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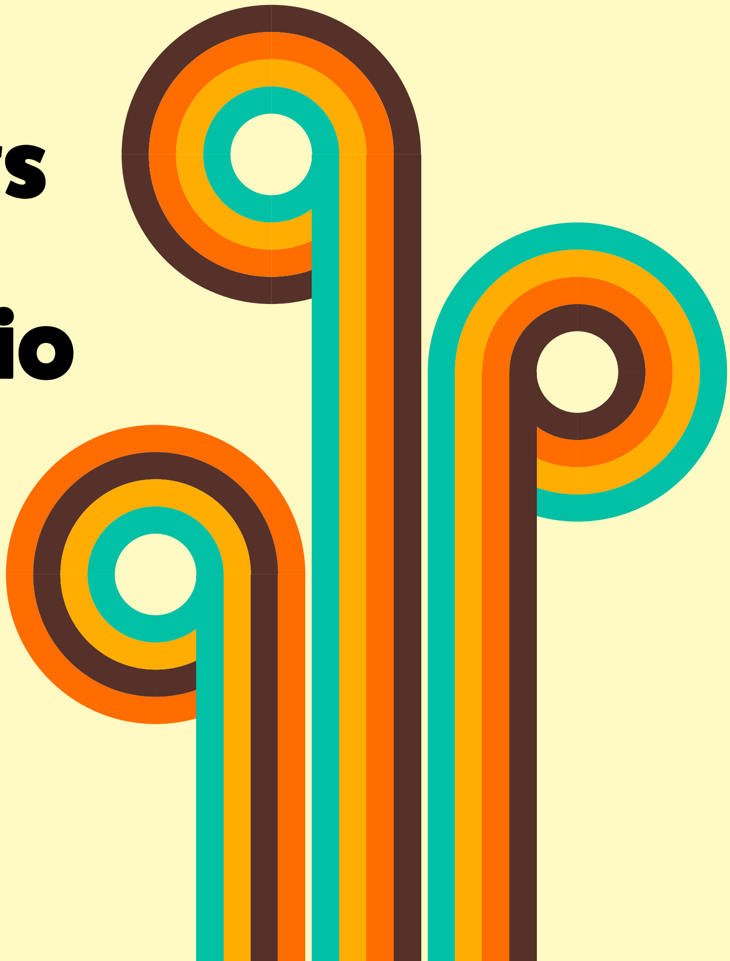

PLUS

THE REAL REASON WHY **FUNDSMITH** HAS DONE SO WELL

THE OPTIONS FOR **ROLLS-ROYCE** SHAREHOLDERS AS **£2 BILLION** RIGHTS ISSUE LOOMS

WHAT **ASDA'S SALE** MEANS FOR SUPERMARKET RIVALS

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% Total Return

12 months ending August	2020	2019	2018	2017	2016
Fundsmith Emerging Equities Trust	-1.0	-9.7	+9.5	+3.6	+21.5
AIC Global Emerging Markets Sector	-11.2	+1.3	-1.2	+18.2	+25.8

Source: Financial Express Analytics

www.feetplc.co.uk **Available through your stockbroker**

Fundsmith LLP is a limited liability partnership registered in England and Wales with number OC354233. Its registered office address is 33 Cavendish Square, London, W1G 0PW

Pace picking up for acquisition-fuelled fundraisings

Numerous companies are raising cash to buy rivals or expand skills

Equity fundraisings are taking a different shape with the reasons behind asking shareholders for cash shifting more towards long-term strategic thinking, with the select few still seeking to shore up their balance sheet now coming across as desperate.

In March to May, the principle reason for companies issuing new shares was to raise money to strengthen their balance sheet. The cash helped to plug a hole from lost revenues and to provide options should the pandemic be prolonged into 2021.

Proactive management were wise to strengthen finances as it increasingly looks like the crisis is going to last for longer than people might have expected six months ago.

After a dip in activity in August, equity fundraisings are picking up pace again with £2.1 billion raised by 30 London-listed companies in September.

The reasons behind the latest fundraisings have diverged into two categories. Among the desperate souls, **Rolls-Royce (RR.)** has joined **International Consolidated Airlines (IAG)** in launching a multi-billion-pound rights issue. While both fundraisings are fully underwritten by various investment banks, meaning they are guaranteed to get all the money, the timing was odd.

For months both Rolls-Royce and International Consolidated Airlines were shrouded by speculation that they needed more cash, yet both seemed to twiddle their thumbs before pressing the button.

'They both the left fundraisings late which looks the wrong decision now,' says Oliver Brown, fund manager at **MFM UK Primary Opportunities (B905T77)**. 'They probably felt an equity raising would have been too dilutive to shareholders in March when the pandemic struck, so they took a wait and see approach. They've finally decided, or more probably shareholders told them, to raise money.'

By waiting so long, shares in both companies have fallen hard as investors speculated that the businesses were running out of luck. In Rolls-Royce's case, its shares had slumped to 17-year low before the rights issue was launched.

In contrast, a growing number of companies are issuing shares to raise cash to help fund acquisitions. It suggests these management teams are feeling confident not only about the present but also about the ability to grow and take market share despite Covid-19.

Investors should sit up and take notice of these firms. It's easy for a business to hide away in the current environment and just focus on keeping the usual day to day stuff going until conditions improve. To remain focused against all the background noise and have an eye on the longer prize is very positive.

Making strategic progress now arguably puts companies in a much greater position when the economy really does start to pick up. Names raising cash in recent weeks for deals include **Diploma (DPLM)**, **TT Electronics (TTG)** and **Essentra (ESNT)**.

While there is always the risk a company overpays for an acquisition, or doesn't integrate it well, in the current environment doing deals shows a company is able to navigate through the crisis and think about future value creation. This long-term approach is exactly how investors should think.

SHARE PLACINGS BY LONDON-LISTED STOCKS IN 2020

	Total value (£m)
March	1,093
April	3,248
May	6,333
June	4,733
July	3,249
August	1,370
September	2,075
October	2,125
TOTAL	24,226

Source: Company announcements, AJ Bell Data 1 March to 2 Oct 2020

Contents

CFA UK Publication of the Year CFA UK Journalism Awards 2019

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

All roads East

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But with more than 18,000 listed companies, the challenge is knowing in which direction to head. To find the companies which could turn into tomorrow's front runners requires an extensive intelligence network of local analysts across Asia. Coupling that with an approach that seeks mispriced, quality businesses run by trusted people, Fidelity Asian Values PLC is an investment trust that is going places.

PAST PERFORMANCE

	Aug 15 – Aug 16	Aug 16 – Aug 17	Aug 17 – Aug 18	Aug 18 – Aug 19	Aug 19 – Aug 20
Net Asset Value	50.0%	18.2%	0.6%	2.3%	-9.0%
Share Price	49.4%	23.4%	7.5%	7.7%	-19.4%
MSCI AC Asia ex Japan Small Cap (N) Index	32.6%	26.9%	1.9%	0.0%	10.4%

Past performance is not a reliable indicator of future returns.
Source: Morningstar as at 31.08.2020, bid-bid, net income reinvested.
 The MSCI AC Asia ex Japan Small Cap (N) Index is a comparative index of the investment trust.

Past performance is not a reliable indicator of future returns. The value of investments can go down as well as up and you may not get back the amount you invested. The shares in the investment trust are listed on the London Stock Exchange and their price is affected by supply and demand. The investment trust can gain additional exposure to the market, known as gearing, potentially increasing volatility. Investments in emerging markets can be more volatile than other more developed markets.

This trust invests more heavily than others in smaller companies, which can carry a higher risk because their share prices may be more volatile than those of larger companies and the securities are often less liquid. This fund uses financial derivative instruments for investment purposes, which may expose the fund to a higher degree of risk and can cause investments to experience larger than average price fluctuations.

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Fidelity INTERNATIONAL

What Asda's sale means for supermarket rivals

The Issa brothers and TDR Capital are taking control of the UK supermarket

Asda's takeover by billionaires Mohsin and Zuber Issa and private equity group TDR Capital will have implications for UK rivals including **Tesco (TSCO)**, **Sainsbury's (SBRY)**, **Morrisons (MRW)** and **Marks & Spencer (MKS)**.

US retail titan Walmart has announced the sale of a majority stake in Asda, Britain's third biggest grocer, in a £6.8 billion deal that is subject to regulatory approval and expected to complete in the first half of 2021.

The Issa brothers are famed for building up petrol station empire EG Group which is co-owned by fellow Asda buyer TDR. Walmart will remain a minority investor in the UK supermarket with a seat on the board.

Asda has struggled to gain market share in UK grocery for some time, with price cutting and negative operational gearing in a highly competitive market taking a toll on earnings.

The new owners have stated they will invest about £1 billion in Asda over the next three years, which should keep rivals on their toes, although broker Shore Capital points out this is behind the annual investment spend of Asda's major quoted peers and German discounters Aldi and Lidl.

Asda is unlikely to add much new capacity to the industry either, according to Shore Capital, 'so helping to sustain the positive balance between market value and space'.

While the Issa brothers are likely to lower prices to make Asda more competitive, the broker doesn't believe the value-focused supermarket will be 'irrational' in terms of slashing prices. This should allay investors' worst fears that a margin-eroding price war will happen.

Asda has opportunities to grow in forecourt convenience, online and through partners including **Greggs (GRG)** – EG already boasts strong ties to the baker – but these are 'unlikely to shake the stability of the industry' according to Shore Capital.

Intriguingly, the broker does float the possibility

Asda has struggled to gain market share in UK grocery for some time, with price cutting and negative operational gearing

that the Issa brothers could explore a grocery, forecourt and bargain store combination with high-flying **B&M European Value Retail (BME)** longer-term, which would certainly shake things up.

Should Asda's new ownership result in greater online success, this could have implications for rivals including online grocery delivery specialist **Ocado (OCDO)**, whose shares reacted negatively to claims from Norwegian robot technology company AutoStore that Ocado has infringed its technology rights.

Ocado has assured the market it has 'multiple patents protecting the use of our systems in grocery', which it will 'always vigorously protect' while it investigates the claims.

Shore Capital concludes that for the wider grocery market, the Asda sale is 'a development that it can quite comfortably accommodate, but let's see'.

For the listed supermarkets, it is 'no worse than a neutral development and we retain our positive sector stance, noting liquid, solvent, growing and increasing free cash generative businesses.'

Cineworld faces liquidity crunch as cinemas close again

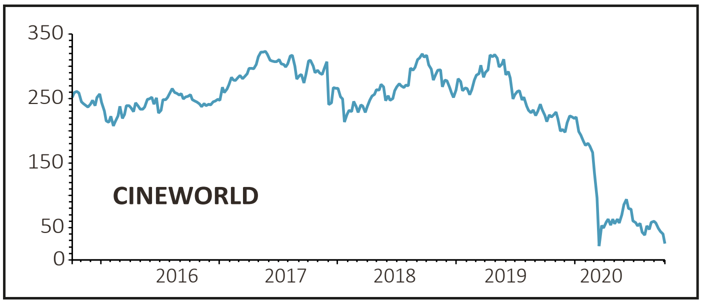
One analyst forecasts a need for $300 million to see it through more tough times

Cinema group **Cineworld (CINE)** may need an extra $300 million liquidity to get it through the current crisis, having announced plans to close its UK and US cinemas again on a temporary basis.

Investment bank Jefferies says as at 31 August, Cineworld had c$260 million in liquidity (c$150 million cash, plus $110 million undrawn revolving credit facility). 'We assume $40 million to $70 million monthly cash burn when shut (higher when quarterly interest payments due),' says analyst James Wheatcroft.

'Our monthly cash burn and liquidity analysis shows a $300 million liquidity requirement (assuming a $50 million buffer). Conservatively, we have assumed a potential $200 million 2Q21E CARES Act payment nets against a payment potentially due to former Regal shareholders.'

Wheatcroft believes Cineworld will seek additional liquidity from government loans, revolving credit facility extension and covenant waiver, extended term loans and private placements.



'Assuming all current shareholders are shareholders because they believe in cinema life after Covid, then an equity raise could provide another financing avenue,' he adds.

Film studios continue to delay big-name releases and the postponement to April 2021 of the James Bond film *No Time To Die* seems to have been the catalyst for Cineworld closing many of its theatres again. Subsequently, *Dune* has been pushed back a year to October 2021 and *The Batman* has been delayed until Spring 2022.


Copyright MGM

The primary driver for getting people into cinemas is the film slate and there has been a dearth of big-name new releases in recent months. Film studios don't want to risk releasing potential blockbuster hits unless they are comfortable that there will be a willing audience to see them on the big screen.

One problem of Cineworld's own making is the huge debts it has built up acquiring businesses including US chain Regal. Even without the aborted $2.3 billion purchase of Canadian cinema group Cineplex the company reported net debts of $8.2 billion at the end of June 2020. This far exceeds the current £380 million equity value of the business.

It is almost certain that Cineworld will need to refinance its balance sheet and accelerate discussions with landlords to find a solution for its substantial lease liabilities which amounted to $166 million in the first half of the year.

The quick unravelling of business which has seen the shares drop nearly 90% over the last year is a reminder to investors of the dangers of too much debt.

Housebuilders rally on Boris Johnson's bid to help first-time buyers

The Prime Minister wants long-term fixed-rate mortgages with only 5% deposits

Shares in UK housebuilders rallied on 5 October following reports that the Government wants first-time buyers to be able to take out long-term fixed-rate mortgages with just a 5% deposit under a scheme referred to as 'Generation buy'. This could potentially act as another tailwind for the property sector.

In an interview with *The Telegraph*, prime minister Boris Johnson said he had a solution to the problem of unaffordable property deposits. This might involve banks dropping stress tests on some applicants.

'It is understood that the Government could also accept some of the risk through a form of state guarantee to give lenders additional confidence,' *The Telegraph* said.

Most lenders have withdrawn their low-deposit mortgage offerings for fear of taking on too much risk but the Government is concerned that when the stamp duty holiday ends in March 2021 the housing market will grind to a halt once again.

The Nationwide home price index increased by 5% on an annual basis in September, marking an acceleration from August's 3.7% growth rate and the biggest jump since September 2016, as the housing market recovery continues to defy the sceptics.

As well as an increase in prices, mortgage approvals are climbing. Approvals in August were almost 85,000, the highest since 2007 and well above the monthly average of 66,000 over the last few years.

How Trump's Covid-19 diagnosis has impacted stock markets

Wild swings have been seen on Wall Street as commentators say markets 'overreact' ahead of elections

US PRESIDENT Donald Trump's coronavirus diagnosis and three-day stint in hospital dominated headlines and market sentiment.

Schroders chief investment officer Johanna Kyrklund says stock markets have a 'tendency to overreact' to daily news around elections, while George Lagarias, chief economist at Mazars, says that for all the sensationalism around Trump's health, unless it deteriorates rapidly it's unlikely to have any material impact on risk assets like stocks.

The uncertainty over the outcome of the election, whether there will be a peaceful transfer of power and the health of the president could result in continued volatility ahead of election day (3 Nov).

Markets fell sharply on 2 October when it was revealed Trump was admitted to hospital with Covid-19, with sentiment impacted by uncertainty over how the election would play out, and wider concerns about the impact of the leader of the world's largest economy potentially being incapacitated.

News of Trump being discharged from hospital on 5 October saw the S&P 500 surge 1.8%, Nasdaq 2.3% and Dow Jones 1.7%.

It seems investors also moved past the fact US job creation halved month-on-month in September with only 661,000 new jobs added, compared to 1.49 million in August and well below analyst expectations of 900,000 new jobs.

The options for Rolls-Royce shareholders as £2 billion rights issue looms

The company is taking measures to help repair a balance sheet hurt by Covid-19

Shareholders in **Rolls-Royce (RR.)** are being asked if they want to back a £2 billion rights issue aimed at securing the company's future.

The rights issue is fully underwritten by a panel of investment banks, meaning Rolls-Royce is guaranteed to get the full amount even if shareholders don't take up all the new shares.

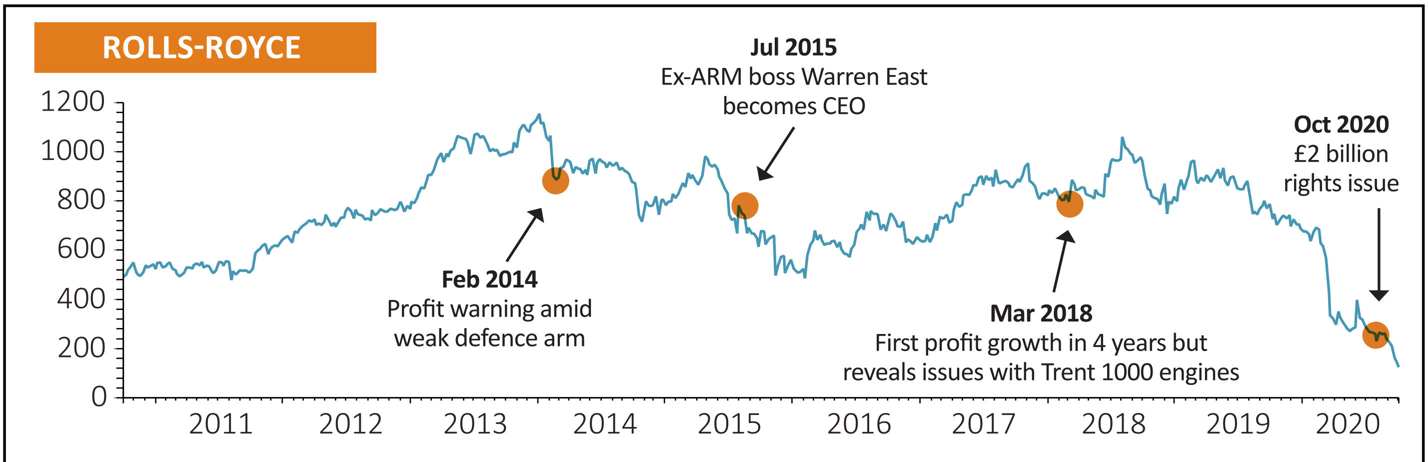
The engineer is also issuing a further £1 billion worth of debt, has agreed a new two-year loan facility of £1 billion (contingent on the success of the rights issue); and received a guarantee from the UK Export Finance agency on a further £1 billion loan.

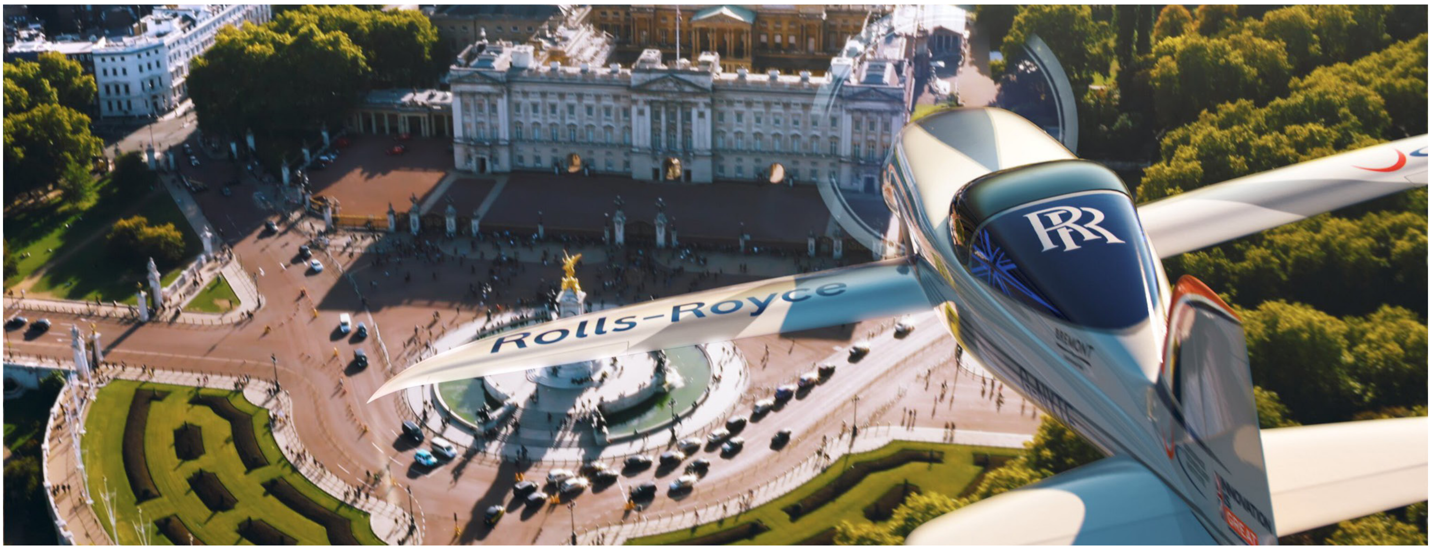
WHY IS ROLLS-ROYCE ACTING NOW?

Disruption to the aviation sector is having a significant impact on demand for the aircraft engines Rolls-Royce makes and sells.

The company expects to see a cash outflow of £4 billion in 2020 and about £3.2 billion worth of debt is due to be repaid in 2021.

The importance of the long-term servicing and maintenance agreements associated with these engines means the reduction in the number sold





now could affect the business for years into the future even if or when the airline industry recovers.

WHAT ARE SHAREHOLDERS' OPTIONS?

Shareholders have four main options. The first option is that they can exercise the right to buy new shares at 32p – this a 10-for-three issue meaning shareholders can buy 10 new shares for every three they already own.

The second option for shareholders is to sell their rights to someone else in return for cash, without having to sell their existing shares. The amount a shareholder will receive for their rights will depend on what people are willing to pay for them.

The rights issue price of 32p represents a 41.4% discount to the theoretical ex-rights price of 54.6p per existing share by reference to the closing price of 130p on 30 September 2020. The theoretical ex-rights price is the implied market price once all the new shares are issued.

The third option is to sell some of the rights and potentially use the proceeds to buy some of the discounted shares.

The fourth option is to do nothing. In this situation, shareholders' rights are expected to be sold in the market at the best available price by Rolls-Royce and the proceeds returned to shareholders via their investment platform provider minus any charges.

WHAT HAPPENS NEXT?

A shareholder vote to approve the rights issue will be held on 27 October. Investors will receive their nil paid rights on the 'ex rights date' of 28 October providing they haven't sold their holding before that date.

The period in which to exercise or sell the rights is expected to run from then until 11 November although the deadline is likely to be 6 November for many investment platforms. This is expected to be confirmed soon. The new fully paid shares will be credited to accounts on or around 12 November.

WHERE DOES THIS LEAVE THE COMPANY?

Once the rights issue and rest of the recapitalisation process is complete the company should, on its own assessment, be able to weather macro-economic risks through to 2022 when it expects to return to strong cash generation.

Investment bank Jefferies earlier this year noted: 'We don't envisage airlines placing large orders for new aircraft before 2024 or Airbus and Boeing launching new aircraft programmes before the end of 2025.'

The duration of the pandemic and the restrictions on air travel associated with it remain highly uncertain.

Rolls-Royce itself has noted that total maintenance demand is now expected to be up to 10% to 15% lower in 2022 than previously expected. It is taking steps to adapt to lower demand by reducing the size of its civil aerospace business and pivoting towards its defence and power systems operations. It also plans to sell its ITP Aero aero-engine subsystem design arm.

Pre-Covid-19, the engineer was having to deal with faults on its Trent 1000 engines. This situation had escalated from what was initially characterised as a relatively minor issue to one that was expected to cost upwards of £1.5 billion to fix.

Novacyt looks really cheap despite share price rally

The testing specialist should see a major uplift in earnings thanks to a big contract win

There aren't too many firms which have delivered a 10-fold increase in first-half revenues to €72.4 million and a 13-fold increase in gross profits to €60.3 million in 2020, all from organic sources. This makes diagnostics firm **Novacyt (NCYT:AIM)** pretty unique.

But the excitement has arguably only just begun with the latest contract win (29 Sep) to supply the Department for Health and Social Care (DHSC) potentially worth £250 million for phase one over the next six months and phase two worth considerably more.

NOVACYT
BUY
(NCYT:AIM) 632p
Market cap: £460 million

Unsurprisingly the shares have been on a tear, recently hitting a new all-time high of 652p, and the shares are up 90-fold over the last year. However, even before the latest contract win the company indicated that full-year revenue and EBITDA (earnings before interest, taxes, depreciation and amortisation) would exceed €150 million and €100 million respectively.

Given the year-end is only three months away the stock is on a cheap 4.5 times EV/EBITDA. We believe this is a great opportunity to get on board an exciting growth business.

It isn't without risks given the early stage nature of the company and lack of broker coverage, meaning there are no earnings estimates in the market.

And prospective investors should be aware that the current boom for Covid-19 testing may well peak at some point over the next year and a half, creating a cliff for Novacyt's earnings.

NOVACYT DEVELOPMENT TIMELINE

In response to the Covid-19 emergency, Novacyt made the strategic decision to develop a diagnostic test in early January 2020.

The company launched the test in late January 2020 and subsequently received clinical use approval from a number of leading global regulatory authorities, including CE Mark accreditation and Emergency Use Authorisation (EUA) from the US Food and Drug Administration (FDA) and the World Health Organisation (WHO).

This rapid development of a test for Covid-19 positioned Novacyt at the forefront of the global response to the spread of the virus.

This included increasing the company's own production capacity at its wholly-owned Primerdesign site in Southampton, as well as entering into contract manufacturing partnerships.

The firm also beefed up its supply chain capacity by expanding the key raw material supplier base to develop a long-term and sustainable high volume supply of its tests.

The company operates from three manufacturing sites occupying 40,000 square feet.

In July 2020, Queen Mary University of London announced the initiation of a 2,000-patient clinical trial using Novacyt's innovative near-patient testing system, which can deliver a result within an hour.

Therefore this may be a stock to own short-term rather for years to come, unless it can successfully diversify its source of earnings.

NEW STRATEGY

Management is aware of the need to offset future reductions in Covid-related revenues and recently presented a clear and ambitious new strategy.

Novacyt aims to leverage its reputation, market intelligence and relationships developed during the Covid-19 response to commercialise new products. It wants to expand its presence in respiratory and transplant clinical diagnostics to become a leader in the field.

The company will supplement its product portfolio and expand capabilities through selective and earnings-accretive mergers and acquisitions.

In the short-term it is looking for strategic targets which will increase the vertical integration of the group. Longer-term the focus will shift to bigger opportunities to deliver revenues and profitability in key infrastructure markets.

Organically the firm will build its own direct sales force in the EU and US while continuing to develop its successful distributor and partnership sales model in the rest of the world.

MARKET OPPORTUNITY

The market for in-vitro diagnostics (blood-based samples used to provide diagnosis or treatment monitoring) is growing at around 5% annually and is expected to be worth $110 billion by 2030 according to some forecasts.

The growth is underpinned by an ageing world population and an expected increase in the incidence of chronic and infectious diseases.

The company believes that one of the lessons learned from the pandemic is that it exposed the limitations of relying on closed systems with few suppliers providing testing equipment. Increasing use of open systems and multiple suppliers will play into the hands of the partner network that Novacyt has created.

With the launch of Novacyt's near-patient testing system in July 2020, the company looks well positioned to address this drive towards rapid, decentralised testing.

FINANCIAL OVERVIEW

There aren't any broker estimates available but we do know that revenue growth has been strong and June sales amounted to €25.4 million, around a third of first-half sales. It's likely that management guidance of at least €150 million for the full year is very conservative before taking account of the DHSC order.

Net cash generation in the first-half was strong reaching €24.6 million, allowing the company to repay a €5 million bond subscribed by Harbert European Growth Capital. It also converted a Vatel €4 million bond into equity.

The company was debt free as of 30 June with cash in hand of €19.7 million compared with €1.8 million in December 2019.

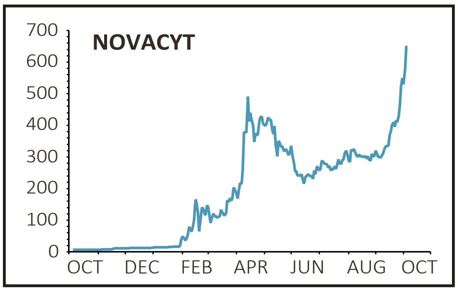
We acknowledge that the shares have already gone up by a large amount. However, the DHSC order on 29 September represents a significant change in the company's fortunes.

So many small caps claim they are going places but often disappoint. In contrast, Novacyt is actually achieving tremendous sales numbers meaning the market excitement is justified. It's in a sweet spot and investors should get on board now.

NOVACYT FIRST-HALF RESULTS

	2019	2020
Revenue	€7.2m	€72.4m
Gross profit	€4.6m	€60.3m
Gross margin	63%	83%
EBITDA	€0.15m	€49.4m
Recurring operating profit / (loss)	(€0.6m)	€48.7m
Operating profit / (loss)	(€0.66m)	€48.3m
Profit / (loss) after tax	(€1.2m)	€40.2m

Source: Novacyt



Don't miss out on this high-quality European growth company

This could be a good opportunity to buy a top-class name at a cheaper price

From humble beginnings in the mid-1960s as a simple textile-maker located in Galicia in north-western Spain, Industria de Diseno Textil – better known as Inditex – has transformed itself into a global fashion powerhouse with more than 7,000 stores in 200 countries and a reputation for being on-trend and quick to market.

Inditex operates eight different brands including Zara and Bershka and design, sourcing and manufacturing are localised. Over half the firm's factories are located close to its headquarters in Arteixo, yet it works with nearly 2,000 suppliers and over 8,000 factories globally.

A large part of Inditex's investor appeal is its historically high gross margins and earnings before interest, tax, depreciation and amortisation (EBITDA), thanks to its streamlined design and production process and its negative working capital position.

Pre-Covid, the firm's gross margin was close to 60% while EBITDA margins were near 30% compared with ratios of 40% and 20% respectively for **Next (NXT)** and much lower ratios for fast-fashion firms like H&M and Primark.

INDUSTRIA DE DISENO TEXTIL (INDITEX)

BUY

(ITX:BME) €24

Market cap: **€75 billion**

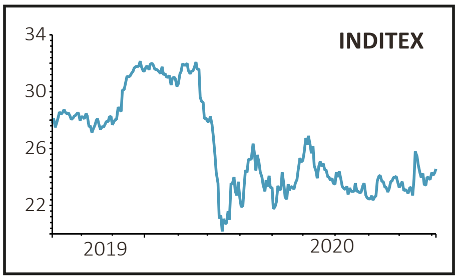
Another part of the firm's appeal is its focus on sustainability and governance issues. Inditex has signed up to the United Nations' 17 Sustainable Development Goals, while over 90% of its stores are eco-efficient, with zoned, energy-efficient lighting and heating, and priority given to using recycled or reused materials in their construction.

Like all clothing retailers Inditex suffered heavily during the pandemic, but by the end of July 96% of stores were open again and during September total sales including online were down just 11% year-on-year. E-commerce sales were up 74% in its first-half period. Inditex was early to spot the potential of online sales, setting up its website in 2010.

Financially the firm is on an extremely strong footing with net cash of €6.5 billion as of the end of July, and it has kept its 60% dividend payout ratio although it has decided to delay both 2020 and 2021 dividends until calendar 2021 and 2022.

Forecasts for this year and next year look overly conservative, with analysts not expecting sales and EBITDA to get back to pre-Covid levels until the beginning of 2023.

With the Madrid-listed shares trading at €24 compared with €32 pre-Covid and all-time highs of €36 back in 2017, this is a good opportunity for UK investors to pick up a high-quality European business, offering growth and diversification at a discount. Just remember that investment platforms may have additional fees such as forex exchange charges when buying overseas-listed stocks.



PREMIER FOODS
(PFD) 98.2p

Gain to date: 136.9%
Original entry point:
Buy at 41.45p, 23 April 2020

CAKE AND GRAVY maker **Premier Foods (PFD)** could be in line for a windfall amid a bid from Italy's Newlat Food for bread maker Hovis, in which it has a 49% stake.

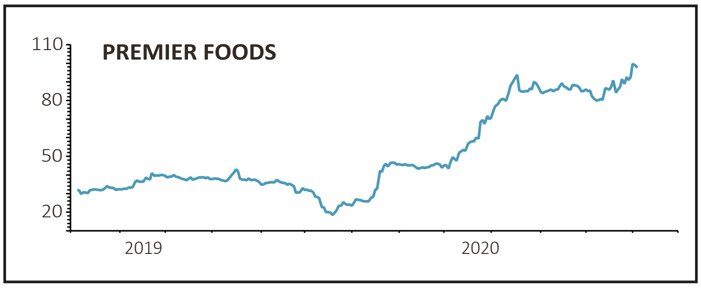
Having written off the value of the asset in 2016, the proceeds from any sale would represent a hefty profit on the balance sheet and potentially enable further reductions in its borrowings.

The company has separately announced plans to redeem £40 million worth of corporate bonds. The decision follows strong trading for the food producer in the first half of its financial year (running to 26 September 2020).

The redemption of £40 million of the £130 million outstanding on bonds due in July 2022 is expected to reduce the cost of financing and save the company £2 million a year in interest costs.

The combination of strong trading and an improving balance sheet position is rewarding our faith in the business in spades – with the shares more than doubling since the spring.

Investors should get more insight into the company's recent trading with the scheduled publication of its first-half results on 11 November.



SHARES SAYS:
The upcoming trading update looks like it could be a positive catalyst. Still a buy.

A.G. BARR

(BAG) 469p

Loss to date: -6.1%

Original entry point:

Buy at 499.5p, 7 May 2020

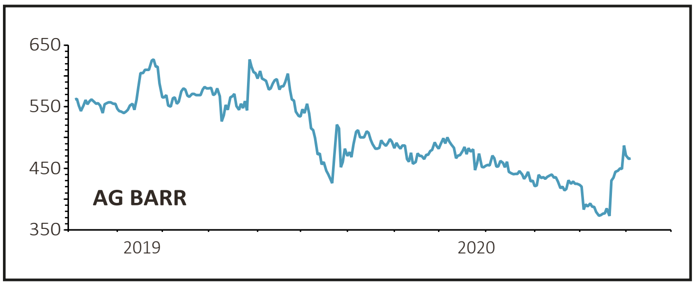
HAVING DRIFTED downwards since our bullish call on the stock, **AG Barr's (BAG)** shares enjoyed a strong rally in September.

A key catalyst for the rally was the publication of its half-year results (22 Sep), where AG Barr maintained full-year profit guidance and said it expects to resume dividend payments in 2021.

Results for the six months to 25 July reflected the challenges created by the pandemic, yet Liberum Capital upgraded its full year pre-tax profit forecast from £19 million to £30.7 million due to a better than expected sales performance, tight cost control and better gross margins from the IRN-BRU and Rubicon brands owner.

AG Barr is proving its resilience during the Covid-19 pandemic, performing strongly in the 'take-home' channel and starting to see sales in the hospitality and 'on the go' consumption segments recover as lockdown restrictions ease. Cash continues to build on the balance sheet too.

Liberum insists 'the resilience shown during Covid-19, the flexibility of management to adapt to the changing trading patterns with a quick shift in product and channel mix underpins our confidence that AG Barr remains a high-quality company with highly resilient cash flows', while Shore Capital sees the depressed stock rating as 'an excellent entry point opportunity for such a high-quality equity'.



SHARES SAYS:

AG Barr is a long-term compounder with a portfolio of iconic brands. Keep buying.

CENTAMIN

(CEY) 151p

Gain to date: 14.2%

Original entry point:

Buy at 129.6p, 1 August 2019

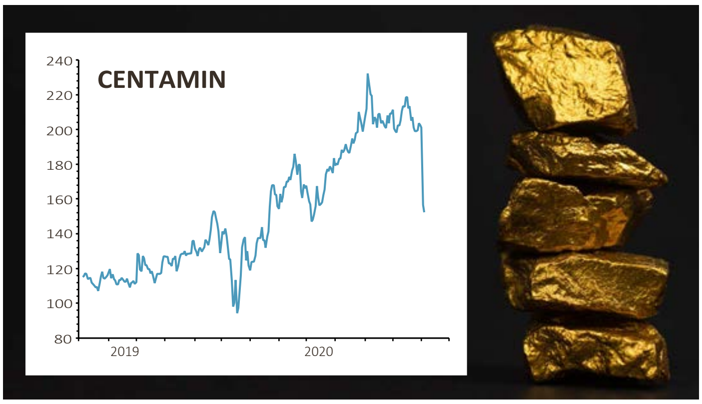
SHARES IN GOLD miner **Centamin (CEY)** have lost around 25% of their value since 2 October after ground movement forced it to close off an area of its Sukari mine, hurting its production output and damaging its ability to profit from the rally in the gold price.

Centamin had to halt operations at the Sukari open-pit Stage 4 West wall as a safety measure, and as a result says fourth quarter gold production will fall to 70,000 ounces.

Considering Sukari is Centamin's only mine, any operational problems at the site will be felt more keenly than peers who produce gold from numerous mines.

Analysts at Berenberg said the changes would reduce production for 2020 to 444,000 ounces of gold versus 516,000 ounces previously, a 14% reduction, and would push up Centamin's all-in sustaining costs from $903 per ounce of gold to $1,039 per ounce, a 15% increase.

They added the 'bigger concern' is that it could necessitate a redesign at Sukari 'based on shallower pit angles with higher resultant strip, which would have a negative impact on costs and free cash flow generation'.



SHARES SAYS:

Take profits. We'll reconsider our stance on the stock once we know if there's a bigger problem at Sukari or not.

THE PANOPLY HOLDINGS
(TPX:AIM) 111.3p

Gain to date: 23.7%
Original entry point:
Buy at 90p, 6 August 2020

WHILE SHARES IN digital enabler consultancy **The Panoply Holdings (TPX:AIM)** have lost some of the momentum they enjoyed in September, we are still sitting in a healthy position having flagged the appeal of the stock in August.

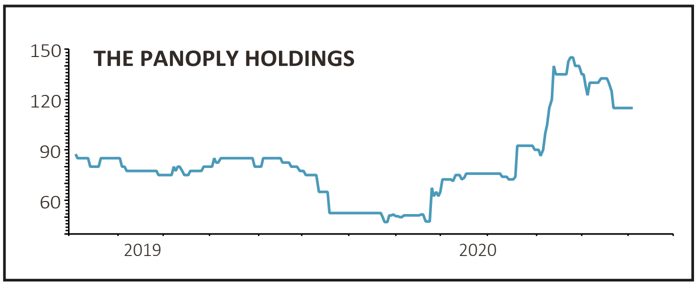
The company has announced several significant items of news including the £8.8 million acquisition of Difrent (8 Sep) – a business focused on providing digital consulting services to the health and social care sectors.

This represented a further step in its three-year plan to use its shares and cash flow to make acquisitions which can boost revenue by £35 million.

On 14 September the company said it was confident of meeting its recently upgraded annual earnings expectations amid strong trading.

Chairman Mark Smith said Panoply had signed around £10m of new contract wins in the first two months of the current quarter, including a £1.8m contract with Cheshire West and Chester Council.

This underpins our faith in the ability of the company to benefit as Covid-19 pushes businesses and organisations to get their digital plans up to speed.



SHARES SAYS: ↗
We remain fans of Panoply as it executes on its medium-term growth plan. Keep buying the shares.

The real reason Fundsmith Equity has done so well

There is more to its performance than meets the eye

Terry Smith, founder of asset manager Fundsmith, has built an excellent track record since launching the business a decade ago. According to Morningstar the **Fundsmith Equity Fund (B41YBW7)** has delivered five-year annualised returns of 20.4% compared with 15.4% for the MSCI ACWI Growth index.

Since inception in 2010 the fund has delivered a compound annual growth rate (CAGR) of 18.3% a year after fees, which means investors have seen the value of their investment go up more than five-fold.

A STRAIGHTFORWARD STRATEGY

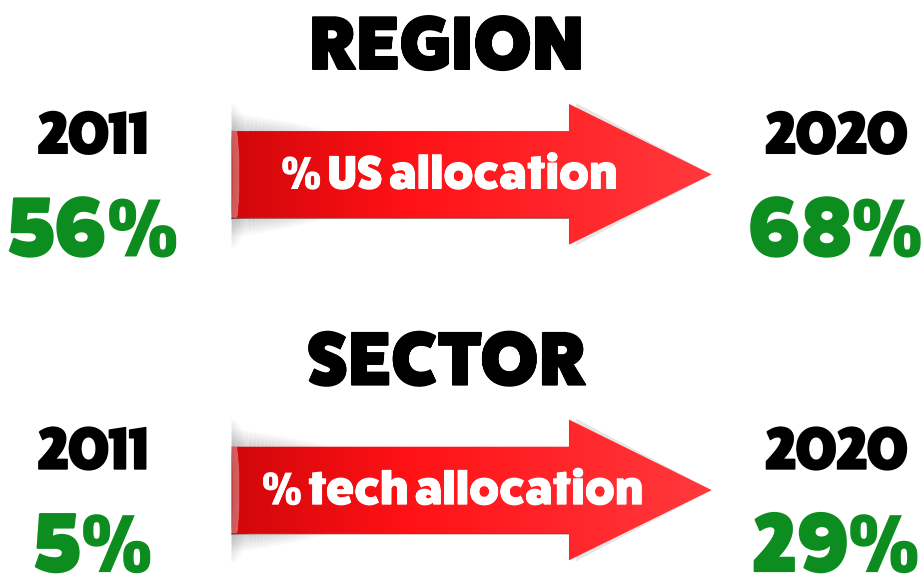
Smith has boiled down his investment process to the bare essentials which he eloquently describes in the firm's owner's guide. That would get the approval of Albert Einstein who once remarked, 'if you can't explain it to a six year old, you don't understand it yourself'.

Here, we take a closer look at the Fundsmith Equity Fund as it approaches its 10-year anniversary to see how the strong performance has been delivered and highlight some of the key drivers.

While we don't know the precise purchase and sale prices for the fund's holdings, the dates when the fund first purchased its holdings are publically available which have been used to estimate which shares may have had the biggest impacts on fund performance since inception.

We only focus on those shares which have been held for at least five years and we have not taken account of any dividend payments.

Fundsmith's shift towards US and technology over a decade



Source: Fundsmith, Shares.

WHAT IS DRIVING PERFORMANCE?

Some investors may take it for granted that good performance is a direct result of devising a superior investment strategy and executing it well, but that isn't always the case. Other factors outside the manager's control can also have an impact.

Fundsmith's stated goal is to invest in what the managers consider are the best global businesses and hold on to them for a long time and in so doing benefit from a compounding of business value.

The best companies are defined as those which achieve sustainably high returns on operating capital and reinvest earnings in order to grow the business.

Accordingly, the fund's 'buy and hold' strategy is predicated on share prices moving up with rising earnings.

The other driver of share performance is the valuation that investors are willing to pay for future earnings which can move up and down depending on investor mood. The manager says the fund does not explicitly rely on an increase in valuation in its investment decisions.

That's because Smith believes share valuations matter less than business fundamentals saying: 'Provided you have the patience, quality stocks do tend to produce the sort of performance over long periods of time that makes their valuation fade into insignificance.'

AMPLIFYING RETURNS

While that's great in theory, in practice share prices can be driven by sentiment for quite a long period. A good example is Microsoft which has become one of the fund's largest holdings, driven by strong share price performance.

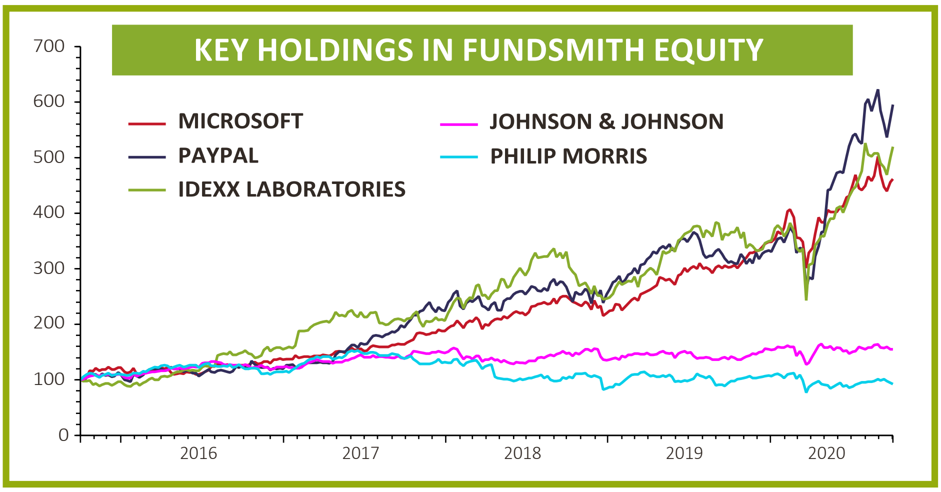
The shares have risen 11-fold since 2013, when the fund first started buying. This is equivalent to a compound annual growth rate of 39%. A significant part of the return has been down to a re-rating of the shares.

Enterprise value to EBITDA (earnings before interest, tax, depreciation and amortisation) has increased three-fold to 22.3 times from 7.25 times while the PE has increased by 2.6-fold. If the business were valued today at the same PE as 2013 the stock price would be $77 compared with the current price of $206.

Arguably it's not a concern if some of the stocks the fund owns get driven up by increasing investor sentiment. Focusing purely on fundamentals, the underlying CAGR of earnings at Microsoft has been a very respectable 15% a year, satisfying the manager's expectations of a high quality growth company.

On the other hand, the performance of Microsoft has probably had a disproportionately positive impact on the fund's overall performance. A falling PE would damage the fund's performance irrespective of the fundamentals of Microsoft's business. Valuation expansion and shrinkage is always at the mercy of febrile investor sentiment.

Another top 10 holding, payments business Paypal has



seen its shares rise at a CAGR of 39% a year since the fund first started purchasing shares in July 2015, equating to a five-fold increase. Despite earnings growth of 22% a year the shares have also benefitted from a valuation tailwind, without which the shares would be trading at half current levels.

Diagnostic test instruments company Idexx Laboratories is another fund holding which has seen its share price increase five-fold over the last five years, in part driven by an expansion of the PE multiple that investors have been prepared to pay for the business.

LOW GROWTH STOCKS

These examples illustrate that a re-rating combined with double digit earnings growth can really turbo-charge shareholder returns. Sometimes even low growth is rewarded. Take the fund's long term holding in Finnish lift company Kone, which has seen earnings growth average a lacklustre 4% a year.

Despite this the shares have seen a big re-rating over the last nine years resulting in the share price going up 3.5-fold.

However this hasn't been the case in tobacco stock Philip Morris International, first purchased by Fundsmith in 2011. The shares have only delivered a CAGR of 2% a year.

The main reason for the lacklustre performance is because the price to earnings ratio is virtually unchanged over the last nine years, which means the value of the fund's holding has grown in line with the growth in earnings.

RECURRING THEME

These examples illustrate a recurring theme played out across markets since the financial crisis of 2008, with investors paying up for earnings growth and quality shares which are seen as relatively resilient.

A good example of a low growth, but high quality share which has re-rated is healthcare stock Johnson & Johnson which the fund first purchased in May 2014. The shares have since gone up around 43% which is equivalent to a CAGR of 6% a year.

However, without the benefit of a re-rating the shares would only have delivered a return of 14%, or a CAGR of 2% a year, the same underlying growth in earnings for the company.

Factors outside the manager's control have so far had a net positive impact, but that doesn't mean it will remain or recur in future periods.

PORTFOLIO CONCENTRATION

The fund manager isn't fixated on benchmarks when building the portfolio which means it can end up highly concentrated in certain markets or sectors. That said 29 holdings are generally accepted as sufficient to achieve the benefits of diversification.

Around two thirds of the portfolio is exposed to US firms and 30% is invested in the technology sector. This is quite a change from just after inception when only 56% was invested in US shares and technology was a mere 5% of the fund.

Strong performance of US markets and technology in particular has been a factor in the changing composition of the fund.

DISCLAIMER: Editor Daniel Coatsworth has a personal investment in Fundsmith Equity

By **Martin Gamble**
Senior Reporter

LOW GROWTH, RECOVERY OR SECOND WAVE

The investments to own in each scenario

By **Yoosof Farah**, **Martin Gamble**, **Tom Sieber** and **Daniel Coatsworth**.

We see three different scenarios for markets going into 2021 and inflation will play a key role.

First is strong economic recovery with rising inflation and this scenario favours cyclical stocks. For example, this might be commodity producers who would sell their metals for higher prices. Banks would be another beneficiary as rising inflation can drive up loan rates and demand for credit may also increase if the cost of living goes up.

Second is a weak growth environment with low inflation, which would favour quality companies that can deliver growth. This has been the winning trade for many years and investors would have to be prepared to pay high ratings to own growing businesses.

Third is a severe second wave of coronavirus which is when you want to own gold. A heightened level of infections and deaths would cause upset among the markets and investors would probably flock to safe-havens, with gold being a natural place to park money in times of trouble.

We'll now go into each scenario in more detail.

INFLATION MATTERS

Inflation has a major influence on financial markets. It affects all aspects of the economy, from consumer spending, business investment and employment rates to government programs, tax policies and interest rates.

Having collapsed in March at the height of the coronavirus pandemic as lockdowns and travel bans came into force around the world, five-year forward inflation expectations in the US have since picked up again and are almost near all-time highs according to Federal Reserve Economic Data (FRED).

US inflation is seen as the world's most important economic variable, given the American economy is the largest of them all and the country's central bank, the Federal Reserve, tends to set the tone for other major central banks around the world when it comes to monetary policy.

SCENARIO 1: STRONG ECONOMIC RECOVERY, RISING INFLATION

ANALYSTS AT Morgan Stanley believe inflation is back, and on a global level they think the world economy is reflating quicker than anticipated. They see a synchronised global economic recovery from the second quarter of 2021 onwards.

This view is shared by BlackRock, which thinks the likelihood of higher inflation is not yet reflected in market prices, opening a window of opportunity for long-term investors. But they warn that once higher inflation appears, it's likely to be too late for investors to react – markets will have already moved to price in higher inflation expectations.

SWITCH TO CYCLICAL STOCKS

Investments that would do well in this scenario are cyclical stocks, like mining and construction companies, as well as financial stocks and emerging market stocks – all of which, in relative terms, have struggled in recent years.

In the investing world, cyclical stocks are those whose fortunes swing depending on the business cycle of an economy. A cyclical stock typically goes up in the boom years of the economy and down when the economy is lower.

DEPENDENT ON VACCINE

It's important to note the scenario of strong economic growth and higher inflation assumes coronavirus vaccines are successfully developed and made broadly available within the first three months of next year.

But various high-profile figures in the medical community have warned the public, and indeed governments, against seeing a vaccine as a panacea.

They argue that some of the experimental approaches being taken in developing a coronavirus vaccine have never been mass produced before. There are also questions about the length of immunity to Covid-19 after being vaccinated and the preparedness of supply chains to mass manufacture and distribute enough vaccines at the scale and speed required.

High-profile figures in the medical community have warned the public against seeing a vaccine as a panacea

FORCES AT PLAY

In BlackRock's view, there are some significant forces at play. Firstly, due to the Covid-19 fallout higher global production costs are likely.

Deglobalisation and the remapping of supply chains will be accelerated by the post Covid-19 desire to achieve greater resilience against a range of potential shocks, it says, adding that reduced global competition in economies may embolden companies to hike prices when domestic cyclical pressures rise.

Selected large companies have more pricing power than ever to pass higher labour costs on to customers.

Secondly, major central banks are evolving their policy frameworks and explicitly intend to let inflation overshoot their targets.

BAD FOR GROWTH STOCKS

According to AJ Bell investment director Russ Mould, a strong recovery with this type of rising inflationary environment would be bad for growth stocks, such as all the tech names which have soared this year.

This is because a lot of growth stocks trade on a big premium to wider markets as growth is seen to be scarce.

Mould explains: 'In an inflationary recovery growth wouldn't be scarce at all, you'd be able to pick it up in the street. You'd get it from cyclicals, financials and emerging markets, all of which are bombed-out, having performed badly, and all of which are in the value bucket.

'They're all a lot cheaper and therefore if you got a strong inflationary recovery, it would potentially be the catalyst for value after a decade or more in the doghouse.'

Here are two stocks worth buying if you think this scenario will happen.

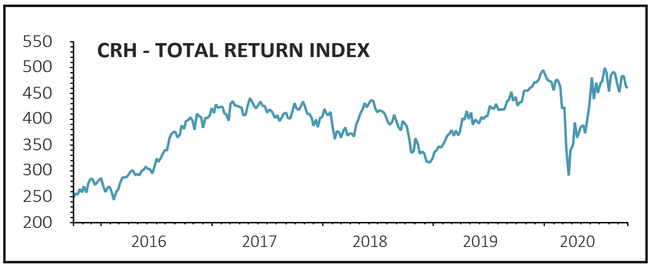
INVESTMENTS TO MAKE IN THIS SCENARIO

CRH (CRH) £27.97

CRH: The Queensferry Crossing, near Edinburgh, Scotland

Construction materials group **CRH (CRH)** has a measure of insulation from fluctuations in the economy thanks to its diversification and exposure to infrastructure spending – with governments likely to spend big in this area to help kick-start the recovery from Covid-19.

That said, construction in the round remains a highly cyclical sector and a material rebound in the economic outlook would substantially improve the prospects of CRH after it saw revenue dip 3% in the first half of 2020 to €10.9 billion.



As it currently stands, CRH is forecast to see pre-tax profit drop to €1.78 billion this year before bouncing back to €2.1 billion in 2021 – in line with 2019's result. For 2022, analysts forecast €2.4 billion pre-tax profit. A pick-up in economic activity could easily result in these forecasts being lifted.

BHP (BHP) £16.45

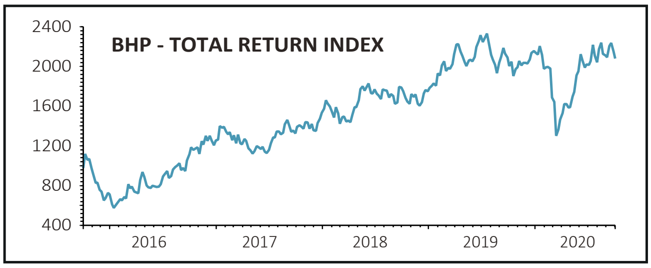
According to Morgan Stanley, metal prices could rise in the 12 months following an increase in inflation expectations, potentially by as much as 50%.

An increase commodity prices would be good for miners, particularly the big diversified ones which dig lots of different metals out of the ground.

Among the major diversified miners on the London market, **BHP (BHP)** stands out due to its attractive commodity mix.

The miner produces copper and iron ore – two metals which typically do well in a strong economic recovery – and it also has big exposure to nickel, a metal set to be increasingly important in the electric vehicle revolution.

Unlike **Rio Tinto (RIO)** and **Anglo American (AAL)**, BHP has no exposure to the diamond market, which is in structural decline and has been significantly affected by the pandemic.



BHP: Nickel West Australia

SCENARIO 2: WEAK ECONOMIC RECOVERY, LOW INFLATION

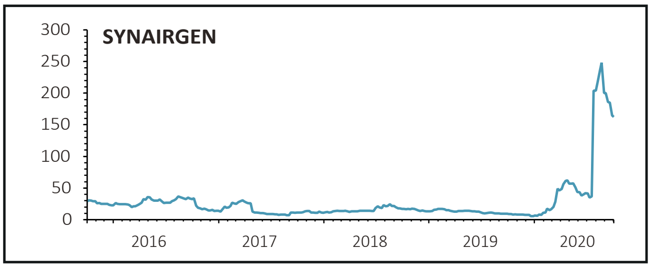
THE SECOND scenario is that we see weak economic activity with low levels of growth and little inflation, something it is argued we've had for the last 10 years anyway.

This scenario would benefit growth stocks, many of which have done well as the coronavirus pandemic accelerated certain trends.

Working from home and the faster shift to online shopping have benefitted the big tech firms and online retailers.

Healthcare stocks have also outperformed. Having been out of favour with investors for the last few years they've become hot property with some remarkable share price performances since the pandemic started.

For example, respiratory drug development company **Synairgen (SNG:AIM)** soared as much as 430% a single day following a major breakthrough in treating hospitalised coronavirus patients.



The share price rally of such stocks is getting increasingly harder to justify, particularly as the underlying landscape in the sector has become a lot more competitive, which raises the risk that perceived financial benefits could quickly disappear if another firm finds a better or cheaper solution.

But on a broad sector basis some analysts see growth stocks continuing to do well, as guidance from the major central banks for low interest rates to continue for the foreseeable future continues to push investors towards growth companies.

WHY GROWTH STOCKS?

Growth stocks have typically done well in a low interest rate environment compared to value stocks.

Investors have been happy to pay any price to own a company that is growing its earnings, as that should also fuel the share price.

Central banks are currently looking to keep rates low because in theory the lower the interest rate, the more willing people are to borrow money to make big purchases, such as houses or cars. It is hoped this will create a ripple effect of increased spending throughout the economy.

WHAT ABOUT BONDS?

Along with growth stocks, bonds are the other asset class seen to do well in a weak economic recovery where interest rates are low and there's little sign of inflation picking up.

Morningstar investment analyst Nicolo Bragazza says this is because it comes down to duration, both for growth stocks and bonds.

Bragazza explains: 'Academic studies show there are shorter duration and longer duration stocks, value being shorter duration and growth longer duration.

'Value stocks, which tend to be companies in traditional sectors, have cash flows and pay dividends and their benefit for investors is short-term, but for growth stocks investors rely on the future prospects and the benefit of big cash flows in the future.'

He adds: 'There is a unifying view with bonds. A weak economic environment where interest rates are low is positive for longer term bonds and long duration stocks. But shorter duration bonds, like shorter duration value stocks, have underperformed.'

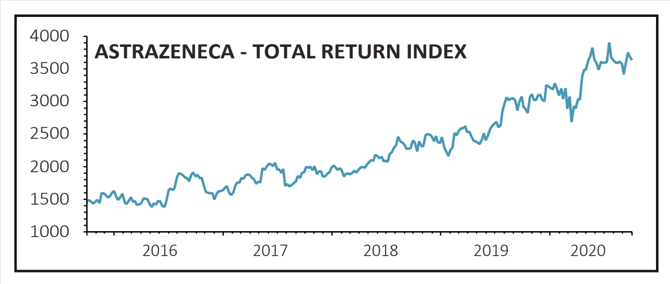
But Bragazza also points out there is a distinction in corporate bonds between investment grade bonds and junk or high yield bonds, with high quality bonds more likely to do well in a weak environment as those with a lower rating are more sensitive to economic activity.

Here are our two investment ideas if you think we're in for weak economic recovery with little inflation.

INVESTMENTS TO MAKE IN THIS SCENARIO

AstraZeneca (AZN) £85.10

Pharmaceutical giant **AstraZeneca (AZN)** has built a strong cancer drug franchise over the last few years and offers investors a robust growth outlook supported by a healthy pipeline of new drugs.



In addition, any positive news flow in relation to its Covid-19 vaccine candidate in collaboration with the University of Oxford should have a major influence on the share price. The European Medical Agency (EMA) has just started a review with the aim to speed up any future approval process.

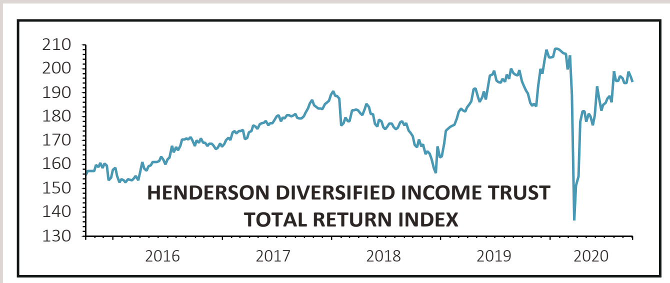
Near-term earnings momentum and an amply covered 2.6% dividend yield should remain attractive in a low growth, zero interest rate environment. The shares are not expensive on a price to earnings ratio of 19.6 for 2021 and 16.3 for 2022.

Henderson Diversified Income Trust (HDIV) 88p

If economic growth becomes anaemic and interest rates remain at historically low levels for an extended period, investors are likely to favour resilient businesses which have strong balance sheets. There are plenty of equity funds to choose from that focus on quality investments, but in the bond fund world they are relatively scarce.

Among the bond fund names that do have a quality focus is the £165 million **Henderson Diversified Income Trust (HDIV)**, managed by industry veteran John Pattullo and Jenna Barnard. It has a policy of lending to good quality businesses and a tight focus on strong free cash flow generation.

This strategy allows the fund to provide relatively safe income with a current yield of 5.1%. The fund has net gearing of 15%, ongoing management charges are 0.9% and it is trading on a 4% discount to net asset value.



SCENARIO 3: SEVERE SECOND WAVE OF CORONAVIRUS

THE THIRD scenario is a severe second wave of coronavirus cases, with the ensuing hit to the economy and further stimulus from governments and central banks to try to steady the ship.

In this scenario it's also likely there would also be a further debasement of paper currency, as one of the impacts of measures like quantitative easing is that it can devalue the country's domestic currency.

The expectation is that this would be beneficial for gold, which historically has done well in such scenarios and among other things is seen as a hedge against currency debasement.

Gold is typically viewed as one of the ultimate safe-haven assets because it is one of the very few assets which acts as a true store of value and has maintained its purchasing power over the years.

For example, if you put a stash of 500,000 Italian lira and a one ounce gold coin in your attic in 1990, and then found it 30 years later, that wad of lira would now be worthless but the gold coin – which back then would've been worth just under $400 – would've grown in value almost five-fold and now be worth $1,900.

HANG ON A MINUTE

However, Michel Perera, chief investment officer at Canaccord Genuity Wealth Management, points out that gold has been 'behaving erratically' this year and won't immediately correlate in the way people expect.

Gold has been 'behaving erratically' this year and won't immediately correlate in the way people expect

Michel Perera, Canaccord

He explains: 'Gold is behaving a little like a risk-on asset at the moment, not risk-off. It's correlating a lot more with oil, copper and equities, and I'm not sure gold will react as expected (in another downturn). It will eventually fall in line, but it won't do it immediately.'

Perera also thinks growth stocks will continue to outperform in this scenario, as the trends we've adopted over the past few months – working from home, more video calls via a computer, higher spending with regards to our health – are likely to continue, again benefitting the tech and healthcare names which have done well in the year to date.

GOLD MINERS

If gold does eventually perform as expected in the event that a severe second wave of coronavirus cases causes another big hit to the economy, then gold miners – a leveraged play on the gold price – should do well.

But in this case, picking the right gold miner is crucial as any operational issues or setbacks could hold them back from joining in the wider rally.

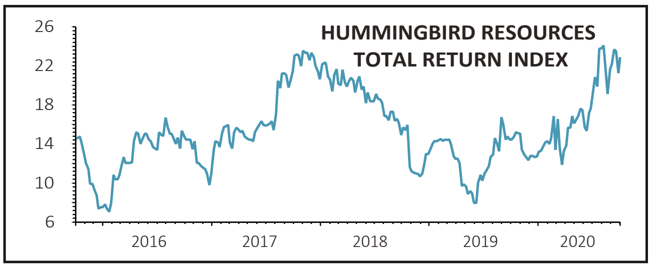
As well as our suggestion for a gold mining stock to buy if you believe there will be a severe second wave of coronavirus, we also suggest a financial trading platform provider which could do well if markets become really choppy again. Read on to get the details.

INVESTMENTS TO MAKE IN THIS SCENARIO

Hummingbird Resources (HUM:AIM) 37.9p

Like most gold miners, **Hummingbird Resources (HUM:AIM)** has had a good 2020 as reflected in its share price, yet it still trades on less than five times forecast earnings and has a more than reasonable price to book value of 1.14 times, according to Stockopedia.

The firm has paid down a chunk of its debt and reiterated its commitment to having no borrowings by July 2021.



Analysts appear to be excited by the company and Canaccord Genuity's Sam Catalano says that the Kouroussa gold project it recently bought could help generate further value for shareholders with the potential to double Hummingbird's production output.

A key risk to the share price is that one of its mines is in Mali, where there has recently been unrest, but political risk comes with the territory of investing in any mining stock.

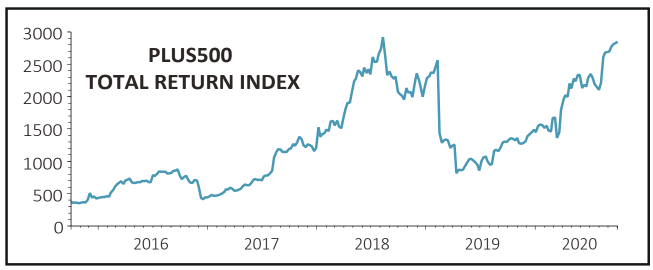
Plus500 (PLUS) £15.32

Heightened market volatility earlier this year was music to the ears of Plus500 as more people tried their hand at trading stocks.

Plus500 advertised heavily to make sure its name was in front of people looking to take advantage of big swings in the market. This strategy worked, leading analysts to upgrade earnings forecasts several times in 2020.

Its shares have risen 76% year to date and the company has delivered a stream of good news.

Another market wobble caused by Covid-19 becoming more severe would be a tailwind for Plus500. As such, we believe this stock would significantly outperform the market in the event of a bad second wave.



Renishaw is one of the best UK businesses on the market

Investments in areas like neurology and 3D printing technology could create tremendous value in the future

Despite a strong recovery for the share price since the big correction in March, the market is still underestimating the long-term potential at precision engineering firm **Renishaw (RSW)**.

FOUNDERS STILL HEAVILY INVOLVED

More than 50% of Renishaw's shares are owned by founders David McMurtry and John Deer who occupy the executive chairman and non-executive chairman roles, having set up the business in 1973.

In this article we will explore how the company is investing for future growth and why investors with a five to 10-year timeframe should buy the stock and hold it through good and bad times.

A CROWN JEWEL

The company is one of the UK stock market's crown jewels. It is a genuinely outstanding business and a global leader in the development and manufacture of high-end precision measurement kit.

Renishaw's products are used across a range of sectors including healthcare and automotive. Its products run from 3D printed customised medical implants to the hardware and software used in improving the calibration and performance of machine tools.

The company's deep reserves of skill and expertise have helped to erect significant barriers to entry to its areas of business and reduce the competitive threat it faces. To maintain this position, it consistently allocates around 15% of sales to research and development.

In the words of investment

bank Berenberg: 'We find a lot to like about the business: market leadership, founder-led, high insider ownership (c50%), net cash balance sheet and exceptional margins (c30%) and returns (c40%) in good markets.'

At present upwards of 90% of revenue and profit comes from metrology – essentially the precision measurement bit – but it is investing heavily in its neurology and additive manufacturing (3D printing) solutions which Berenberg believes could add £500 million in earnings and add billions of pounds worth of value to the group over time.

17%
Revenue invested in research and engineering
Source: Renishaw Annual Report 2019

GROWTH OPPORTUNITY

Renishaw designs and makes 3D printing systems which employ the complex laser power bed fusion process, specialising in areas which require high volumes and high levels of precision.

The company believes its RenAM 500Q machine can help reduce the cost of this production method and open up new markets which are currently dominated by conventional manufacturing.

This equipment could also be employed in conjunction with other Renishaw products and offered to its existing customer base.

The group is developing machines and equipment for the treatment of neurological disorders like Parkinsons and epilepsy. These encompass four main areas: its Neuroinspire surgical planning software, its Neuromate robot which enables reliable and accurate placement of electrodes within a patient's brain, Neuroguide tubes and implants used to support this process, and its Neuroinfuse drug delivery system.

The differences between this part of the business and the remainder of Renishaw were acknowledged by the creation of a new entity – Renishaw Neuro Solutions.

The company is currently engaged in clinical trials with Finnish healthcare firm Herantis Pharma, whereby Herantis provides the drug and Renishaw takes care of the delivery system.

In early September 2020 the partners announced positive results from the latest stage in this process.

COVID HIT

The company was not immune from a Covid-19 impact, particularly given it has exposure to the aerospace sector, with

RENISHAW'S RECIPE FOR SUCCESS

The company continuously invests in R&D and has masses of in-house intellectual property. It is also a vertically integrated business – with high quality manufacturing facilities in the UK, Ireland, Germany, India, the US and France. This enables it to keep close control of its supply chain and ensure the highest levels of quality control on its products.

The company has a highly embedded position with its customers and looks at how its products can best benefit individual businesses with well-resourced and skilled sales and technical support teams. The idea being to work in partnership with clients to understand and solve their problems.

adjusted pre-tax profit down 50% to £48.6 million in the 12 months to 30 June.

Dividends have also been paused to preserve the balance sheet, which showed a net cash position of £120.4 million as at 30 June, and the pressures on demand brought about by the pandemic will likely be reflected in an upcoming trading update on 22 October.

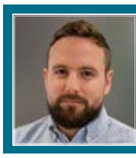
However, it was notable that Renishaw was able to maintain supply to its customer base throughout lockdown. The company has also taken costs out of the business which should make it more profitable as demand recovers.

The shares are richly priced – at £57.85 and based on Berenberg forecasts they trade on 59 times 2021 earnings per share (EPS) and 38.5 times 2022 EPS. However, Renishaw is rarely cheap and this story is not about the next two or three years of earnings but the long-term potential driven by investments in new products and technology. A solid buy.

94%

Export sales outside the UK in key markets

Source: Renishaw



By **Tom Sieber**
Deputy Editor

RUSS MOULD
AJ Bell Investment Director

Predictions for a FTSE 100 earnings rebound look shaky

A profit recovery for the index depends heavily on sectors like financials and oil and gas

No-one can agree upon the origins of the quote, 'hope is not a strategy'. This column cannot be sure and a trawl of the internet sees commentators attribute to everyone from former US president Barack Obama to film director James Cameron to former New York City mayor Rudi Giuliani to one-time Green Bay Packers American football coach Vince Lombardi.

One thing is certain however – hope is not a strategy when it comes to investment. Any selection should be made with downside protection in mind first, followed by a clear assessment of potential returns, with a set price target or overall gain, to ensure that possible rewards more than compensate for the possible dangers.

At the moment, it seems as if fears of an extended economic downturn thanks to a prolonged pandemic are being offset by investors' hopes for more fiscal and monetary stimulus, which they feel in turn will stoke a sharp recovery in profits, dividends and – presumably share prices and asset valuations – in 2021 and beyond.

This scenario could yet pan out and it is unlikely that central banks and governments will stop running quantitative easing schemes, racking up budget deficits or even experimenting with new ideas such as Modern Monetary Theory or Universal Basic Income if the economic outlook becomes any more uncertain.

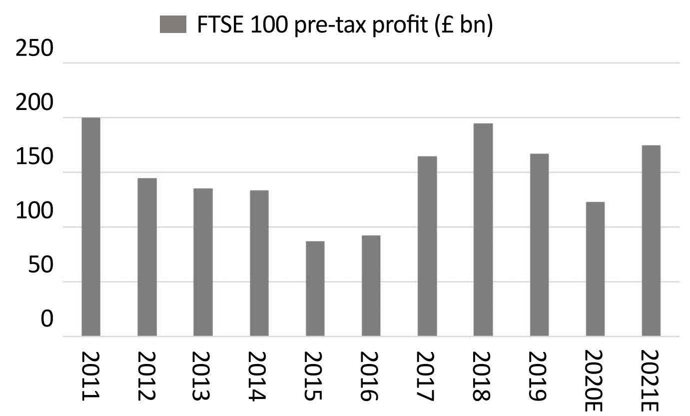
They do seem to be underpinning hopes for a rapid recovery in UK plc's earnings power, at least if trends in FTSE 100 earnings forecasts are any guide.

TRIO OF TESTS

Taking an aggregate of the bottom-up forecasts for all 100 members of the UK's premier index, analysts are currently expecting a sharp rebound in pre-tax profit to £174.2 billion in 2021, from 2020's £122.2 billion.

To test the reliability of such an estimate – and whether it is a safe assumption upon which to base an assessment of the valuation of the UK market (since the FTSE 100 represents over 80% of its market cap and earnings power) – investors can look at three barometers.

Analysts are forecasting a big bounce in FTSE 100 earnings in 2021



Source: Company accounts, Sharecast, analysts' consensus forecasts

RUSS MOULD
AJ Bell Investment Director

The first is how the 2021 forecast compares to recent history.

An outcome of £174.2 billion in 2021 would take next year's pre-tax profit total for the FTSE 100 to a level 5% above that of 2019 and one just 10% below 2018's all-time high. Investors must weigh the effects of the pandemic, the efficacy of policy response and how corporate and consumer behaviour may (or may not) change as part of their analysis here.

The second is to gauge analysts' confidence in their own forecasts. This can be done by tracking momentum in the estimated aggregate profit totals.

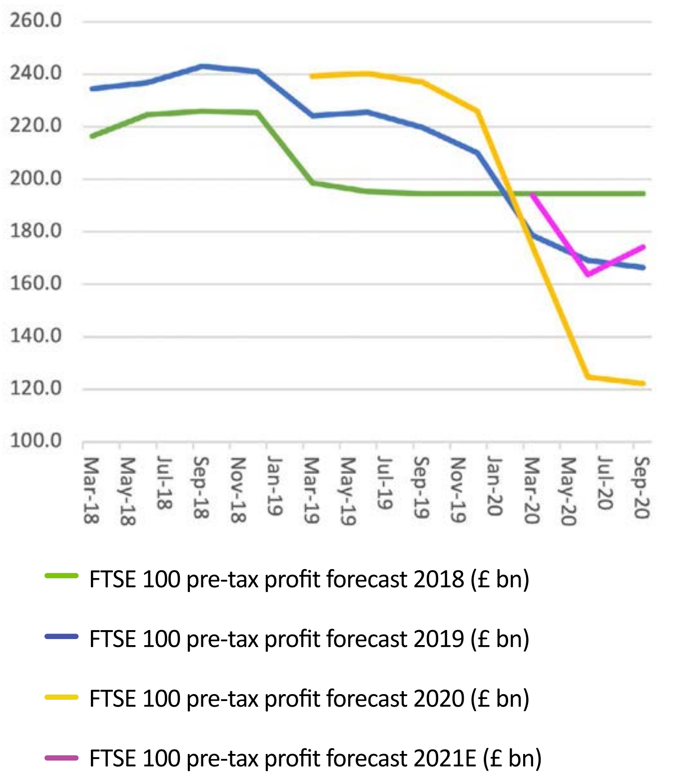
The bad news is that estimates for 2020 are still sliding lower, as the pandemic refuses to go away and the Government juggles policies designed to protect the public's physical health with the need to manage its financial health.

The good news is that estimates for 2021 have started to creep higher. A 6% upgrade in analysts' earnings forecasts since July offers some encouragement.

The third is to look at the mix of the earnings recovery, by sector and stock.

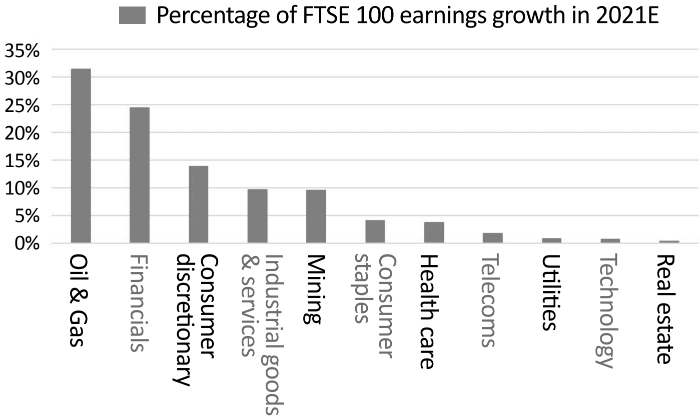
In terms of sectors, oil and gas is expected to generate nearly a third of the FTSE 100's £52 billion jump in pre-tax profits on its own. Another quarter of the increase is seen coming from financials (banks and insurers) and another quarter from consumer discretionary and industrial stocks.

Consensus FTSE 100 earnings estimates for 2021 are creeping higher



Source: Company accounts, Sharecast, analysts' consensus forecasts

Oils, financials and cyclicals are seen spearheading the FTSE 100's earnings recovery in 2021



Source: Sharecast, analysts' consensus forecasts

This picture is confirmed by the company-by-company breakdown of forecast FTSE 100 profit growth. **BP (BP.)** and **Shell (RDSB)** top the list, with four banks also in the top 10, alongside two miners – **Glencore (GLEN)** and **Anglo American (AAL)** – as well as British Airways owner **International Consolidated Airlines (IAG)** and aerospace supplier **Rolls-Royce (RR.)**.

It seems fair to say this is a high-octane mix. If there is a strong global economic recovery, thanks to a vaccine, fiscal and monetary stimulus or the virus simply becoming less potent, then the UK could well be a very interesting place to invest. Consensus forecasts put the FTSE 100 on 13.6 times earnings for 2020 with a prospective yield of 4.2% and sentiment on cyclicals – and especially oils and banks – is washed out.

If the opposite happens, and the pandemic lingers and drags the economy down, it would be unwise to put too much faith in forecasts of a rip-roaring earnings recovery, or that 4.2% dividend yield for that matter (although that still comes in at 3.7% if you assume the banks pay nothing again, thanks to regulatory or economic pressures).

The drive away from hydrocarbons and toward renewable energy could also hold back BP and Shell, and thus the FTSE 100, in the near term.

Just 20 firms are forecast to generate more than 80% of the FTSE 100's profits growth in 2021

	Change in forecast pre-tax profit 2021E (£ million)
BP	9,942
Royal Dutch Shell	6,349
HSBC	3,896
International Cons. Airlines	3,330
Lloyds	2,577
Rolls Royce	2,568
Glencore	2,509
NatWest Group	2,389
Barclays	2,084
Anglo American	1,274
AstraZeneca	1,246
Vodafone	831
Standard Chartered	699
British American Tobacco	698
Compass	585
Whitbread	576
Prudential	525
Associated British Foods	475
Unilever	437
Tesco	389
TOTAL	43,379
TOTAL FTSE 100 estimated growth	51,960
Contribution from the 20 stocks	83%

Source: Sharecast, analysts' consensus forecasts

Why do shares sometimes react so differently to positive news updates?

Much depends on expectations and good news often travels slowly

It's fair to say that more often than not as human beings we overreact to information, which in turn can lead share prices to overreact in the short term.

Yet, as our recent article on momentum showed, if a stock is in a clear trend – positive or negative – it can experience a lot of short-term volatility but remain in that trend for some time, often longer than most investors anticipate.

If markets were genuinely efficient, share prices would incorporate all available news, good and bad, at all times. The only thing which should prompt a share price to go up or down would be new news of a company-specific nature, not news about the market in general.

GROUND RULES

However, the market has a tendency on the one hand to get over-excited about the future, continually bidding stocks up and on the other hand to take a bleak outlook and send share prices lower.

In other words, whenever a company releases news – good or bad – context matters greatly. Delivering good news when markets are in panic mode is

unlikely to stop a company's share price from falling.

Then there is the matter of degree. Good news can actually be bad news if it fails to meet the weight of investors' expectations. Delivering a 25% increase in earnings would normally be enough to see a company's share price jump, but if investors are primed for a 50% earnings increase it's quite possible the shares will fall instead.

If you see shares fall on what at face value appears to be good news, it can be a sign that market expectations are too high. If that's the case, investors may have got ahead of themselves and the shares could be vulnerable to further selling as expectations are reset.

This is arguably what happened to food-to-go retailer **Greggs (GRG)** in January when it said full-year 2019 earnings would be 'slightly higher' than management had previously forecast, sending its shares down rather than up.

After a diet of constant positive earnings surprises, investors were expecting fireworks but instead the news was a damp squib. The arrival of the coronavirus has since led to a drastic rebasing of growth expectations.

MANAGING EXPECTATIONS

This is why companies spend so much time managing expectations, through trading updates, analyst and media briefings and presentations to investors. No finance director wants to see his company's shares hammered due to poor communication, so there is a tendency for companies to set achievable earnings targets in order to be able to deliver a small 'beat' each quarter.

It should be said that, if results are going to be way above forecasts – or for that matter way below them – companies have a duty to pre-announce this news to the stock exchange so as not to withhold market-sensitive information.

The issue with managing expectations, however, especially if part of the directors' pay is based on share price performance, is companies can find themselves having to improvise and discover new ways of beating consensus forecasts.

We aren't talking fraud on the scale of firms like Wirecard, but investors should be on their guard for companies using unusual accounting techniques or making deals to give the appearance that their businesses are hitting their targets when in fact they aren't.

REPEAT OFFENDERS

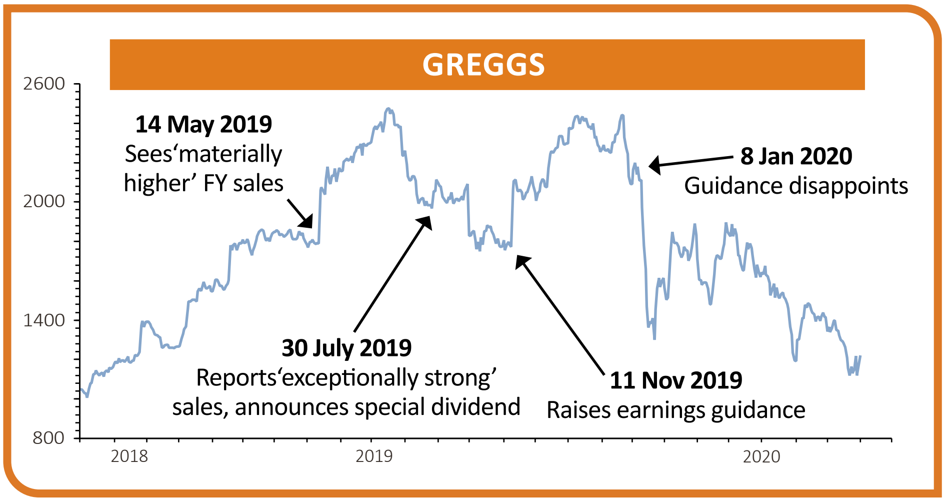
A third factor to take into account when a company reports is sentiment. If a firm has consistently disappointed investors and analysts have had to repeatedly lower their forecasts, the chances are that one piece of good news won't be enough to change the market's view.

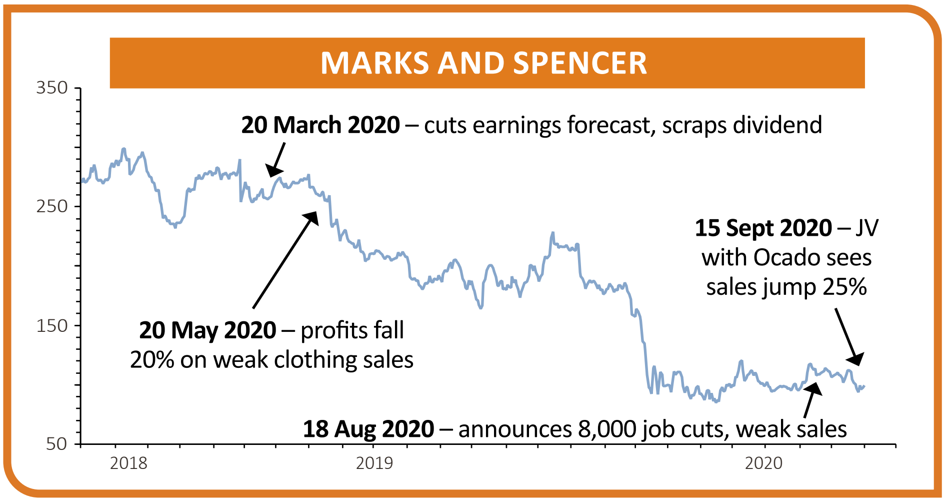
Royal Mail's (RMG) double-digit intraday rally on a positive revenue surprise (11 Sep) demonstrated that a bombed-out stock can bounce in the short-term.

It's well known that we experience pain a lot more intensely than we experience pleasure, and it's the same with investing. If we lose money in a stock, we are unlikely to look at it again with the same enthusiasm – once bitten, twice shy, as the saying goes.

Therefore it can take a lot of good news before an under-performing company truly turns the corner and investors begin to trust it again. A good example might be retailer **Marks & Spencer (MKS)**, which had loyal fans up to 2015 when its shares traded close to 600p, but which has disappointed in terms of sales ever since and lagged the FTSE 100 to such an extent it was finally ejected from the index in June.

Recent news flow has actually been quite positive, especially in terms of sales of its food and household products on the new online retail platform jointly-owned with **Ocado (OCDO)**, but the shares are still trading below 100p and we get the sense that after years of being let down many investors have given up hope of a revival.





By **Ian Conway**
Senior Reporter

The investment trust that says ditch growth stocks and buy value

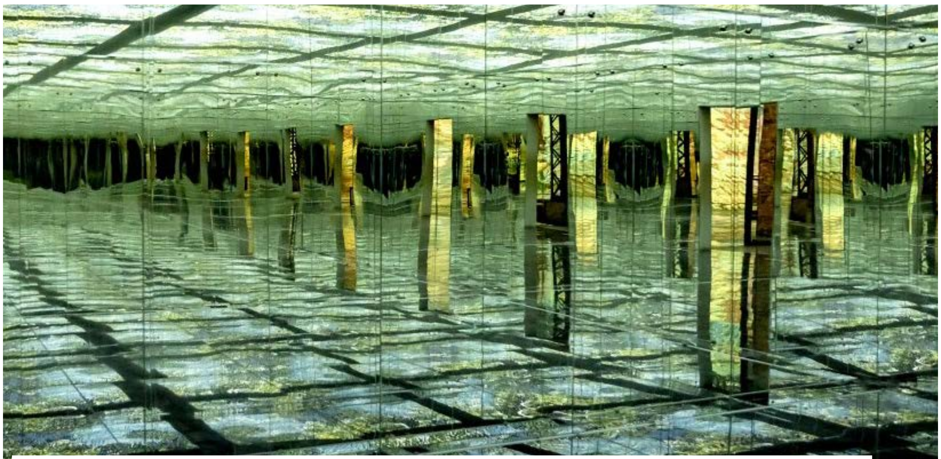
Henderson European Focus Trust's John Bennett believes it is 'game on' for a V-shaped recovery in Europe

Growth has been all the rage with investors for the past decade but there could be change ahead. **Henderson European Focus Trust (HEFT)** says it is time to sell growth and buy value.

Co-manager John Bennett believes inflation is coming which will drive a contraction of price to earnings (PE) multiples. 'And when that happens, you'll want to own a completely different kind of stock, and it is not growth stocks,' he insists.

Bennett says Henderson European Focus has never positioned itself as either a 'full fat' growth or value trust, commenting: 'We've always been a bit of a blend manager. We tilt to growth, or we tilt to value. The clear and increasing tilt from the second quarter of this year was to value and all we've done ever since is harden that stance.'

While the fund manager's latest conviction about the value style has yet to feed through into positive returns this year, the longer track record is encouraging.

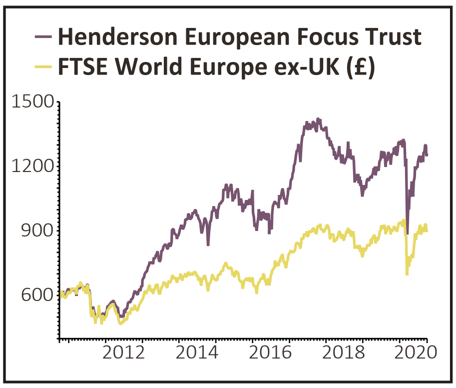


French construction materials group Saint Gobain features in Henderson European Focus Trust's portfolio

SEEKING INFLEXION POINTS

Henderson European Focus has a concentrated portfolio of between 35 and 45 European companies, scouring the continent for inflexion points where companies or sectors are set for a period of growth. The trust has a strong bias towards large cap companies, namely market price tags of €1 billion and above.

It has comfortably outperformed the FTSE World Europe ex-UK index over the past decade, returning 188.2% versus 119.2% for the benchmark.



It outperformed in seven of the 10 years to the end of 2019, but 2020 has been a tougher period where a 5.8% loss to 30 September compares with a mere 0.5% decline for its benchmark. That's left the trust trading at a 12.6% discount to net asset, versus a 10.9% average discount over the past 12 months according to Morningstar.

This wider discount does come with some benefits though. It means investors can access a portfolio of household names well below their market value including food giant Nestle, German enterprise tech sector titan SAP, drug maker Roche and paints and coatings maker Akzo Nobel.

PORTFOLIO CHANGES

'We've been selling the winners

of the last decade or more to buy the losers,' says Bennett, 'but we hope they are the past losers, not the future losers. We've bought autos, so our portfolio now owns Daimler and Peugeot – I've spent a career avoiding those names, so this is a very fundamental change.'

The stock picker has sold down consumer staples such as **Unilever (ULVR)** and Danish brewer Carlsberg, as well as pharmaceutical stocks including Novartis, while also reducing its exposure to the technology sector.

"We've bought autos, so our portfolio now owns Daimler and Peugeot – I've spent a career avoiding those names, so this is a very fundamental change"

John Bennett, Henderson European Focus Trust

The manager believes this is a 'game on' V-shaped recovery in which many European businesses are participating, particularly in sectors such as capital goods. Bennett, who also bought back into European banks in early June, concedes that 'as we've gone more value, we've deliberately gone down the quality curve a bit'.

Yet he is adamant Henderson European Focus hasn't bought hyper-leveraged companies. He says: 'We've bought stuff with strong balance sheets and strong or changing management. That's why we bought Daimler, that's why we bought French construction materials group Saint Gobain. I love to invest in management change.'

He highlights the holding in LafargeHolcim, the world's largest cement maker, where new management have been 'gripping that big underperforming empire'. He's convinced they are going to turn it around.

Bennett believes we are living through what will be looked back upon as a seismic shift geopolitically, economically, and for markets and the kind of assets and stocks investors want to own.

'We're coming to the end of a 40-year regime in financial markets and we're coming to the end of the American century and handing over to the Asian and Chinese century, so not tactical but very, very strategic.'

THE INCOME CHALLENGE

Europe hasn't been able to avoid the wave of dividend cuts and suspensions triggered by the Covid-19 pandemic, but Bennett points out 2.8% yielding Henderson European Focus Trust held the payout for the half year to 31 March at 9.6p, and has ample revenue reserves to 'tide us over while we await the return of dividend growth to the portfolio'.

At the interim results, chairman Robert Jeens also said the trust was well-placed through its revenue reserves to smooth dividend payments.

However, he added: 'It will be important to assess the likely longer-term revenue impact of this crisis. The board will consider what final dividend to propose at the end of the year in the light of the relevant evidence available at that time.'

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

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Where do I stand with tax if I gift £100,000?

Tom Selby weighs up the tax implications of a reader giving money from their pension

I am 71 and have a SIPP which may exceed my £1.25 million lifetime allowance by the time I reach 75.

I am considering shortly making a gift of £100,000 to my child from this pension pot. Would this: (a) reduce my tax liability at age 75 by reducing the amount of my pension pot? (b) be tax-free?

David

Tom Selby
AJ Bell
Senior Analyst says:

As you have a lifetime allowance above £1,073,100 (this is the lifetime allowance for the 2020/21 tax year) I assume you have individual or fixed lifetime allowance 'protection'.

For those who aren't familiar with pension tax rules, each time the Government has cut the lifetime allowance – which caps the amount someone can build up in pension savings over their lifetime – it has introduced new forms of protection designed to ensure those who had already built up funds worth more than the new, lower limit were not adversely affected.

This article explains more about how these protections work and the lifetime allowance in general.

To make a gift from your SIPP you would first need to access the money, creating an immediate income tax charge unless you only withdraw tax-free cash.

The income tax would apply to the entire withdrawal if you had already 'crystallised' your fund prior to accessing the money on this occasion. Crystallising just means choosing a retirement income route such as drawdown and usually taking your 25% tax-free cash.

If you were crystallising the funds now, depending on how much lifetime allowance you have left you may be able to take the entire £100,000 as tax-free cash. Alternatively, you could take a lump sum where up to 25% of the withdrawal would be available tax-free, with the rest subject to income tax.

The gift could also eventually be subject to inheritance tax upon your death. Money left in a pension, on the other hand, would be IHT-free and could be passed on to your nominated beneficiaries tax-free if you die before age 75.

If you die after age 75 it would be passed on at your recipient's marginal rate of income tax – although they would only pay this when they made a withdrawal.

I am assuming the purpose of depleting your fund by £100,000 – other than to gift the money to your child – would be to reduce your tax liability when HMRC 'tests' how much lifetime allowance you have used on your 75th birthday.

One of the lifetime-allowance tests HMRC makes is on the growth of your drawdown pot, so taking payments from your drawdown pot before you reach 75 can reduce or eliminate any lifetime allowance charges. Money taken out of your drawdown pot is subject to income tax.

From a tax perspective whether you access some of your pension before age 75 (and pay income tax) or leave the money in the SIPP (and pay a lifetime allowance charge of 25%) should make little difference.

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.

What would make people more interested in ETFs?

These types of funds are low cost but they are not (yet?) as popular in the UK as in the US

The passive funds market in the US is huge, with exchange-traded funds (ETFs) widely used by a range of investors, both novice and sophisticated.

Globally, the ETF market is worth more than $7 trillion, according to ETFGI, of which around $4.6 trillion is in US-listed funds, while $1.08 trillion is in Europe-listed funds.

The UK is behind the curve when it comes to the everyday appeal of these products – why is that, and what can the funds industry do to change things?

WHY POPULAR IN THE US?

There are a few reasons why ETFs are so popular in the US. An important one is that they offer investors a tax advantage, which gives them an edge compared to active US mutual funds.

'The tax efficiency associated with ETFs is much stronger than the traditional US mutual fund alternative that most investors have used in the past,' explains Steven Dunn, US-based head of ETFs at Aberdeen Standard Investments. 'So, for high net worth investors with investments outside of a retirement account, that's a big deal.'

THE RISE OF ROBOS

Another reason for their popularity is the way the advice market has changed in the US, which set the stage for the rise of ETFs.

Describing this 'tremendous transition', Dunn explains that the way people were able to consume financial advice broadened and the advice model became more dynamic.

This resulted in more online investment offerings coming to the market from low-cost providers, triggering price competition.

Advisers who had traditionally used actively managed mutual funds moved towards lower-cost ETFs so they could maintain their advice fees while giving consumers cheaper funds.

'Once advisers had the ability to build a lower-cost portfolio that is transparent and tax-efficient, that contributed to the take-off in ETFs in the US,' adds Dunn.

While robo-advisers with risk-graded ETF portfolios are also now gaining ground in the UK, they are not yet on the same scale as some of the very established players in the US.

PRODUCT PIPELINE

Product development has also happened differently in the two markets. Dunn notes there used to be a perception that the UK and Europe were five years behind the US in terms of ETF development, but now the same types of funds you can buy in the US are available globally. 'What may lag behind a little is some of the infrastructure behind it,' he adds.

Kenneth Lamont, passive funds research analyst for Europe at Morningstar, says large providers selling ETF products into Europe will often launch in the UK first. This is partly to do with regulation and the structure of the market compared to the more fragmented European market. So, in that sense, the UK is ahead of the curve on the product side compared to Europe.

SYNTHETIC SUSPICION

But what type of ETFs are actually selling in each market? In the UK, there has been a lot of innovation with products in the smart beta area, or those offering factor or thematic exposures.

While the big, core building blocks of portfolios such as FTSE 100 or S&P 500 ETFs still account for the bulk of assets, there is product evolution going on, especially in the fixed income market, notes Dunn, and thematic funds have become more interesting to investors.

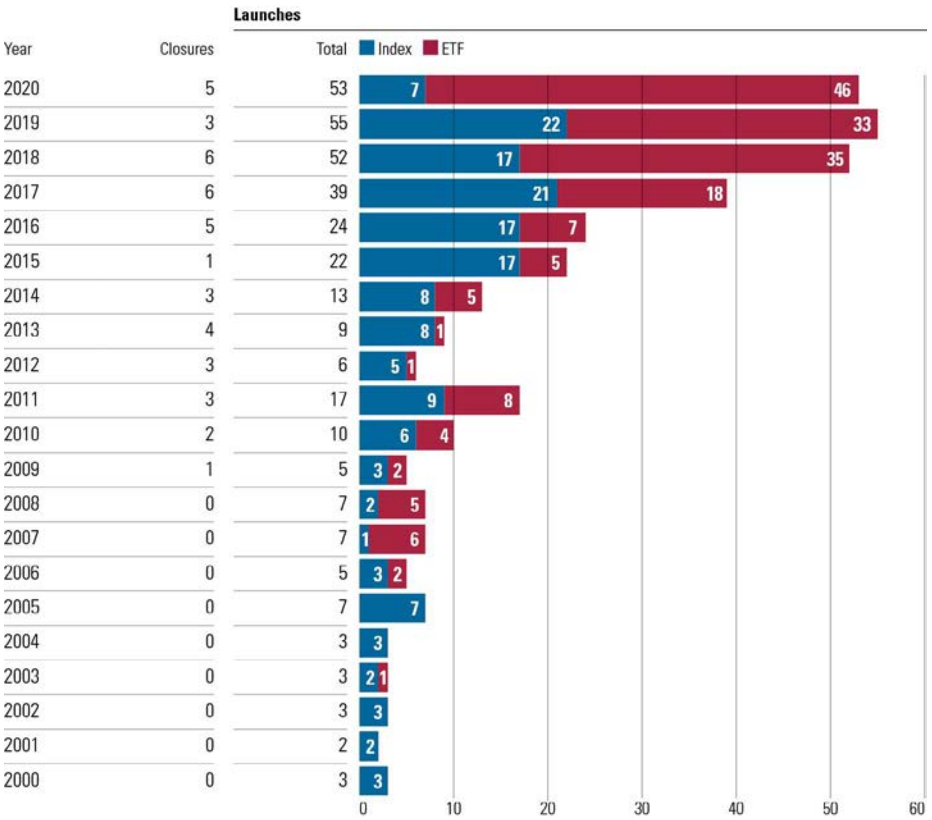
On the downside, one feature of the UK funds landscape has been investors' dislike of certain types of products, Lamont argues, notably synthetic ETFs. These use derivatives to replicate the performance of an index without actually holding the physical securities in that index.

'Another issue for the UK audience is that there's been a lot of suspicion with ETFs because in the past there were a lot of synthetic providers…and the use of derivative required a certain level of due diligence from a retail investor. People would rather buy a safe and simple product. In the US, you don't actually have any synthetics, or at least very few, so that's another big difference,' Lamont says.

ESG CHANGES THE GAME

The ESG revolution could be the thing that sees the UK and Europe catch up to the US on ETFs. Europe is the largest market for sustainable passive funds, according to Morningstar, accounting for more than three quarters of global assets, while the US represents 20%.

The number of sustainable investment ETFs has soared in recent years



Source: Morningstar Direct, Morningstar Research. Data as of 06/30/2020.

America has been a slow adopter of ESG, while at home we have wholeheartedly embraced the shift to a more responsible type of investing. ETF providers are rushing to roll out products which tap into this huge and growing trend, which is being largely driven by young investors who are tech-savvy, values-focused and open to using ETFs.

'We're seeing record levels (of inflows), record launches, and for once Europe is leading the charge on this so, yes, I think that will favour ETFs, there's a lot of product out there,' says Lamont.

But the US is waking up to the importance of ESG, with investors caring more about where their dollars go and product providers starting to respond.

'The US has been very slow to embrace the ESG aspects, and maybe that had to do with the legacy product, maybe they weren't as good, maybe the performance wasn't there. But you have seen the pendulum swing in the US as investors become much more aware of where and how they're investing,' says Dunn. 'ETFs play really nicely into that space because of their transparency, that will certainly provide a leg up to these products.'

If fund providers use the opportunity of growing investor interest in ESG to educate consumers on ETFs and market them better, perhaps they will soon become as mainstream here as they are across the Atlantic.

By **Hannah Smith**

Using the PEG ratio to find growth at a reasonable price

This metric helps you to identify the trajectory of earnings

The price-to-earnings (PE) ratio is a great starting point for beginner investors looking to get to grips with the valuation of companies listed on the stock market.

However, it has big limitations. It won't, for example, give you any idea on the trajectory of a firm's earnings.

THE PEG RATIO

A measure which takes the PE a step further and looks to incorporate earnings growth is the price-to-earnings growth (PEG) ratio.

This is not much more difficult to calculate than the PE. A stock's PEG rating is calculated by dividing the PE by the growth rate of its earnings for a one-year period.

PE ratio =	**Share price ÷ earnings per share (EPS)**
PEG ratio =	**PE ratio ÷ annual EPS growth (%)**

As with a PE it is more relevant to look at a forward-looking number, using earnings forecasts.

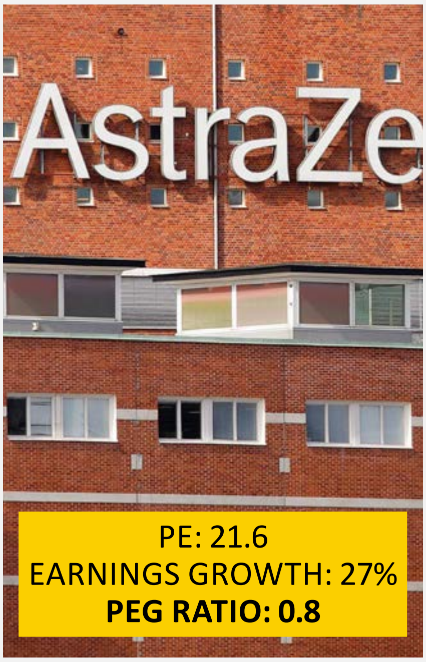
Websites like Sharecast and Reuters will have the forecast earnings per share figures for UK stocks which will enable you to work out both the PE, dividing the share price by the forecast earnings per share (EPS), and the level of EPS growth – comparing the forecast number with the most recent reported figure. If earnings are falling the PEG will be a negative number.

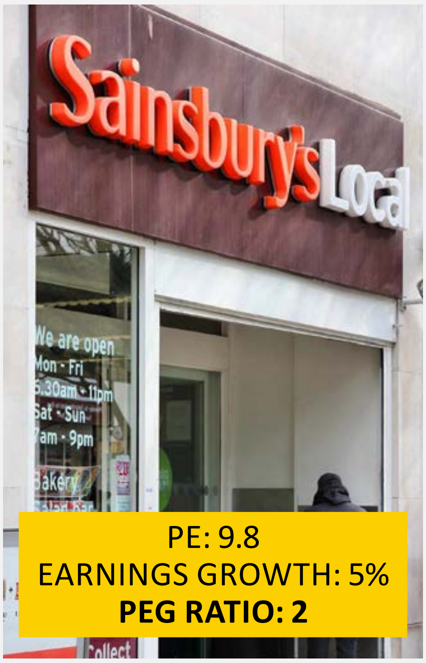
As a rule of thumb, a PEG ratio of 1 or lower is considered to demonstrate good value relative to the growth on offer.

The idea of so-called 'growth at a reasonable price' (GARP) and the accompanying PEG metric were brought to wider attention by Jim Slater in the early 1990s and explored in depth in his 1992 book *The Zulu Principle*.

Like the PE, the PEG is just

> ***"Any PEG of 0.5 or less should prompt serious questions and an analysis of the firm's financial, strategic and operational fundamentals."***





PUTTING PEG INTO PRACTICE

Let's look at two real-world examples to see how the PEG can add an extra layer of insight.

At a price of £84.94 and forecast EPS of 394.5p, pharmaceutical firm **AstraZeneca (AZN)** trades on a forward PE of 21.5. Its earnings growth is forecast to be 27%. That means the PEG ratio is 21.5 ÷ 27 = 0.8.

Supermarket **Sainsbury's (SBRY)** forecast EPS is 19.5p. At a share price of 192p this translates into a PE of 9.8. Earnings growth is forecast to be 5%. This implies a PEG of 2.

If you simply used the PE you might think Sainsbury's was much more attractively valued than AstraZeneca but the PEG helps tell you that Sainsbury's is not cheap compared to its growth profile, based on the principle that bargain stocks must have a PE of 1 or less. Conversely AstraZeneca looks better value using the PEG ratio.

a starting point for further research. It is a tool which might help you narrow down a search for a potential investment, but you need to understand the number in some context.

For example, an engineer might suffer a decline in earnings based on forecasts for the next financial year but is expected to grow earnings by 11% in the following year. The first year PEG is therefore meaningless while in year two its PEG might be a reasonable 0.9. This highlights a problem with PEG in that it is less effective for cyclical or volatile earnings patterns.

WHAT HAPPENS WHEN EARNINGS COLLAPSE AND RECOVER?

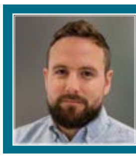
Let's assume a hypothetical company called Metal Basher had serious operational failures in its factory one year and saw its earnings fall 30% as a result. Having found a fix for the problems, earnings are forecast to rebound by 20% the following year and with the shares on a PE of just 10, this adds up to a PEG of 0.5.

The PE is depressed not just because the shares have adjusted to reflect the lower earnings but because they have also de-rated to a lower valuation to reflect the diminished reliability of said earnings. It might trade on a seemingly attractive PEG but Metal Basher is not really offering growth at a reasonable price.

And adopting the principle that if it looks too good to be true it probably is, any PEG of 0.5 or less should prompt serious questions and an analysis of the firm's financial, strategic and operational fundamentals.

It is worth examining the earnings trend over a period of time when looking at a PEG, and it is fair to say the metric isn't as kind to mature companies which generate stable profit and could still have appeal to investors thanks to their ability to pay out dividends.

Also, like the PE, the PEG is reliant on the veracity of earnings forecasts and takes no account of a company's borrowings. We will look at a measure which incorporates debt in the next part of this series.



By **Tom Sieber**
Deputy Editor

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Trading statements

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