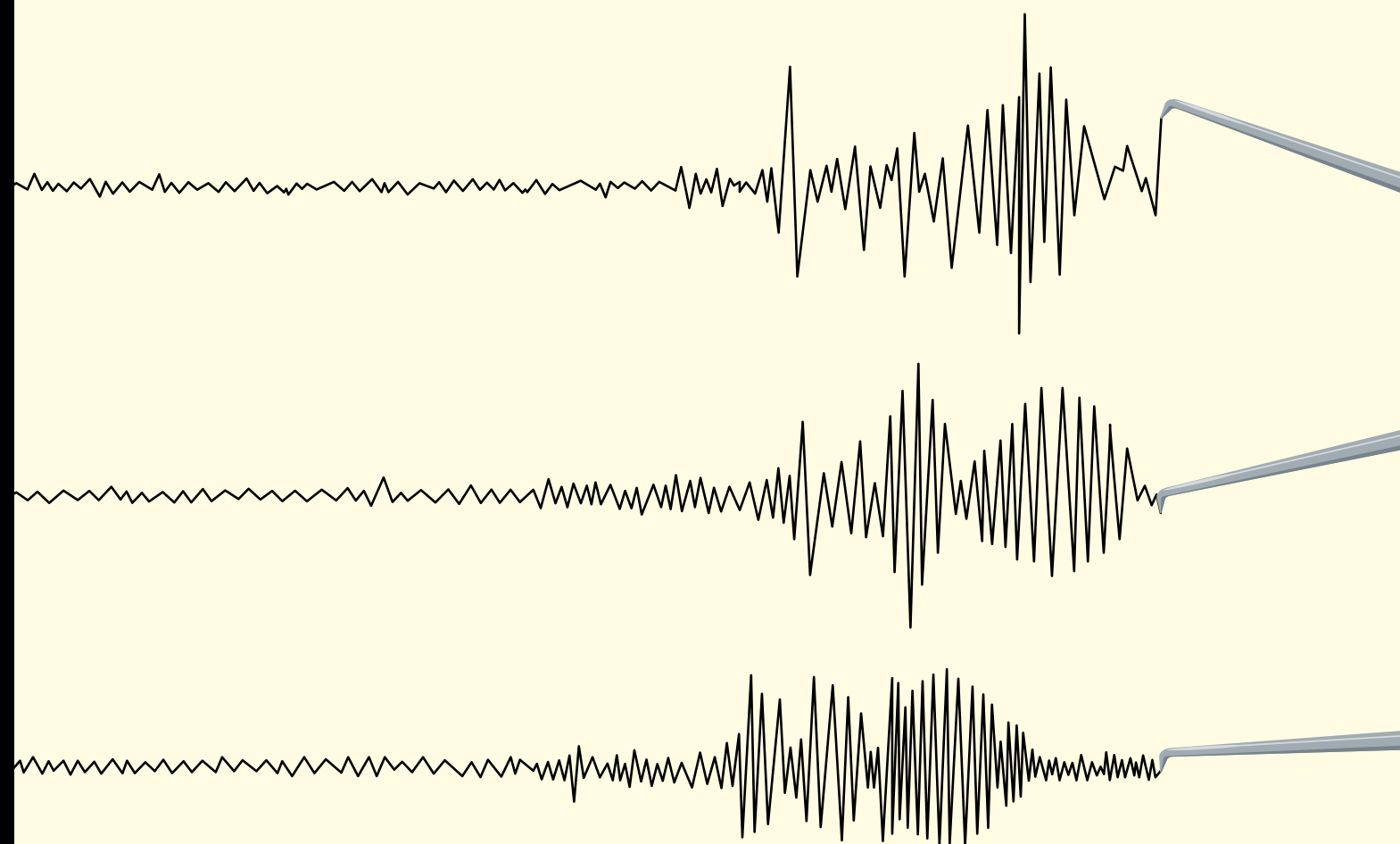


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**What could happen next after the  
mini-Budget earthquake**

**FEATURE**

Reasons why it pays to invest in small caps  
despite recent sell-off





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# The best investors are hunting for their next winners while stocks are on sale

It's been a brutal year but don't take your eye off the long-term opportunities

It's a difficult time to be a manager of a growth fund in the current market. Investors are no longer willing to pay high earnings multiples to own these types of stocks, and inflationary pressures mean growth is evaporating for many companies in this space.

This matters because investors have put a lot of faith in growth funds over the past decade as they've delivered some of the best returns. ISAs and pensions are full of these types of investment products.

For example, between the start of 2012 and 1 November 2021, the MSCI All Countries World Growth index generated a 345% total return in sterling, according to FE Fundinfo. That's nearly four times the 90% total return from the UK's FTSE 100 index.

There has subsequently been a reversal of fortunes. Since 1 November 2021 and the end of September 2022, on a total return basis the MSCI All Countries World Growth index has lost 15% whereas the FTSE 100 has only dipped 2%.

So, for someone whose portfolio contains growth funds, the past 11 months have been challenging to say the least. Popular names to have taken a beating include **Scottish Mortgage (SMT)** which is down 49%, **Blue Whale Growth Fund (BD6PG78)** has dropped 26% and **Fundsmith Equity Fund (B41YBW7)** has lost 10%.

With everything looking so gloomy, it's understandable that market sentiment is poor. However, there is also a decent chance some good companies are now on sale at great prices.

History shows the market tends to overreact.



When everything is looking good, stocks can overshoot on the way up, and that's precisely what happened last year as we came out of the pandemic. Valuations got too rich for many businesses. This year the opposite has happened, with companies being sold down indiscriminately regardless of whether their growth prospects have got worse, stayed the same or improved.

It may feel hard given the background noise, but now could be a good time to start looking for the stocks that could deliver good returns in the future. Posting on Twitter, fund manager Simon Young (@UKstockpicker) recalled one of his mentors who ran the Mercury Keystone Trust, who said that in periods with big share price declines, 'buy a little bit of sensible companies and in the long run you'll do ok.' That's a sound approach.

A lot of growth funds will be setting themselves up for the next leg by picking up quality stocks that don't normally trade this cheaply. For example, George Sakellaris, manager of the **Brown Advisory US Mid Cap Growth Fund (BYW8R75)**, says he has been buying quite a few stocks since markets turned down.

Sakellaris accepts there could be more downgrades to earnings forecasts and that the broader economic backdrop isn't great, however being an investor is about taking advantage of opportunities and he believes there are plenty of them available.

**DISCLAIMER: The author owns units in Fundsmith Equity Fund**

# Why dollar strength and foreign exchange volatility is bad for stock markets

While the pound has been weak it is dollar strength which is more worrying

**A**fter a relatively calm period foreign exchange markets have become a source of stock market uncertainty. Sharp moves in exchange rates are not conducive to international trade which has already suffered from the effects of the pandemic.

The recent 10% fall in sterling against the US dollar may help UK exporters (goods are cheaper for foreign buyers) but the other side of the coin is that imports become more expensive, contributing to inflation and reducing margins.

This puts pressure on the Bank of England to tighten policy when the government's loose fiscal policy is pulling in the other direction. The same tussle is happening in the US and the EU. The divergence is contributing to currency volatility.

## Year-to-date currency performance against the US dollar











Currency	Change (%)
 Brazilian Real	3
 Mexican peso	2
 Canadian dollar	-8
 Chinese renminbi	-11
 Australian dollar	-11
 South African rand	-11
 Euro	-14
 Swiss franc	-16
 UK pound	-17
 Japanese yen	-26

Table: Shares magazine • Source: Google Finance, data to 4 October 2022



The clear winner has been the US dollar. The world's reserve currency has been on fire, gaining around 20% against a broad basket of currencies.

Historically a strong dollar has been a harbinger of bad times to come. In 2008 the dollar gained 22% against that same basket of currencies amid the financial crisis and in 2020 on the eve of the pandemic it advanced 7%.

As a reserve currency the dollar is seen as a safe haven and investors tend to flock to it during times of market stress or fears of a downturn.

Morgan Stanley says every 1% increase in the value of the dollar reduces S&P 500 earnings by around 0.5%. It goes on to say the recent move in the greenback creates an 'untenable situation for risk assets' that has historically ended in a crisis.

The Japanese yen has fallen by more than a quarter this year to 24-year lows as the central bank sticks to an accommodative policy in contrast to most other banks.

Most commodities are priced in US dollars and its strength has made it more difficult for emerging economies which rely on importing food and other essentials. Several emerging economies also have foreign debts priced in dollars.

The Brazilian real and Mexican peso have held-up well with both currencies gaining against the US dollar, reflecting economic resilience and sought-after exports.

For investors with international portfolios, a weaker pound has increased the relative value of their foreign holdings. [MGam]

# FTSE 100 firms set for record cash return in 2022 but pressures are mounting

Just 20 names are expected to account for nearly 75% of the index's dividend payments in 2022

**F**TSE 100 companies are on course to return a record amount of cash to shareholders in the form of buybacks and dividends this year, but this generosity may not last given pressure on profit margins.

AJ Bell's latest Dividend Dashboard report shows that while the expected FTSE 100 aggregate dividend of £81.5 billion, up 11% year-on-year, is short of the record £85.1 billion seen in 2018, once you add in the £1.3 billion of special dividends and a record £50.3 billion buybacks, index constituents are on course for their largest ever cash return.

However, while the forecast 2023 dividend total of £87.7 billion would be an all-time high, it

would represent a slowdown in growth to 8% and, notably, earnings are not expected to keep pace, growing by just 4%.

Offering some comfort is that dividends on average are expected to remain covered more than two times by earnings, a traditional threshold over which payments are seen as reasonably secure.

Just 20 names are expected to pay nearly three quarters of the FTSE 100's dividends in 2022, a list dominated by resources, financial and healthcare firms. With oil and mining firms expected to scale back payments in 2023 after a bumper period, next year's dividend growth relies on banking, insurance and pharma stocks. [TS]

**DISCLAIMER:** Financial services company AJ Bell referenced in this article owns Shares magazine. The author (Tom Sieber) and editor (Daniel Coatsworth) own shares in AJ Bell.

## Resilient Greggs holds firm on outlook in good start for Roisin Currie

Value-for-money sandwiches-to-pizzas seller rallies on resilient quarterly showing

FOOD-ON-THE-GO firm **Greggs (GRG)** served up a surprisingly positive trading update for the third quarter to 1 October, with like-for-like sales from company-managed stores up 9.7% year-on-year.

Admittedly, growth did moderate in August as the food-to-go retailer lapped a prior year comparative boosted by 2021's strong 'staycation' effect, yet Greggs reported a reassuring pick-up in

September sales and left full-year guidance unchanged.

Greggs also reminded the market that supported by a strong balance sheet, it is working on developing ways of expanding capacity to 'support our significant growth ambitions'.

Reaffirmed guidance came as a big relief following a series of profit warnings from domestic consumer-facing names over recent weeks with investors particularly

pleased as new CEO Roisin Currie maintained the outlook for this year's cost inflation at around 9% rather than lift it.

Greggs insisted it now holds 'an appropriate level of forward purchasing cover in respect of our fourth quarter requirements for key food and energy commodities' and has 'significant energy cover for the first quarter of 2023, with average costs expected to be below the level of the recently-announced price cap'.

Labour costs could still be a headache for the business heading into 2023 and as pressures on household budgets continue to mount the resilience of Greggs' value-based proposition is likely to be further tested. [JC]



# Find out which stocks surged and slumped during a turbulent third quarter

Micro Focus and Synthomer among the biggest movers during a bumpy three months

**T**he FTSE 350 index finished a volatile third quarter to September 2022 down 4.5% amid continuing worries over stubbornly high inflation and rising rates as well as geopolitical instability.

A slew of profit warnings, notably from consumer stocks, and a sell-off following the mini-Budget, capped off a testing quarter for investors.

Stocks that performed strongly ranged from companies receiving bids to beneficiaries of surging energy prices and businesses that confounded the doom and gloom by reporting positive operational performances.

The best performing stock was **Micro Focus (MCRO)**, up 86% after it agreed a buyout by Canadian software giant OpenText. Hot on its heels with a 74.5% gain was inter-dealer broker and volatile markets beneficiary **TP Icap (TCAP)**, also boosted by reports institutional investors are pushing for a sale of high-margin data division Parameta, which could fetch as much as £1.5 billion, and a subsequent return of capital.

Also flying high were fast-growing payments play **Network International (NETW)** and **Bank of Georgia (BGEO)**, up more than 60% and 50% respectively with support from strong results, while promotional products seller **4Imprint (FOUR)** rose 46% as its sales reached record levels.

Among the index's worst performers were chemicals firm **Synthomer (SYNT)** and meat, seafood and vegetarian products packer **Hilton Food (HFG)**, which dived after profit warnings. Also leaving a sour taste was **Ocado (OCDO)**, off 39.5% after Ocado Retail, its online grocery joint venture with **Marks & Spencer (MKS)**, warned that 'trading down' by consumers meant full-year financial targets would be missed.

Looking at all UK-listed companies, stellar performers included commercial aircraft leasing

## FTSE 350 Q3 winners and losers

Stock	% change
Micro Focus International	86%
TP Icap	74.5%
Network International	60.5%
Bank of Georgia	52.2%
4imprint	46.3%
Synthomer	-52.7%
Hilton Food	-47.7%
888	-44.2%
Ocado	-39.5%
Jupiter Fund Management	-38%

Table: Shares magazine • Source: SharePad, % change 30 June 22 to 30 Sept 2022

concern **Avation (AVAP)**, which soared 650% as the aviation sector's post-pandemic recovery continued and the company signalled its return to profitability and said it had materially reduced its debt.

**Diurnal (DNL:AIM)** investors were in the money after the hormone-deficiency drug specialist agreed a premium-priced takeover from US-based neuroscience biopharmaceutical company Neurocrine, while **RPS' (RPS)** shares rocketed 129% higher after Tetra Tech gazumped WSP in a takeover bid for the consulting engineer.

Major third quarter casualties included online sofa seller **Made.com (MADE)**, which sank 92.7% in Q3 after revealing a desperate need for funding and hanging up the 'for sale' sign and embattled **Cineworld (CINE)** which is working through the Chapter 11 bankruptcy process in the US. [JC]

# Will Porsche shares surge like Ferrari or skid like Aston Martin?

Sports car maker lists in Germany with top of the range €75 billion valuation

**S**hares in **Porsche (P911:ETR)** have made a steady start after the German sports car maker listed shares in Frankfurt on 29 September 2022.

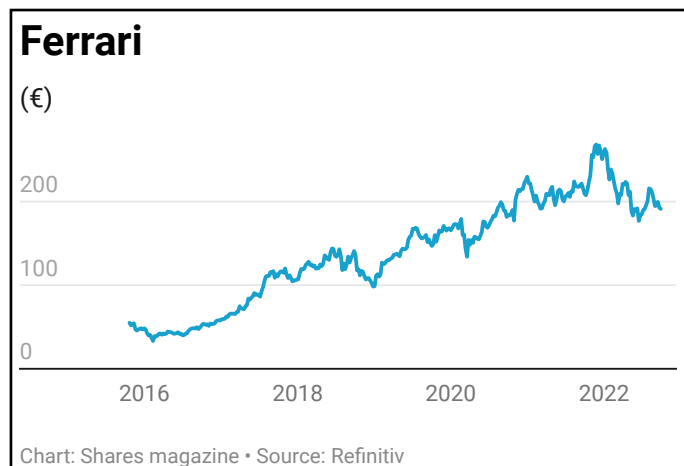
The shares climbed as high as €85.88 following the closely watched IPO (initial public offering), the largest listing in Germany in more than 25 years despite a backdrop of global economic uncertainty.

At the time of writing (4 Oct), the shares were changing hands at €83.08, having begun trading priced at €82.50.

Spun out of **Volkswagen (VOWG:ETR)**, Porsche's IPO valued the business at €75 billion. Volkswagen raised €19.5 billion from selling down some of its holding, with the proceeds being used to aid the company's electrification transition. It retains a 25% stake in Porsche.

Cornerstone investors included sovereign wealth funds from Qatar, Norway and Abu Dhabi, as well as T Rowe Price.

Car companies have had mixed fortunes listing on a stock market, with rival sports car makers **Ferrari (RACE:BIT)** and **Aston Martin Lagonda (AML)** perhaps the obvious examples of how fortunes can diverge.



Ferrari listed in 2016 and has since seen its share price rally nearly 400% thanks to consistent sales growth and 25% operating margins.

Aston Martin opened at £19 at the time of its IPO, giving the company a £4.1 billion valuation, although it had been hoping for a figure as high as £5.1 billion as late as the week of the launch. By the end of the first day of trading in October 2018 the shares had fallen to £18.10, and the flotation has been an unmitigated disaster ever since.

Its shares plunged to a historic low of 114.15p earlier this week with profitable growth remaining absent. The company recently raised more money by selling new stock through a heavily discounted rights issue, which saw Chinese auto group Geely acquire a 7.6% stake in the business.

Last month **Harley-Davidson (HOG:NYSE)** demerged its electric motorcycle subsidiary **LiveWire (LVWR:NYSE)** and floated it on the US stock market via a merger with special purpose acquisition company AEA-Bridges Impact. Harley Davidson retains a 74% stake in the business.

LiveWire hopes to start delivering its new S2 Del Mar electric motorcycle from Spring 2023, promising a 110-mile range and 0-to-60 miles an hour within 3.1 seconds. The company's flagship product is the eponymously titled LiveWire which launched in 2019. [SF]

# Ideal time to invest in life sciences cheaply through this trust



High demand and low supply mean rents and valuations are rising

## LIFE SCIENCE REIT

BUY

(LABS:AIM) 72p

Market cap: £251 million



**A**lthough it only came to market in November 2021, the UK's first listed real estate investment trust focused on life science properties has had a busy year.

Not only has it already invested the net proceeds of its £350 million IPO (initial public offering), its NAV (net asset value) has risen this year thanks to revaluation gains on its specialist portfolio.

The most recently declared NAV per share as of the end of June was 102.1p, which means at today's price of 72p the shares are trading on a discount of almost 30% to book value.

Part of the reason for this discount is the poor performance of REITs in general following the UK 'mini-Budget' which saw long bond yields soar, reducing the net present value of future earnings

from 'long duration' assets such as property.

Another reason for the share-price weakness is the fact the trust is geared towards growth rather than income, resulting in a low dividend payout (4p per share) which compares poorly with the returns being offered on some cash deposits.

What this means, however, is investors who missed the shares the first time round now have the chance to enjoy significant potential upside as the trust taps into the unrelenting demand for high-quality UK lab space.

Life science firms are investing heavily in research and development to bring forward new technologies and treatments to meet the needs of an ageing UK population and the associated increase in healthcare costs.

The trust specialises in providing real estate, ranging from offices to labs and production facilities, in the 'Golden Triangle' from Oxford and Cambridge to the Knowledge Quarter of north London which is attracting the most investment and therefore has the tightest supply and the lowest vacancy rate.

Companies which want to set up in this 'cluster' are typically looking for flexible space where they can have all their operations in one building, with rents ranging from £60 per square foot to more than double that depending on the level of specification.

This compares with maximum rents of less than £15 per square foot on big-box units for online retail and multi-let industrial units.

The trust has a blue-chip list of clients and is seeing increasing demand from outside the traditional life science disciplines, with agri-tech and food technology firms also competing for laboratory space.

While interest rate fears are likely to hang over the REIT sector, the trust took the precaution of capping the coupon on its debt over the summer, meaning it is largely hedged against future rate rises, which gives us added confidence in management. [IC]

## Life Science REIT



Chart: Shares magazine • Source: FE Analytics



# How Crestchic is powering up for a growth push and why now is a great time to buy

Leading player in the load banks industry has transformed its business and is delivering excellent returns

**CRESTCHIC**

**BUY**

(LOAD:AIM) 270p

Market cap: £77.7 million



**T**he market is picking up on the reality that **Crestchic (LOAD:AIM)** is a transformed business with real momentum behind it. With the valuation remaining attractive we think investors should buy the stock.

Despite a 40% rally in the shares over the past three months, with the company delivering its fourth earnings upgrade of 2022 alongside its first-half results, the shares still trade on just 9.9 times Shore Capital's latest earnings per share forecast for 2023.

Crestchic has been on a journey. Formerly known as Northbridge Industrial Services, the company sold off its Australian oil drilling tools business

## Crestchic's strong earnings growth

A= Actual, E= Estimate

Year	Earnings per share (p)
2021A	4.1
2022E	24.6
2023E	27.4

Table: Shares magazine • Source: Shore Capital



Tasman in March 2022. This left the focus entirely on its load banks business.

Load banks are equipment used to test power systems and Crestchic manufactures, sells and rents them out to clients across the UK, Americas, Europe and Middle East – it is a market leader.

They can be permanently installed at a facility to be connected as required or portable versions can be used for testing standby generators and batteries. Its customer base includes data centres, oil, gas and mining operations as well as renewable power and marine facilities where a loss of power could result in significant financial and reputational damage.

Data centres, linked to the exponential growth in the cloud computing sector, are an increasingly important end market for Crestchic, with Shore Capital estimating they accounted for 30% of revenue in 2021. According to market research and consulting firm Precedence Research data centre construction is expected to enjoy a compound annual growth rate of 6% between 2021 and 2030.

Having signed a lease on a new rental depot in Texas and appointed a business development manager in the US, the company is poised to take advantage of demand in a large US data centre market.

The disruption to the energy sector created by the war in Ukraine has increased demand for renewables, a sector where load banks are often crucial to testing back-up and storage facilities required to mitigate the intermittent nature of these power sources.

Servicing demand should be easier thanks to an 60% increase in capacity at its factory in Burton-on-Trent. An improved balance sheet and strong cash generation should also enable the company to invest in its rental fleet and drive organic growth.

Net debt stands at £1.5 million. The company returned to paying dividends earlier this year, with scope to surprise on the upside on this front given Crestchic's strong financial position. [TS]

# Ruffer delivers positive return in difficult times but sees more pain for investors

The trust's defensive characteristics offer a good antidote to rising global recession risks and further market turmoil

## RUFFER INVESTMENT COMPANY (RICA) 303p

**Gain to date: 5.5%**

**Original entry point:**

**Buy at 287.25p, 8 July 2021**

We originally said to buy capital preservation trust **Ruffer Investment company (RICA)** to add some protection to your portfolio during inflationary times. We highlighted its proven track record of making money in up and down markets.

It continues to deliver against a difficult market and macroeconomic backdrop, making a positive return year-to-date return (+3.1%) against a fall of 10.2% in the FTSE-All Share index.

### WHAT'S HAPPENED SINCE WE SAID TO BUY?

The managers have 'battened down the hatches' more than usual with the lowest allocation to equities (16.4%) in over two decades and a



clear focus on the trust's primary objective to preserve capital.

The trust has also bolstered unconventional protections to defend against a worsening of financial conditions. Chief investment officer Henry Maxey says: 'So far this year, we have seen a repricing of risky assets. Now, we see the potential for something worse: a growing pressure for the liquidation of risky assets.'

For Maxey illiquidity has become the new leverage. He notes the ingredients for a liquidity event have been around for some time, but the combination of rising interest rates and the start of quantitative tightening raise the odds of it happening.

Maxey adds: 'I remain extremely cautious of asset prices generally and equities in particular. For the first time in my Ruffer career, I believe we should have the minimum practical amount of 'sail in the wind'.

'I prefer to be highly liquid and take short or long risk exposure contingently via options as liquidity and real-world events play out over the next few months.'

The trust's biggest weighting at the end of August was in short-dated bonds and inflation-protected bonds, each representing just under 30% of assets. Illiquid strategies and options along with cash holdings represented just under a quarter of assets.

### WHAT SHOULD INVESTORS DO NEXT?

Ruffer has done a great job of protecting capital and appears well positioned to continue to do so should markets fall further. Keep buying its shares. [MGam]





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# Essentra's transformation to a pure-play industrial supplier is now complete

With a strong balance sheet the company can grow market share

**ESSENTRA** (ESNT) 211p

**Gain to date: -32%**

Shares in industrial group **Essentra (ESNT)** jumped as much as 15% on 3 October on news the firm had agreed the sale of its filters business, completing its strategic repositioning.

Unfortunately, that still leaves them almost a pound below our 310p entry point in November 2021 despite the fact the firm has done exactly what it said it would.

## WHAT'S HAPPENED SINCE WE SAID TO BUY?

True to his word, chief executive Paul Forman has streamlined Essentra, turning it into a focused industrial component-maker with the disposal of two of its three divisions.

First, the packaging business was sold to Austrian firm Mayr-Melnhof, one of a handful of companies which dominates the sector globally, for £312 million in June.

This represented an exit multiple of 12.5 times enterprise value to earnings before interest,



tax, depreciation and amortisation, a significant premium to the average multiple for deals in the sector.

This week, the firm revealed it had agreed to sell the filters division to a private family office for an enterprise value of £262.1 million, completing its exit from two low-margin businesses and allowing it to concentrate on the high-margin components sector.

## WHAT SHOULD INVESTORS DO NEXT?

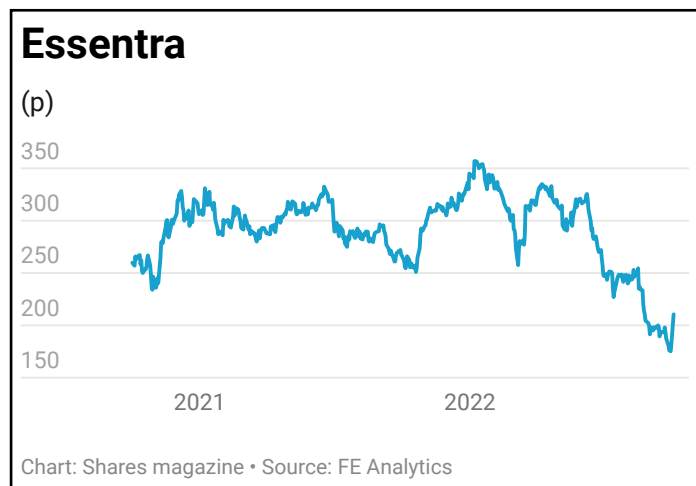
There are several reasons to stick with Essentra now it is a pure-play business.

As a high-margin manufacturer Essentra should re-rate as it loses its conglomerate discount and trade on a higher multiple of earnings approaching those of rivals such as **Diploma (DPLM)** and **RS Group (RS1)**, formerly known as Electrocomponents.

And after redeeming its debt early the firm will have no gearing which means free cash flow will increase.

Also, the company has promised to return £150 million or around a quarter of its market capitalisation to investors in the form of a special dividend which is an unexpected bonus.

Finally, having completed his mission to focus the group, Forman is leaving in January to be replaced by the current managing director of the components division, whose brief is to grow the business both organically and through acquisitions. [IC]



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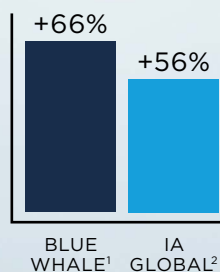


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# AFTERSHOCK

## What could happen next after the mini-Budget earthquake

By Tom Sieber and Martin Gamble

*The UK market remains in turmoil as the aftershocks unleashed by the mini-Budget earthquake on 23 September continue to rumble.*

*Despite the Government's U-turn on the 45% tax cut, investors are still wondering what will happen next with gilts, the pound and companies in their portfolio.*

*In this article we look at some of the areas which might be most affected and discuss the stocks and sectors which are most at risk.*

### CHAOS UNFOLDED

It is hard to overstate the events which have transpired since chancellor Kwasi Kwarteng delivered his mini-Budget. The pound hit a new record low against the dollar, yields on the five-year gilt were briefly trading at five times their level at the start of 2022, the Bank of England pumped £62 billion into the system to maintain financial stability and the mortgage market has seen products withdrawn left, right and centre.

While the long-term impact is hard to determine, in the short term it will be more expensive for consumers, business and the Government itself to borrow and the valuations of different asset classes will be affected. The Bank of England is likely to introduce a big rate hike at its next meeting on 3 November, if not before.

### WHY THE BANK OF ENGLAND INTERVENED



Since the start of the year UK 10-year gilt yields have increased from around 1% to 4%, reflecting the Bank of England's aggressive hike in interest rates to dampen rampant inflation.

Periods of stress often reveal previously obscure pressure points. That happened on 28 September when the Bank of England was forced to start buying gilts. The immediate catalyst was a risk that pension funds which had invested in liability-driven investment swaps – financial products linked to the gilt market – might become insolvent.

The central bank's temporary purchase of longer dated gilts to stabilise market conditions is a stop gap measure to allow the long end to function normally rather than a stimulus to the financial sector.

Rather confusingly the Bank of England still intends to go ahead with quantitative tightening (reducing its balance sheet) at the end of October, namely selling gilts.





## STOCK MARKET DOMINO EFFECTS

The negative reaction of bond and currency markets to the mini-Budget has a big influence on UK stock markets.

For years companies and their shareholders didn't need to worry too much about financial leverage for two simple reasons.

Persistently low interest rates meant companies could service much higher debts while the Bank of England's quantitative easing policy meant refinancing was easier to achieve.

Companies will now find it harder to refinance their debts while inflation continues to challenge

margins. The cost of servicing debts will rise and eat up more cash, reducing profits.

The firms most at risk will be those which have high financial leverage and low operating margins.

One additional factor to consider is operational gearing. Even a small drop in revenues can have a big impact on companies which have relatively high fixed costs. These are harder to cut during a downturn, which means profit margins are squeezed.

Companies with already wafer-thin margins are particularly at risk of falling into losses.

Shares has used Stockopedia software to screen for companies with high leverage, low margins and high operational gearing.

From the initial list adjustments have been made to reflect only interest-bearing debt by removing lease-based debts. Although high inflation may result in higher lease costs in future, the focus is on companies' current ability to service debts.

The key metric used to measure financial leverage is net debt to EBITDA (earnings before interest, tax, depreciation, and amortisation). Companies with ratios close to three and

### Firms with high leverage, low margins and high operational gearing

Company	Net debt latest (£ million)	EBITDA TTM (£ million)	ND/EBITDA (x)
J D Wetherspoon	£912	£40	22.7
Marston's	£1,257	£59	21.3
International Consolidated Airlines**	£11,600	£870	13.3
Motorpoint	£168	£32	5.2
Micro Focus International*	£3,668	£914	4.0
Aston Martin Lagonda	£600	£164	3.6
WH Smith	£336	£94	3.6
Petrofac*	£341	£104	3.3
Capita	£710	£218	3.3
James Fisher And Sons	£147	£56	2.6

EBITDA= Earnings before interest, tax, depreciation and amortisation. TTM= Trailing twelve months. ND= Net debt. \*Net debt and EBITDA in dollars. \*\* Net debt and EBITDA in euros.

Table: Shares magazine • Source: Stockopedia, Refinitiv, Shares

above are considered more vulnerable to rising interest rates.

However, each company's circumstances are relatively unique. The maturity profile of the debts, whether they are owed to banks or bond investors, and the strength of relationships are all factors to be weighed.

Talking a snapshot in time does not always reflect the full picture. For example, pub groups **JD Wetherspoon (JDW)** and **Marston's (MARS)** have not yet fully recovered from the pandemic, so the latest EBITDA does not reflect 'normal' trading. In addition, both firms have well invested freehold estates which banks are generally more comfortable lending against.

To give an idea of the scale of adjustment some companies will need to make to account for higher costs of borrowing, look at car retailer **Motorpoint (MOTR)**. In January it negotiated a new £29 million revolving credit facility which expires in May 2024. The average interest rate paid on its debts last year was 1.4%. The new credit facility looks well timed because UK interest rates have gone up more than four-fold since it struck that deal.

## WHAT THE BIG MORTGAGE SQUEEZE MEANS FOR CONSUMER-FACING COMPANIES

One of the most immediate impacts on ordinary people of recent events has been chaos in the mortgage market where some products have been pulled entirely and rates have been moving steadily higher.

This is bad news for the housing market as it will make it more difficult for people to get on the ladder in the first place and more expensive for people to move home, with predictions for a significant crash in house prices. This has been reflected in the weak share price performance for housebuilders and property portal **Rightmove (RMV)**.

Anyone coming off a fixed-rate mortgage deal is likely to face a big increase in their monthly payment, likely running into hundreds of pounds.

This will leave them with significantly less

## UK consumer confidence is at all-time low

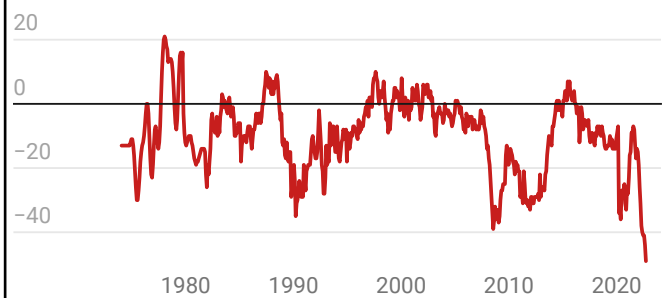


Chart: Shares magazine • Source: GfK

disposable income and will therefore have an impact on consumer-facing businesses. Most insulated are those, principally the supermarkets, which sell staples like food and household goods.

That doesn't mean they won't face any pain at all – trolleys are likely to be less full. Ocado Retail, the joint venture between **Ocado (OCDO)** and **Marks & Spencer (MKS)**, reported average basket sizes fell 6% in the three months to 31 August, even before the current turmoil. This has implications for the profitability of online grocery operations where the costs of delivery are the same, regardless of how much people are ordering.



If they can afford it individuals may prioritise spending on getting away given the enforced hiatus on holidays during the pandemic. The weak pound and the high costs of jetting abroad may see more people pursue staycations, with the owner of low-cost hotel chain **Whitbread (WTB)** a potential beneficiary. The likes of travel operator **TUI (TUI)**, British Airways operator **International Consolidated Airlines (IAG) Jet2 (JET2:AIM)**

## Most consumer-facing stocks have had a terrible year but the mini-Budget made things even worse

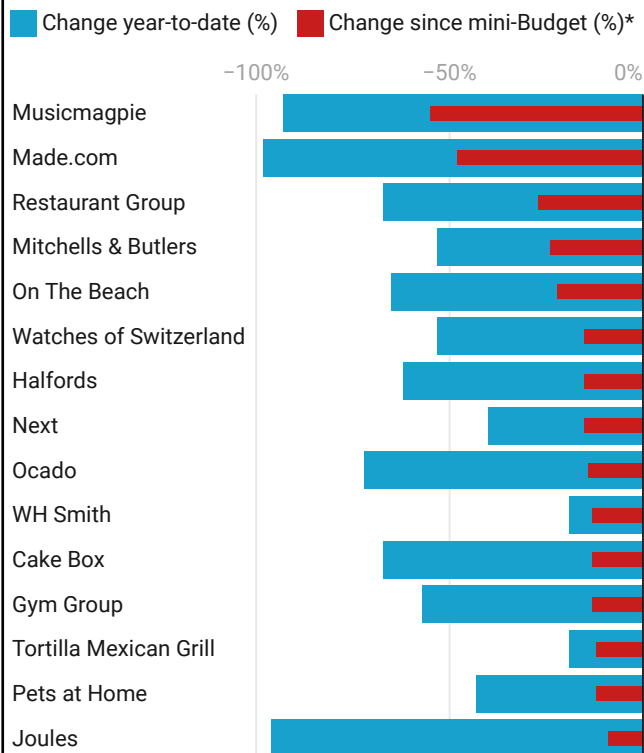


Chart: Shares magazine • Source: SharePad. Data to 11.15am, 30 September 2022. \*Since market close 22 September 2022

and **EasyJet (EZJ)** could see a recent recovery in demand knocked off course.

Eating out and takeaways may become less frequent due to affordability which is bad news for the likes of **Restaurant Group (RTN)**, **Deliveroo (ROO)** and **Just Eat Takeaway (JET)**. Socialising at pubs, bars and nightclubs could also suffer as people tighten their belts.

Both eateries and pubs face a significant impact from rising energy costs. All Bar One owner **Mitchells & Butler (MAB)** recently warned of an 88% increase in its heating and utility bills for 2023 compared with the pre-Covid level.

Retailer **Next's (NXT)** profit warning on 29 September, with full price sales expected to be

down 1.5% in the second half of its financial year to the end of January 2023, suggests no-one selling discretionary goods right now is safe.

You can read about the retail businesses which look most resilient and most vulnerable in this [article](#). Strong balance sheets and a compelling offering to shoppers are an absolute must in such difficult conditions.

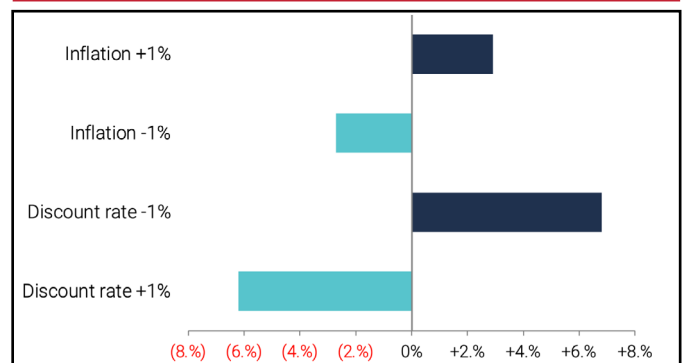
## WHY REITS AND INFRASTRUCTURE TRUSTS FELL

Real estate investment trusts (REITs for short) and infrastructure trusts have been heavily sold off in the wake of the mini-Budget as the market has adjusted to higher discount rates for long duration assets.

Two key elements make up the discount rate. First you have the risk-free rate which is typically taken as the yield on government bonds. Then there is the risk premium – the part which reflects the risk associated with investing your money. The risk-free rate has soared and this has been reflected in falling net asset values.

In discussions with infrastructure funds ahead of the mini-Budget, most observed to *Shares* that discount rates had remained relatively stable despite rising rate expectations, and they argued this stability reflected the strong appeal of the asset class.

### Pantheon Infrastructure sensitivity of portfolio to inflation and discount rates



Source: Pantheon

The mini-Budget appears to have changed the calculus. The sensitivity analysis from **Pantheon Infrastructure (PINT)** shows the impact of inflation and discount rates on its portfolio, and this should be a good proxy for the wider infrastructure space.





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Global Investors

# Weak pound raises the prospect of more UK takeovers

Here are six companies which look ripe to receive a bid from a foreign player

**W**eakness in the pound will only serve to heighten the likelihood of foreign companies buying UK businesses.

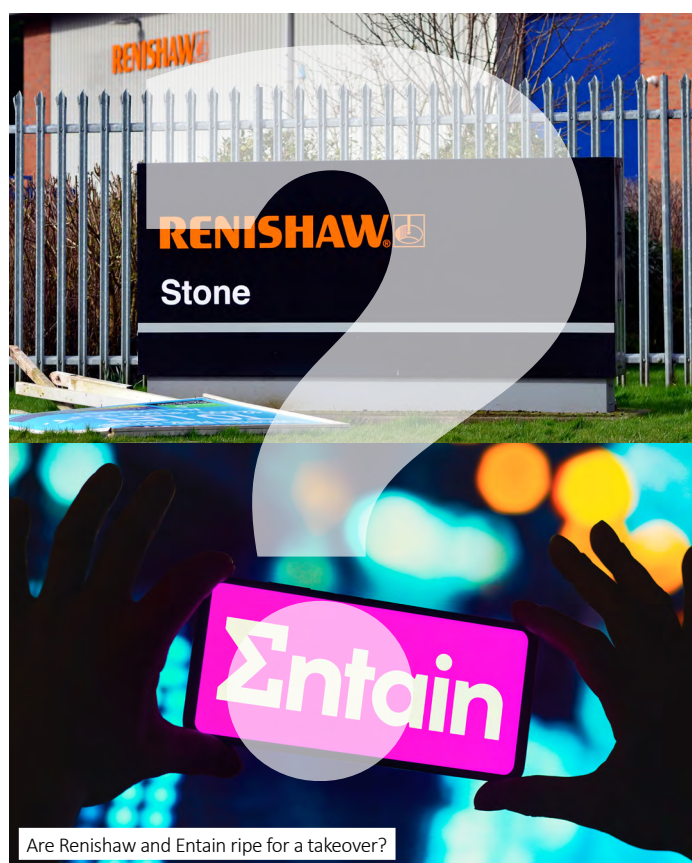
We saw this happen when the pound slumped after the EU referendum on Brexit in 2016, including takeovers for chip giant Arm and broadcasting group Sky.

UK stocks have been cheap on a relative basis to many other geographies since then, and now they've got even cheaper due to political, financial and market chaos.

## RENISHAW SALE REVIVAL?

Potential takeover candidates include precision engineer **Renishaw (RSW)**. It ticks all the right boxes for a takeover – a specialist in a niche area, an owner lots of intellectual property and it has two large shareholders who might be persuaded to accept a deal at the right price.

The business was put up for sale on 2 March 2021 after chairman David McMurtry and deputy



chairman John Deer – both in their 80s – said they wanted to dispose of their combined 53% stake in the business. Prior to this announcement the shares traded around £57 and then hit £65 a month later, having risen as the market speculated how much it could be worth in a takeover offer.

If we use £65 as the potential bid price, it would have equalled \$90 on the day that share price peak was achieved (23 April 2021). At current exchange rates (3 October 2022), a US bidder would only have to pay approximately \$73 for an asset worth £65. That's a reduction of 19% in 18 months.

The next thing to realise is that a mixture of Renishaw ending its formal sales process in July 2021 and concerns about a slowdown in the global economy served to pulled down the engineer's share price to £34.66 – nearly half the peak reached last year.

If we said that a US buyer offered a very generous 50% bid premium, that implies a takeout price in the region of £52 a share or \$58 in US dollars.

McMurtry and Deer might argue that still significantly undervalues the business on a long-term basis, but the maths illustrate how the slump in the pound and UK stocks works to the advantage of overseas buyers, particularly in the US.

## Renishaw

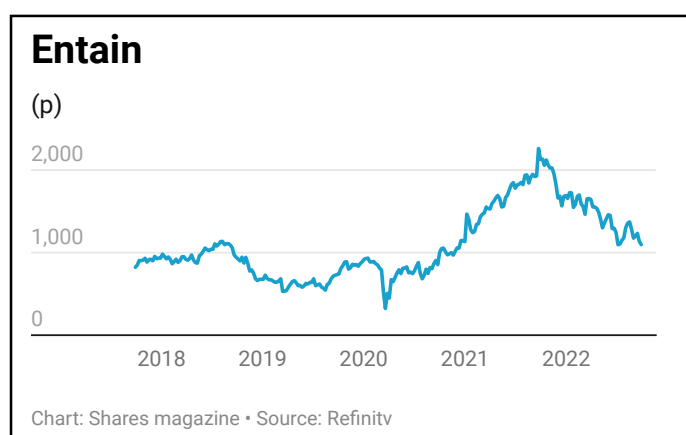


Chart: Shares magazine • Source: Refinitiv

## MORE POTENTIAL TARGETS

So, who else might be an obvious takeover target among UK-listed stocks? In addition to companies with niche skills and intellectual property, other attributes that make for natural targets include a strong market position in a certain geography. Quite a few takeovers by foreign players of London-listed companies have been to expand geographically or to bolster a position in a certain market.

The telecoms space is attracting interest from European investors, including two French billionaires taking stakes in **BT (BT.A)** and **Vodafone (VOD)**.



In the gaming space, **Entain (ENT)** and **Playtech (PTEC)** have both been subject to bid interest in the past. For example, **MGM Resources (MGM:NYSE)** offered \$11.06 billion or 0.6 shares per Entain share in January 2021 for the UK business, based on the closing price on 31 December 2020. That valued Entain at £13.83 per share or \$18.90 based on the exchange rate at the time of the offer.

Entain currently trades at £10.72 per share and reports suggest MGM is still interested in buying the British business because that would enable it to own their BetMGM joint venture outright.

If MGM came back with a new offer pitched at 50% above the market price – the type of bid premium that should excite investors – then it would have to pay £16.08 per share. At today's exchange rate that equals \$18.02 per share, so approximately 5% less than it offered nearly two years ago despite representing a substantially bigger bid premium than the 20% it made last time.

Naturally this is pure speculation and a hypothetical example, but it is another illustration of how the latest currency movements would work in the favour of someone funding a UK takeover in dollars.

## THESE FOUR ALSO LOOK LIKE TAKEOVER TARGETS

Looking at the FTSE 350, there are quite a few other stocks which stand out as being potential takeover targets, either because they are experts in a particular field, they would provide the buyer with greater scale, or their shares are cheap because of short-term issues.

We must stress these names are on our list because of the above qualities, not because of chatter about a takeover in the market. However, the fact they seem obvious targets to us would also suggest that trade or private equity buyers are looking closely at them, particularly those based overseas who would benefit from the weak pound should a bid be made.

**Darktrace (DARK):** Companies around the world have no choice but to take extra precautions to protect their networks and systems given increasing threats from hackers. That spells long-term growth opportunities, and a private equity

company would almost certainly want a slice of this pie.

Darktrace is one of the key players in the cybersecurity industry and uses artificial intelligence to spot hacks and data leaks. Private equity group Thoma Bravo held talks with Darktrace earlier this year about a possible offer. While they couldn't reach an agreement, one suspects that other players might be watching the cybersecurity group closely with a view to making an offer.

**Dechra Pharmaceuticals (DPH):** The veterinary products group has bought a lot of companies over the years, but will it become prey now its shares have tanked, and the pound is weak?

Dechra has a presence in multiple countries including the US which is the world's largest animal health market. A US rival or a private equity group might view Dechra as an opportunistic takeover



## Takeover targets?

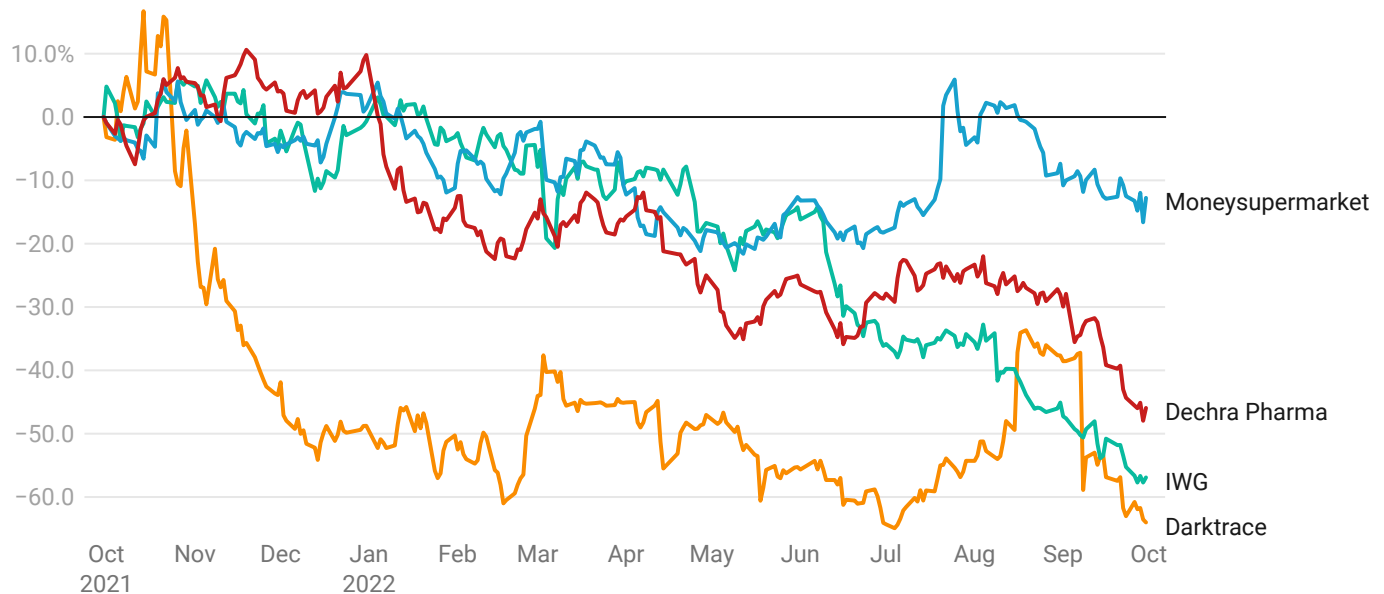


Chart: Shares magazine • Source: FE Analytics

target given its share price has more than halved this year, putting the stock back at levels last seen at the start of the Covid pandemic.

Over the past seven or eight years, investors have been happy to pay at least 25 times earnings to own the shares. The stock is now trading on 22 times forward earnings yet net profit for the current financial year is expected to be four times larger than the year to June 2020.



**IWG (IWG):** In August, Regus-owner IWG said it had benefited from the rise in hybrid working as more people split their working time between home and the office. For the first half of 2022, IWG said costs had gone up much less than revenue and that it was 'cautiously optimistic' on the outlook for the full year.

However, the market has not shared the company's enthusiasm, with the stock continuing to fall amid fears that a recession would reduce demand for temporary workspaces. Year-to-date

the shares have fallen by 59%.

Chief executive Mark Dixon clearly thinks the shares are a steal as he's just bought £1.2 million worth of stock. That's the first time he has acquired more shares on the market since investing £91.3 million of his own money as part of IWG's fundraise during the height of the pandemic in June 2020.

Private equity sniffed round the business in 2018 and then again last year – now the shares are lot lower and weakness in the pound would give a foreign bidder an extra advantage.

**Moneysupermarket (MONY):** The valuation is depressed because consumers cannot shop around for energy deals due to the surge in prices, thereby hurting one of its key revenue streams. However, recession tends to drive people to look for better deals on cards and loans, which should benefit the comparison site's money arm.

With an average 42.7% return on capital employed since 2016, according to SharePad, and trading on a mere 12 times forward earnings, we find it hard to believe there aren't companies running the numbers on Moneysupermarket at its current share price.



By **Daniel Coatsworth** Editor



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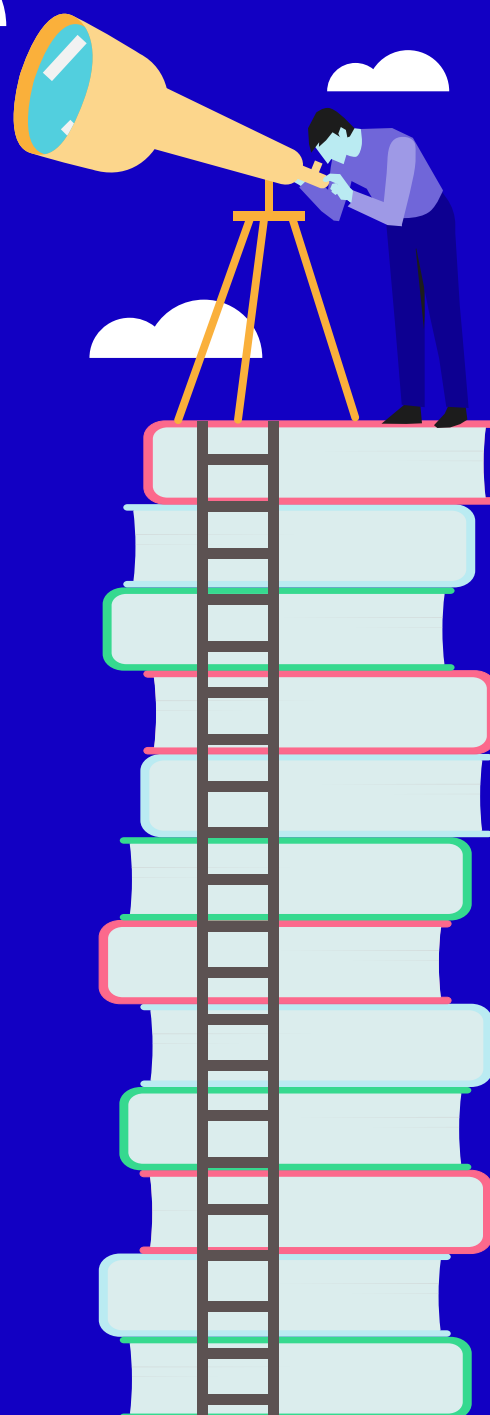
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Discrete Performance*	Q2 2017 Q2 2018	Q2 2018 Q2 2019	Q2 2019 Q2 2020	Q2 2020 Q2 2021	Q2 2021 Q2 2022
Share price	10.9%	0.6%	-11.6%	34.7%	-12.6%
Net Asset Value**	8.7%	2.8%	-8.9%	37.4%	-11.7%
Benchmark#	8.5%	6.1%	2.3%	24.5%	-2.6%

Please note that past performance is not a guide to future performance. Witan Investment trust is an equity investment. The value of an investment and the income from it can fall as well as rise as a result of currency and market fluctuation and you may not get back the amount originally invested.

\*Source: Morningstar/Witan. Total return includes the national investment of dividends.

\*\* The Net Asset Value figures value debt at fair value. # Witan's benchmark is a composite of 85% Global (MSCI All Country World Index) and 15% UK (MSCI UK IMI Index). From 01.01.2017 to 31.12.2019 the benchmark was 30% UK, 25% North America, 20% Asia Pacific, 20% Europe (ex UK), 5% Emerging Markets.





# What just happened with gilts and why Adam Smith nailed it



Central banks are intervening amid clear signs of stress in the markets

**I**t will be of little or no consolation to investors, but the UK is not the only country whose economic foundations are coming into question. The Bank of England has had to intervene in the gilt market, ostensibly to support the value of defined benefit pensions and more generally to bring order to the government bond market, while China has stepped in to support its currency in the foreign exchange markets and so has Japan.

Moves to return policy to anything like 'normal' have barely started and currency and bond markets have already started to buckle. This suggests that at some stage central banks will have to recant and return to cutting rates, relaunching QE (quantitative easing) as the Bank of England is already doing, albeit under a different guise, or both.

## **BAD HABITS**

The UK has specific issues of its own to address, not least as it has two particularly bad habits. First, it spends more than it earns, with the result that we run an annual budget deficit and carry an ever-growing national debt. Second, it buys more than it sells, so a current account deficit builds as exports lag imports.

These twin deficits leave the UK reliant upon others to fund those bad habits and this may be why the mini-Budget may represent an unlikely tipping point. Initially looking to push through £45 billion in (apparently) unfunded tax cuts does not look like a big deal when compared to a national debt that is already £2.4 trillion. Even the suggested £150 billion price tag for household and business

energy subsidies looks small in that context. But the cavalier way in which the plan was presented, the manner in which the Bank of England is looking to tighten policy as the Government loosens it and the ongoing uncertainty as to what happens when this support package expires, and oil and gas prices are still elevated in effect combined to break the UK gilt market. Buyers of government debt – in effect, lenders of money to the UK – decided they were getting far little yield by way of compensation for the risks they were taking. That is why gilt yields shot higher and the Bank of England had to step in.

## **THREE'S A CROWD**

But it is not only the Bank of England who is keeping busy. Three major policy interventions in a week does not feel like a good sign, especially as Japan is still keeping monetary policy ultra-loose, as it leaves its headline interest rate unchanged at minus 0.1%, while China is responsible for two of the 12 interest rate cuts logged worldwide by the website [www.cbrates.com](http://www.cbrates.com) this year (compared to 271 rate hikes).

All three are struggling to juggle high debt with low rates and a firm currency. Something must give, and chaos is breaking out in the UK even when interest rates are 2.25% and the Bank of England can point to a mere £32 billion, or 3.5%, reduction in its £895 billion QE scheme.

Most disconcertingly of all, the US Federal Reserve is only just embarking upon quantitative tightening and seems determined to press ahead





## China is looking nervously at the falling value of the yuan ...



## ... as Japan intervenes to support the yen.



with further interest rate rises of its own. The Fed Funds rate is only at 3.25% and the Fed's total assets stand at \$8.9 trillion.

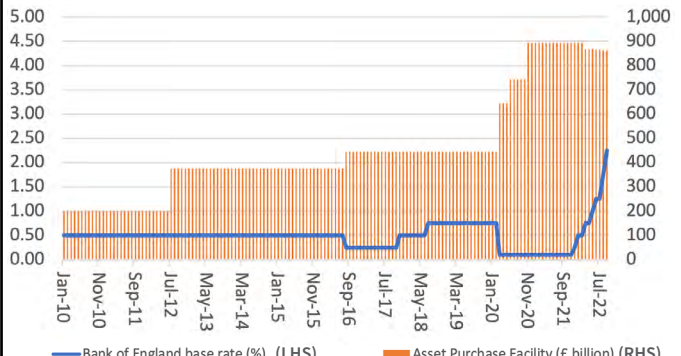
### POLICY PATHWAYS

Three nations are therefore failing, it seems, to maintain lofty debts alongside low borrowing costs and a firm currency.

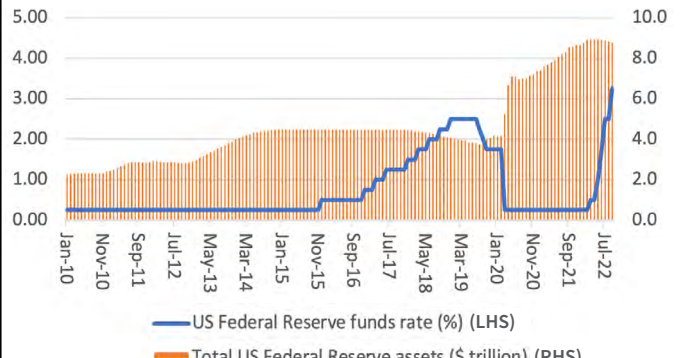
Eighteenth-century economist Adam Smith would not be surprised. In *The Wealth of Nations* Smith wrote, 'History shows that once an enormous debt has been incurred by a nation, there are only two ways to solve it: one is to simply declare bankruptcy and repudiate the debt. The other is to inflate the currency and thus to destroy the wealth of the ordinary citizen.'

You can argue that neglects a third option, which

## Bank of England has barely started with QT ...



## .... And nor has the Fed, but markets are rocking anyway



is to get the economy growing so the debt can be paid back (and Liz Truss and Kwasi Kwarteng will argue this is their plan), and a fourth, which is to start a war, but regrettably Smith looks to be spot on.

At one end of the spectrum, Suriname, Sri Lanka and Lebanon have already defaulted. Zambia, Ghana and Egypt look to be in trouble.

At the other end we have the US, EU and UK where inflation is galloping along, and central banks may be faced with a choice between letting it run and sacrificing their currencies, or tightening policy and watching debt-laden economies slide into a recession for which they are ill pre-prepared. The Bank of England's lurch back to QE (albeit in a different guise) may well be a pointer for the path they are most likely to take.



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±As at 31 January 2022, holdings >1% of NAV

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# Pod Point has lots of cash but it's hit a speed bump with growth

Net cash represents 91% of electric vehicle charging infrastructure firm's market valuation

**E**lectric vehicle charging infrastructure play **Pod Point (PODP)** arrived on the stock market just under a year ago to some fanfare but its subsequent performance has been distinctly underpowered.

We viewed the story as interesting back in November 2021 but felt the valuation was too demanding at the stock market listing price of 225p. That proved an accurate reading as the shares have since fallen by three quarters in value to 58.9p.

As CEO Erik Fairburn tells *Shares* the company faces a 'speed bump' in its road to growth thanks to supply chain issues in the wider electric vehicle space. He points out that while plug-in vehicle registrations were up 26% year-on-year in the first half of 2022, for the second quarter they were down 2%, the first fall on record.

This has a significant impact on Pod Point because more than 60% of its business is derived from the installation of charging units at people's homes, something they are only likely to pursue once they know they will be receiving their electric vehicle soon. Lead times on electric vehicle orders are currently 12 to 24 months.



Pre-tax profit was already not on the cards before 2025 and that date could arguably be pushed out even further thanks to the current electric vehicle supply problems.

What gives Fairburn confidence that growth is merely delayed rather than derailed is that it's a problem of supply rather than demand. Regulatory drivers and the high cost of fuel means there is still strong appetite to make the switch to electric and the infrastructure required to keep all these vehicles on the road will still need to be built.

He says the company may benefit from an enhanced market position coming out of the current supply crisis as smaller rivals with weaker balance sheets fall away. The company has a 22% share of the home market and 5% of the commercial market – putting charging units in locations like retail parks and workplaces.

Pod Point is in a relatively strong financial position with net cash of £82.1 million as at 30 June, representing 91% of its £90 million market valuation.

Longer-term the company could benefit from a growing amount of recurring revenue, which doubled in the first half to £800,000.

Areas Pod Point is targeting include energy monitoring services, hosting software services to allow its charge point hosts to set and manage charging tariffs for drivers and electrical grid load management.

## Pod Point sales

(£ million)

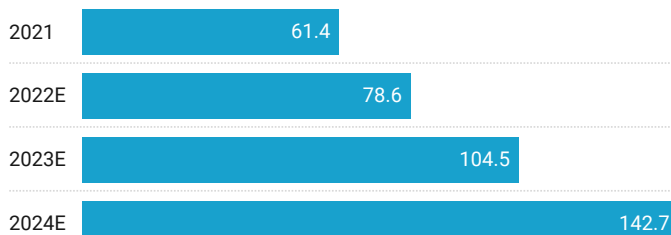
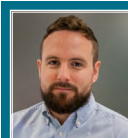


Chart: Shares magazine • Source: Shares, company announcements



By **Tom Sieber** Deputy Editor



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*Actual Investors*



# SAINTS: the Baillie Gifford trust which has performed best in 2022

'I like to think we provide our investors with peace of mind' – manager James Dow

**T**he **Scottish American Investment Trust (SAINTS)** or 'SAINTS', has been managed by Baillie Gifford since 2004 and is focused on delivering real dividend growth by increasing capital and growing income.

Notably over the last 12 months it has performed better than other trusts in the asset manager's stable, including higher profile names like **Scottish Mortgage (SMT)**. In absolute terms though, it has still lost investors money (-7%) and it compares less



favourably on a longer-term view, though its aims are different than a more pure growth-focused fund like Scottish Mortgage and perhaps better suited to the current market environment.

The trust was founded in 1873 to seek higher income outside the UK and has grown its dividend for 48 consecutive years. The last time the dividend was cut was 1938, before the Second World War.

Since 2014 the trust has grown its dividend by 2.9% ahead of UK consumer price inflation, more than maintaining investors' purchasing power. The current dividend yield is 2.9%.

The trust aims to be a core holding for investors looking for income and has an objective to grow the dividend at a faster rate than inflation over rolling five-year holding periods which it has comfortably achieved.

Total growth in net asset value over the last decade has been 246%, exceeding the benchmark return (FTSE-World Index) of 232%. The trust trades at 12.2% discount to net asset value, the deepest discount since Baillie Gifford started managing the fund nearly two decades ago.

Led by co-heads James Dow and Toby Ross, who have a combined 34 years of investment experience, they are supported by portfolio manager Ross Mathison and the depth of Baillie Gifford's research resources.

## FOCUS ON STEADY GROWERS

Dow told *Shares* that the team are focused on finding and investing in steady, long-term

## How SAINTS compares to other Baillie Gifford trusts over the past 12 months

	Total return (%)
Scottish American Investment Trust (SAINTS)	-7
Baillie Gifford Japan Trust	-29
Monks Investment Trust	-30
Baillie Gifford China Growth Trust	-32
Pacific Horizon Investment Trust	-33
Baillie Gifford UK Growth Trust	-36
Baillie Gifford Shin Nippon	-38
The Schiehallion Fund	-38
Keystone Positive Change Investment Trust	-43
Edinburgh Worldwide Investment Trust	-43
Baillie Gifford US Growth Trust	-45
Scottish Mortgage Investment Trust	-45
Baillie Gifford European Growth Trust	-48

Table: Shares magazine • Source: FE Fundinfo, 3 October 2022

compounders which throw-off sustainable, resilient dividends.

The team believe that dividend growth is closely associated with compounding and enhances returns.

Dow said the approach is similar in style to investment guru Warren Buffett, and Fundsmith founder Terry Smith. SAINTS likens compounding to the effect of a snowball rolling down a long hill. The further it travels, the faster it gains in size.

The team operate a global mandate which gives them a larger universe than a purely domestically-focused one with more than 5,000 companies to consider.

### BOTTOM-UP ANALYSIS

They conduct bottom-up company analysis where the primary objective is to discover the size of the growth opportunity and test the resilience of the dividend by looking at previous downturns.

A 'deep dive' is conducted to assess the reputation of the company, its competitiveness and industry trends. The portfolio consists of 60 names roughly equally weighted and the managers often start with a 1% position and look to add over time.

The average size of holdings across the portfolio is under 2%. Positions are trimmed if they reach 5% of the portfolio. Companies are held for the long term to benefit from compounding and the average holding period is around seven years.

### RISK MANAGEMENT

Companies in the portfolio are consistently reviewed to ensure they are delivering expected earnings and dividend growth. Those failing to achieve expectations are sold. An example is personal care and hygiene products company



## Scottish American Investment Trust top 10 holdings

Company	%
United Parcel Service	3
Novo Nordisk	3
Microsoft	3
Fastenal	3
Proctor & Gamble	3
Albermale	3
PepsiCo	3
TSMC	3
Watsco	3
Roche	2
<b>Total</b>	<b>28</b>

Table: Shares magazine • Source: Scottish American Investment Trust, Data as at 31 August 2022

Kimberly Clarke de Mexico which was sold in early 2022. The company had failed to deliver expected growth. It turned out to be more sensitive to the Mexican economy than the team anticipated.

In its place SAINTS purchased US small business services provider **Intuit (INTU:NASDAQ)**. Dow believes the company can grow its earnings by around 15% a year as it adds new customers and increases customer spending.

### PRUDENT GEARING TO ENHANCE YIELD

The trust uses its ability to borrow money to invest in higher yielding investments such as property and infrastructure which represent around 15% of assets. SAINTS recently refinanced its long-term borrowing facility which reduced the cost of funding from 8% to 3%. The facility runs until 2048.

The trust has an annual ongoing charge of 0.62% a year. Investors interested in buying the trust also need to factor in dealing charges and platform fees if applicable.



By **Martin Gamble** Education Editor





# INVESTING IN ASIA | INVESCO ASIA TRUST PLC



## ***Ian Hargreaves and Fiona Yang*** *Fund Managers*

Fund Managers Ian Hargreaves and Fiona Yang recently sat down with David Kimberley from Kepler Trust Intelligence for a deep-dive discussion on investing in Asia; from how they pick their investments to their engagement with Asian companies around Environmental, Social and Governance (ESG), and more.

Watch the video to hear them discuss:

- 00.40** – Their experience and expertise
- 02.54** – Overview of the Invesco Asia Trust plc (IAT)
- 04.11** – How they pick their investments
- 06.46** – Stock example – Mahindra & Mahindra
- 09.33** – Key considerations for investors looking to invest in Asia
- 13.25** – How they've navigated Covid...
- 19.40** – ...and the events of 2022 so far
- 21.48** – The regions and sectors they're most excited about
- 27.09** – IAT's dividend policy
- 28.59** – Their engagement with companies on ESG issues



### INVESTMENT RISKS

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

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

The Invesco Asia Trust plc invests in emerging and developing markets, where difficulties in relation to market liquidity, dealing, settlement and custody problems could arise.

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

The Invesco Asia Trust plc uses derivatives for efficient portfolio management which may result in increased volatility in the NAV. In addition, some companies are suspending, lowering or postponing their dividend payments, which may affect the income received by the product during this period and in the future.

### Important Information

Data as at 2 August 2022 unless otherwise stated.

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Further details of the Company's Investment Policy and Risk and Investment Limits can be found in the Report of the Directors contained within the Company's Annual Financial Report.

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**EMEA 2450477/2022**



# REASONS WHY IT PAYS TO INVEST IN SMALL CAPS DESPITE RECENT SELL-OFF

**We talk to the experts about the risks and rewards in the market now**



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

**F**ollowing on from the pandemic and war in Ukraine, UK stocks are being buffeted by headwinds from hot inflation, rising rates and the cost-of-living crisis. But it is UK small and mid-cap investors that have endured the toughest period over the past year, with the small cap, mid cap and AIM indices all suffering severe setbacks.

The good news, however, is this sell-off has created opportunities across a cohort of quality smaller companies with attractive growth prospects that now trade at valuations significantly lower than their recent history. And the set-up is more compelling when you remember that historically, UK smaller companies have outperformed larger stocks over time.

## SMALL CAP DISCOUNT

Kirsty Desson, manager of the **Abrdn Global Smaller Companies Fund (B777SP3)**, stresses that small cap performance has varied in different global markets.

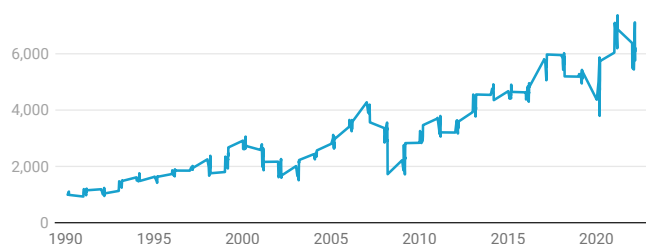
She says small caps have only marginally underperformed large caps year-to-date. 'If you look at the MSCI World index, that's down around 23% now and the MSCI World Small Cap index is down 24%, so only marginally weaker.

'What is certainly true is that valuations for small caps are still at quite a significant discount to large cap peers and that has been consistent for some time, really since Covid.'

Despite prevailing risk-off sentiment, Desson

**This popular UK small cap index has delivered 1,016% total return since September 1990...**

**Numis Smaller Companies + AIM index (excluding investment companies)**



Data: 3 September 1990 to 29 September 2022  
Chart: Shares magazine • Source: Refinitiv

**... but the performance hasn't been great over the past 12 months**

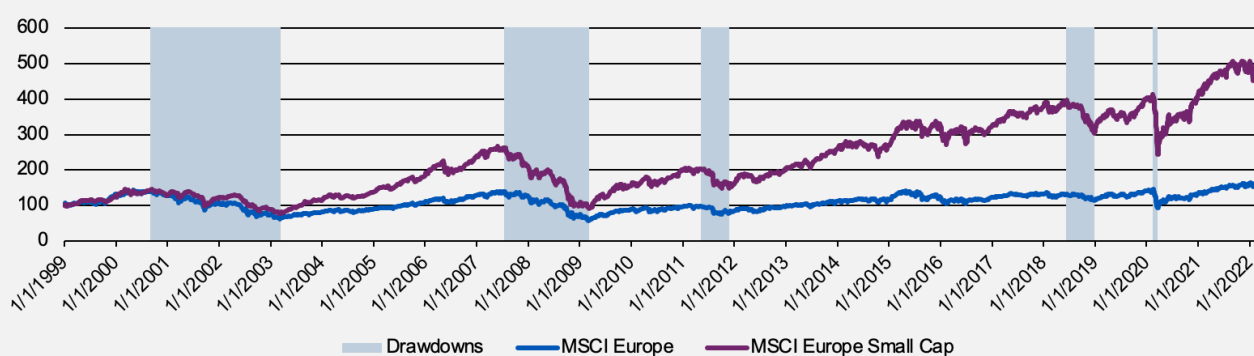
**Numis Smaller Companies + AIM index (excluding investment companies)**



Data: 12 months to 29 September 2022  
Chart: Shares magazine • Source: Refinitiv



## History shows small caps tend to recover quicker than large caps



Start Date	End Date	Large Cap			Small Cap		
		Large cap Drawdown	Recovery Date	Time To Recover (m)	Small Cap Drawdown	Recovery Date	Time to Recover (m)
Sep 2000	Mar 2003	-49.3%	Dec 2019	202	-59.0%	Jan 2005	23
Jul 2007	Mar 2009	-66.5%	Apr 2015	73	-60.4%	Jan 2014	58
May 2011	Nov 2011	-27.6%	Jan 2013	13	-21.7%	Jan 2013	14
Jun 2018	Dec 2018	-23.8%	May 2019	4	-15.8%	Dec 2019	12
Feb 2020	Mar 2020	-41.4%	May 2021	14	-35.4%	Jan 2021	10

Source: Abrdn, Refinitiv Eikon, in EUR, 01 January 1999 to 09 March 2022

argues investors should at least start thinking about an allocation to the small cap sector, one perceived as riskier than the large and mid-cap universe.

She points out that in the periods coming out of the downturns triggered by the bursting of the tech bubble and the 2008 financial crisis, from the trough, small caps dramatically outperformed large caps in both those periods. 'While it is difficult to have a crystal ball, investors do want to be in small cap names coming through into a recovery.'



## BARGAINS GALORE?

Jonathan Brown manages **Invesco Perpetual UK Smaller Companies (IPU)**, an investment trust trading at a 18.7% discount to net asset value which demonstrates how out of favour corporate small fry are at present.

Brown thinks the small cap sector is very cheap at the moment, whether you compare it to valuations it has traded on historically or other global indices.

Paul Marriage, manager of **TM Tellworth UK Smaller Companies Fund (BDTM8B4)**, says the small cap discount to large cap is deeper now than in 2008. He adds: 'Stocks were sold off heavily in 2008. But what's happened this year is things have been sold off heavily, but small caps have been sold off more, though absolute valuations aren't quite down to 2008 levels.'

Marriage bemoans the fact that the small cap sell-off has been 'pretty indiscriminate'.

'AIM has underperformed the large and mid-cap indices and is in a pretty horrible place, and most small cap funds including us have got plenty of AIM, but we're negotiating that okay.'

He says certain companies are being valued as if they won't exist in five years' time. Yet he sees opportunities to find some that should be around in 2027 and may also be a lot more valuable by then.

Like Desson, Marriage makes the case for allocating to small caps for a recovery. 'Typically, when people get more risk-on, the first things to go up would be more liquid, easier to buy mid-caps. And then small caps have what I describe as

an “Andrex rally”. You know, “stronger for longer”, because they start at a lower place.’

Ken Wotton, manager of UK small caps trust **Strategic Equity Capital (SEC)** and co-manager of the **LF Gresham House UK Smaller Companies Fund (BH416G5)**, argues the longer-term opportunity within British small caps is ‘extremely compelling’ at present. He says: ‘There remain scores of high-quality, resilient businesses on offer, and the agile demeanour and niche positioning of smaller caps may allow these companies to navigate more smoothly through broader economic headwinds.’

Wotton says the fall in valuations and current sterling weakness relative to the US dollar has made UK small caps attractive to foreign investors and investors could see companies acquired at highly attractive multiples over the coming months.

## LATEST INVESTMENTS

The biggest holdings of £1.2 billion Abrdn Global Smaller Companies Fund include payroll firm **Paylocity (PCTY:NASDAQ)**, swimming pool supplier **Pool Corp (POOL:NASDAQ)** and video game industry services company **Keywords Studios (KWS:AIM)**.



The fund focuses on three key factors; quality, growth and momentum, as Dessen says stocks with these characteristics have the greatest likelihood of outperforming.

‘In small caps, we find that stocks that are unprofitable, blue sky or don’t have a sustainable growth outlook, those are the companies that have the greatest amount of risk.

‘In terms of delivering the most optimal risk-adjusted returns, we like companies with good quality metrics, so solid balance sheets, decent cash flows, strong margins, defensible competitive advantage and solid ESG.’

## Abrdn Global Smaller Companies Fund



Chart: Shares magazine • Source: Refinitiv

New names added to the fund’s portfolio this year include **Carlisle (CSL:NYSE)**, one of the largest roofing repair companies in the US with around 30% market share which ‘does a lot of insurance and commercial work and still has a huge backlog, meaning the earnings outlook is very well supported for the next year’.

Dessen’s other new buys in 2022 include Japan-listed **Sho-Bond (1414:TYO)**, an expert in the maintenance of roads, bridges, tunnels with a steady income stream where the money stems from the government. ‘That stock has been doing very well for us,’ says Dessen.

The fund also invests in Australia-based building company **Johns Lyng (JLG:ASX)**, a contractor that rebuilds and restores properties after damage after insurable events such as weather and fire damage.

## UNDERSTANDING

## THE PROCESS

Tellworth UK Smaller Companies Fund typically invests in companies in the £100 million-to-£500 million market cap range. The £247 million fund uses an investment process called ‘P3M’, which seeks to encompass the characteristics desired in a company and stands for ‘product, market, margin and management’.

Its holdings range from engineering, environmental and strategic consultancy **Ricardo (RCDO)** and content creation-focused hardware and software firm **Videndum (VID)** to P3M exemplar **AB Dynamics (ABDP:AIM)**, a ‘world leader in testing driving systems that keeps on delivering’ in terms of organic growth and earnings upgrades, according to Marriage.

Teleradiology company **Medica (MGP)**, one of

the UK's leading outsourced scanning businesses which is saving the NHS money, has caught the fund manager's attention. The shares are currently trading on less than 13 times next year's expected earnings. Marriage believes historically the market would have paid a much higher multiple for the type of defensive growth on offer.



Team17 acquired the company behind Firefighting Simulator in January 2022

The fund manager recently invested in **Team17 (TM17:AIM)**, the video games developer and publisher which Marriage describes as looking like 'a good company at the wrong price' at the point he bought its shares. 'We had watched the share price halve after a poorly managed placing earlier in the year.'

## Team17



Chart: Shares magazine • Source: Refinitiv

A new position for Invesco Perpetual UK Smaller Companies is identity data intelligence platform provider **GB Group (GBG:AIM)**, which Brown has added to the portfolio over the last few months. That looks fortuitous timing as it recently received a takeover approach and there is chatter that more than one party is interested in buying the company.

'GB Group had previously sold off very heavily, which prompted us to get involved and its recent takeover approach doesn't surprise us,' says Brown.

'A lot of these businesses are trading at low valuations and if you look at what's happened to sterling, things look especially cheap if you are a US buyer, for example. Hopefully there will be competing offers for GB. It is a business that we would hope to hold for many years, so it would have to be a good offer to prise it from our hands.'

## COMING BACK INTO FASHION

Keywords Studios has been a popular stock for small cap funds to own over the years, but it hasn't always enjoyed a rising share price.

## Keyword Studios



Chart: Shares magazine • Source: Refinitiv

'It's a stock we've held since IPO quite a few years ago now and we took a lot of profits 18 months ago. Keywords has since derated a long way, but the business is still trading very well,' says Brown.

The fund manager says Keywords is benefiting from growth within the computer games sector but also from increased outsourcing. 'We think the business has the potential to grow for many years to come.'



## UNDERSTANDING THE OPPORTUNITY

Anna Macdonald, one of the managers of the **TB Amati UK Listed Smaller Companies Fund (B2NG4R3)**, is a fan of **Learning Technologies (LTG:AIM)**, which has become, through organic development and acquisitions, a market leader in digital learning and talent management.

It comprises a Software and Platforms division that sells multi-year software-as-a-service licences to enterprises. The other division, Contents and Services, delivers fixed price projects to clients, and grew substantially on the addition of GP Strategies in 2021, where the team has doubled margins, while growing sales.

‘While corporate training spend is normally correlated to GDP growth, we believe Learning Technologies has resilient sector exposure,’ says Macdonald. ‘For example, the CEO says that GP Strategies has served General Motors for 40 years, and the automotive industry

is caught “in the eye of a change storm”, as the way we make and consume cars requires completely different market training and change management.’

Macdonald adds that a free cash flow yield of more than 8% is compelling for an AIM-listed business-to-business operator generating 75% of revenues in US dollars.

As for Ken Wotton, he has recently boosted Gresham House UK Smaller Companies’ holding in high margin motor insurer **Sabre Insurance (SBRE)** in the belief ‘there could be material capital growth ahead’ for a company which dominates the premium and hard-to-insure vehicle categories and which pays a substantial dividend. ‘Its competitive advantage lies in proprietary data processes and intellectual property, leaving Sabre Insurance less vulnerable to wage inflation,’ he adds. [JC]

**DISCLAIMER: Editor Daniel Coatsworth owns units in Abridged Global Smaller Companies Fund and TM Tellworth UK Smaller Companies Fund**

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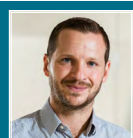


# I heard some pension funds were close to insolvency. Is mine safe?

Tom Selby explains why the Bank of England had to step in to calm markets

*Is my pension at risk? I'm a member of my company's defined benefit scheme and have been reading stories suggesting they might be at risk of insolvency. Is there anything I could/should do?*

**Nathan**



**Tom Selby**, AJ Bell Head of Retirement Policy, says:

Firstly, and most importantly, there is no need to panic or do anything.

Defined benefit, or DB, pensions pay a promised retirement income from a set age (your 'normal pension age'). This income usually has at least some inflation protection built in, although in private sector DB schemes increases may be capped. The income you receive from your DB scheme will be based on the number of years you have been in the scheme and your salary.

In terms of what is currently happening, the thing to remember is that it's the solvency of your employer that matters most when it comes to paying your pension. Provided your employer doesn't go bust, it has a legal obligation to continue to stand behind the pension promises it has made.

Even where the sponsoring employer goes to the wall, the Pension Protection Fund or PPF exists as a safety net to ensure members get most of their promised retirement income.

The income you receive from the PPF if the sponsoring employer goes bust will depend on whether you have reached your scheme's normal pension age or not.

Those who have reached their scheme's normal pension age will receive 100% of their promised benefits. Those who have yet to reach their scheme's normal pension age will usually get 90%



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of their benefits paid.

In most cases, PPF payments relating to pensionable service from 6 April 1997 will rise in line with inflation each year, subject to a maximum of 2.5% a year. Payments in relation to service before this date won't increase, however.

## SO...WHAT HAPPENED?

The decision by the Bank of England to buy £65 billion of UK Government bonds, or 'gilts', was in part driven by fears of a sell-off of gilts by pension funds. This fear was exacerbated by 'hedging' strategies lots of pension funds have in place.

When the interest rate or 'yield' on Government gilts rises, the accounting value of liabilities linked to DB schemes falls. So, in theory, the rising yields we have seen in recent weeks





should have been good news for the funding position of DB pension schemes.

However, lots of DB schemes hedge interest rate risk using financial instruments. This just means these instruments aim to broadly cancel out the impact of gilt yield movements. If gilt yields rise, liabilities fall, and the financial position of the pension scheme improves. This will trigger a cash call from the investment bank operating the hedge.

This has caused a problem because of the speed at which gilt yields have risen. Schemes were going to have to sell down assets to pay cash to investment banks, but one of the main assets held by DB schemes is... gilts.

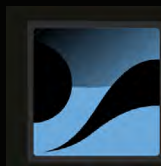
The risk the Bank of England tried to address

last week was therefore of a further gilt sell-off – on top of what we had already seen – and additional instability in the UK economy.

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

Send an email to [asktom@sharesmagazine.co.uk](mailto:asktom@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.



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# How will the latest tax changes affect me?

We run the numbers on Kwasi Kwarteng's new tax system

**T**he latest mini-Budget announced tax changes for the nation, but how much better off will you be from them?

The first Budget from the new chancellor Kwasi Kwarteng has caused controversy and seismic market movements, but away from that reaction



## Impact of National Insurance changes between Sunak and Kwarteng systems

Salary	2022/23: Total National Insurance bill	2023/24: Total National Insurance bill	National Insurance saving between 2022/23 and 2023/24	Tax saving as a percentage of income
<b>£10,000</b>	£3.98	£0.00	£3.98	0.04%
<b>£12,000</b>	£70.23	£0.00	£70.23	0.60%
<b>£25,000</b>	£1,736.08	£1,491.60	£244.48	1.00%
<b>£35,000</b>	£3,061.08	£2,691.60	£369.48	1.10%
<b>£45,000</b>	£4,386.08	£3,891.60	£494.48	1.10%
<b>£55,000</b>	£5,238.08	£4,618.60	£619.48	1.10%
<b>£75,000</b>	£5,888.08	£5,018.60	£869.48	1.20%
<b>£100,000</b>	£6,700.58	£5,518.60	£1,181.98	1.20%
<b>£150,000</b>	£8,325.58	£6,518.60	£1,806.98	1.20%
<b>£500,000</b>	£19,700.58	£13,518.60	£6,181.98	1.20%
<b>£1,000,000</b>	£35,950.58	£23,518.60	£12,431.98	1.20%

Table: Shares magazine • Source: AJ Bell. \*Figures for 2022/23 take the total tax earners would have paid under Boris Johnson's Government.



## How changes to income tax affect you

Salary	2022/23: Total income tax bill	2023/24: Total income tax bill	Total tax saving between 2022/23 and 2023/24	Tax saving as a percentage of income
£10,000	£0.00	£0.00	£0.00	0.00%
£12,000	£0.00	£0.00	£0.00	0.00%
£25,000	£2,486.00	£2,361.70	£124.30	0.50%
£35,000	£4,486.00	£4,261.70	£224.30	0.60%
£45,000	£6,486.00	£6,161.70	£324.30	0.70%
£55,000	£9,432.00	£9,055.00	£377.00	0.70%
£75,000	£17,432.00	£17,055.00	£377.00	0.50%
£100,000	£27,432.00	£27,055.00	£377.00	0.40%
£150,000	£52,460.00	£52,083.00	£377.00	0.30%
£500,000	£209,960.00	£209,583.00	£377.00	0.10%
£1,000,000	£434,960.00	£434,583.00	£377.00	0.00%

Table: Shares magazine • Source: Source: AJ Bell. \*Figures for 2022/23 take the total tax earners would have paid under Boris Johnson's Government. They do not take into account the cut to National Insurance rates announced by Liz Truss, which come into force in November

much of the public are left wondering how much better off they will be next year as a result of the tax changes.

### WHAT HAS CHANGED ABOUT NATIONAL INSURANCE?

First up, the National Insurance system was altered again. Former prime minister Boris Johnson and former chancellor Rishi Sunak had already unveiled changes to the system for the current tax year, but Kwarteng undid some of those.

The move means that from November this year National Insurance rates will fall to their previous level, before the Sunak/Johnson 1.25 percentage point surcharge was added. It means that we will all now pay rates of 12% and 2%, rather than the current 13.25% and 3.25%, bringing us back to the same tax rate as last year.

The other move the former chancellor made was raising the threshold at which you pay National Insurance. Usually, this limit increases with inflation each tax year and it was £9,880 for the first few months of this tax year. After that it was raised to

£12,570, bringing it in line with the income tax threshold.

It means anyone earning less than this amount won't pay any National Insurance. After that you pay the 12% rate up to £50,270 and then 2% on any earnings above that level.

The new chancellor chose to maintain that new, higher threshold at the same time as cutting rates, giving a boost to most taxpayers. As you can see from the first table, that saves someone on £25,000 a year around £245 a year in tax, while someone on £100,000 a year will save £1,182 a year – but a similar saving as a proportion of their total income.

### WHAT ABOUT INCOME TAX CHANGES?

The new chancellor also unveiled two big changes to the income tax system: reducing the basic rate of tax down from 20% to 19% and scrapping the higher rate of tax altogether, which was 45%. However, in the subsequent days the Government did a U-turn on the additional rate of tax, and it will no longer be scrapped.

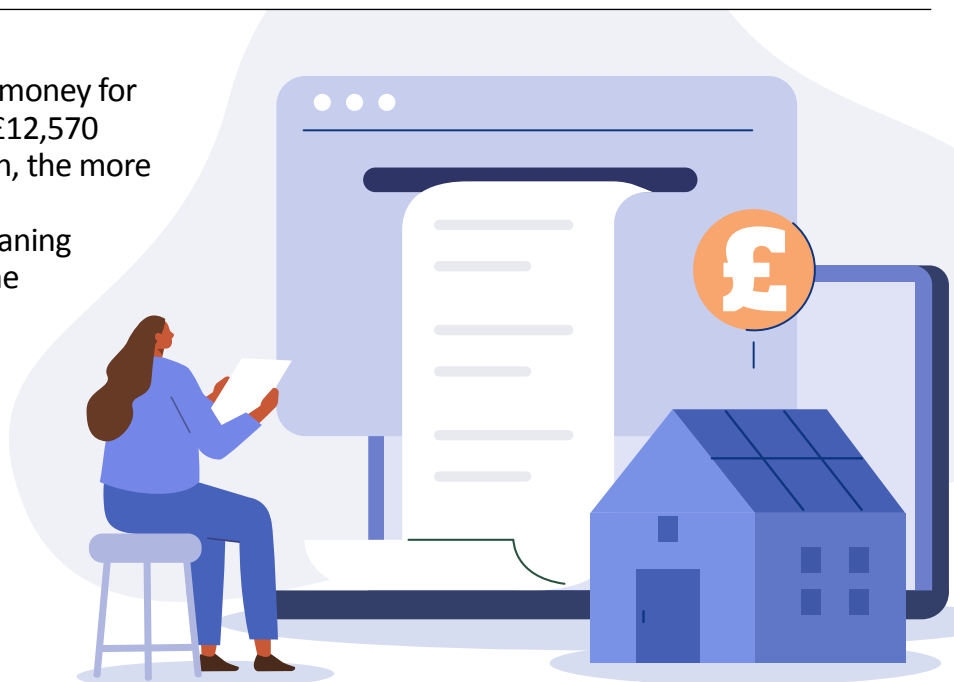
The cutting of basic-rate tax saves money for anyone who earns over the current £12,570 threshold. Clearly the more they earn, the more they benefit from that tax reduction.

The maximum benefit is £377, meaning that anyone who earns more than the higher rate income tax threshold will save that amount. Someone on £25,000 will save around £124, while someone on £55,000 will save the maximum £377.

### WHAT'S THE TOTAL IMPACT?

The combined impact of the National Insurance and basic-rate tax savings mean that most people earning around £20,000 all the way up to £150,000 will save around 1.5% of their income in tax.

However, this percentage then gets smaller for higher earners as their total tax savings is the same as someone on a far lower salary, meaning the saving is diluted.



By **Laura Suter**  
AJ Bell Head of Personal Finance

## Total impact of tax changes

Salary	Total tax in 2022/23	Total tax in 2023/24	Total tax saving between 2022/23 and 2023/24	Tax saving as a percentage of income
<b>£10,000.00</b>	£3.98	£0.00	£3.98	0.00%
<b>£12,000.00</b>	£70.23	£0.00	£70.23	0.60%
<b>£25,000.00</b>	£4,222.08	£3,853.30	£368.78	1.50%
<b>£35,000.00</b>	£7,547.08	£6,953.30	£593.78	1.70%
<b>£45,000.00</b>	£10,872.08	£10,053.30	£818.78	1.80%
<b>£55,000.00</b>	£14,670.08	£13,673.60	£996.48	1.80%
<b>£75,000.00</b>	£23,320.08	£22,073.60	£1,246.48	1.70%
<b>£100,000.00</b>	£34,132.58	£32,573.60	£1,558.98	1.60%
<b>£150,000.00</b>	£60,785.58	£58,601.60	£2,183.98	1.50%
<b>£500,000.00</b>	£229,660.58	£223,101.60	£6,558.98	1.30%
<b>£1,000,000.00</b>	£470,910.58	£458,101.60	£12,808.98	1.30%

Table: Shares magazine • Source: AJ Bell. \*Figures for 2022/23 take the total tax earners would have paid under Boris Johnson's Government. They do not take into account the cut to National Insurance rates announced by Liz Truss, which come into force in November 2022.

# SHARES

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## New investment opportunities

**WEDNESDAY**  
**19 OCTOBER 2022**

Registration **17:15**  
Presentations to start at **17:45**



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

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- Talk with the company directors and other investors

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**Nigel Pocklington, CEO**

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#### Event details

**Registration 17:15**  
**Presentations to start at 17:45**  
Complimentary drinks and buffet available after the presentations

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## KEY ANNOUNCEMENTS OVER THE NEXT WEEK

### Full-year results:

**7 October:** JD Wetherspoon. **11 October:** SCS, YouGov. **12 October:** ASOS.

### Half-year results:

**11 October:** Eneraqua Technologies, Sanderson Design.

### Trading updates

**10 October:** Sirius Real Estate, Unite.

**11 October:** Reach. **13 October:** Entain, Hays, Rathbones.

**14 October:** Jupiter Fund Management.

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