate William F. Sharpe to help investors understand the return of their investment compared to its risk.

The Sharpe ratio measures the performance of an investment compared to a so-called 'risk-free asset' like a government bond, and the ratio is the average return earned in excess of the risk-free rate.

While the Sharpe ratio looks at all volatility, i.e. both on the way up and on the way down, the Sortino ratio – developed by investment academic Frank Sortino – excludes upside volatility (because why would you be concerned when your investment goes up) and only looks at downside volatility.



## JUST FOCUSED ON DOWNSIDE VOLATILITY

As a general rule, a Sharpe ratio with a score of one or above is considered good, while for the Sortino ratio a score of two or above is what fund pickers look for though one or higher is still acceptable.

In his annual letter, Smith calls the Sortino ratio an 'improvement' on the Sharpe ratio.

He says: 'Whereas the Sharpe ratio estimates risk by the variability of returns, the Sortino ratio takes into account only downside variability as it is not clear why we should be concerned about upside volatility (i.e. when our fund goes up a lot) which mostly seems to be a cause for celebration.'

AJ Bell head of active portfolios Ryan Hughes says that while the Sharpe ratio remains the more common measure, it could be better to use Sharpe for low volatility assets, like bonds, and Sortino for higher volatility assets like shares, also known as equities.

Hughes explains, 'The rational for Sortino is that upside volatility is considered good for equities and therefore equities shouldn't be penalised for having high upside volatility.'

"It could be better to use Sharpe for low volatility assets, like bonds, and Sortino for higher volatility assets like shares"

## TECHNICAL TERMS EXPLAINED

- **UPSIDE** – the potential increase in value of an investment, measured in monetary or percentage terms.
- **DOWNSIDE** – the negative movement in the price of an investment, sector or market.
- **STANDARD DEVIATION** – a commonly used way to quantify risk, measuring how much the value of your portfolio moves around.
- **RISK-FREE RATE** – the rate of return on a hypothetical investment, over a given time period, with no risk of financial loss. Terry Smith defines this as 'basically the return on government bonds'.
- **EXCESS RETURN** – a measure of how much an investment has returned compared to a benchmark or index (e.g. an active UK equity fund compared to the FTSE 100), also known as alpha.

### FUND SELECTION TOOL

The Sortino ratio could also help you pick a fund to invest in, as after all investment fund managers are judged on how good they are at turning risk, measured by volatility, into return.

The majority of people who pick funds for a living look at the Sharpe ratio when assessing the above, but Patrick Thomas, an investment director at Canaccord Genuity Wealth Management, thinks it is better to look at both the Sortino and Sharpe ratios.

Thomas explains, 'A fund manager who does a consistent excess return of 2% with 2% standard deviation is as good as a fund manager who delivers a consistent excess return of 12% with 12% standard deviation, i.e. despite the different risk and return of the two funds, both fund managers have delivered the same Sharpe ratio.

Sortino ratio – only factors in downside volatility

'But they are not the same obviously. So clearly, the main issue is that the Sharpe ratio fails to distinguish between downside volatility (generally considered bad) and upside volatility (which no investor ever moans about).

'So that's why they modified the Sharpe ratio to take into account only downside volatility by developing the Sortino ratio.

'Again, the higher the ratio the more attractive the risk-adjusted return. So it's essentially a sign of a fund that is going to perform well in negative markets.'

But he adds Smith talking about the Sortino ratio in his letter is 'a bit strange', given that fund managers typically have to use a long/short strategy or some other type of hedging in order to demonstrate a 'genuinely attractive' Sortino ratio.

### A SELECT FEW HIT THE MARK

Fundsmith Equity has a Sortino ratio of 1.22 since inception, which is well above the 0.59 for its MSCI World Index benchmark but still below the two mark that is considered the gold standard.

However, most funds on the market fail to reach a Sortino ratio of one for any meaningful period of time, even when using the most commonly used risk-free rate at the moment – the yield on 10-year UK gilts, which due to the low interest rate environment currently stands at 0.6%.

According to data from FE Analytics, only Fundsmith, **Investec Global Franchise (B7VHRM9)** and **Morgan Stanley Global Brands (3248249)** have a Sortino ratio above one over five years.

The funds that do have a Sortino above two are mostly property or commodity funds, which tend to be less volatile as they often have illiquid assets that are only priced once or twice a year.

By **Yoosof Farah**
Reporter

**KEY**

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










## KEY ANNOUNCEMENTS OVER THE NEXT WEEK

### Full year results

**14 February:** AstraZeneca, Royal Bank of Scotland, Segro, Tullow Oil. **18 February:** Glencore, Sunrise Resources, The Renewables Infrastructure Group. **19 February:** RPS. **20 February:** BAE Systems, Morgan Sindall, Rathbones, Smith & Nephew.

### Half year results

**17 February:** Petra Diamonds. **18 February:** BHP, Blancco Technology Group, Pan African Resources. **20 February:** Arc Minerals, Hays, McBride.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