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SHARES

WE MAKE INVESTING EASIER

VALUE INVESTING

THE COMEBACK KID

The investment style still has a lot of merit

PLUS

ANIMAL MAGIC: SOLID GROWTH OUTLOOK FOR PET-RELATED COMPANIES

CAN ASHTEAD MAINTAIN ITS **STELLAR GROWTH RECORD?**

AVIVA COULD DELIVER OUTSIZED GAINS UNDER NEW LEADERSHIP

Mattik | Madrid, 2018

The price conundrum for stock market winners

Avon Rubber is the latest quality company to trade on a valuation that looks too rich to stomach

Every now and again you come across a stock which keeps churning out good news, fuelling a share price rally.

Backing winners is an obvious strategy for investors; after all, surely there is merit in putting your money into a business that is going places rather than one that is stuck in the mud?

Therein lies the problem. Do you pay a high premium to own the shares of a 'winning company'? Or do you pay a discount to own a slice of a company that needs fixing?

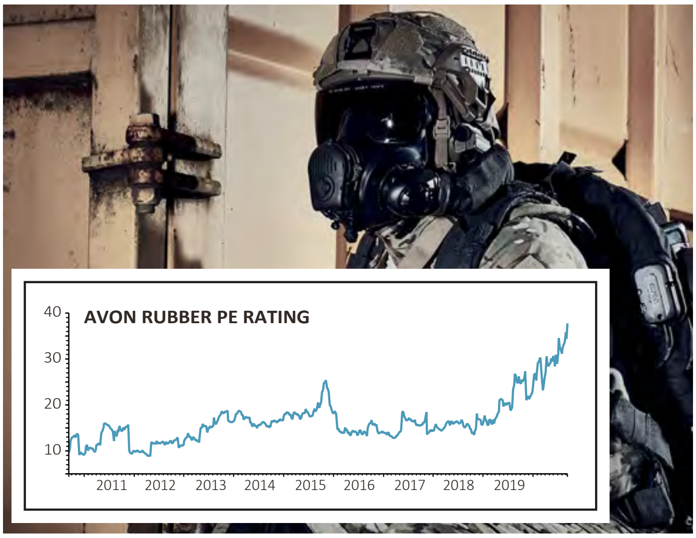
Two months ago *Shares* looked at **Games Workshop (GAW)** and concluded that it was a brilliant business but the valuation was too rich. The stock has subsequently risen by 22% after trading continued to beat expectations, leaving us looking silly for being too cautious.

We're now at the same crossroads with **Avon Rubber (AVON)**, another high-flying stock that keeps issuing positive news. If you put valuation to one side, this business has much to offer.

It has become the global market leader in advanced CBRN (chemical, biological, radiological and nuclear) respiratory protection systems for the world's military, homeland security, first responder, fire and industrial markets. Avon Rubber has also progressed from being a liner and tubing manufacturer for the dairy industry to being an innovator and having the market leading milking point systems brand in Milkrite.

Helping to fuel momentum this year has been a run of contract wins in the defence industry and a deal to sell its dairy business, meaning it will soon solely focus on the protection market. The disposal proceeds will help top up the pension fund and facilitate acquisitions where it can hopefully make higher returns.

Deals are already being forged, including the proposed acquisition of Team Wendy which is a leading supplier of helmets/helmet liner and retention systems. This will complement Avon Rubber's existing ballistic helmet business.



The strategic progress seen across the business in recent years hasn't gone unnoticed by the investment community. As the chart shows, investors have been happy to pay a much higher multiple to own the shares, going from sub-20 times before 2019 to now trading on circa 40 times earnings.

Operating margins have been improving in every year bar one since 2009 and Avon Rubber has a long track record of delivering strong returns from the investments it makes in the business. It is now capitalising on an opportunity to extend its product range so it can offer more to existing and new customers.

There is a lot to like about this high quality business, but any interested investor should think hard about whether they want to pay the current rating. The market is pricing in a lot of future success today which makes the stock vulnerable to a large correction if Avon Rubber cannot delivered the expected growth.

Avon Rubber and Games Workshop are near the top of our list of stocks to buy when the market next goes through a sticky patch. We simply cannot justify paying today's prices.

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CFA UK Publication of the Year CFA UK Journalism Awards 2019

News Provider of the Year (Highly Commended) CFA UK Journalism Awards 2020

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Markets are holding firm following an earlier recovery

Investors should remain watchful of political and economic risks which could destabilise markets

The initial market rebound from the coronavirus correction was rapid as investors dusted themselves off and, aided by central bank and government stimulus and vaccine progress, looked towards a recovery for businesses and the economy.

The story of the third quarter has been one of relative resilience for the markets despite a complicated backdrop of mounting political risk and apparent evidence of a second wave of coronavirus infections.

The FTSE All-World index, encompassing the major developed markets, is up more than 9% since 30 June. In part this reflects the heavy weighting of the US where, despite a recent wobble, tech stocks have helped lead a strong advance with the Nasdaq 100 up by double digits.

Chinese stocks have also enjoyed strong gains over the summer. Shanghai's CSI 300 index is up nearly 12% in the third quarter to date, helped by data showing economic recovery.

The FTSE 100 is the obvious laggard so far in the third quarter, falling by more than 1.5%. This likely reflects the index's heavy weighting to areas like oil and gas and mining and much smaller representation for sectors such as technology which are perceived as relative winners in the pandemic.

The UK also continues to wrestle with the issue of Brexit with legislation being introduced which would alter the exit deal agreed with the EU and by the Government's own admission break international law.

This has led to increased fears of an unruly end to the transition period at the end of this year and has put pressure on sterling. Most observers believe the deadline for any kind of deal between the UK and EU is October.

How global markets have performed so far in the third quarter

Index	Performance since 30 June (%)
CSI 300 Index (China)	11.7
Nasdaq 100 (US)	11.0
Nasdaq Composite (US)	9.9
SSE Composite Index (China)	9.9
FTSE All-World	9.3
S&P 500 (US)	9.1
DAX Xetra (Germany)	7.5
Nikkei 225 (Japan)	5.7
CAC 40 (France)	2.8
FTSE 100 (UK)	-1.5

Source: SharePad, as at 15 September 2020

By that point attention may have turned firmly to the US and its presidential election – where Democratic hopeful Joe Biden holds a healthy lead in national polls but his attempt to unseat incumbent Donald Trump may well come down to a few battleground states. This raises the sceptre of an extremely tight race and a disputed outcome.

Finally, there remains plenty of speculative money in the markets, with a recent report from *Bloomberg* revealing record inflows upwards of $1.5 billion into US exchange-traded fund ProShares UltraPro QQQ – which offers three-times leveraged exposure to the Nasdaq index.

The multitude of issues bubbling away would suggest another global market correction is not out of the question either this year or early 2021, meaning it is worth having cash on hand ready to invest in quality businesses at more attractive prices should the opportunity arise like it did in March.

Changing consumer habits could favour companies less reliant on city centres

A new sales trend could be emerging among businesses in the UK

Local high streets and out-of-town retail parks could see a resurgence as the public opts to either stay near to their homes for shopping and leisure activities, or to go somewhere with ample car parking space so they don't mix with others in close proximity on public transport.

There are already signs that commercial city centres including London are suffering as working and travel habits change.

The latest Coffer Peach survey tracking the pubs and restaurants sector found in August that London saw a 13.4% like-for-like drop in sales and 28.1% overall fall, compared with a 7.9% drop outside the M25.

Associated British Foods (ABF) recently said UK sales for its Primark fashion chain since reopening in May were expected to be 12% lower on a like-for-like basis. However, by excluding its four large UK destination city centre stores, sales would only be down 5%.

Casino operator **Rank (RNK)** noted in a recent trading update that its venues outside of London achieved 75% of prior-year revenues which means they are operating with positive cash flow, in contrast to London where trading remains weak with revenues only hitting 40% of prior year levels.

The shift in activity away from big city centres could improve the earnings prospects of businesses already focused on out-of-town locations such as neighbourhood café and bar operator **Loungers (LGRS:AIM)** which had reopened all of its sites by 7 August. On 16 September it reported 'significant market outperformance' since reopening, adding that sales were positive even when excluding the impact of the Eat Out to Help Out scheme and VAT reduction on food and non-alcoholic drinks.

Similarly, pubs group **Marston's (MARS)** with

its focus on suburban locations and smaller towns may well see its earnings recover faster than rivals which focus on large cities.

The same case could be made for neighbourhood retailer **McColl's (MCLS)** which has over 1,400 convenience stores spread across the UK. It recently reported that food grocery and alcohol sales had been particularly strong.

Value retailer of cards and gifts **Card Factory (CARD)** operates through a national chain of over 1,000 stores and is omnipresent in small towns across the UK, as well as having an online offering which management believes could treble by 2025.

'The UK greeting card market has been flat, by value, at c.£1.3bn over the past three years and is forecast to remain so,' says Liberum analyst Adam Tomlinson. 'This is driven by the fact that card giving is engrained in British culture, with 76% of adults having purchased at least one card in the last year.'

Card Factory will reveal to investors whether recent business has been resilient or not when it issues results on 29 September.

Large number of UK stocks see 20%+ gains in a week

Positive news flow is among the catalysts driving the significant stock movements

Forty two companies on the UK stock market have seen their share prices rise by at least 20% over the past week (to 15 September), principally as investors race to own shares issuing positive news, albeit some of the aforementioned stocks moved on no news at all.

One of the biggest gains came from specialist car brake maker **Surface Transforms (SCE:AIM)**, whose shares rocketed 98% to an intraday high of 48.5p during trading on 14 September after it revealed a big contract win and raised expectations of annual growth in revenue.

Due to increased retrofit and original equipment manufacturer sales in spite of the coronavirus pandemic, the firm expects revenue for the year to be £2 million, which is £400,000 ahead of market expectations, and signed a contract worth £27.5 million over its lifetime with an unnamed vehicle manufacturer to supply carbon ceramic brake discs.

Security services provider **G4S (GFS)** jumped 28% to 180p after Canadian peer GardaWorld announced the terms of a £3 billion takeover approach for the business.

GardaWorld, the largest privately-owned security services firm in the world, has proposed an all-cash offer of 190p per share for G4S, which it said represents a premium of 86% to the target's share price prior to its first approach in June.

Engineered electronics-maker **TT Electronics (TTG)** jumped 37% on 10 September after the firm announced the launch of a 'ground-breaking' Covid-19 screening device.

TT has been working with UK start-up iAbra and partners, including chipmaking giant Intel, on the design and manufacture of a device called Virolens. A first round of testing at Heathrow Airport was successful and iAbra is about to embark on clinical trials so that the device can be certified for medical use.

Having already been a nine-bagger since the start of 2020, gold mining explorer **Greatland Gold (GGP:AIM)** jumped a further 41% to 23.64p following two bits of positive news on 10 September. Driving the shares were more promising drilling results from its flagship Havieron deposit in Western Australia and Greatland being granted a mining lease for the project.

Going the other way was oil explorer **Hurricane Energy (HUR:AIM)**, whose shares fell 54% to 2.93p on 11 September after it sharply marked down its flagship project's recoverable reserves.

The company now expects to extract 16 million barrels of oil from its Lancaster field over a six-year period, well below the 37.1 million it expected to extract previously.

UK Market: top risers over the past week

Iconic Labs	95%
88 Energy	69%
Deltic Energy	66%
Chariot Oil & Gas	64%
ProPhotonix	61%
Great Western Mining	60%
Scancell	58%
Surface Transforms	58%
Alba Mineral Resources	54%
Carclo	52%

Source: SharePad. Data to 15 Sep 2020 11am

Supermarkets face new pressures despite online boom

Yet Ocado continues to issue positive news and enjoy a rising share price

Supermarket sales eased in August as the sector begins to eye a key festive period which could be blighted by new coronavirus restrictions and a weak consumer backdrop.

The brightest star in the groceries firmament continues to be **Ocado (OCDO)** which despite some teething problems bucked the somewhat downbeat backdrop to report (15 Sep) a strong start for its joint venture with **Marks & Spencer (MKS)**.

The successful launch also spared Marks the embarrassment of being the only major food retailer without an online delivery service earlier this year when the shift to an internet-based weekly shop started to accelerate.

Ocado's switch on 1 September from offering Waitrose products to now having M&S food and drinks has driven an increase in the number of products in customer baskets and prompted strong forward orders.

Success for the M&S tie-up gives Ocado more room to focus on the technology area of the business which generates most excitement for investors. Its Ocado Smart Platform solution is aimed at supermarkets around the world looking to launch or augment an online delivery arm. Since Ocado secured its first international client in June 2017 the shares are up 686%.

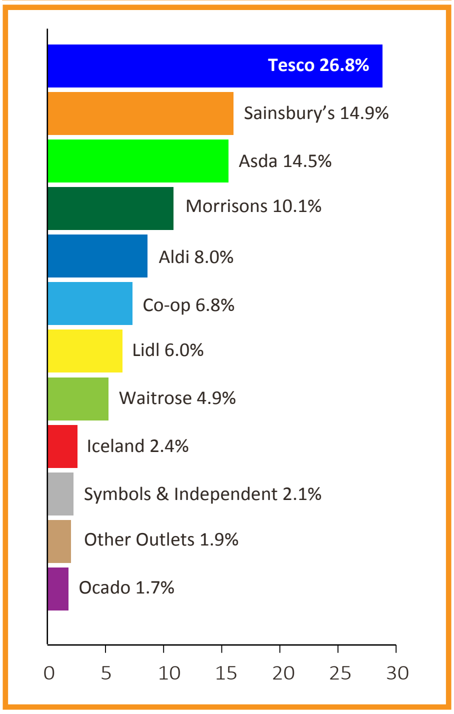
UK sector data from market research outfit Kantar on 15 September showed growth in supermarket sales slowed markedly in August compared with July.

Some of this was attributed to the impact of the Eat Out to Help Out scheme which encouraged more people to venture out to restaurants rather than cooking meals at home.

According to Kantar, supermarket sales were up 10.8% year-on-year in the 12 weeks to 6 September 2020 but up just 8% in August – the slowest rate since April 2020.

Online grocery sales were up 77% year-on-year in the four-week period to 6 September – although they have dropped back to 12.5% of total sales from a peak of 13.5% in August.

GB GROCERS' MARKET SHARE



Source: Kantar, data covers 12 weeks to 6 September 2020

The impact the recently-introduced 'Rule of Six' might have on Christmas gatherings and the gloomy economic outlook are potential headwinds for the sector.

On 10 September **Morrisons (MRW)** received an unfavourable market reaction as it announced plans for price cuts alongside its first-half results as it looks to tailor its offering to a customer base which is feeling the pinch.

However, Shore Capital analyst Clive Black is positive overall about the supermarkets' prospects in the wake of the pandemic. He says: 'The industry's strategic relevance and reputation has been enhanced by its behaviour through the coronavirus crisis whilst the online channel has migrated from marginally loss-making to profit.

'Challenges and uncertainties persist – Covid, recession, UK-EU, Christmas with six – but we feel more confident about positive operational gearing, liquidity and solvency, free cash generation, ongoing dividend declarations and more.'

Aviva could deliver outsized gains under new leadership

New chief executive plots course to higher returns

Insurance giant **Aviva (AV.)** started 2020 on a high after reporting record earnings for the prior year and a promise from chief executive Maurice Tulloch to bear down on controllable costs.

He said: 'There is much more to do simplifying our business, reducing costs and navigating competitive markets to make Aviva a stronger, simpler, better company.'

Just a few months later he was replaced by former AXA UK chief executive and ABI chair Amanda Blanc, who vowed not only to simplify the business but to go further, reviewing 'all strategic opportunities, at pace, in order to unlock value for shareholders'.

That was code for disposals, which Tulloch – an Aviva 'lifer' – had shied away from, much to the disappointment of investors.

True to her word, last week Blanc set the ball rolling by agreeing to sell a majority stake in Aviva's prized Singapore business to a local firm for £1.2 billion in cash and a further £400m in dividends and marketable debt securities.

'In selling Singapore for £1.6bn, Aviva will realise value equivalent to 15% of the market capitalisation for a loss of just 5% of earnings and negligible cash generation,' comments Jefferies analyst Philip Kett. 'These proceeds will be retained to support central liquidity (ultimately used to reduce leverage when debt rolls off).'

AVIVA
BUY
(AV.) 301p
Market cap: £11.3 billion

The deal marked 'a significant first step in our new strategy to bring greater focus to Aviva's portfolio' as well as bringing 'excellent upfront value for shareholders', according to Blanc.

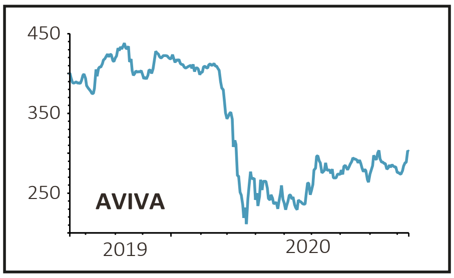
It represents the first step in shifting Aviva's focus to its core UK, Ireland and Canada operations. The non-core entities are interests in mainland Europe and parts of Asia.

Despite lower sales and a rise in Covid-related general insurance claims, the core Aviva business has weathered the pandemic, reporting a robust set of half-year results, and the group's solid return on equity has allowed it to reinstate dividend payments.

Despite this, the shares trade on a 12-month prospective multiple of just 6.5 times earnings – one of the lowest ratings in the FTSE 100 index – and a prospective yield of 8.6%, towards the top end of the range for a FTSE stock.

In addition, we would argue that the funds business, Aviva Investors, deserves greater recognition due to the high returns it gets for customers and the value it adds to the business.

Last year 84% of the firm's funds beat their benchmark, generating third-party net inflows of £2.3 billion compared with net outflows the year before.



On sale: use Mercantile to access market winners at a discount

This dividend paying trust targets companies with attractive growth prospects

A 12.9% discount to net asset value at **The Mercantile Investment Trust (MRC)** means investors can access some of this year's top performing stocks on the cheap, including gold and silver miner **Polymetal (POLY)** and fantasy miniatures maker **Games Workshop (GAW)**. Investors also get exposure to various other stocks with the potential to be bigger businesses in time.

Shares believes Mercantile's bias to small and medium-sized companies would provide reassuring diversification to a portfolio focused on large caps, while dividends have increased six-fold over the last 20 years and income remains an important part of the trust's strategy.

Mercantile's discount to net asset value in part reflects a perception that small and mid-caps are more vulnerable to a recession than their larger corporate brethren, although the FTSE 250 has actually beaten the FTSE 100 year-to-date and Mercantile's winning strategy is reflected in an outstanding long-term performance record.

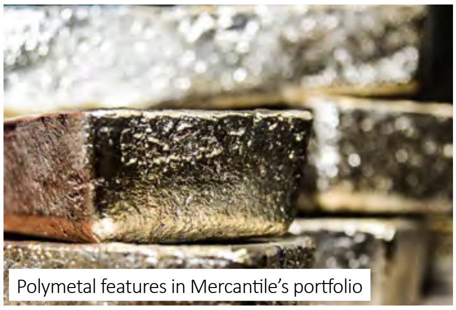
Over the past 10 years it has generated 10% annualised share price returns versus 7.97% from its FTSE All-Share excluding FTSE 100 companies and investment trusts benchmark, according to manager JPMorgan Asset Management.

THE MERCANTILE INVESTMENT TRUST
BUY
(MRC) 181.1p
Market Cap: £1.45 billion

Managed by Guy Anderson and Anthony Lynch, the pair focus on identifying tomorrow's market leaders by targeting UK companies outside the FTSE 100 that have significant room for growth and which is not recognised by other investors.

More specifically, the managers seek exposure to structurally strong business areas, to companies with high internal rates of return that reinvest their cash flows. Crucially, the managers pay close attention to capital allocation policies.

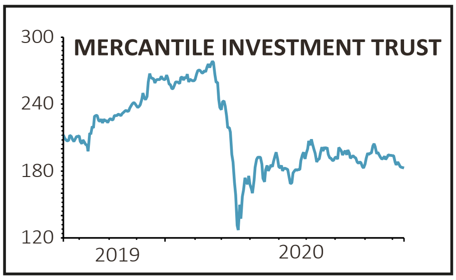
The trust has notable exposure to the software and computer services sector via names such as **Softcat (SCT)** and **Computacenter (CCC)**. The managers also like the retail space, as illustrated by stakes in **B&M European Value Retail (BME)** and **Dunelm (DNLM)**.


Polymetal features in Mercantile's portfolio

Mercantile pays a quarterly dividend and aims to grow the shareholder reward in line with inflation as a minimum. The current intention is at least to maintain last year's total dividend of 6.6p for the year to March 2021, implying an attractive 3.6% yield at the current share price.

The trust has more than a year of retained earnings, so even if every company in Mercantile's portfolio didn't pay a dividend this year the trust could maintain the payout. Fortunately, many companies are now restarting dividends, so we don't see a situation where it needs to use up its reserves quickly.

As of 11 September, the trust was 10% geared which relates to borrowing money which it then invests in the market to hopefully boost returns.



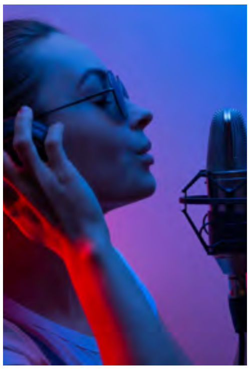
FOCUSRITE

(TUNE:AIM) 819p

Gain to date: 19.2%

Original entry point:

Buy at 687p, 23 July 2020



WHILE WE flagged audio technology specialist **Focusrite (TUNE:AIM)** as very much a long-term investment opportunity we are still pleased to see our faith rewarded early.

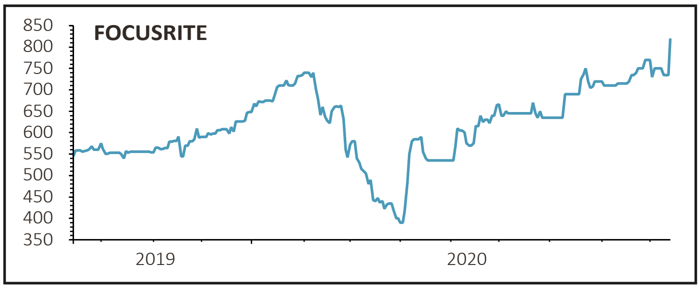
A 14 September trading update reported that revenue and profit for the 12 months would be ahead of market expectations.

The core Focusrite engineering business grew approximately 23% while a full-year contribution from ADAM audio and eight months from Martin Audio, acquired in December 2019, helped to push revenues up by half from £84.7 million last year to around £129 million.

Gross profits and earnings before interest, tax, depreciation and amortisation (EBITDA) also improved and are expected to be ahead of analysts' projections before the announcement.

Earnings have been boosted by demand from both professional and amateur musicians ordering products through the internet, with the company's tech also in demand for voice-over work and in the production of TV shows like *The Voice*. Longer term we think the company can tap more into fast growing areas such as podcasts.

The company also joined the growing list of names paying back funds received under the UK's job retention scheme.



SHARES SAYS:

We believe there is lot more growth to come. Keep buying.

COCA-COLA COMPANY

(KO:NYSE) $51

Gain to date: 5.2%

Original entry point:

Buy at $48.48, 30 July 2020

OUR RECENT 'buy' call on beverages behemoth **The Coca-Cola Company (KO:NYSE)** is a decent 5.2% in the money and we are staying positive on the business behind the world's most recognisable soft drink.

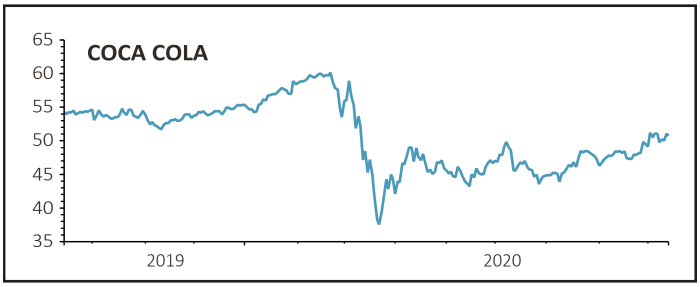
James Quincey-led Coca-Cola's shares have risen since the company announced (28 Aug) a major workforce restructuring plan involving voluntary and involuntary layoffs for employees in the US, Canada and Puerto Rico – Coca-Cola said a similar programme will be offered in many countries internationally.

In addition, nine new operating units will replace 17 business units as the company focuses on cutting costs and scaling new products faster.

Although Coca-Cola's overall global severance programmes are expected to cost the soft drinks colossus $350 million to $550 million, the market welcomed the focus on slashing costs and becoming a leaner organisation.

While there is no end in sight to the pandemic, we continue to like Coca-Cola as a recovery play. The consumer defensive colossus has proven pedigree in surviving challenging periods and emerging stronger over the long term.

It has also proved a market-beating investment with dividends forming an important part of total returns.



SHARES SAYS:

Keep buying.

SMART METERING SYSTEMS

(SMS:AIM) 660p

Gain to date: 40.4%

Original entry point:

Buy at 470p, 24 October 2019

DESPITE what is a very uncertain period for companies amid all the economic turmoil from the coronavirus pandemic, smart meter installer **Smart Metering Systems (SMS:AIM)** has continued to show its resilience to wider shocks.

On a reported basis the company swung from a £1.7 million loss in the first-half last year to a £194.4 million pre-tax profit.

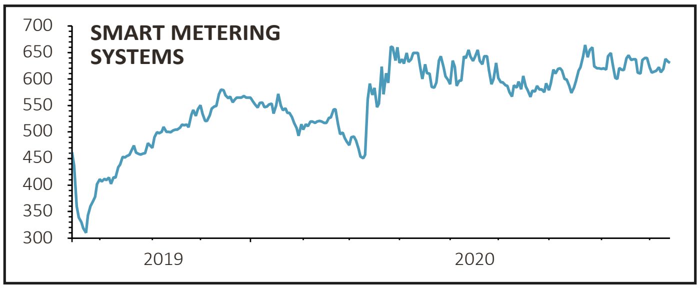
This was helped by the £291 million sale of a minority of its meter assets, which also wiped out debt. The company now has £44.5 million in net cash on its balance sheet.

It plans a 25p per share final dividend which will increase at a fixed rate of 10% a year to 2024.

Chief executive Alan Foy told *Shares* the dividend is underpinned by cash from existing assets and adds that 'we're not reliant on any growth in our business at all to pay the dividend'.

SMS also revealed it is looking at battery storage as a key growth area after the smart meter rollout is complete, having secured a strong and growing pipeline of grid-scale projects.

Foy says: 'We're really excited about battery storage. It will be many times the size of smart meters and we see that as a real, tangible, viable business opportunity beyond smart meters.'



SHARES SAYS: ↗
Hold on to the stock for the income stream.

VALUE INVESTING

THE COMEBACK KID

"Investment success doesn't come from buying good things, but rather from buying things well."

(Howard Marks)

By **Martin Gamble** Senior Reporter

Surely every investor loves a bargain and in various ways all investors think of themselves as value investors. Sadly, what's been working for investors since the great financial crisis of 2008 is more akin to quality and growth investing. This strategy focuses on the potential growth and quality of a business and less on valuation.

Value managers don't shun growth, but they focus more on the price they have to pay for a business relative to expected growth. They know that for most businesses the valuation will revert back to a normal rating over time. After all, companies go through a life cycle, growing fast in the early years before fading and eventually shrinking in later years.

In the low inflation, low interest rate world of the last decade so-called new economy businesses have prospered while old economy bricks and mortar have struggled, resulting in higher earnings upgrades for the former and mainly downgrades for the latter. If you like to follow the earnings, value has been a tough ride.

James Henderson, co-manager of **Lowland Investment Company (LWI)** and **Henderson Opportunities Trust (HOT)**, says the trick is to search out old economy companies that are reinventing themselves and refocusing on their strengths. These types of companies can be purchased at cheap prices because of well-known problems.

One such holding for Henderson is **Marks & Spencer (MKS)** which he believes is doing the right things to reinvigorate its brand and reduce its estate to get back to earning a decent profit. The joint venture agreement with **Ocado (ODCO)** for online groceries came at the right time, especially given the added momentum online has achieved due to Covid-19.

VALUE VERSUS GROWTH

Academics have found value to be one of five factors that explain stock returns along with momentum, size, profitability and beta.

The chart shows the performance of value versus growth using a database created by Eugene Fama and Kenneth French who were professors at the University of the Chicago Booth School of Business.

In this case, value is defined as low price to book value and growth as high price to book.

ROLLING 10-YEAR TOTAL RETURN DIFFERENCE: FAMA-FRENCH (VALUE VS GROWTH)

JPMorgan, Fama-French Dataset

Value has gone through long patches of poor performance in the past but has bounced back strongly such as the 138% outperformance after the 1941 trough and the 107% recovery from its 1999 trough when the dotcom bubble burst.

PAYS TO BE PATIENT

Value investing has proved its worth over the very long run. Based on FTSE Russell and Fama-French data, $1,000 invested in large cap growth stocks in 1930 would be worth $2.8 million today while the same $1,000 invested in large cap value stocks would be worth $14 million.

Joel Greenblatt, the author of *The Little Book that Beats the Market* insists that one of the reasons value investing works in the long-run is because it goes through periods of underperformance, which causes investors lose faith. In other words, if it worked all the time, everybody would follow it and it would stop working.

Greenblatt helped to fund Michael Burry's hedge fund Scion Capital and featured in the one of the best books on the financial crisis by Michael Lewis called *The Big Short* which was also made into a film with actor Christian Bale in the role of Burry.

But the underperformance of value investing since December 2006 is one of the longest and deepest stretches in its history and has led many observers to proffer that 'this time is different' and value will never make a comeback, despite doing so in the past.

Investment legend Sir John Templeton said those four words are the most dangerous words in finance and in 1933 they feature in his 16 rules for investment success.

WHAT IS THE MARKET SAYING?

Is the extreme underperformance telling investors this time really is different or should they heed Templeton's advice, take the opposite view and buy value stocks and funds?

Bank of America is in the camp which believes conditions are ripe for value to come back to form. In a recent note it said: 'We expect global manufacturing trends to turn sharply positive over the coming months, consistent with a rise in bond yields, just as has been the case in every recovery over the past 20 years. If bond yields increase in line with our expectations, this would imply 20% plus upside for value versus growth stocks.'

In the other camp is an even larger contingent who believes the current low interest rate environment is here to stay and value will continue to struggle.

While the academic evidence supporting a 'value style' of investing is clear, the applications of this style of investing are varied and you won't find any investment firm that solely uses price to book ratios to build portfolios.

FATHER OF VALUE INVESTING

American economist Benjamin Graham, born in 1894, wrote two of the most important books on investing – *Security Analysis* with David Dodd, and *The Intelligent Investor* which Warren Buffett described as the 'best book on investing ever written'.

Graham applied logic and rigour to the world of investing and was one of the first to separate stock market sentiment from the fundamentals or economic factors that drive company earnings. He did this by introducing his Mr Market analogy.

Mr Market is either deeply depressed or crazily exuberant and every day he offers to buy your shares at either a huge premium or on a huge discount. Graham cautioned investors that Mr Market was to serve them and not to inform them. What mattered was intrinsic value.

Intrinsic value is based upon the future earnings power of a business and isn't nor should ever be a precise value. Ideally, it should be materially higher that the current market price, providing what Graham called 'a margin of safety', which Buffett says are the four most important words in investing.

Buffett studied under Graham at Columbia University as did John Templeton. Graham later introduced a formula called the Graham Multiple. This is probably one of the first mathematical models used to estimate intrinsic value.

Buffett went on to practice Graham's methods when he started his investment partnership in 1956 to good effect. He often referred to his value style as the 'cigar butt' approach or the equivalent of finding a discarded cigar which has a few free 'puffs' left, and which you then discard.

Graham managed his own investment partnership and later Buffett offered to work for the partnership for free, but Graham turned him down. Buffett joked that his price was too rich for the value-focused Graham.

IMPORTANT POINT

The most important point about Graham's approach and the reason it is followed by value managers is that it is based on a full fundamental analysis of a business and its prospects that encompass both problems and opportunities. None of it can be boiled down to a number or single metric.

Buffett eventually moved on from cigar-butt investing, influenced by his long-term business partner Charlie Munger and the investor Philip Fisher, who wrote the book *Common Stocks and Uncommon Profits* in 1958.

Buffett has said in the past that growth and value are 'joined at the hip', meaning an evaluation of future growth should always form part of the analysis in arriving at intrinsic value.

In Buffett's view, separating value and growth makes no sense, but the investment industry has built a profitable business peddling the idea of style investing.

In the 1990s so-called quantitative managers built on the Fama-French data to create multi-factor models and today quant managers control over $1 trillion of assets. The value factor for them is a characteristic feature of a stock rather than a fundamental assessment of the business.

THE FUNDSMITH WAY

Terry Smith, the founder of asset manager Fundsmith, often quotes Buffett and clearly

UNDERSTANDING THE GRAHAM MULTIPLE

Value investor Pzena recently purchased a 5% stake in **J Sainsbury (SBRY)**, so let's use that as an example to see how Benjamin Graham's formula works.

Intrinsic value = earnings per share, multiplied by (8.5 + 2 times the long-term growth rate).

Inputs: EPS 18.7, Growth 3%

Intrinsic value= 18.7p times ((8.5+ (2*3)) = 18.7*14.5= 271p

Sainsbury's share price is currently 185p = 32% discount

We used 2021 consensus earnings because it is lower than the 2020 outcome. For Graham a 32% discount would probably qualify as sufficient margin of safety.

likes to think of himself as a rational investor. Like Berkshire Hathaway, Smith has produced an owner's manual outlining the buy and hold strategy for Fundsmith's various funds including the popular **Fundsmith Equity (B41YBW7)**.

Fundsmith's strategy is to seek out high quality businesses which have sustainably high returns on capital because it looks to earn its return from the increasing value of the business. For this to happen a company needs growth opportunities and to reinvest a portion of its cash back into the business. This compounding of returns is what drives stock value.

Smith says he looks for businesses with lots of intangible assets because unlike physical assets, they are harder for competitors to replicate and therefore act as barriers to protect high rates of return on capital. The sorts of intangible assets he seeks are brands, patents, proprietary databases and client relationships.

Businesses with a lot of intangible assets tend to trade at high price to book ratios because they own fewer tangible assets and as a result require less equity. On that basis they would fail to qualify as value under classic rules used by Fama-French.

Smith insists that he won't buy quality businesses at any price because of the risk of underperformance. Implicitly the fund manager is adopting a margin of safety and value approach to his quality investing.

BOOK VALUE PROBLEMS

Book value is based on historical costs which fail to reflect the true value of a company's assets. Albert Einstein once wrote 'not everything that counts can be counted and not everything that can be counted counts.'

Most businesses today have more intangible assets like brands and databases than tangible assets such as plant and machinery. But accountants have yet to come up with a reliable way to put a value on intangible assets in the same way they do for tangible assets.

There are brand consultants who estimate brand value by looking at brand recognition, marketing expenditure and contribution to financial performance. For example, Amazon is thought to be the world's most valuable brand, worth around $220 billion, but you won't find that figure on the balance sheet. The accounting book value is $62 billion while intangibles and goodwill are $14 billion.

Most businesses today have more intangible assets like brands and databases than tangible assets such as plant and machinery.

VEILED VALUE

There are an increasing number of companies which have negative equity, which means they cannot be measured using price to book value. For example, breakdown services company **AA (AA.)** has consistently had negative book value since coming to stock market six years ago.

This means it doesn't qualify as cheap on price to book, but on other value measures like price to earnings (2.8 times) and price to sales (0.2 times) it offers value.

US-based O'Shaughnessy Asset Management has analysed the increasing number of negative book value stocks in the US and some of them rank cheap on alternative value measures.

O'Shaughnessy calls these stocks 'veiled value' because they look expensive but are cheap, the opposite of 'value traps' which look disarmingly cheap but are expensive. The asset manager calculates there are over 258 veiled value stocks in the US worth over $3.9 trillion of market value.

This underscores the importance of using a range of metrics rather than relying on a single measure.

SCREENING FOR VALUE STOCKS

The most reliable way to a screen for value is to use different metrics in the search rather than looking for a single magic bullet. If a stock appears to offer value on different measures, you are on safer ground.

To give readers an idea of the current opportunities, *Shares* used Stockopedia to screen for UK stocks that met the following criteria: market cap over £100 million, cheapest 25% on forward price to earnings, cheapest 25% on enterprise value to EBITDA, and the cheapest 25% on price to book. We excluded financial stocks.

Enterprise value measures the total value of the business including net debt or cash. EBITDA stands for earnings before interest, tax, depreciation and amortisation and is a measure of the cash flow a business generates.

SHARES' SCREEN: CHEAPEST UK VALUE STOCKS

Name	Price to Book	EV / EBITDA TTM	PE Rolling 2y
Reach	0.3	1.1	1.9
Cineworld	0.4	6.0	4.1
Kenmare Resources	0.4	4.3	4.0
Firstgroup	0.4	5.0	3.6
Bakkavor	0.5	5.6	4.3
Card Factory	0.5	3.3	3.4
BT	0.7	3.9	5.3
Costain	0.8	5.1	4.6
Playtech	1.0	6.4	10.7

Source: Stockopedia. TTM = Trailing 12 months.

Among the other ways to screen for opportunities is a Ben Graham quantitative approach called the Enterprising Investor. The criteria is trailing PE below 10, current ratio above 1.5, long-term debt less than 1.1 times working capital, EPS streak greater than four years, dividend paying, trailing EPS greater than five years ago, price to book less than 1.2 times.

GRAHAM ENTERPRISING VALUE SCREEN

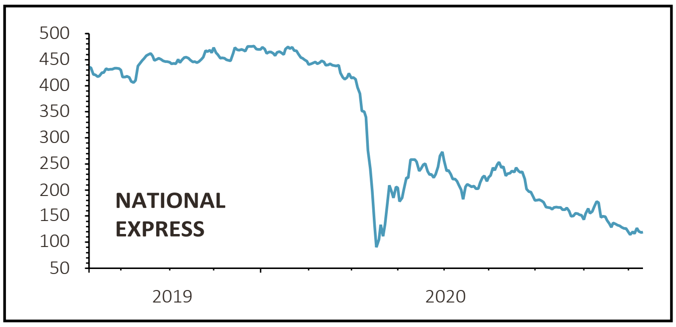
Name	Price to Tangible Book
Mccarthy & Stone	0.5
B.P. Marsh & Partners	0.7
Inland Homes	0.8
N Brown	0.9
Bellway	1.0
H & T	1.0
Redrow	1.0
Vistry	1.1
Ferrexpo	1.1
Taylor Wimpey	1.1

Source: Stockopedia

TWO VALUE STOCKS TO BUY

National Express (NEX)

Price: 120.1p
Market cap: £727 million



The travel sector has been badly hit by coronavirus for obvious reasons and bus, coach and rail operator **National Express (NEX)** has been no exception.

In our view this has created an opportunity to buy the market leading operator at a knock-down price of around 7.4 times 2021 earnings and an EV/EBITDA of 4.5 times based on Berenberg forecasts.

National Express satisfies two of the three filters on the first of the two aforementioned screens; it just falls short on the EV/EBITDA ranking. Investors should appreciate that these screens are used as a tool to reduce the universe to the most promising candidates.

While there are some question marks over the pace of National Express' recovery there are other catalysts for the shares which appear to be underappreciated by the market.

These include growth in its North American school bus operation where the impact of Covid-19 on public finances potentially prompts an increase in outsourcing.

There is also an opportunity to grow its shuttle bus operation for companies, universities and hospitals in the US. The company's WDU business, acquired for $84.3 million in 2019, provides this service to large corporations in Silicon Valley such as Facebook. National Express is also building on an already strong position in Morocco.

The fact that around half of group revenue is contracted – essentially it gets paid even for services which haven't been running – plus compensation received on its UK bus routes, intended to protect a societally important service, means it has a measure of breathing space.

The company remained EBITDA positive in the second quarter of 2020 at the height of lockdown. While its net debt isn't insignificant and could hit six times earnings in 2020 according to Berenberg, this looks like a temporary issue and its net debt to EBITDA covenant has been waived until December 2021. Berenberg expects the ratio to fall to 2.6 in 2021 and 1.6 in 2022.

Kenmare Resources (KMR)

Price: 235.39p
Market cap: £258 million

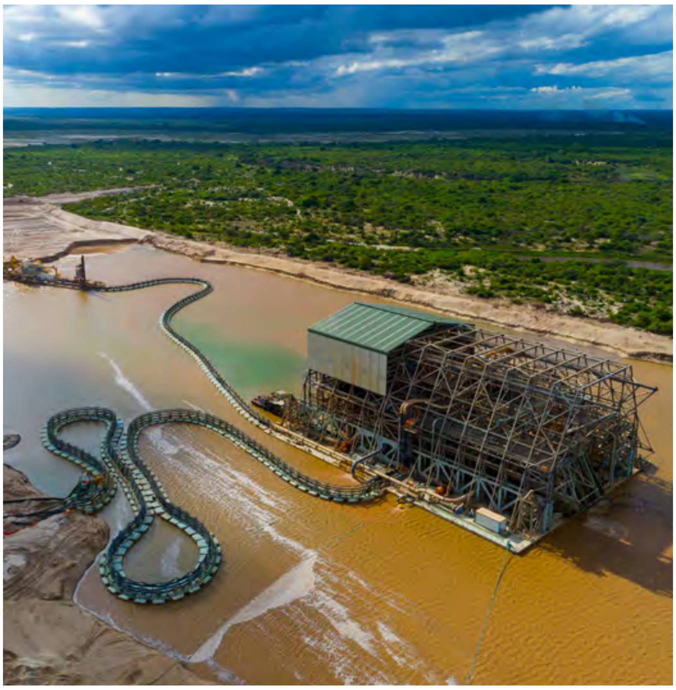
Mineral sands miner **Kenmare Resources (KMR)** is a significantly undervalued stock whose shares could see a sizeable re-rating if it can complete a capital project that will enable its production to soar.

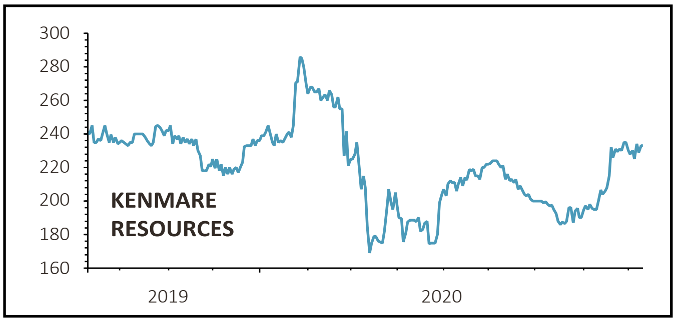
The company is moving a wet concentrator plant in Mozambique to an area where it will mine significantly higher-grade ore. It says the project is 70% done and hopes to have the plant relocated and for mining to begin in the fourth quarter of this year.

This the last of three big capital projects Kenmare flagged in 2018. It will enable the company to produce 1.2 million tonnes of ilmenite a year, a 35% increase on its 2019 level, and given its fixed cost base is also expected to drive profit margins higher.

The miner trades on a price to book value of just 0.4 times according to Stockopedia, significantly lower than other miners and almost half the valuation of its **Base Resources (BSE:AIM)**, another mineral sands miner on the UK stock market.

There are risks to buying the shares, such as if Kenmare has problems with the plant relocation and forecast weakness in the ilmenite market in the second half of this year. But expectations for the business are already low, and if can complete its latest project – and unlock higher revenues while keeping costs stable – the miner stands a chance of winning the support of more investors and for its shares to trade on a higher rating.





THREE FUNDS TO BUY

For investors who don't feel comfortable choosing individual shares it's possible to get a broad exposure to the value style via funds. We like the look of the following investment trusts and exchange-traded fund.

Henderson Opportunities Trust (HOT)

Price: 851p
Market cap: £90 million
Yield: 2.9%
Discount to NAV: 17.9%

The £90 million trust aims to achieve capital growth in excess of the FTSE All-Share index by investing in 70 to 100 stocks with a strong bias towards smaller, early-stage companies that hold growth potential. The co-managers James Henderson and Laura Foll employ a value style that involves investing in out of favour or under-researched companies trading on attractive valuations.

Over the last 10 years the net asset value of the trust has delivered an average annual return of 9.9% a year which is handsomely ahead of the Morningstar category benchmark of 6%. On the same basis the trust's shares have delivered 10.7% versus 6.25% for the benchmark.

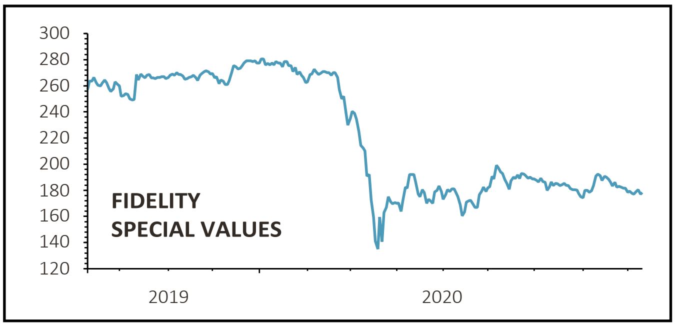
The fund's largest sector weighting at 25% is in industrials suggesting plenty of exposure to value stocks. Technology and financials, another classic out of favour value sector, make up a further 39% of the trust's assets.

The largest holding (3.7%) is in **RWS (RWS:AIM)**, a leading language and localisation provider, which is merging with **SDL (SDL)** to create the largest language services and software company in the world.

The investment trust's management fee is 0.55% of net assets and the ongoing charge is 0.91%. The trust has net gearing of 14% which could amplify gains and losses.

Fidelity Special Values (FSV)

Price: 178.3p
Market Cap: £514 million
Yield: 3.2%
Discount to NAV: 11.5%



Managed by Alexander Wright and Jonathan Winton, the trust aims to achieve long-term capital growth through investing in UK companies the managers believe to be undervalued or where the potential has not been recognised by the market.

The NAV has grown at an average annual growth rate of 7.15% a year over the last 10 years, similar to the 7.2% growth in the price of the trust and ahead of the Morningstar category benchmark of 5.92% and 6.15% for the NAV and price respectively.

Serco built and will operate and maintain Australia's RSV Nuyina scientific research ship

The trust's largest sector allocation is to industrials (23%), with consumer cyclicals and financial services at 13% each, suggesting good exposure to the value part of the UK market.

Insurers **Legal & General (LGEN)** and **Aviva (AV.)** are the two largest holdings with around 4.5% in each. Also featuring in the top 10 is tobacco company **Imperial Brands (IMB)** and outsourcer **Serco (SRP)**.

The trust has a net gearing of 14% which means it has borrowed money to invest. That can work in its favour in strong markets but exacerbate problems when markets are declining.

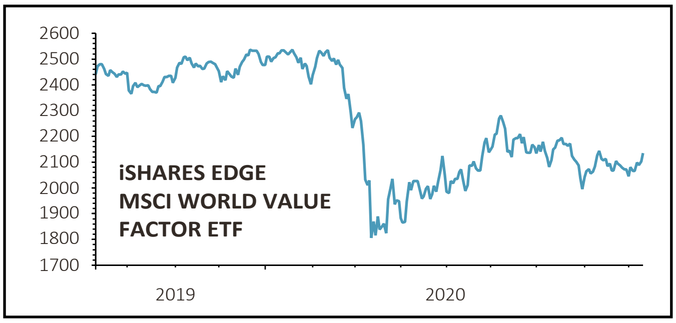
The management fee is 0.85% of net assets and the ongoing charge is 0.96%.

iShares Edge MSCI World Value Factor UCITS ETF GBP (IWFV)

Price: £21.03
Market Cap: $1.7 billion

Managed by BlackRock, this value factor exchange-traded fund is the largest in the passive value space and provides investors with global exposure to a diversified portfolio of large cap value companies.

Launched in 2014 the ETF has delivered an



average annual return of 5.8% over the last five years, lagging the Morningstar category benchmark of 7.78%.

The performance difference is explained by the fund's geographical exposure which is split between the Americas (38.5%), Greater Asia (33.8%) and Europe (27.7%), meaning the fund is underexposed to the Americas and overexposed to Asia and Europe compared with the benchmark.

The industry exposure shows an overweight towards economically sensitive sectors and cyclical companies at the expense of consumer defensive stocks. That positions it well should markets rotate towards value.

The top 10 holdings include US chip maker Intel, telecommunications giant AT&T and computer services company IBM. The UK's **British American Tobacco (BAT)** also features in the portfolio.

The ETF charges an annual management fee of 0.3% of assets.

DISCLAIMER:

Editor Daniel Coatsworth has a personal investment in Fundsmith Equity referenced in this article

FINDING INCOME IN A DIVIDEND DROUGHT: A CONTRARIAN APPROACH

Whatever your stage of life, Covid-19 has caused huge changes. From unprecedented restrictions on personal movement to an accelerated shift to online working and shopping, no life has been untouched. For those in retirement, concerns about reliable income have been growing as the global economic outlook has worsened and dividend cuts abound.

Why income investors should look globally

The pandemic has had a major impact on corporate revenues, and it will take some time for companies to fully get back on their feet. To secure their long-term survival many businesses have boosted their cash reserves by reducing their dividends, with roughly half of the UK's FTSE 100 companies cancelling, cutting, or suspending payments.

For retirees reliant on equity portfolios for income, the scarcity of dividends is a headache. Historically, a relatively small number of UK stocks have provided the majority of income, but now investors with a UK bias are facing a potential shortage.

The obvious answer to concerns about the concentration of income risk in the UK is to diversify. Investing in a portfolio of global equities provides an income stream from a much broader pool of investments than is available from UK stocks alone.

A contrarian approach can pay dividends

The Scottish's high-conviction, bottom-up investment approach delivers an equity portfolio that is spread across multiple regions and sectors, providing diversification of risk. Although our contrarian investment style doesn't actively target companies that pay high dividends, the out of favour investments that we are attracted to tend to pay higher dividends over the course of an economic cycle. That rewards us, and our shareholders, while we wait for the improving business prospects that we foresee.

The Scottish currently has a dividend yield of around 3.1%, which is one of the highest in our AIC peer group. What's more, the Company recently announced that it will increase its regular dividend for the year, despite the dividend drought.

> “the out of favour investments that we are attracted to tend to pay higher dividends over the course of an economic cycle”

A dividend reserve – the benefit of long-term thinking

Over the years, The Scottish has prudently built a substantial revenue reserve in preparation for leaner times. As at 30 April 2020, this reserve was greater than 2.5 times last year's regular dividend, giving the Company the ability to keep paying its investors when dividends are temporarily in short supply.

The Scottish's intention to continue to grow the regular dividend over the longer term backs up our status as a 'dividend hero' (as recognised by the Association of Investment Companies). By adding to our unbroken run of 36 consecutive years of regular dividend growth we aim to keep income flowing, when other funds may be turning off the taps. ■

14 August 2020

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RUSS MOULD

AJ Bell Investment Director

Insightful commentary on market issues

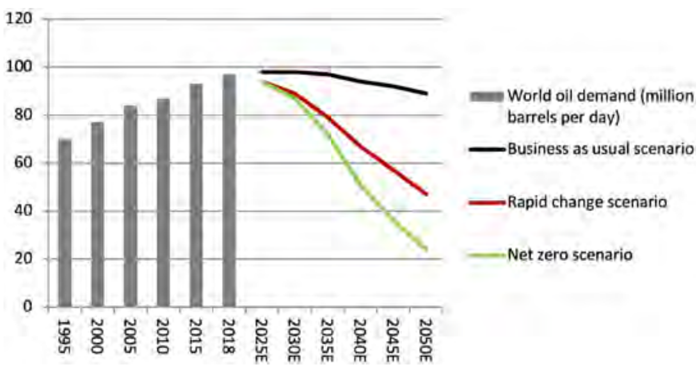
Is oil still on a slippery slope?

A report from BP suggests demand for crude has already peaked

Oil major **BP's (BP.)** latest annual *World Energy Outlook*, released in conjunction with a three-day presentation from chief executive Bernard Looney and team outlining the oil major's new strategy, offers three scenarios for demand for crude oil in 2050.

They range from 89 million barrels a day, barely 10% below 2019's peak of 98 million as nothing much changes politically or socially, all the way down to 24 million, as the world goes carbon neutral.

BP's research suggests oil demand could fall by up to 75% by 2050



Source: BP World Energy Outlook 2020

The possibility that oil demand could go down by three-quarters between now and 2050 means Looney's desire to prepare BP for a zero-carbon world is perfectly understandable.

It also leaves investors with a decision to make. Those willing to select individual securities on their own must now decide whether to place their faith in Looney and the company's ability to reinvent itself. Its plan is made all the more complicated by weak oil prices depriving BP of vital cash flow, just when it needs to invest heavily in both its new strategy and the maximisation of value from hydrocarbon assets where there are already considerable sunk costs.

Those who wish to avoid the rough and tumble of stock-specific risk and prefer to use active or passive funds must still assess their potential for exposure to BP and other oil stocks.

This is particularly the case in the UK, where analysts' consensus forecasts for 2021 assume that BP and **Royal Dutch Shell (RDSB)** will generate between them 7% of total FTSE 100 profits and 11% of the headline index's total dividend pay-out.

WANING WEIGHTING

Whether such forecasts are reliable, too optimistic or too conservative will be especially important for investors in FTSE 100 tracker funds, as they indirectly own BP and Shell whether they like it or not.

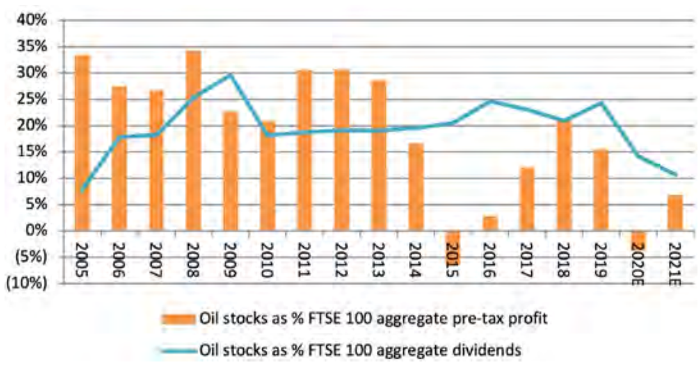
For those investors who do not wish to embrace oil stocks, for financial or philosophical reasons (or both), it is worth considering the following:

- From a dividend perspective, the oil majors' combined forecast pay-out represents its lowest portion of the FTSE 100 total since 2005;
- From an earnings perspective, BP and Shell's contribution is way lower than it was in 2005, when they generated one-third of FTSE 100 profits between them.

These numbers at least explain why oil shares are doing so badly. The FTSE All-Share Oil & Gas Producers sector is now worth just 7.1% of the FTSE All-Share itself, a fraction above 1992's

RUSS MOULD
AJ Bell Investment Director

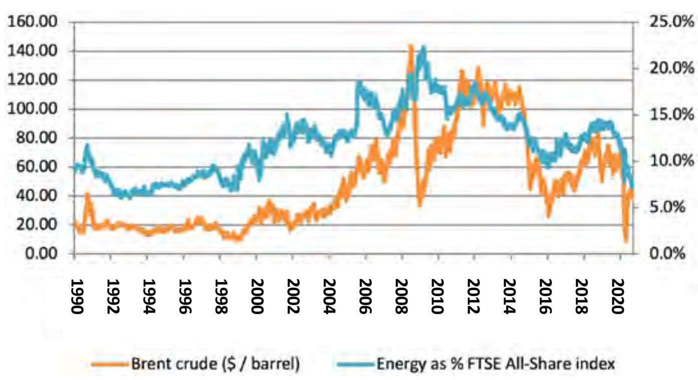
UK oil majors' forecast profit and dividend contributions to FTSE 100 totals continue to ebb



Source: Company accounts, Sharecast, consensus' analysts forecasts

modern-day low of 6.3% and almost identical to 1998's cyclical trough of 7.0%.

UK oil sector weighting is near all-time lows



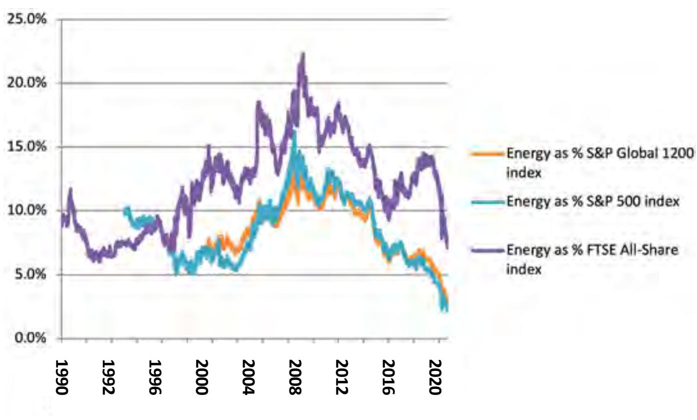
Source: Refinitiv

Those dates are interesting because BP cut its dividend in 1992 (just as it has done this year), while crude oil prices dipped briefly below $10 a barrel in late 1998, just as they did this spring.

CRUDE CALCULATIONS

On a global basis, oil shares' weighting in the S&P Global 1200 index and America's S&P 500 benchmark stands at record lows of 2.9% and 2.2% respectively. The S&P 1200 Energy index's valuation of $1.3 trillion means the industry currently carries a lower price tag than Microsoft and is worth barely four times more than Tesla, whose current car volume sales are tiny, at least for now, at around 100,000 units per quarter.

Global oil sector weighting is already at all-time lows



Source: Refinitiv

Investors with exposure to individual oil firms, specialist energy funds (be they active or passive) or geographic stock indices with a hefty exposure to oil companies (which would include the FTSE 100) must now decide if this marked bout of oil stock underperformance is merely cyclical or the result of something more structural.

If BP's zero-carbon scenario holds true, even the most wilfully contrarian investor may struggle to make a case for exposure to oil stocks, at least until the earnings mix begins to truly slant away from hydrocarbons, as it is hard to divine what could be a catalyst for higher oil prices and thus higher earnings.

Yet if the 'no change' case pans out, owing to political or social inertia, the picture could be very different. Demand could recover in a post-pandemic world and do so just as oil majors cut investment, US shale output falls and global oil rig activity is down more than 50% year-on-year.

That could make for a surprise cyclical comeback from an industry that financial markets seem to be writing off – the FTSE All-Share Oil & Gas Producers index rose 50% in 2016, the year after BP and Shell last made a combined loss, just as they are forecast to do in 2020.

Can Ashtead maintain its stellar growth record?

With its end markets slowing, some think the shares are fully valued

In any table of UK 'quality growth' companies or 'compounders', equipment hire firm **Ashtead (AHT)** is usually somewhere near the top if not the top-ranked stock.

By way of illustration, a simple screen of the FTSE 350 index for 10-year total returns – in other words capital gains plus reinvested dividends – puts Ashtead second with an astounding 3,210% return.

This is partly thanks to the firm's remarkable earnings growth – reported earnings per share have risen 268 times from 2010 to 2020, or a compound annual growth rate of 75% –

FTSE 350 top 10 total returns over 10 years

Stock	Market cap £m	10yr total return	Return YTD
Avon Rubber	1,230	3,280%	90%
Ashtead	**12,825**	**3,210%**	**18%**
Games Workshop	2,875	2,130%	44%
JD Sports Fashion	7,974	2,080%	-2%
Liontrust Asset Management	792	1,520%	18%
Ocado	17,522	1,490%	83%
London Stock Exchange	31,585	1,360%	16%
GVC Holdings	4,900	1,090%	-5%
4imprint	573	1,030%	-41%
Rightmove	5,408	827%	-2%

Source: Sharepad, Shares magazine — All data correct as of close 8 Sept 2020

Ashtead earnings and dividends per share

Financial year	Earnings per share (p)	Dividends (p)	Cover
2023E	190.3	51.3	3.7
2022E	156.2	45	3.5
2021E	107.3	39.2	2.7
2020	161.5	40.65	4
2019	165.4	40	4.1
2018	194.4	33	5.9
2017	100.5	27.5	3.6
2016	81.3	22.5	3.6
2015	60.1	15.25	3.9
2014	45.8	11.5	4
2013	27.1	7.5	3.6
2012	17.3	3.5	4.9
2011	0.2	3	na
2010	0.6	2.9	na

Source: Refinitiv, Stockopedia, Shares. April year-end

Ashtead revenues

Financial year	Sales £m	Growth
2023E	5,238	4.5%
2022E	5,014	6.0%
2021E	4,731	2.7%
2020	4,606	11.3%
2019	4,138	21.1%
2018	3,418	17.8%
2017	2,901	28.4%
2016	2,260	23.0%
2015	1,838	24.6%
2014	1,475	22.3%
2013	1,206	19.9%
2012	1,006	6.1%
2011	948	13.1%
2010	838	–

Source: Sharepad, Shares. April year-end and partly to its policy of rising dividends, which have gone from 2.0p per share in 2010 to 40.65p this year.

This growth is thanks to consistent double-digit increases in annual revenue, although that may be coming to an end. From increases of 20% or more from 2013 through 2019, revenue growth slowed to 11% in the year to 30 April 2020 and is forecast to be no more than mid-single digits for each of the next three years.

After such substantial gains, can the firm continue to deliver? Are analysts being too cautious with their revenue forecasts, or is the firm priced for perfection?

MARKET DYNAMICS

Ashtead makes the bulk of its earnings in the US through its Sunbelt rental business. Roughly half of its US turnover comes from the construction market and half from markets such as infrastructure, facilities management, air quality management and emergency response.

The US construction market is mind-bogglingly big – each year somewhere in the region of £1.3 trillion of work is put in place – although figures from consultant Dodge Data suggest that the market didn't grow in 2019 and due to Covid-19 it could take until 2022 to get back to a similar level of turnover.

The equipment rental market, which had been growing by mid-single digits up until last year, is forecast to shrink by as much as 14% this year before recovering slowly through 2021 and beyond, according to IHS Markit. Clearly there are headwinds.

However, even in 2019 when the US construction market stagnated, Ashtead still grew its rental revenues by 10% thanks to 6% organic growth – through the addition of 85 new stores – and 4% growth from bolt-on acquisitions.

Meanwhile its non-construction business boomed with total rental revenue growth of 9% or three times that of the market thanks to specialty areas such as power, heating, ventilation, air conditioning, climate control and air quality.

In an indication of the size of the market for specialty equipment, Sunbelt currently has over 5,000 portable air quality units on rent in the US.

The Canadian rental market is considerably smaller than the US but it offers significant growth potential. Sunbelt Canada's rental-only revenues last year were C$420 million in a market that reached C$7.4 billion, meaning it had just over a 5% share.

However, sales grew at a 30% clip thanks to organic growth of 8% plus bolt-on acquisitions and there is clearly scope to continue consolidating and gaining share.

The third leg of the business is the UK, where 20 separate brands have recently been consolidated under the Sunbelt banner and which makes up less than 10% of group turnover. Given the highly competitive nature of the market, management has been realigning the business, reducing the amount of fleet on hire and trying to improve returns.

STRONG MARGINS

One of the most outstanding features of Ashtead's business is its high returns on capital. Operating or EBITDA

US construction

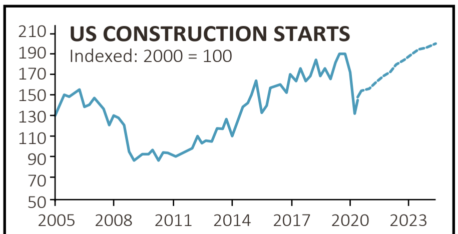
	2016	2017	2018	2019	2020	2021	2022	2023
Market ($bn)	1,211	1,266	1,307	1,307	1,215	1,209	1,303	1,399
Market growth	+7%	+4%	+3%	-%	-7%	-%	+8%	+7%

Source: Dodge Data & Analytics (June 2020)

Rental market forecast

	2016	2017	2018	2019	2020	2021	2022	2023
Market growth	+4%	+4%	+8%	+6-%	-14%	+1%	+12%	+7%

Source: IHS Markit (August 2020)



Source: Dodge Data & Analytics (August 2020)

(earnings before interest, tax, depreciation and amortisation) margins are consistently high, even in the UK business which lags the group average.

Despite the sudden Covid-driven fall in activity in the final quarter of the last financial year, which made a significant dent in profit given that a large proportion of short-term costs are fixed, group EBITDA margins were still 47% and US margins were almost 50%. UK margins were lower but still topped 30% as they did a year earlier.

This ability to generate high returns and to keep reinvesting in the business to create value for shareholders is one of the main reasons why the company is so popular with long-term investors.

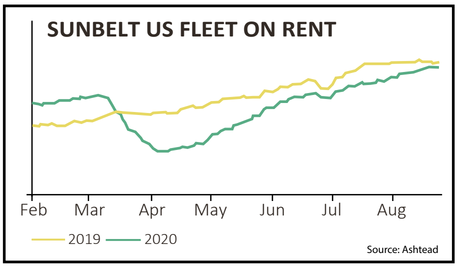
'Management have huge experience of operating through different economic cycles and have a very strong track record of shareholder accretive capital allocation,' says Trevor Green, head of UK institutional equities at Aviva Investors.

'As their recent results showed, even in slower periods for their end markets they are prodigious generators of cash. Being the market leader they benefit from periodic sector consolidation and invariably extract economies of scale from their acquisitions,' adds Green.

Commenting on the firm's latest results, Numis analyst Steve Woolf flagged Ashtead's 'ability to navigate a period of extreme market volatility, while maintaining a focus on cost, cash generation and high levels of customer service'.

In the three months to 30 June, when all three of its major markets suffered a sharp contraction in activity, the company still managed to outperform with group revenues down just 6% as its specialty business stepped up by supplying essential equipment to government and private firms.

The company observed that activity levels had 'increased consistently through the quarter' such that as of the end of June it had almost as much fleet on rent in the US and Canada as last year and slightly more in the UK.



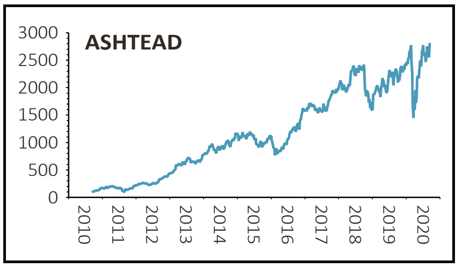
As trading improves, Ashtead should emerge with even greater market share says Woolf, 'further highlighting its competitive advantage'.

CONTRARY VIEW

Yet not everyone agrees with this bullish view. Analysts at investment bank Berenberg believe Ashtead's shares are 'defying the softness in lead indicators and enjoying the propulsion of the recurring narrative of a still elusive US infrastructure bill'.

Central to their negative argument is that 'a combination of reduced asset utilisation, softer used equipment pricing, and renegotiations of rental rates on equipment coming off-hire between cancelled or postponed projects' will lead to margin weakness.

While the latest results and outlook comments from management seem to have reassured investors, the analysts believe consensus cash flow forecasts are too high and remain 'cautious about the prospects for medium-term profitability', while warning that 'these risks are not adequately discounted in the share price'.



Liberum analysts Charlie Campbell and Marcus Cole point to Ashtead's financial solidity and cash generation and expect the firm 'to continue gaining share through its superior service offer, and to enjoy structural growth from increasing exposure to new markets'.

However, like Berenberg they believe the shares are over-priced in the short term and struggle to see much upside after a strong performance and with its fairly full valuation.

Long-term investors are more interested in the firm's well-documented ability to keep compounding its earnings. 'Its markets have the tailwind of steady structural growth,' says Green. 'Even though the share price is hitting all-time highs, investors shouldn't be put off as the valuation remains compelling with past share price appreciation matched by strong earnings growth.'

By **Ian Conway**
Senior Reporter

ADVERTORIAL

Schroders

Eight lessons from previous crises that apply today

Investing in Asia for 30 years has shown me that crises profoundly change the market landscape. Here's how that's affecting the way I'm investing today.

By Robin Parbrook, co-fund manager of Schroder Asian Total Return Investment Company.

As no spring chicken, I think age can be a mixed blessing from an investment perspective. Experience can perhaps bring wisdom but it can also bring intransigence or a lack of openness to new ideas.

This is one of the reasons I constantly challenge myself and consider myself lucky to have teenage children, who – as well as paternal headaches – can provide useful insights to a rapidly-changing world.

But you can't ignore the insights from the past. So, having been investing in Asia for nearly 30 years, what have I learnt from past crises?

Firstly, we need to define in an investment context what we mean by a crisis. I would describe a crisis as a period that leads to a major structural reset in policy and behaviour at a government, corporate and consumer level. This is not just a cyclical dip in markets resulting from a short-lived war (whether it be an Iraq war, terrorist attack or trade war), it is something that has a far more prolonged impact on stock markets.

In this context, I had previously only seen two genuine crises in my career: the Asian Financial Crisis in 1997/98 and the Global Financial Crisis (GFC) in 2008/09.

Like these two previous events, we see Covid-19 in a similar vein. It's a crisis that we believe will have a lasting long-term structural impact on economies and stock markets.

So, how do the Asian Financial Crisis and the GFC affect how I am making investment decisions in Asian equities today? Here are eight lessons I've learned:

1. Change your mindset.

This is not about just picking up your old favourite companies at fair value. During a crisis, I believe you need to start from scratch. You need to recheck the investment case completely given the structural changes in the environment. Scenarios must be rerun and fair values challenged and reset for new assumptions. Worst case scenarios need to be reassessed – investors should not just think outside the box but should often think the unthinkable.

2. Forget focussing on near-term profitability.

Profits are just an accounting treatment at the best of times. Instead, you could focus on the balance sheet and cash flows. Debt can be lethal in a crisis, even in small doses. So, the structure of debt including maturity, covenants[1] and who are the company's bankers are key. Never underestimate how impatient – and sometimes irrational – some banks can be. During the Asian Financial Crisis, I saw many businesses go bankrupt - not because they didn't have a sound business, but purely because twitchy banks (especially those operating outside their home markets) refused to roll credit lines.

3. Be wary of most bank shares.

Banks by their nature are the most leveraged businesses listed on stock markets. Leverage and a crisis don't go well together. Banks are also people businesses, and in Asia state-owned banks and weaker family-run banks don't necessarily attract the most skilled people. Navigating a business though a crisis needs a good management team – organisations full of nepotism and politics are not likely to pull together well. In addition, even for better banks, non-performing loans will come with a lag (as will the rights issues), and on top of this, in a crisis banks can become political hot potatoes. As the GFC and Asian Financial Crisis proved, with a few exceptions, weak banks tend to disappear/become zombies and even the better banks are slow to recover.

4. Countries with strong institutions tend to recover more quickly.

Good coherent government and a well run civil service will tend to mean confidence is restored faster and business can return to normality quicker. During the Asian Financial crisis it was Hong Kong, Taiwan, Australia, Singapore and Korea

[1] A promise in an indenture, or any other formal debt agreement, that certain activities will or will not be carried out or that certain thresholds will be met.

that recovered the quickest, whereas Indonesia, Malaysia, Thailand and the Philippines, with chaotic policy responses, almost collapsed completely. A crisis isn't necessarily a moment to be brave when investing.

5. Disruption accelerates during a crisis.

"Necessity is the mother of invention". A crisis often allows out-of-the-box thinking to come to the fore and breaks down barriers to change. New disruptive players emerge in a stronger position, incumbents can be shaken from their lethargy. A crisis can rapidly accelerate the process of creating winners and losers. We very much see this today amid the Covid-19 crisis, with massive disruption about to hit. Potentially this will include:

- The end of 9-to-5 office working week and mass commuting
- A structural move to working from home
- Online healthcare
- Online education
- Less business travel
- Automation and onshoring of production
- A move to a much more virtual world as artificial intelligence (AI)/5G/Millennials/Generation Z come into the ascendancy.

For investors, a crisis means you may need to review all your investments as disruption accelerates. What is the future of commercial property, banks, airlines, infrastructure owners (i.e. those companies with large fixed assets) in a crisis-driven, disrupted world? Our past experience of crisis suggests many companies' business models need to be reinvented if they are to survive. Nimbler, asset-light companies often do better.

6. Zombies will rise.

In a crisis, governments will often intervene to stop markets clearing, especially in those sectors deemed "strategic". This often leaves lots of zombie companies. This was the case for Korean shipbuilders, Thai property, Korean construction sector and most of corporate Malaysia post the Asian Financial Crisis. The lesson for investors is to avoid investment in sectors that don't "clear" or haven't been allowed to clear by governments.

7. Always buy a good business at a fair price.

When you have done your analysis and decided which businesses are likely to come out of a crisis stronger, don't be overly greedy on the price you are willing to pay for it. The key is to not continually reduce your desired entry level if the share price gets to your initial target, unless the facts and the investment case have changed (see lesson 1).

8. The impact of a crisis can linger for longer than you think.

After the GFC the sluggishness of corporate investment, populism and a desire for less free market capitalism have all been permanent features. After the Asian Financial Crisis, an aversion to debt became permanently ingrained across much of corporate Asia. This should be positive for the Asian corporate sector during the current crisis. Asian corporates are more lowly geared than those in the West, so hopefully can weather the storms better.

But because a crisis is structural it takes a lot longer for stock markets to recover than at other times. Stock markets remain vulnerable and investors twitchy, particularly if, as highlighted above, a crisis accelerates disruption, creating winners and losers.

Investors shouldn't feel the need to chase market rallies during a crisis, unless they believe the bulk of the crisis period has passed.

Flying the flag for best-in-class UK companies

A new investment trust hopes to back good UK firms which are either thriving or temporarily hit by Covid-19 disruptions

The UK market remains unloved with many investors believing it to be full of old economy businesses and lacking growth. While that criticism is fair on a select basis, applying such an opinion to the whole of the market would mean missing out on some good companies.

Asset manager Tellworth is hoping to convince investors that the UK is still full of money-making opportunities with the launch in late September of a new investment trust.

Tellworth British Recovery & Growth Trust will invest in large, mid and small cap stocks which are either UK businesses and global leaders in their respective niche, good British businesses on distressed valuations because of Covid-19, or British companies with promising technology.

The idea is to have a blend of these three groups and adjust weightings depending on what's happening in the market and with valuations.

Hollywood Bowl could appear in the trust's portfolio

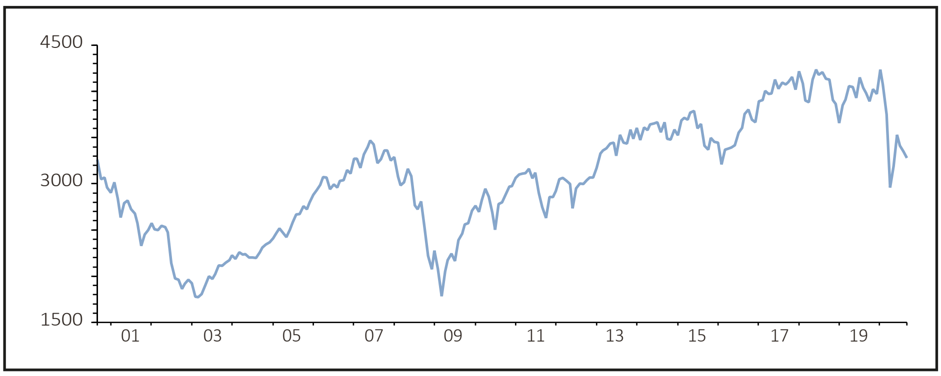
The British global leader segment of the portfolio is likely to contain names one might associate with funds and investment trusts that have a quality tilt, such as **Smithson (SSON)** and **Finsbury Growth & Income (FGT)**.

UK companies seen as being big players in their respective industries around the world include precision engineer **Renishaw (RSW)**, tonic water specialist **Fevertree Drinks (FEVR:AIM)** and credit checking group **Experian (EXPN)**.

Among the stocks likely to appear in the British recovery element of the portfolio is tenpin bowling centre operator **Hollywood Bowl (BOWL)**.

'There are some really good quality domestic businesses out there but clearly in a tough place at the moment as a lot of them haven't been able to trade,' says Tellworth co-founder John

FTSE All-Share has been left behind



The UK stock market has lagged many other regions since the EU referendum vote in 2016 and then Covid-19 this year

Warren, who will be one of the managers on the new trust.

'We think Hollywood Bowl is one of the best-run fantastic return on invested capital leisure businesses out there, but it hasn't been able to open a bowling alley for six months.'

The British tech stocks segment is likely to be the smallest component of the portfolio, predominantly targeting smaller stocks on the market as the UK isn't known for having lots of large cap tech names.

'Where we see ourselves being really able to excel in tech is in finding younger technology businesses,' comments Warren. 'The UK is good at getting tech businesses to come to the public markets rather than staying private. We don't see ourselves getting involved in unquoted businesses in the first 12 to 18 months of the trust's life, but we are able to do so and won't rule it out.'

WHY MULTIPLE SEGMENTS?

One might question why Tellworth is spreading itself across three different segments of the market rather than having a tight focus on just one area. It's down to a desire to blend investment styles.

'That goes back to the big argument in stock markets this year which is value versus growth,' says Paul Marriage, also co-founder of Tellworth and co-manager of the trust. 'We could build a portfolio that is entirely global leaders and it would be familiar to other funds out there with a growth-biased strategy.

'But if value becomes more liked, we would be left exposed. The recovering Britain component gives us the value balance we have in our other fund portfolios.'

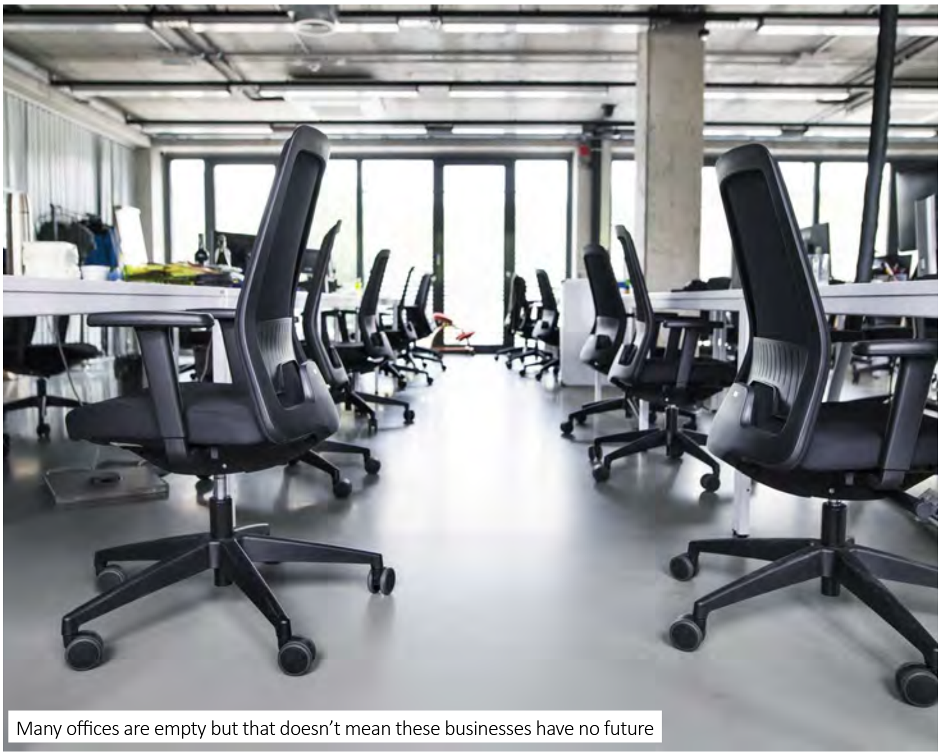
Warren says the purpose of the trust is to back good businesses and be there to support them on future fundraisings and support their growth. In turn the trust would be doing its bit to aid companies that are positively contributing to the UK economy as well as businesses that are flying the flag for Britain as a source of corporate excellence.

The desire to include some high-quality businesses with a global presence ultimately means Tellworth will have to consider paying up for stocks as many in this category trade on high earnings multiples. Warren admits that the market is still happy to pay any price to access growth companies, so Tellworth paying up for a few highly valued, high quality names 'is the right thing to do'.

When there are signs that growth stocks are losing favour, the investment trust will consider increasing its weighting to value names.

'More recovery-type businesses are likely to be in the consumer-facing industries where there has been a huge disruption. Earnings might be depressed but the market does have some really good names,' says Warren.

'We want to make a good return for shareholders – it might be too early to buy into some of the recovery businesses so we can have more money in the companies still producing growth and whom can hopefully still employ lots of people in the UK and grow that employment. Over time as the UK and global economy starts to recover, we will probably want more risk and move into more recovery-type stocks.'



Many offices are empty but that doesn't mean these businesses have no future

ASSET MANAGER RESOURCES

Warren and Marriage set up

Tellworth in 2017, having both moved across from Schroders. They've subsequently hired three other fund managers and an analyst, giving them expertise across big and small company investments and these individuals will provide support for the new trust.

Tellworth has developed a product called 'UK economic thermostat' which is an economic model based on alternative data. The managers think it will give them an investing edge. 'It gives us three to six-month lead indicators on lots of parts of the UK economy which will hopefully help us make the best decision as when to move some of the money into more of the recovery stocks,' says Warren.

They also use an investment process called 'P3M', which seeks to encompass the characteristics desired in a company and stands for 'product, market, margin and management'. To pass the test, businesses need to have a differentiated product, market leadership of a niche, the ability to grow margins and generate cash, and management who own stock and understand shareholder value.

'If you find those things, usually that's a pretty good place to start in terms of making money,' says Marriage.

FILLING A MARKET GAP

Tellworth aims to raise at least £100 million from the IPO (initial public offering) offer which includes the ability for retail investors to get involved via some of the mainstream investment platforms.

The investment trust will have a concentrated portfolio of 35 to 45 stocks and charge 0.65% a year up to £150 million market cap, and 0.6% thereafter, based on market value rather than net asset value.

Marriage says investment trusts already exist to play themes such as US technology, but there isn't anything to play a UK recovery and back the UK at the same time. Therefore, he believes the Tellworth British Recovery & Growth Trust will fill a market gap.

A renewed focus on Brexit trade talks may cause some choppiness in UK stocks near-term, yet the Tellworth team don't seem overly worried. They insist a trade deal doesn't need to be done before they start buying UK domestic stocks as they will be taking a three to five-year view on a business.

'If we get a deal just after this investment trust launches, it would be fortuitously fantastic timing,' says Marriage. 'If we get more noise, we would be buying a falling market. The timing is hard work. I think no deal, no free trade agreement, full fallout is unlikely. After Covid, I don't think any government is going to sign up to that.'

By **Daniel Coatsworth**
Editor

DISCLAIMER: The author owns shares in Smithson referenced in this article

ADVERTORIAL

BAILLIE GIFFORD HIGH YIELD BOND FUND

SEEKING RESILIENCE. TIME WELL SPENT.

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

Global cinema operator, AMC Entertainment. Internet payment provider, Wirecard. Commodity trader, Noble Holdings. All have one common denominator: an inability to repay debt obligations to their lenders. Default. The result is a permanent loss of capital, materially denting returns. As the global health pandemic shatters exposed sectors across the world, default rates within the asset class are on the rise, on course to reach the highest level in a decade. Our approach, seeking out resilience, is unchanged. And in this mercurial new world we find ourselves in, it has never looked more fitting or more powerful.

We believe that, over the long term, an issuer's fundamental resilience will be reflected in the performance of its bonds. All our time, therefore, is focused on bottom-up, qualitative, forward-looking analysis into an issuer's resilience.

Resilience, for us, requires a durable competitive position, a good approach to governance and sustainability (G&S, synonymous with ESG) and an appropriate capital structure. We lend to around 70 companies, who we believe have the right combination of these attributes. Each new issuer in the fund is different to what went before it, building a diverse collection of some of the world's most resilient high yield companies. We stress test our companies through 'pre-mortem' scenarios to appropriately position the holding, reflecting the risks and opportunities of lending to the issuer. Valuation is secondary to building a strong understanding of an issuer's resilience. Our assessment of the valuation opportunity is not based on a quantitative financial model, but on a qualitative understanding of the company's future resilience.

We believe this approach limits the downside, exposing us to fewer value-destructive credits. We are proud of the High Yield Bond Fund's history of incurring less than half the default rate of the market since its inception. Equally important, our approach maximises the upside the asset class has to offer, investing in more bonds of higher quality than peers and doing so with greater conviction.

Client focus on G&S factors has never been greater and is only accelerating with time – and rightly so. We believe our early decision to integrate G&S into our investment process has enhanced our ability to source dependable income streams, whilst making a positive contribution to the world. We believe the fund is well positioned to deliver resilient, long-term income, building on its top quartile performance since inception. This 18-year track record is offered for the most competitive fees in the industry, with total charges for the fund of 0.37 per cent per annum, with no entry or exit fee.

We believe our approach delivers on Baillie Gifford's principal goal - to add value to clients, support companies and benefit society through thoughtful long-term investment.

ANNUAL PAST PERFORMANCE TO 30 JUNE EACH YEAR (%)

	2016	2017	2018	2019	2020
Baillie Gifford High Yield Bond Fund (B Inc Shares)	0.9	12.6	1.7	6.7	-0.6
Investment Association Sterling High Yield TR	0.7	10.4	1.0	5.2	-2.3

Past performance is not a guide to future returns

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

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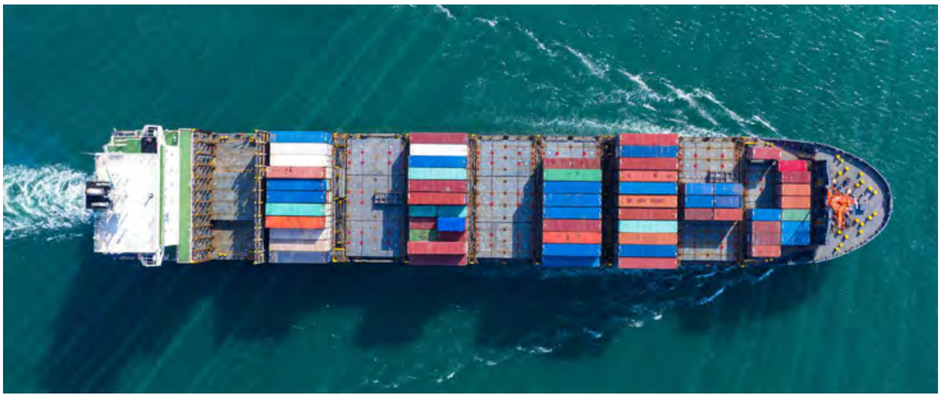
High yielding trusts: are the rewards worth the risks?

Investors hungry for income could find some opportunities once they've fully understand the business models of alternative investment trusts



Many investment trusts offer high yields which might tempt some investors in the current environment. But are they more trouble than they're worth?

Some may be worth pursuing, while others can have complex investment models and come with underappreciated risks.

HOW MUCH CAN YOU GET?

Data from the Association of Investment Companies implies there are numerous investment trusts offering yields of 8% to 12% or even more, but the areas in which they invest are quite esoteric.

Doric Nimrod Air Two (DNA2) and **Doric Nimrod Air Three (DNA3)**, for example, are trusts which buy aircraft and then lease them to airlines, while **Tufton Oceanic Assets (SHIP)** leases ships.

While investing in the Doric funds is really a binary bet on the survival of its main customer, state-owned airline Emirates, the Tufton fund has a more diversified portfolio of ships, although it has been affected by changing supply and demand and disrupted global trade due to Covid-19.

Miton fund manager Nick Greenwood owns Tufton in his portfolios, benefiting from its 8.6% yield. He says the assets have 'residual value' as scrap steel even if their value depreciates.

SPECIALITY FINANCE

Many high-yielding trusts borrow money to increase the pool of cash available to invest (known as 'gearing') and then use that money to invest in other people's or companies' debt. This web of involvement in the debt space may not appeal to risk-averse investors.

Volta Finance (VTA) is involved in corporate credit, mortgages, and auto and student loans, while **Honeycomb (HONY)** focuses on asset-backed consumer, property and small business loans.

Blackstone/GSO Loan Financing (BGLP) and Volta are among those trusts investing in collateralised loan obligations (CLOs), a single security backed by a pool of debt. Investors get geared exposure to leveraged loans which amplifies the risks.

Packaged loans played a key role in the events that caused the global financial crisis, so they will sound unpalatably risky for a lot of investors. But Sachin Saggar, an analyst at Stifel, says CLOs held up quite well throughout past crises.

'If you look at how CLOs behaved in 2008, they actually came through quite well. They ultimately recovered all their losses plus more. But what you get with them is more volatility and risk.'

Greenwood at Miton says he is 'nervous' about some alternative lenders which have relatively new and untested business models. 'Some of them seem to have run into problems lending money to people that decided they didn't want to pay it back in benign conditions, so I wonder what's going to happen in tougher conditions,' he comments.

FURTHER USES OF GEARING

More mainstream trusts that offer high yields are **Aberdeen Standard Equity Income (ASEI)**, **Merchants Trust (MRCH)** and **Chelverton UK Dividend (SDV)**, in the UK Equity Income sector; and **Acorn Income (AIF)**, in the UK Equity & Bond Income sector.

These trusts can pay high yields

SELECTED HIGH-YIELDING INVESTMENT TRUSTS		
Company	**AIC sector**	**Dividend yield (%)**
Doric Nimrod Air Two	Leasing	29.3
Doric Nimrod Air Three	Leasing	25.4
Volta Finance	Debt - Structured Finance	10.2
Blackstone/GSO Loan Financing	Debt - Structured Finance	9.8
Real Estate Credit Investments	Property - Debt	9.7
Regional REIT	Property - UK Commercial	8.9
Honeycomb	Debt - Direct Lending	8.9
Tufton Oceanic Assets	Leasing	8.5
Aberdeen Standard Equity Income	UK Equity Income	8.2
Acorn Income	UK Equity & Bond Income	8.1
RM Secured Direct Lending	Debt - Direct Lending	8.1
ICG-Longbow Senior Secured UK Property Debt Investments	Property - Debt	7.9
Chelverton UK Dividend	UK Equity Income	7.8
Starwood European Real Estate Finance	Property - Debt	7.7
Merchants Trust	UK Equity Income	7.7

Source: AIC. 9 Sep 2020 based on historic payments, apart from Regional REIT source: Shares, based on company guidance for 2020 and share price 10 Sep 2020

because of their use of gearing. Greenwood comments: 'If a trust draws draw down some debt, they can actually pay out a much higher yield using the investment trust capital structure, but obviously that speeds up the rise or fall in the net asset value. You should always look at the leverage.'

HIGH YIELDS FROM PROPERTY

There are also property funds in the list of high-yielding trusts, such as **Regional REIT (RGL)**, which was, until recently, yielding more than 11% through investing in commercial property such as offices and industrial building outside the M25.

Unfortunately, last month it reduced its quarterly dividend by 21% after adopting a more conservative approach during the pandemic. That still leaves it on an 8.9% yield based on guidance for dividends for the rest of the year and the ones already declared.

Real Estate Credit Investments (RECI), **Starwood European Real Estate Finance (SWEF)**, and **ICG-Longbow Senior Secured UK Property Debt Investments (LBOW)** also feature among the highest-yielding trusts. They provide loans to commercial and residential assets at low loan-to-values.

Saggar notes it is currently hard to value property assets, so these trusts have traded down, however, he thinks their yields 'seem relatively robust at this point'.

'NOT A FREE LUNCH'

So how reliable have these funds been in terms of the track record of their yields, and how sustainable are these sky-high payouts?

Some trusts suspended or reduced their dividend payments in Q1 but have since restarted them, explains Saggar.

In a recent note on CLO funds, Stifel said there were 'good reasons' for funds to amend their dividend policies, namely the impact of coronavirus, but that many were trying to sustain payouts. 'We highlight Blackstone and Volta as being the most cognisant of shareholders' desire to continue to receive an income,' it said.

In July, Stifel said Doric Nimrod should be able to keep up 20%+ yields on its funds for longer than expected, despite an uncertain environment.

Payouts overall have been relatively stable across the sector, says Saggar, although discounts to net asset value have widened on some trusts.

'There are some bargains to be had because people have got rather nervous about some of these very high-yielding trusts, so there are some discounts around,' notes Greenwood. However, the reason for wider discounts is that investors perceive rising risk, and this is something to bear in mind when looking for high yields.

'If something's yielding 8%-plus, there's a reason why and it's not without risk. It's not like it's a free lunch,' adds Saggar.

So does holding a high-yielding trust mean investors are signing up for a wild ride? Not necessarily.

'There is an argument that the high yield will actually smooth the volatility in the share price,' says Greenwood. 'But when you get events like the global financial crisis and the Covid-19 crisis, you're reminded that anything can happen in the short term.'

By **Hannah Smith**

Animal magic: solid growth outlook for pet-related companies

There are numerous stocks offering investors a way to play the animal health theme

People have continued to spend on the health and wellbeing of their pets during the pandemic, implying that retailers and service providers in this area should be fairly resilient.

While the UK pet population has been broadly stable for the past decade, spending on pets has grown by 7% annually over the same period according to investment bank Liberum.

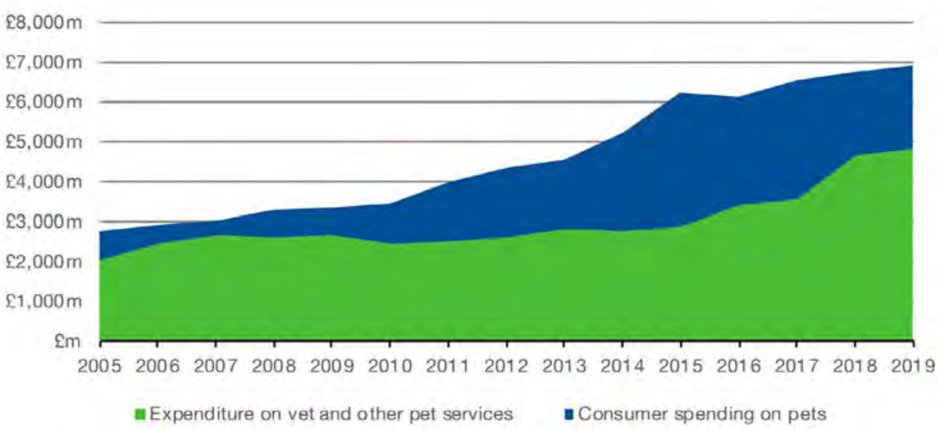
Spend on vet services has also seen strong growth in recent years, by circa 6%; however, the main driver of the overall increase has been the humanisation trend, which has seen owners spend on discretionary items for their pets.

Adoption rates at animal shelters around the world jumped during the pandemic as people looked to relieve lockdown-induced isolation. This has helped to boost the pool of individuals to which companies can sell pet food, accessories and medicines.

In its first quarter update, pet care specialist **Pets at Home (PETS)** said it had 'been encouraging to see tangible signs of heightened demand for pet ownership, a good proxy for longer term growth in the market, as people adopt new attitudes to work and leisure pursuits.'

Chief executive Peter Pritchard encapsulated the attractions of the market by saying: 'In spite of the rapid, wide-ranging and devastating effects of the pandemic, we have remained open for our customers throughout the period and we are emerging as a stronger business. The inherent resilience

UK spend on pets by category



Source: Statista

in our pet care model and the underlying pet care market, as well as encouraging signs of increased pet ownership, all underpin our confidence in seizing the future.'

Among the London-listed stocks in the healthcare space is vet practice operator **CVS (CVSG:AIM)**. It has shifted from a mergers and acquisitions-led strategy to an organic growth plan under a new management team led by Richard Fairman.

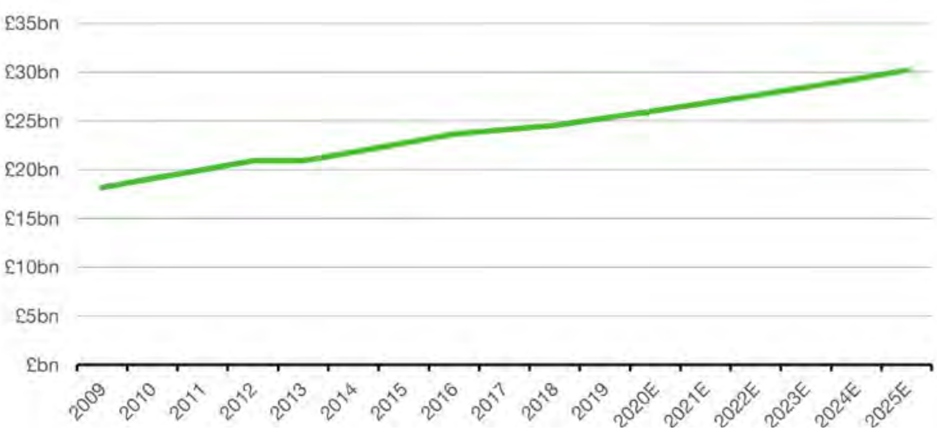
GROWTH TRENDS

Liberum says the diversified animal health sector encompassing veterinary services, retailing, pharmaceuticals and breeding, is an attractive one, seeing 4% to 5% annual growth and boasting high barriers to entry.

Many companies operating in this space have shown dogged resilience during the Covid-19 pandemic. They are highly prized by investors and have seen their share prices scurry higher as a result.

Liberum notes the market for companion animal therapies and vaccines, where **Dechra Pharmaceuticals (DPH)** is a leading player, is worth $12 billion globally and has grown by a consistent 4% to 5% for the past decade, while the European retail market for pet products is worth £25 billion and growing at 3% annually.

European pet product market growing at 3% CAGR



Source: Zooplus

PET PROJECTS

Although pet ownership has been more or less stagnant for a decade pre-Covid, this masks a shift in the mix away from low-cost rabbits to higher-cost cats and dogs, which has been boosted by pet owners spending more per pet than ever before.

'While 4% to 5% annual growth is encouraging, it has been a challenge to meet it,' cautions Liberum. 'Corporate entities are consolidating the vet space, which is raising acquisition multiples, increasing price pressure and making it more difficult to entice/retain vets.'

It says there has been a decade-long shortage of UK trained vets, which has been covered by EU migration, 'something that looks increasingly under threat as we enter the final stages of Brexit'.

A VARIETY OF STOCKS

Priced at 282p, shares in Pets at Home are 32% up on the 213p at which we added them to our *Great Ideas* list in September 2019.

We remain positive on this business, despite prevailing economic uncertainties, since Pets at Home is winning share in a structural growth market and is generating growth online.

Admittedly, like other retailers, Pets at Home's operating costs have increased to cope with social distancing measures, though the long-term outlook remains positive, underpinned by a burgeoning band of loyalty card members and subscription customers.

Overseas stocks relevant to the broader animal health theme include Swiss food giant Nestle, which has bulked up its Purina PetCare division with the acquisition of premium cat and dog food brand Lily's Kitchen, and European online pet product retailer Zooplus.

The second quarter was better than expected for US-listed Chewy while Nasdaq-

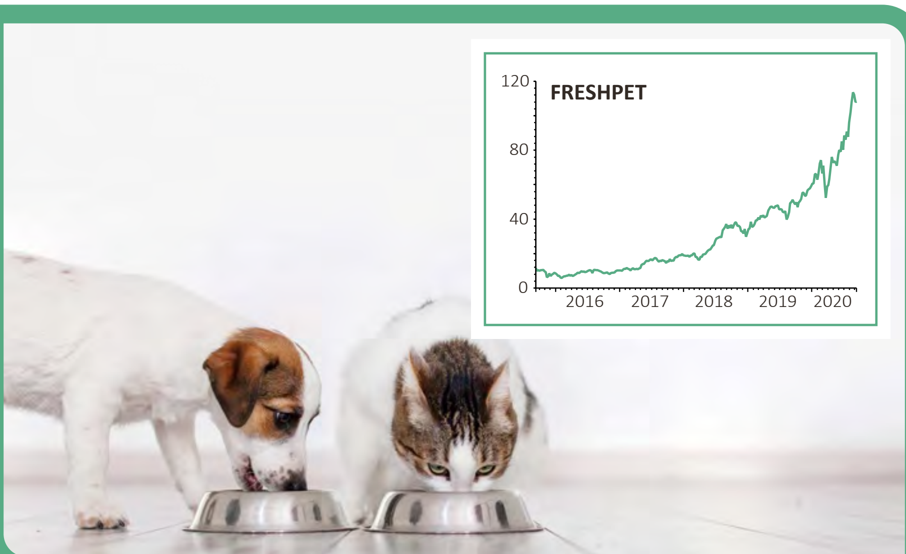
quoted Freshpet has performed strongly since its 2014 stock market debut. The US is also is home to Zoetis, the world's largest animal health company which was spun out of drugs giant Pfizer in 2013.

On the UK market, the pet theme is relevant to veterinary pharmaceutical products group **Animalcare (ANCR:AIM)**, aquaculture biotechnology specialist **Benchmark (BMK:AIM)** and livestock products firm **Eco Animal Health (EAH:AIM)**, 'all now focused on new strategies and in some cases restructuring their businesses' according to Liberum.

Veterinary pharmaceuticals concern Dechra reported underlying operating profits 0.7% ahead at £128.3 million for the year to June and increased the dividend by 8.5% to 34.39p.

Dechra's treatments include Mirataz which is the only approved medication for the management of weight loss in cats in the US and Europe, and dog diabetes product Akston. It continues to deliver growth ahead of the market.

Another of *Shares' Great Ideas* is animal genetics leader **Genus (GNS)**, which smashed forecasts once again when reporting annual numbers (8 Sep), despite the challenges of Covid-19 that affected supply chains in January and tough second-half comparisons, highlighting the company's resilient qualities.



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

Not furloughing staff could be a badge of quality for a business

Many companies that didn't need government help have a history of strong returns

The UK Government's wage subsidy scheme is due to end in October, a deadline that could spark a fresh wave of corporate redundancies and financial stress.

For investors, this means taking action to ensure their stock portfolios are culled of potential financial basket cases and focused on quality companies that are stable, robust, and most likely to sustain shareholder returns through future turmoil.

PROPPING UP EMPLOYMENT

An estimated 9.6 million jobs, spread over 1.2 million different employers, were furloughed in the UK as part of the Government's job retention scheme, according to figures from Statista. The scheme, introduced in response to the economic damage caused by the Covid-19 pandemic, covers 80% of an employees' usual monthly wage, up to £2,500, tapering to 70% in September, and 60% from 1 to 31 October, when the scheme closes down.

Analysts at investment bank Liberum estimate that the workforce furlough scheme and corporate financing facilities put in place have injected close to £50 billion into the economy since March, with that figure expected to rise to around £80 billion by the time the furlogh scheme stops next month, based on Statista calculations.

To pay for this scheme, among others, it is likely the Government will have to resort to levels of borrowing not seen since the Second World War.

In May 2020, UK unemployment was running at 3.9%, one of the lowest recorded unemployment rates since 2010.

Since then, companies including **International Consolidated Airlines (IAG)**, **Royal Mail (RMG)**, **Lloyds (LLOY)**, **Rolls-Royce (RR.)** plus an abundance of retailers including **Marks & Spencer (MKS)** have announced plans to slash thousands from their workforces.

The Office of Budget Responsibility predicts nearly 12% unemployment in the last quarter of 2020, albeit as a worst case scenario.

Furloughed jobs in UK travel, tourism and hospitality industries

% workforce	Share of respondents
96-100	61%
91-95	22%
86-90	5%
81-85	4%
71-80	4%
51-70	2%
0-50	2%
No staff furloughed	1%

Source: Statista

DEFENSIVE QUALITY

This has led Liberum's analysts to the conclusion that companies who have not had to rely on Government support through the pandemic may offer defensive characteristics.

'Companies that did not furlough any employees despite operating in cyclical industries have demonstrated the ability to weather a major pandemic,' it says, and they represent 'defensive choices for investors concerned about future lockdowns or second waves'.

Alternatively, stocks which have chosen to self-fund or repay furlough support even though they are under no obligation to do so provide a strong indication of both corporate governance and future shareholder returns adds Liberum.

With limited formal information available Liberum compiled its own database by scanning FTSE 350 company announcements that mentioned certain key words and phrases to gauge the level of use of the Government's job retention scheme since inception.

The broker's findings indicated that within two months of launch, over 60 companies had started claiming subsidies for furloughed employees, rising gradually since May to 83 of the UK's 350 largest companies. But more interestingly, they also tracked companies that had pledged not to furlough any employees. That number now tops 75 since April.

We have added our own layer of analysis to Liberum's sample list of 30-odd companies, which includes names like chemicals firm **Croda (CRDA)**, defence equipment supplier **Avon Rubber (AVON)**, **Games Workshop (GAW)** and **Bodycote (BOY)**.

Some of the world's top investors, including Warren Buffett, Terry Smith, and Nick Train put a lot of store in return on capital employed (ROCE) and return on equity (ROE) figures as a way to gauge the quality of a company.

In simple terms, high ROCE and ROE means that companies are very effective at generating profits. Often, this profitability is the result of a competitive advantage, such as a strong brand, unique products or best in class technology.

To be a truly high-quality company, a stock needs to demonstrate that high levels of ROCE and ROE can be consistently repeatable.

Companies that can generate profits throughout the economic cycle could offer protection during market downturns as well as above-average returns over the long-run.

Examples of companies that did not use the furlough scheme

	5-year ROCE	5-year ROE
Games Workshop	68.3%	56.8%
Paypoint	58.9%	76.5%
Persimmon	28.1%	25.7%
Berkeley	27.5%	25.2%
Bellway	25.3%	19.3%
Croda	23.1%	30.9%
XP Power	22.3%	24.0%
Avon Rubber	21.8%	44.1%
Redrow	21.8%	21.7%

Source: Sharepad

By **Steven Frazer**
News Editor

Seeking help with a pensions allowance calculation

A reader wants to know how to do a tax sum if they exceed the lifetime allowance level

I'm 56, have a SIPP and want to retire in 2028, so I've started looking at the lifetime allowance cap.

If my SIPP exceeded the current value of £1,073,100 to say a value of £1,500,000, would the 25% tax-free amount for withdrawals be based on the cap or my total pot size?
Keith

Tom Selby
AJ Bell
Senior Analyst says:

Usually the maximum tax-free cash you can take from your pension is limited by the lifetime allowance. This means in 2020/21 someone 'crystallising' their retirement pot could be entitled to up to £268,275 in tax-free cash (25% of the current lifetime allowance of £1,073,100).

'Crystallising' your pension just means choosing a retirement income option, such as entering drawdown or buying an annuity.

You need to do this in order to unlock your tax-free cash, at which point HMRC will test how much lifetime allowance you have used.

Since 2018/19 the lifetime allowance has been linked to consumer prices index (CPI) inflation. Given you plan to retire in 2028, that could have a significant impact on both your available lifetime allowance and consequently your tax-free cash entitlement.

For example, if CPI runs at 2% a year – in line with the Bank of England's target – then by 2028 the lifetime allowance could be worth north of £1,250,000, implying a tax-free cash entitlement of at least £312,500.

The actual lifetime allowance and tax-free cash available to you will depend on what happens to CPI and government tax policy – neither of which can be guaranteed.

There are circumstances where someone could have a tax-free cash entitlement worth more than 25% of the current lifetime allowance.

The lifetime allowance was introduced on 6 April 2006 (a point known as A-day) and at the time was set at £1.5 million, implying a maximum tax-free cash entitlement of £375,000.

Because some people had already built up a tax-free cash entitlement worth more than £375,000 at that point, rules were introduced to allow people to protect this entitlement.

Those who claimed 'primary' protection were able to have the monetary amount of their tax-free cash rights at 5 April 2006 protected (subject to upward indexing).

Those who claimed 'enhanced' protection were able to have their tax-free cash protection quoted as a percentage of their fund, rather than a monetary value.

Certain types of pension scheme also offered tax-free cash entitlement worth more than 25% of the fund value prior to A-day. Where this was the case, 'scheme specific' protection may have been offered, allowing the member to maintain their pre-A-day entitlement.

Lifetime allowance 'fixed' protection and 'individual' protection regimes were also made available each time the lifetime allowance was cut in 2012, 2014 and 2016. Those who successfully applied for one of these protections were entitled to 25% tax-free cash based on their protected lifetime allowance amount.

DO YOU HAVE A QUESTION ON RETIREMENT ISSUES?

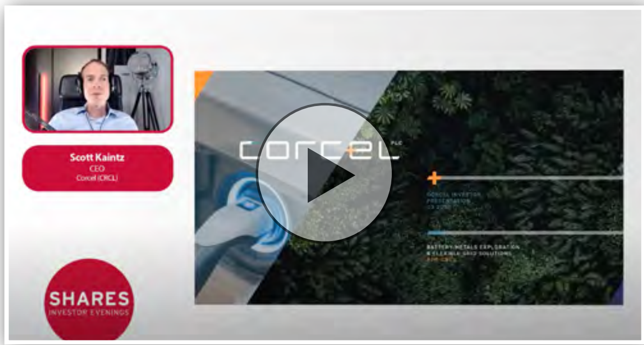
Send an email to **editorial@sharesmagazine.co.uk** with the words 'Retirement question' in the subject line. We'll do our best to respond in a future edition of *Shares*.

Please note, we only provide information 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.

WATCH RECENT PRESENTATION WEBINARS

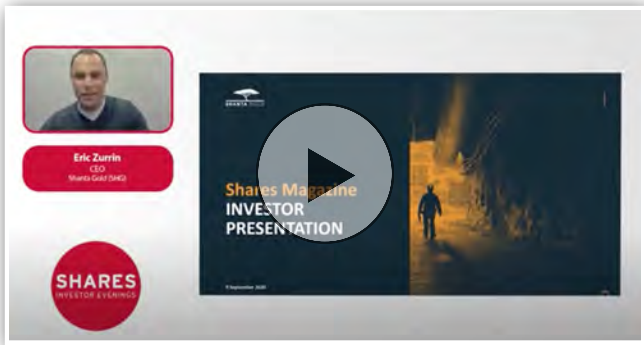
AEX Gold (AEXG) – Eldur Olafsson, Founder and CEO

AEX Gold is focussed on building a full-cycle gold company in South Greenland's gold district. AEX was founded in 2017 as an exploration company with a focus on locating high-grade gold deposits in Greenland.



Corcel (CRCL) – Scott Kaintz, CEO

Corcel is a mining and mineral resource development company, with interests in flexible energy storage and production. The Company was founded in 2004 and listed in 2005.



Shanta Gold (SHG) – Eric Zurrin, CEO

Shanta Gold is a gold producing company. The group's principal activities are the gold investment in mining, exploration, and production in Tanzania. Its main project operations are New luika gold mine, Singida and Songea.

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Explaining stock options and warrants and why they are important

These instruments can have an impact on ordinary shares

As a beginner investor, the most important things to understand are how to buy and sell shares, what can move a company's share price and how and where to find investment ideas.

But when you gain some investing experience, you may come across things called stock options and warrants, particularly if they are relevant to a company you own shares in.

Mostly popular with financial institutions, options and warrants are tools which can help investors potentially benefit from rising and falling share prices.

But it's important to note they are way up the risk spectrum and should only be used by highly experienced investors. They're relevance to most of us will be the impact they can have on an ordinary shares in a company.

WARRANTS AND OPTIONS 101

So what are warrants and options? A stock warrant gives a shareholder the right to purchase a company's shares at a particular time in the future, at a price set in the present, known as the exercise price.

Warrants are issued directly by the company concerned, so when an investor exercises a warrant, the shares that fulfil the obligation are not received from another investor but directly from the company.

A stock option works in a similar way but is not issued by the company. Instead options are bought from a market maker (a professional buyer and seller of shares).

There are two types of warrants – a call warrant and a put warrant. A call warrant is the right to buy shares at a certain price in the future, and a put warrant is the right to sell back shares at a specific price in the future.

Likewise there are two types of options – a call option and a put option. A call option gives you the right to buy shares in a particular company at a fixed price within a set period, while a put option gives you the right to sell shares in a particular company within a set period.

WHEN PEOPLE PURCHASE THEM

Stock options are purchased by investors when they expect a company's share price to go up or down (depending on the option type). For example, if a stock currently trades at £4 and an investor believes the price will rise to £5 next month, the investor would buy a call option today so that next month they can buy the stock for £4 a share then sell it for £5 a share, making a profit.

Stock options trade on an exchange, just like stocks themselves. When an investor exercises a stock option, that investor typically passes the shares to another investor.

Usually options last for three months and you can either buy or sell the shares, or let the option lapse. There are also traded options which can be bought and sold in their own right.

A stock warrant differs from an option in two key ways. A company issues its own warrants, and the company issues new shares to satisfy the transaction. A firm may issue a stock warrant if they want to raise additional capital.

You might, for example, buy a warrant for 10p which allows you to buy shares in a company for 100p.

HOW OPTIONS AND WARRANTS WORK IN PRACTICE

In September 2020 gold and lithium miner **IronRidge Resources (IRR:AIM)** gave guidance to shareholders about its options and warrants.

The company had on issue a total of 32 million warrants and 23.9 million options, exercisable at 12p each through to 25 June 2022. It said that these warrants and options can be exercised by the holder at any time up to that date.

However, it added that all of the warrants and options are also subject to an early exercise trigger in the event that the company's shares trade at an average price of 16p or above for a period of five consecutive business days, called a call condition.

Where the call condition has been satisfied, this means the company can call on all shareholders to exercise their warrants and/or options. It added that any warrants or options not exercised at the end of the agreed 30 day period (20 days to elect to convert and 10 days to pay) would be cancelled by the company.

But IronRidge also said that while the call condition outlined above had been satisfied, it didn't intend to call on investors to exercise their warrants and/or options until 2021, as it already had all the money it needed to carry out its current activities.

WARRANTS CAN BE LONGER TERM THAN OPTIONS

Stock warrants can last for up to 15 years, whereas stock options are short-term only.

One important thing to note is the dilutive impact on shareholders. If a company you own shares in is thinking about issuing warrants, or already has some outstanding, the dilutive impact is something you'll need to know about.

This is because if the company says it is considering issuing warrants, that means more shares coming into issue, and so an investor's ownership percentage of the company will decrease.

Often the market reacts negatively to stock dilution, and when a company makes an announcement regarding warrants usually its share price falls immediately to reflect the potential dilutive impact of the yet-to-be-issued warrants.

By **Yoosof Farah**
Reporter

KEY

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Full year results

22 September: 1PM, Bluefield Solar Income, Litigation Capital. **23 September:** Allergy Therapeutics, PZ Cussons. **24 September:** CVS, DFS.

Half year results

18 September: Applegreen, Gemfields. **21 September:** Augean, MaxCyte, Pennant . **22 September:** Alliance Pharma, ASA, AG Barr, Cambridge Cognition, Ergomed, Frenkel Topping, Inspecs, Judges Scientific, Kingfisher, NAHL, Parity, Personal Group. **23 September:** Cloudcall, ECSC, Equals, LoopUp, Strix, Ten Entertainment, Warpaint, Xeros. **24 September:** Biome, Ebiquity, Faron, GYG, Pendragon, Portmeirion, SIG.

Trading statements

24 September: United Utilities.

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