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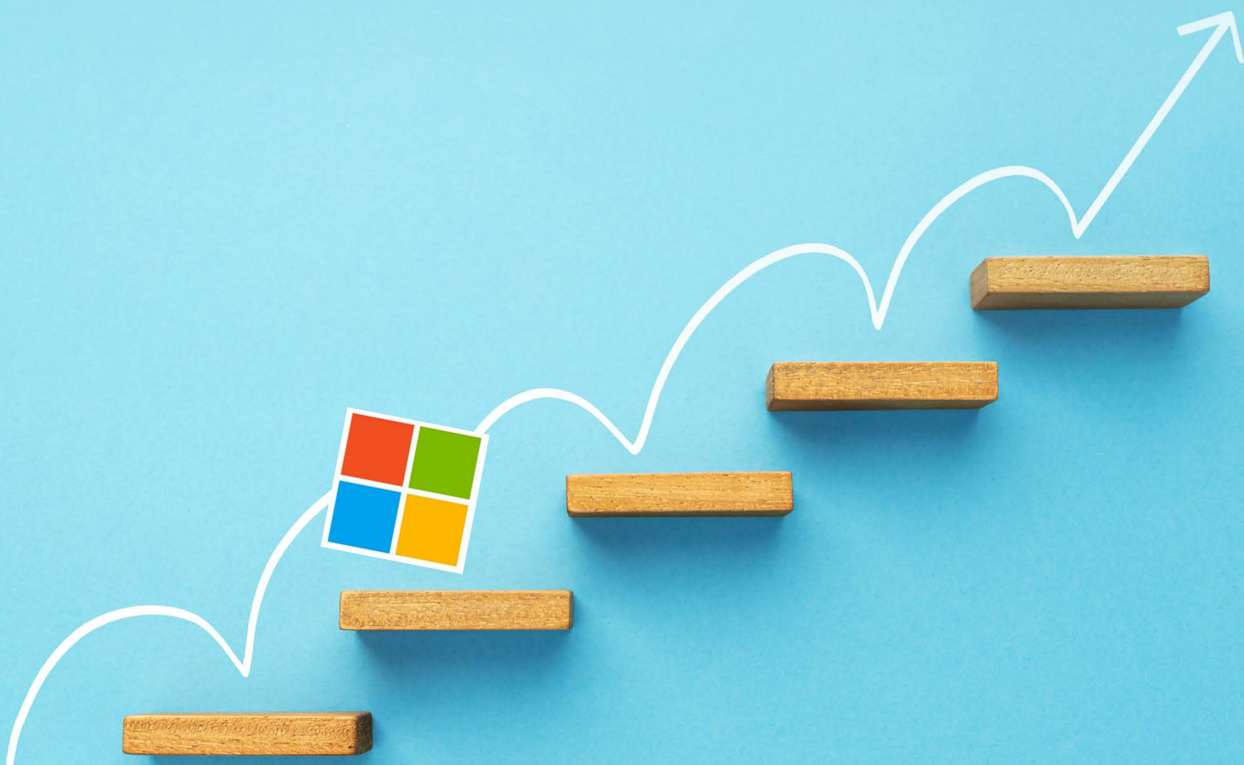
SHARES

WE MAKE INVESTING EASIER

ANALYSE A STOCK IN 5 EASY STEPS

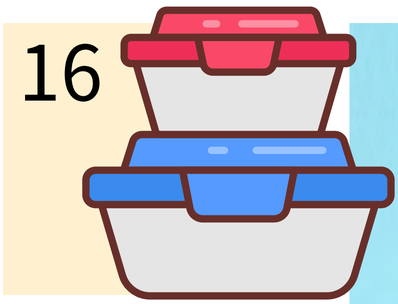
This week: Microsoft

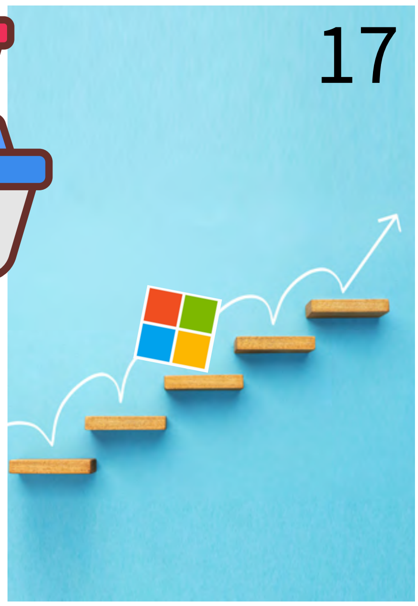


ENGINEERING SECTOR

Everything you need to know about investing in this space

Contents





Three important things in this week's magazine

1


News

The important points from Barclays, HSBC, Lloyds and NatWest results

Higher interest rates prove to be a double-edged sword and investors love share buybacks

Higher interest rates haven't been the easy ticket to superior profit growth for banks that analysts predicted last year

The latest results from UK banks show there are negative effects from rates going up fast

2


Sector Report: Engineers

How UK engineers have transformed to top the charts on the UK market

Ways to play this standout and increasingly high quality sector

Investing in engineers has been a fruitful place over the years, with superior gains on average compared to the FTSE All-Share index

This week's sector report looks at the evolution of engineering firms and ways to invest in the space via stocks and tracker funds

3


ANALYSE A STOCK IN 5 EASY STEPS

This week: Microsoft

Microsoft has outperformed the US market over the past 12 months

There are good reasons why Microsoft has been such a rewarding investment as Steven Frazer explains in this week's main feature

He explains how to analyse the stock in five easy steps and the important bits to consider when doing your research

Visit our website for more articles

Did you know that we publish daily news stories on our website as bonus content? These articles do not appear in the magazine so make sure you keep abreast of market activities by visiting our website on a regular basis.

Over the past week we've written a variety of news stories online that do not appear in this magazine, including:

The top funds that investors have been loading up on in July

Wall Street Week: Markets take rate hike in their stride, Coke has fizz and tech doesn't disappoint

Retail powerhouse Frasers delivers record results and raises full year profit guidance

Greggs serves up tasty first half results, but upgrades absence sends shares down 5.5%

The important points from Barclays, HSBC, Lloyds and NatWest results

Higher interest rates prove to be a double-edged sword

While the different share price reactions to their first-half results might suggest the reporting season for the big UK banks was a mixed bag, behind the headline figures there were a few common themes across the sector which were notable.

The first and most obvious takeaway is higher interest rates haven't been the cure-all for bank margins and profits which analysts expected at the start of the Bank of England's rate-hiking cycle.

While the ultra-low interest rate environment following the pandemic was clearly bad for margins, it was generally assumed that rising interest rates would be all good news.

As it turns out, higher interest rates – like higher prices for food and fuel – have had a dampening effect on both household demand for credit and on businesses' willingness to borrow.

First to report was the UK's largest lender by market share, **Lloyds (LLOY)**, which as well as its high-street brand owns Bank of Scotland, Halifax and Birmingham Midshires.

Lloyds' net interest margin – which measures the difference between the interest rate it pays on deposits and the rate it charges on loans and is a key indicator of profitability – increased by just 0.04 percentage points between December 2022 and the end of June to just 3.14%.

How the market reacted on the day of each bank's results

Company	Share price
HSBC	2.6%
Natwest	2.3%
Lloyds	-1.7%
Barclays	-5.3%

Table: Shares magazine • Source: Marketscreener

Guidance for the full year was no more encouraging, with the net interest margin seen 'above 3.10%', while provisions for bad loans increased by £662 million against £377 million last year as the bank took a more downbeat view of the UK economy.

While **Barclays (BARC)** posted a better-than-expected profit for the half year period, it was largely due to tight cost control and lack of fines, and despite an increase in the dividend and its share buyback programme investors homed in once again on the net interest margin and bad loan provisions.

As well as more than doubling its bad loan charge to £861 million, the bank lowered its margin outlook for the year to 'around 3.15%' due to competition for deposits as customers look for better rates on their savings, another negative consequence of the hiking cycle.

NatWest (NWG) got off lightly by comparison, considering its net interest income missed forecasts and its margin guidance for the full year was no better than Barclays', but its ultra-low level of bad loan provisions and a surprise new share buyback programme were enough to see its shares gain.

Frustratingly, **HSBC's (HSBA)** results told us very little about the UK market as they included a big gain on the acquisition of SVB UK, and attention focused purely on its huge share buyback. [IC]

Smithson bounces back from a poor year with significant outperformance in 2023

After a miserable time in 2022, the mid-cap investment trust has enjoyed a strong recovery

It was a good first half of the year for **Smithson Investment Trust (SSON)** after it significantly beat the market. The Fundsmith-managed vehicle grew net asset value by 11.7%, outperforming the MSCI World Small and Mid-Cap index by 9.8 percentage points.

That goes some way to making up for the miserable time investors experienced in 2022 where the quality-focused trust delivered net asset value total returns of -31.7% versus -13.7% for the benchmark index.

'Economic factors such as inflation, interest rates and growth are hard to predict accurately. Our investment manager does not attempt to forecast future macroeconomic conditions and focuses instead on identifying good companies with robust business models that will be able to thrive throughout market cycles. The board believes that the patient investor will be well rewarded,' said Smithson chairman Diana Dyer Bartlett.

Since its inception on 19 October 2018, Smithson's net asset value per share total return has delivered a compound annual gain of 10.2% compared with 7% from its benchmark index. Despite that track record, the trust currently trades on a 11.7% discount to net asset value.

Over the past year Smithson has increased exposure to the industrials sector from 19% to 33% of the portfolio, making it the first time since launch that technology wasn't the dominant sector.

This shift was partly a result of taking new positions in technical consultant **Exponent (EXPO:NYSE)** and fluid and metering specialist **IDEX (IEX:NYSE)**. Selling its stake in simulation software group **Ansys (ANSS:NASDAQ)** reduced tech exposure, portfolio holding **Sabre (SABR:NASDAQ)** was reclassified by index provider MSCI from tech to consumer discretionary and payroll firm **Paycom (PAYC:NYSE)** moved to the industrial sector.

Chart: Shares magazine • Source: Refinitiv

Smithson benefited from having a stake in software company **Simcorp (SIM:CPH)** as its shares jumped 38% in a single day earlier this year after receiving a takeover bid by Deutsche Börse.

US-based cybersecurity company **Fortinet (NASDAQ: FTNT)** performed well as a portfolio constituent, up over 45% during the half-year period. 'Corporate cybersecurity budgets remained healthy, allowing the company to grow revenue by 32%,' said fund manager Simon Barnard.

He also highlighted software company **Nemetschek (ETR: NEM)** whose valuation fell during the interest rate increases last year but whose share price has performed better this year.

Barnard was also apologetic for the performance of the investment trust last year: 'While periods of underperformance are undesirable and always very uncomfortable, they do tend to have the silver lining of producing subsequent periods of improved prospects.' [SG]

DISCLAIMER: Daniel Coatsworth who edited this article owns shares in Smithson

Domino's Pizza shares up 42% in a month but analysts still to be won over

There are concerns around the stock valuation and ongoing decline in delivery orders

Shares in **Domino's Pizza (DOM)** are up by 42% since 5 July to 393p yet analysts appear unconvinced the UK's largest pizza chain has turned a corner.

Four out of the eight analysts who cover the stock have a 'hold' or 'sell' rating and four have a 'buy' rating while the average analyst price target sits around a tenth below current levels.

Before its latest results, the consensus earnings estimate for both 2023 and 2024 had been revised down by around 22% and 11% respectively since December 2022 according to Refinitiv data.

On 1 August, Domino's reported first-half like-for-like sales growth close to 10%, raised full year profit guidance by around 8% and announced a new £70 million share buyback to return some of the proceeds from the disposal of its German associate.

Negatives which once hampered the shares have melted away like freshly sprinkled cheese on a hot pizza. The long-running spat with franchisees was settled in December 2021 and the year-long drought without a permanent CEO came to an end last month after industry veteran Andrew Rennie was appointed.

Numis described Rennie as a 'very high quality' appointment and one that removes a 'key

Chart: Shares magazine • Source: Refinitiv

overhang' for the share price.

Jefferies, which has an 'underperform' rating and 240p price target for the shares implying 39% downside, said: 'We have been cautious on lower top-line opportunities versus history. The arrival of a new CEO with a strong Domino's track record could provide a top-line growth catalyst.'

Liberum last month raised its price target to 300p from 230p and moved to a 'hold' rating from 'sell' following the appointment of Rennie and called the move a 'game changer' while complementing interim CEO Elias Diaz Sese who 'kick-started a bold new strategy, one which we were warming to.'

Following the half-year results Liberum raised its price target by 20% to 360p but kept its 'hold' rating on valuation grounds with the shares trading on 19 times forward earnings.

'But we do note the positive steps taken under the group's value, digital and convenience strategy,' the broker conceded.

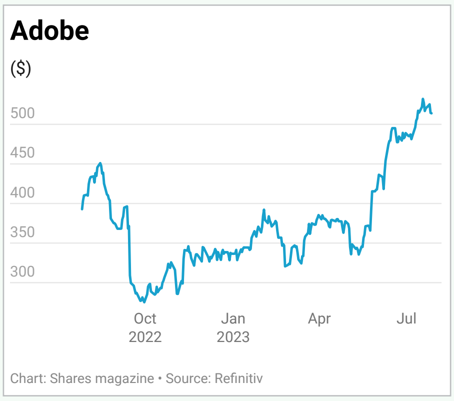
Domino's reported 'encouraging' momentum with like-for-like system sales excluding split stores increasing by 7.9% and total orders up 2.3% in the three weeks since 25 June 2023.

Collection orders increased by 17.3% in the second quarter, suggesting customers are seeking cheaper ways to buy Domino's products during the cost-of-living crisis. Collections are typically discounted, either by price or deals such as buy one, get one free.

Delivery orders continue to be in decline at -3.9% in the second quarter but the trend has shown improvement on the previous three quarters (-4.9% in Q1 2023, -5.1% in Q4 2022 and -12.7% in Q3 2022). [MG]

How Adobe rode the AI wave to gain 50% in 2023

Creative digital software firm has been in demand with investors



Creative digital software firm **Adobe (ADBE:NASDAQ)** is one of the best performing US stocks so far in 2023, gaining more than 50% with its shares enjoying particular momentum since May.

Adobe has a dominant 50% share of the creative software market, according to analysts. Its offering includes Adobe PDFs, Photoshop and its image and graphics library, Adobe Stock. But the company's suite extends far deeper with professional Creative Cloud products like InDesign, Illustrator and Premiere Pro, among many others.

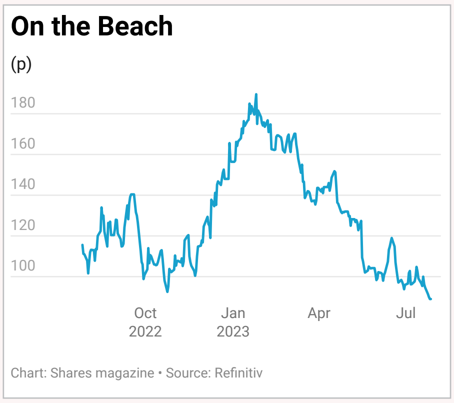
For now, the emergence of AI (artificial intelligence) is being seen as a positive for the business as it is built into more of its product suite. However, there are some concerns AI could kill off its graphic designer customer base.

For now, Adobe looks set fair. It beat second-quarter estimates thanks to a robust performance across all areas of the group, reporting adjusted earnings of $3.35 per share, topping the consensus estimate of $3.31. Though there was some disappointment over third quarter earnings guidance of $3.33 against the $3.40 forecast.

Adobe is likely to report its third quarter earnings in late September, which will cover the three-month period to the end of August. [TS]

On The Beach's shares are looking ill after halving in six months

The beach holiday specialist is out of favour as marketing costs have soared



To say online travel agent **On The Beach (OTB)** has had a bad year is an understatement.

The first summer holiday season not besmirched by either Covid or major delays has been marred by escalating marketing spend which has helped keep the company loss-making – £6 million in the red for the six-month period to 31 March 2023.

The company has faced strong competitive pressures in the value short-haul market it specialises in, with **EasyJet (EZJ)** investing in its package holidays arm and **Jet2 (JET2:AIM)** continuing to take market share.

Because On The Beach doesn't own aircraft it is less a master of its own destiny and it is also exposed to forex movements as well as the risks to demand posed by pressured household budgets in the UK.

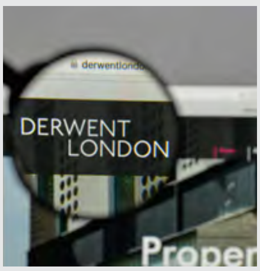
The flipside is the company has limited fixed costs and Shore Capital analyst Katie Cousins sees scope for a turnaround in its fortunes if it can expand in the premium sector and from long-haul, with potential to double its revenue and earnings if it could replicate its share of the short-haul space. [TS]

UK UPDATES OVER THE NEXT 7 DAYS

FULL-YEAR RESULTS
August 8: Hargreaves Services
August 10: Hargreaves Lansdown

HALF-YEAR RESULTS
August 4: WPP
August 7: Page Group
August 8: InterContinental Hotels, SIG, IWG, Zotefoams, Glencore, H&T Group, Rotork, Abrdn, TI Fluid Systems
August 9: Hill and Smith, Coca-Cola HBC, TP ICap, Flutter Entertainment
August 10: Derwent London, Tritax Big Box Reit, Hostelworld, Spirax-Sarco Engineering, Capital & Regional, Atalaya Mining, OSB, Entain, Lancashire, Persimmon, Network International, Videndum

TRADING ANNOUNCEMENTS
August 4: Pets at Home
August 9: Bellway



Difficult market conditions weigh on Persimmon's shares

Higher mortgage rates and fewer reservations are seen crimping demand

Given the poor performance of **Persimmon's (PSN)** shares this year it's fair to say investors aren't expecting great things from the UK housebuilder when it reports first-half earnings on 10 August.

In its first-quarter trading update in April, the firm was more upbeat than many had hoped, even suggesting full-year completions could reach the top end of its 8,000 to 9,000 target range, although that still implied a 40% drop from last year's total.

With the Bank of England's base rate having risen from 4.25% to 5% and mortgage rates having topped 6% in the interim, stymying the first-time buyer market, and no more support from the Help to Buy scheme, any change to its previous guidance is likely to be seized on by the market.

Chart: Shares magazine • Source: Refinitiv

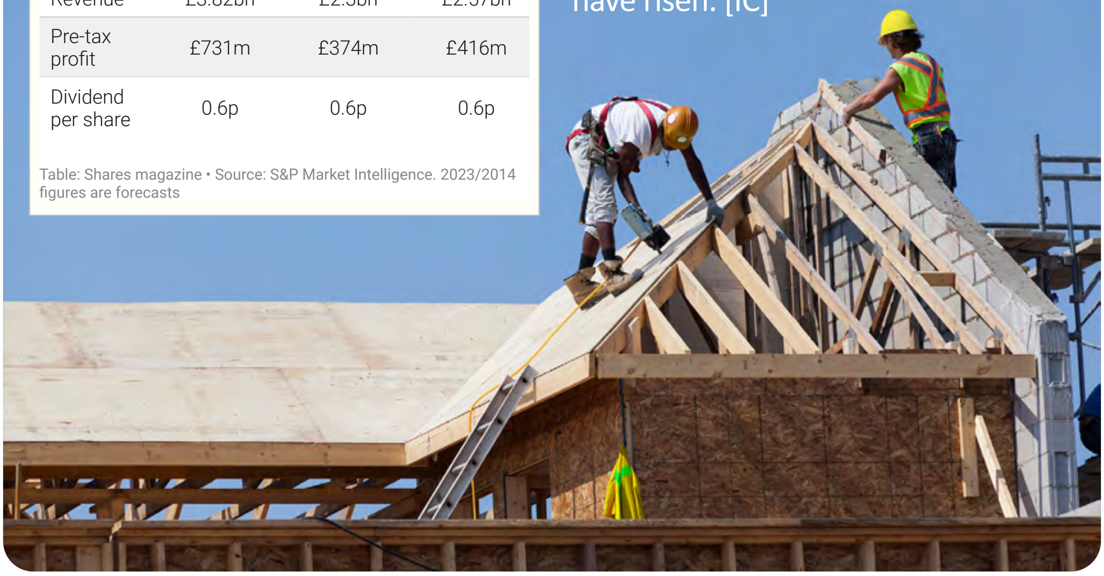
Net private reservations will also be scrutinised, having collapsed to 0.3 per outlet per week in the final quarter of 2022 after the disastrous 'mini-Budget' and recovered to 0.62 in the first quarter – still a long way short of the 0.98 ratio of the first quarter last year.

Anecdotal evidence suggests the supply chain squeeze and shortage of materials which followed the invasion of Ukraine have eased, so there may be some positive news on input costs, but the tight labour market means wages are likely to have risen. [IC]

What to expect from Persimmon

	2022	2023E	2024E
Revenue	£3.82bn	£2.3bn	£2.57bn
Pre-tax profit	£731m	£374m	£416m
Dividend per share	0.6p	0.6p	0.6p

Table: Shares magazine • Source: S&P Market Intelligence. 2023/2014 figures are forecasts



This is how much Walt Disney should have made in its third quarter

The entertainment giant has been pushing for an increase in Disney+ numbers

Entertainment giant **Walt Disney (DIS:NYSE)** is scheduled to report third quarter earnings on 9 August with analysts forecasting $22.49 billion revenue (Q3 2022: $21.5 billion) and $0.99 earnings per share (Q3 2022: $1.09).

The $158 billion group, which combines content production, streaming services, theme parks and licencing, reported a 13% increase in revenue to $21.8 billion in the second quarter compared to the same period a year earlier. However, subscribers at its streaming operation Disney+ shrank by 4 million to 157.8 million, which compares with 238 million subscribers at **Netflix (NFLX:NYSE).**

Chief executive Bob Iger originally planned to stay at Disney until 2024 but recently extended his contract to 2026. Since returning to the company last year, he's focused on cost-cutting, restructuring, improving staff morale and finding a successor for the top job.

Walt Disney

($)

Chart: Shares magazine • Source: Refinitiv

What to expect from Walt Disney

Period	Revenue	Earnings per share
Q3 *(3 months to 30 June 2023)*	$22.49bn	$0.99
Q2 (3 months to 31 March 2023)	$21.8bn	$0.93
Q1 (3 months to 31 Dec 2022)	$23.43bn	$0.99

Table: Shares magazine • Source: Investing.com *Forecast

Another key priority is making Disney+ profitable, which Iger hopes to achieve by the end of the 2024 financial year. Disney+ launched in 2019 and its original goal was to 'flood the digital shelves with as much content as possible'.

After rallying at the start of the year, shares in Disney have been drifting downwards for the past six months as investors question if Iger's turnaround programme could take longer than previously expected to execute. [SG]

US UPDATES OVER THE NEXT 7 DAYS

QUARTERLY RESULTS

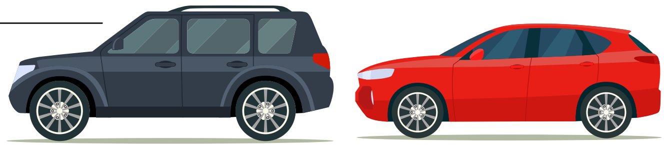
August 4: Enbridge, Dominion Energy, Fisker

August 7: Berkshire Hathaway, Tyson Foods, Palantir, IFF, Tyson Foods, Beyond Meat

August 8: Eli Lilly, United Parcel Services, Softbank, Datadog, Restaurant Brands, Sun Life Financial, Bentley, Warner Music, Endeavor, Duolingo, Squarespace, Seaworld Entertainment

August 9: Walt Disney, Manulife Financial, Illumina, Roblox

August 10: Ralph Lauren, Krispy Kreme



Buy cash generative Inchcape: the shares are cheap and there's plenty of fuel in the tank

The FTSE 250 car distributor has scope to significantly improve its global market share

Inchcape	
(INCH)	
Price:	822p
Market cap:	£3.39 billion

Leading global automotive distributor **Inchcape's (INCH)** resilient business model and growth potential remain underappreciated by investors. Now is a great time to buy the shares, which are cheap relative to history.

Through its 'Accelerate' strategy, the FTSE 250 company is helping to consolidate a fragmented global market by leveraging its geographic footprint and relationships with car makers. It has scope to penetrate more territories with a wider range of automotive brands. Inchcape's bumper surplus cash flows can also fund further acquisitions or share buybacks.

Sometimes lumped in with car retailers operating on skinny margins and with exposure to the vagaries of the economic cycle, Inchcape is a different beast.

It is a global business with operations in more than 40 markets and an increasing focus on higher margin and resilient distribution activities.

Its responsibilities span everything from product planning and pricing to import and logistics, marketing and the management of physical sales and aftermarket services.

Furthermore, Inchcape's regional exposure is shifting further towards fast-growing and complex emerging markets, everywhere from Argentina, Indonesia and Thailand to Macau, Chile and Kenya.

The company works with over 50 brand partners, ranging from BMW and Toyota to Land Rover, Peugeot, Suzuki and Geely. It helps car manufacturers to keep up with the rapid pace of industry change through the combination of market expertise, unique technology and advanced data analytics.

Inchcape's shares revved higher on well-received first half results (27 July) showing revenue up 45% to £5.6 billion and a 35% adjusted pre-tax profit growth to £249 million. The impressive numbers reflected strong organic growth supplemented by acquisitions, notably Derco, which has transformed Inchcape's market position in the Americas, a region with high economic growth and low motorisation rates.

During the half-year period, Inchcape concluded 11 new distribution deals or transactions, including a global agreement with Great Wall Motors that has significantly increased Inchcape's electric vehicles offering.

With positive momentum at its heels, Inchcape expects full year 2023 pre-tax profits to be towards the top end of the £470 million to £506 million consensus range. Investment bank Jefferies is looking for £499 million pre-tax profit this year, £549 million in 2024 and £604 million in 2025.

Based on this year's 86.2p earnings per share estimate and a forecast 34.5p dividend, Inchcape trades on a prospective price to earnings ratio of 9.5, low relative to historic multiples, and with a 4.2% yield. [JC]

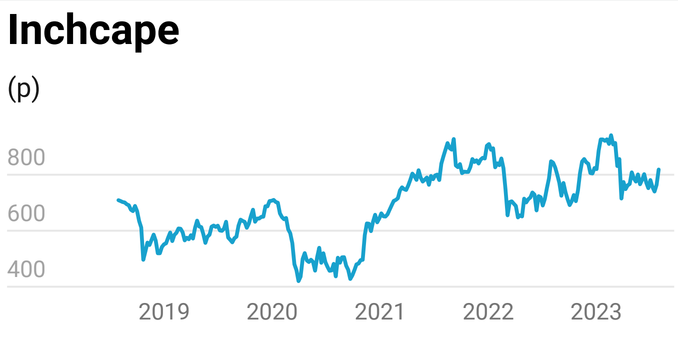


Chart: Shares magazine • Source: Refinitiv

Calnex is a UK tech growth story with great recovery potential

We believe the stock could be trading at 180p within 18 months

Calnex Solutions	
(CLX:AIM)	
Price:	120.5p
Market cap:	£103 million

Most investors don't buy small caps through an index, it's much more of a stock picker's playing field. This is why opportunities can be spotted even in the face of lacklustre performance overall.

While fund managers have been calling the turn for smaller companies all year with little success, *Shares* believes it has uncovered a good investment opportunity to buy into a fantastic 'made in the UK' technology business at an attractive price.

At the start of 2023, **Calnex Solutions' (CLX:AIM)** shares traded at 194p, having braved pandemic markets by listing its shares on AIM in September 2020 at 48p. The stock now changes hands at a 38% discount to January's price.

Before we get into why, let's explain what Calnex is. The Scotland-based company is a global leader in the telecoms network testing space with a distinguished list of customers.

It serves businesses all over the world and across the communications value chain, with leading customers including **BT (BT.A)**, **Ericsson (ERICB:ST)**, **Nokia (NOKIA:HEL)**, **Intel (INTC:NASDAQ)**, and more recently, hyperscale cloud computing providers.

Calnex won its first significant order last year with Facebook-owner **Meta Platforms (META:NASDAQ)**. FTSE 250 telecoms testing kit expert **Spirent (SPT)** is a major partner and sales channel for Calnex equipment.

Expanding products and services beyond its core next generation mobile networks and superfast broadband into other high-growth sectors, like cloud computing, data centres, and applications testing, has been a major driver of growth in recent years.

Profitable and cash generative, it puts capital to very good use, with return on capital employed, Fundsmith boss Terry Smith's favourite financial metric, averaging 25.7% over six years.

So, why have the shares been weak? It's down to major customers delaying investment thanks to recession fears. This saw March 2024 forecasts slashed earlier this year, and the share price to fall from 171p to 117p. Component supply chain problems didn't help, although these have largely tailed-off.

There's not much Calnex can do about macroeconomic trends, but it does imply there is nothing fundamentally wrong with the business, and that it has substantial recovery scope.

Calnex has already said its mid-term pipeline strengthened in the first quarter of fiscal 2024, while it remains exposed to many of the world's mega growth trends.

By the start of 2024 we could be looking ahead to 2025 expectations of around 7p of earnings per share, the original 2024 forecast, implying a price to earnings multiple of 17, about a 40% discount to the pre-warning PE ratio. That could see 50%-odd share price upside over the next 12 to 18 months. [SF]

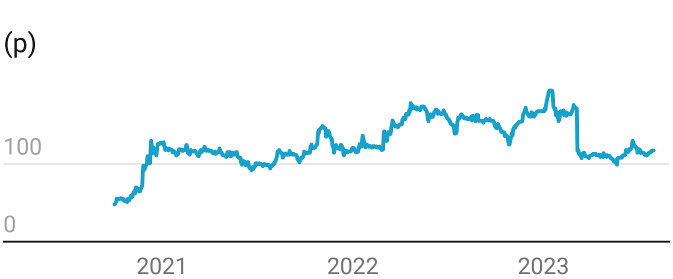


Chart: Shares magazine • Source: Refinitiv

Don't be angry at Heineken's results as the future looks a lot brighter

The shares are really cheap and experts predict a much better time as we move into 2024

Heineken
(HEIA:ASM) €89.44

Loss to date: 6.5%

We highlighted Dutch brewing group **Heineken (HEIA:ASM)** on 20 July for its steady long-term earnings growth which has averaged 8.7% a year since 1992 and the fact the shares traded at their cheapest in a decade based on a cyclically adjusted price to earnings or CAPE basis.

WHAT HAS HAPPENED SINCE WE SAID TO BUY?

Going into the half-year results (31 July) analysts expected the group to report a mid-single digit decline in volume sales and operating profit due to weakness in one or two emerging markets and tough comparisons in Europe.

The actual results came in short of expectations while the company also cut full year operating profit guidance from mid to high-single digit growth to flat to mid-single digit growth, sending shares in the world's second largest brewer down nearly 8% on the day.

Organic revenues grew 5.5% in the six-month period thanks to price increases, which the firm said it had 'front-loaded' this year, although this resulted in a 5.6% drop in organic beer volumes and sent like-for-like operating profit down by a worse-than-expected 8.8% to €1.94 billion.

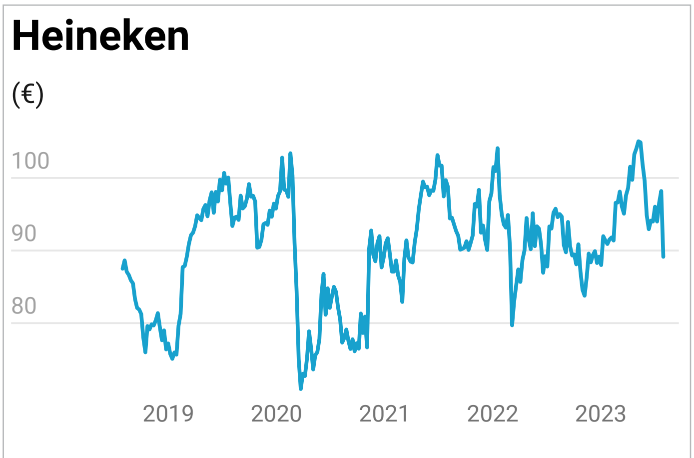


Chart: Shares magazine • Source: Refinitiv

Bank of America acknowledges the disappointing first-half outturn, but notes management is guiding for a 'significant' improvement in the second half driven by better volumes, easing input cost pressures and more cost savings.

The bank sees consensus 2023 earnings per share falling by mid-single digits yet remains positive on the shares, arguing the worst is now behind with a better second half and strong 2024 ahead.

Meanwhile, the bank estimates the shares trade on an approximately 15% discount to consumer staple peers compared with a five-year average of 1%, suggesting overly depressed expectations.

WHAT SHOULD INVESTORS DO NOW?

Shares remains positive on the investment case for Heineken despite the short-term setback in the first-half results which largely reflects management actions to bring forward price hikes.

Price increases are expected to moderate for the rest of the year which should have a positive effect on volumes. The shares remain too cheap. Keep buying. [MG]

Sensible time to bank some profit after Lam Research nearly doubles

It's had a great run but ongoing challenges would suggest now is a good time to lock in gains

Lam Research
(LRCX:NASDAQ) $718.49

Gain to date: 92%

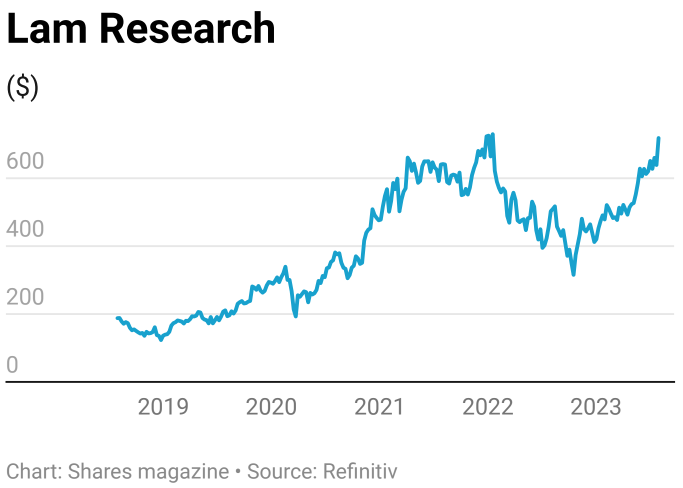


Chart: Shares magazine • Source: Refinitiv

The mood is changing around microchips, where oversupply issues may have peaked and demand is getting back on the front foot.

Microchips kit maker **Lam Research (LRCX:NASDAQ)** hinted at the importance of both factors in its latest quarterly results, reporting better-than-expected figures. Its shares have nearly doubled in price since we said to buy last October.

WHAT HAS HAPPENED SINCE WE SAID TO BUY?

In its fourth quarter results to 25 June, Lam Research generated $3.21 billion revenue, down 31% year-on-year and 17% sequentially. Earnings per share declined by about 1% to $5.98. While that may seem disappointing, it was much better than forecast. Analysts expected $3.16 billion revenue and $5.11 earnings per share.

Also pleasing investors was optimistic commentary from Lam Research and current quarter guidance above market projections.

'While 2023 is a down year [for wafer fabrication equipment], the long-term dynamics for the semiconductor industry are strong,' said Lam Research chief executive Tim Archer, noting that the world is still in the early stages of adopting new technologies such as artificial intelligence, and that he expects the wave to continue over the next few years.

Management guided for $3.4 billion revenue and $5.82 earnings per share in the current quarter, above analyst expectations of $3.3 billion revenue and $5.54 earnings per share.

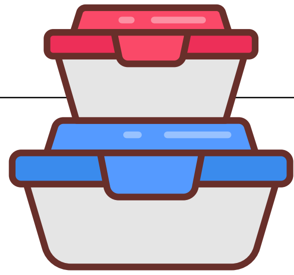
Semiconductor equipment peers like **ASML (ASML:AMS)**, **KLA (KLAC:NASDAQ)**, **Analog Devices (ADI:NASDAQ)** and **Tokyo Electron (8035:TYO)** have been making similarly bullish comments.

WHAT SHOULD INVESTORS DO NOW?

Is it boom time again for chips and chips kit makers? Let's not get carried away, there are still huge challenges ahead, not least the ongoing tech battlefield between Washington and Beijing.

Lam Research's share price is close to all-time highs and is trading on a mid-teens 2024 price to earnings multiple. This gives us pause, and we believe investors who have enjoyed this latest rally show book some profit. [SF]

Editor's View: Daniel Coatsworth



Meme stocks are back into overdrive: it is best to avoid them

Triple-digit gains in just a few days may sound lucrative but this is not proper investing

Should we be worried that meme stocks are back in fashion? I think so. Traditionally associated with lower-quality companies, the fact traders are chasing these types of names could be seen as being top of the market behaviour, certainly for the US where returns have been very good in 2023.

Big money has been made on companies classified as meme stocks this year. For example, food container group **Tupperware (TUP:NYSE)** saw its share price rise by a dramatic 379% in the eight days to 28 July. That's quite a move for a company which warned four months ago that it needed more cash or it could go bust.

Even more fruitful has been online used car retailer **Carvana (CVNA:NYSE)** with a 774% share price gain year-to-date. It recently announced a plan to reduce debt while also reporting better than expected results. However, less than a year ago the company was cutting jobs and was surrounded by speculation of bankruptcy.

What unites both Tupperware and Carvana is that both companies are seen has being damaged goods, businesses with a multitude of problems that need fixing. They are also heavily shorted by people hoping to profit from a falling share price. That's two of the three core ingredients for a meme stock, the other being a hot topic of discussion on social media.

Traders have been known to target stocks with these ingredients with a view that mass buying of the shares will push up the price and cause a short squeeze. They want to ride that 'squeeze' and achieve supersized returns. It's a risky strategy and meme stocks have shown to be extremely volatile, falling as fast as they've risen.

If you want a list of which companies qualify as meme stocks, look no further than the holdings of the **Roundhill Meme ETF (MEME:NYSEARCA)**. It follows an index of companies that are being talked about on social media and are being heavily shorted.

Companies considered to be meme stocks*

Upstart	AI lending platform
Nio	Electric vehicles
Carvana	Online car retailer
Rocket Lab	Aerospace manufacturer
Carnival	Cruises
Rivian Automotive	Electric vehicles
AMC Entertainment	Cinemas
Lucid	Electric vehicles
DraftKings	Gambling
Affirm	Fintech

Table: Shares magazine • Source: Roundhill, 28 July 2023. *According to Roundhill Investments as they are constituents of its Meme ETF.

The index is rebalanced every two weeks.

What's interesting is that the current portfolio isn't restricted to broken companies, as one might expect with meme stocks. Yes, it includes a rogue's gallery of battered and bruised firms, but you also get companies that have been delivering good news. This includes cruise ship operator **Carnival (CCL)** and fantasy sports betting operator **DraftKings (DKNG:NASDAQ)**.

Carnival is up 133% year-to-date as the cruise industry has seen a surge in demand while DraftKings is up 190% this year thanks to better-than-expected results and growing interest in fantasy sports betting.

That suggests the current meme stock craze is not simply about chasing zombie companies like it was last time. It might also be classic momentum investing – buying into stocks that are going up, albeit with the extra filter that these names need to be heavily shorted.

Chasing stocks simply because everyone is talking about them is a fool's game. Long-term investors should look elsewhere for financial gains.

ANALYSE A STOCK IN 5 EASY STEPS

This week: Microsoft

By **Steven Frazer,** News Editor

Stock research is a lot like buying a car. You can base a decision solely on technical specifications, but it's also important to consider how the ride feels on the road, the manufacturer's reputation and whether there is enough space.

Equity investors can choose from thousands of stocks – nearly 2,000 in the UK and another 6,000 or so in the US. Australia, Canada and Europe offer even more.

There is no single way to analyse these companies; after all, banks, miners, pharmaceuticals and tech firms all have their unique characteristics. You could spend months pouring over financial reports, statistics and news relevant to each, but it doesn't have to be this way.

Microsoft has outperformed the US market over the past 12 months

Rebased to 100

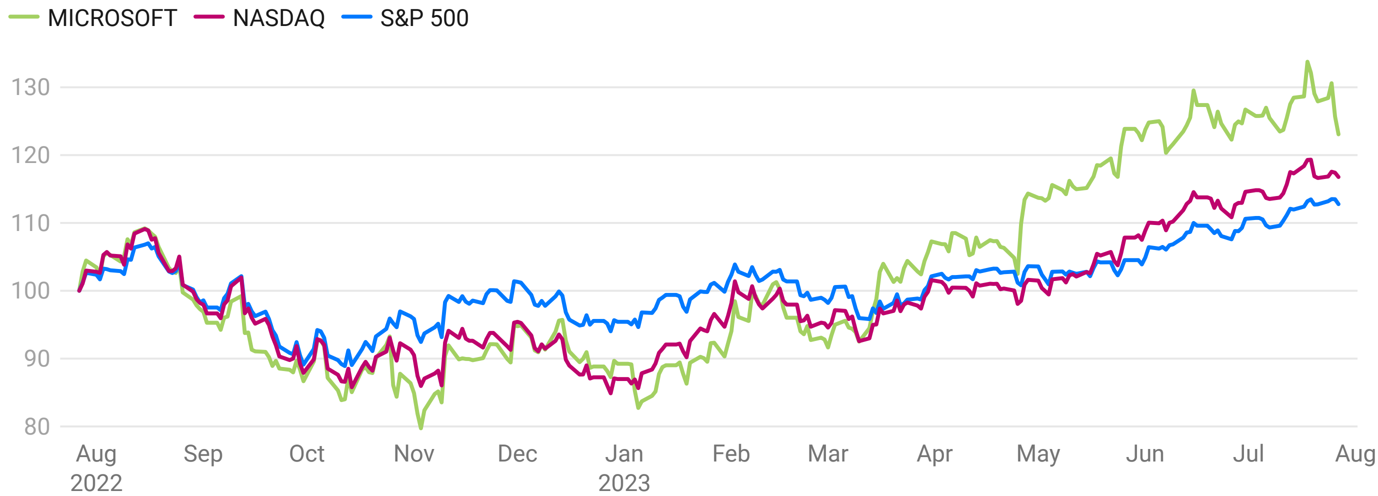


Chart: Shares magazine • Source: Refinitiv

In a new mini-series, *Shares* offers a simple framework which will help form the basis of your investment research.

ANALYSING MICROSOFT

In this opening episode, we are going to look at **Microsoft (MSFT:NASDAQ)**, one of the world's largest and widely-owned companies, and whose share price has been on a tear this year, up 38% since the start of January.

Hopefully, you will come away from this feature with a far deeper understanding of what has driven the software giant's past performance, and a decent chance of sizing up whether that will continue in the future.

STEP ONE ANALYSING SALES GROWTH

As with most growth companies, the best place to start is to look back at the company's history of revenue expansion.

The past five years is fine, but 10 years is better as it should give you a real feel for its growth journey, information that gives you a sharp lens through which to peer into the future.

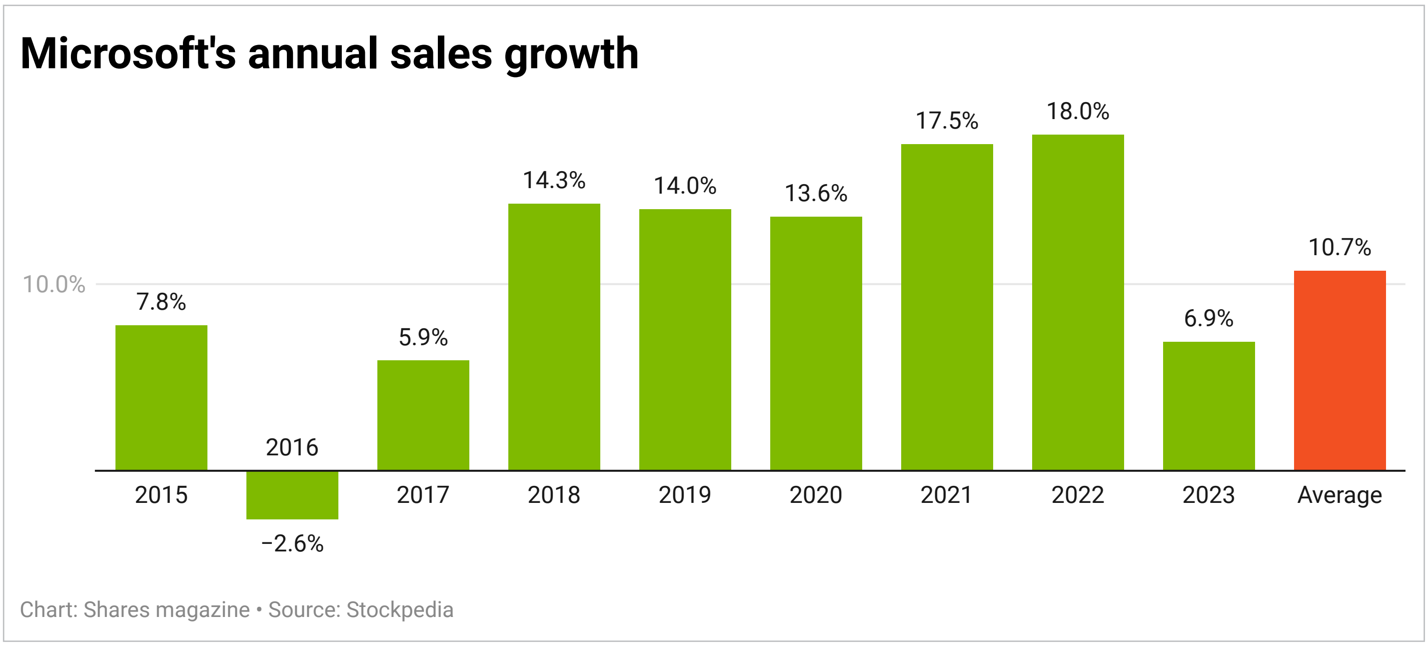
What immediately stands out is that Microsoft's growth has accelerated in recent years, albeit slower in the 12-month period to June 2023.

We know cloud computing has been a big driver, and Microsoft has been very successful at selling its main products – the Windows operating systems, Microsoft 365 suite of productivity applications, Azure big data analytics, etc – as cloud-hosted subscriptions rather than upfront licences.

Cloud computing might seem new, but tech industry experts have been talking about it for decades. Most experts believe we are still in the early adoption phase. What's made the difference in recent years is faster broadband and mobile connections, and advanced microchips giving us much more powerful smartphones and laptops.

That shift from licences to subscriptions temporarily impacted the way Microsoft recorded revenue, meaning growth technically slowed down for a few years during the middle of the last decade. But the switch has paid-off massively, as we can see from Microsoft's far-faster growth since 2018.

We also know that demand for Microsoft's cloud-based products and services exploded during the pandemic, a huge enabler of work-from-home.



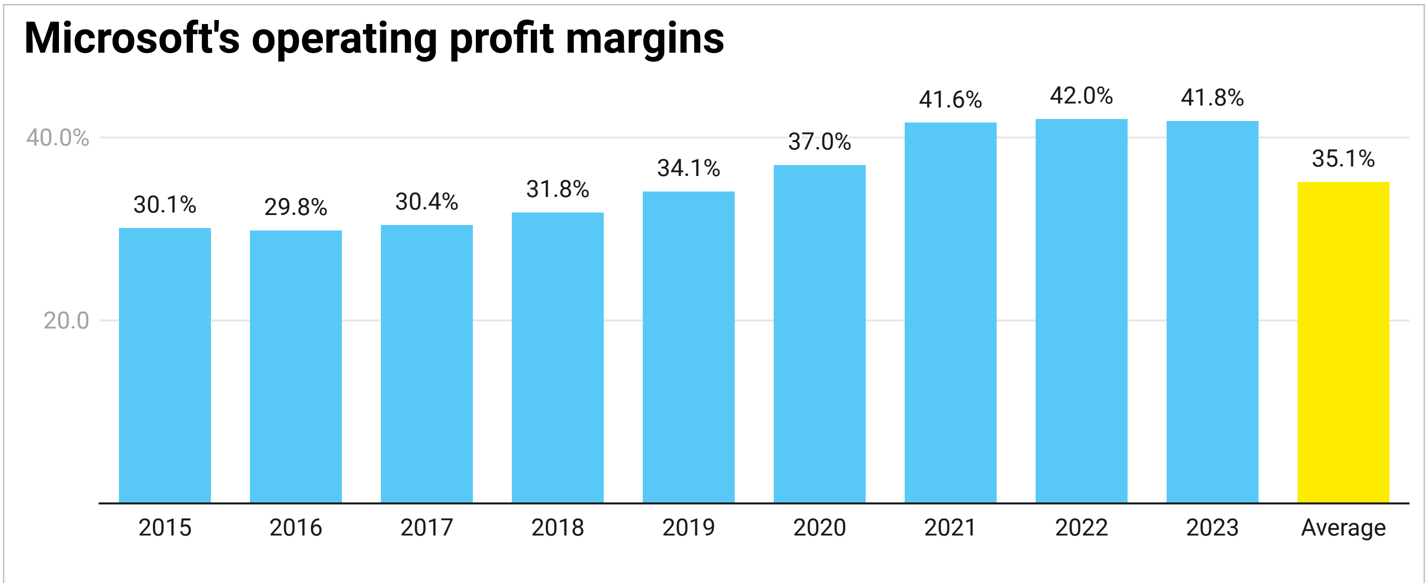


Chart: Shares magazine • Source: Stockpedia

This slowed last year, perhaps inevitably for a business generating nearly $212 billion of annual sales.

There is now another catalyst to fire up sales. Microsoft has emerged as an AI (artificial intelligence) leader, a market looking at enormous growth over the next few years. Data from Statista estimates AI revenues across the tech sector will go from roughly $95 billion in 2021 to $1.85 trillion by 2030.

Putting all of this together, Microsoft's average annual revenue growth of 10.7% over the past decade looks sustainable and could accelerate if the company is able to remain one of the dominant AI forces going forward.

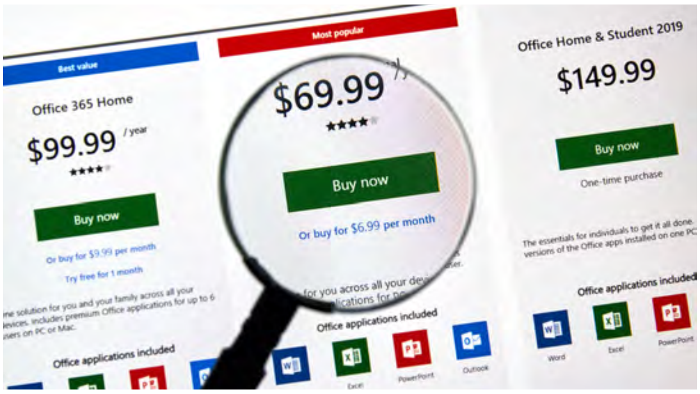
STEP TWO
HOW PROFITABLE ARE SALES?

Next, we want to work out how profitable those sales are likely to be in the future. We do this by looking at operating profit margins, or sometimes called EBIT (earnings before interest and tax) margins.

If margins expand, then profit will grow faster than sales, while the reverse is true.

There are encouraging signs with Microsoft's margins, with the software giant's sales becoming increasingly profitable over time. The pattern ties in with the shift to subscriptions, further evidence that the transition was well worth the bumps along the way.

By and large, about 10 percentage points have been added to operating profit margins since



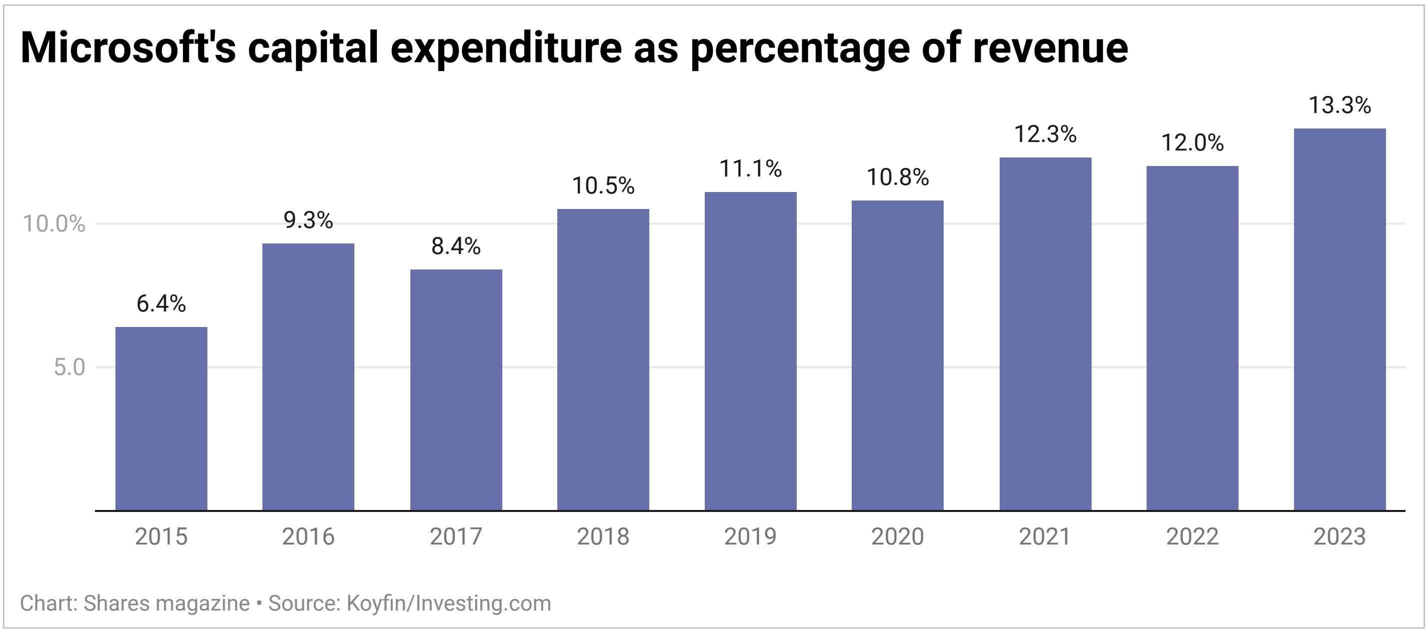
2014. To think of it a different way, the margin improvement over 10 years added roughly $23 billion of extra operating profit from last year's $211.9 billion sales, about $88.5 billion instead of the approximate $65.7 billion had margins stayed flat.

STEP THREE
HOW MUCH PROFIT CONVERTS INTO CASH?

Microsoft will have to invest significant sums in AI to maximise returns from the technology. Capital expenditure as a percentage of sales in low double-digits (13.3% in fiscal 2023) looks unlikely to return to the high single-digits of eight years ago.

This implies free cash flow as a percentage of net income will remain depressed for the next few years. On the other hand, Microsoft's largely subscriptions model means the company is already a very powerful free cash flow machine that has been adding extra muscle in recent years.

Free cash flow in fiscal 2021, 2022 and 2023 was reported at $41.3 billion, $49.5 billion and $52.5



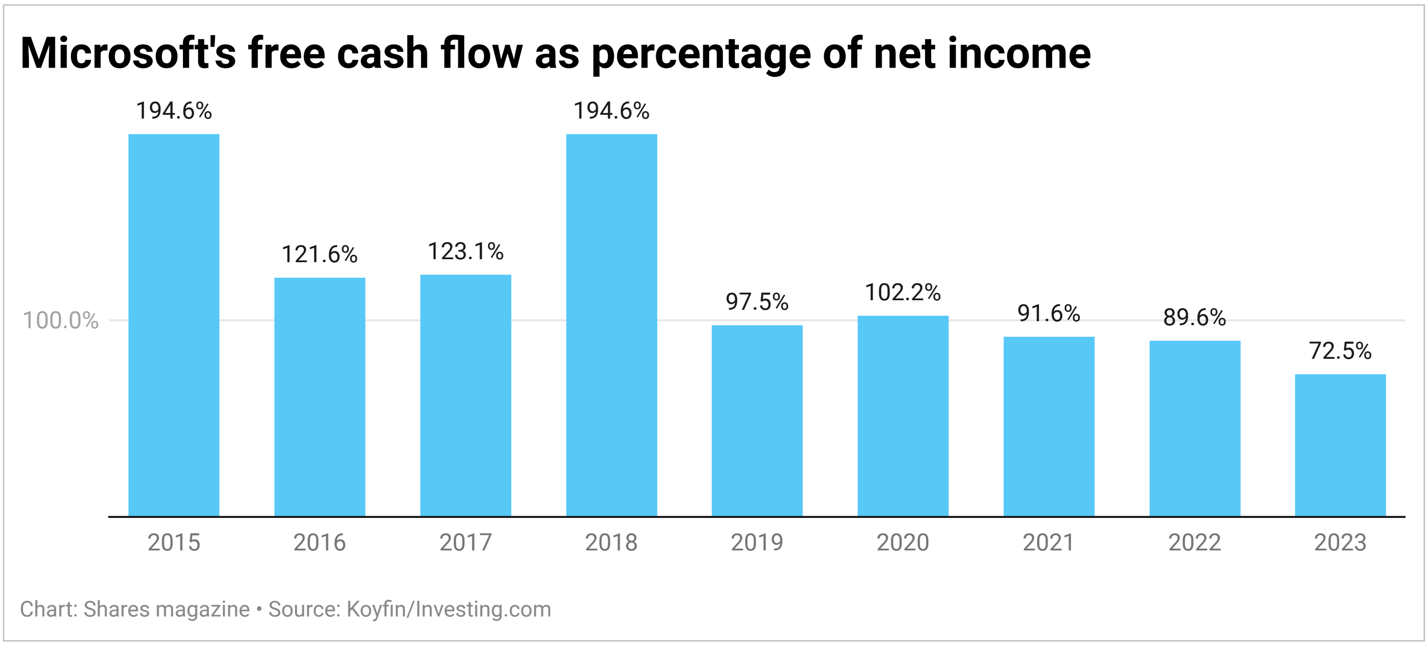
billion respectively, giving Microsoft a large margin of safety for its investment plans. If Microsoft can continue to convert more of its net income into cash flow going forward, free cash flow will grow faster than net profit.

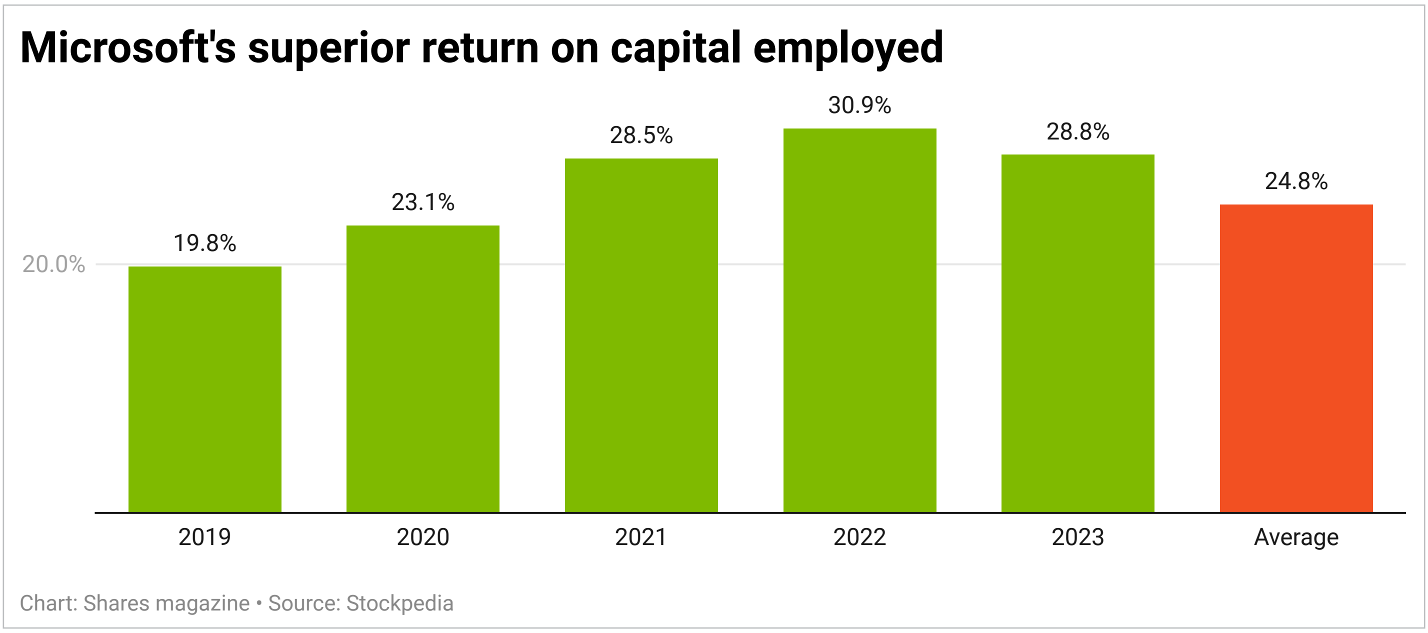
STEP FOUR
QUALITY OF MICROSOFT'S MODEL

Microsoft's balance sheet shows the firm has around $111 billion in cash and short-term investments (shown under the assets side of the balance sheet), and roughly $60 billion in long-term debt (that's the liabilities side).

Servicing more debt could soak up cash flow in the form of interest and capital payments but that's clearly not an issue for Microsoft.

At this point in our analysis, we want to examine return on capital employed, or ROCE, the single most important financial metric for **Fundsmith**





Equity's (B41YBW7) Terry Smith. In simple terms, return on capital employed in the high teens is good, above 20% is very good.

Return on capital employed is a measure of how effectively a company invests its surplus cash to create extra value for shareholders. Microsoft's 24.8% six-year ROCE average means that for every $1 invested, it has created $0.248 of shareholder value. What's more, Microsoft has been getting better at investing its capital over recent years, and there is no reason to believe that an average ROCE of around 25% isn't sustainable in the future.

STEP FIVE VALUATION CHECK-UP

The evidence for owning Microsoft shares is compelling. The wider market largely agrees, hence why the stock has performed well over the years. A 38% year-to-date gain is impressive compared to the S&P 500's 19% return, and it also beats the Nasdaq Composite's 35% return.

Owning the stock has returned an average 27% a year since 2014, far better than either the Nasdaq Composite's 15.7% or the 12.5% of the S&P 500, according to Morningstar data.

The flip side to this situation is that Microsoft's shares are not cheap. At roughly $330, the stock trades on nearly 30 times forward earnings. But it is questionable how useful a simple one-year price to earnings (or PE) ratio really is, given that growth firms like Microsoft are expected to produce much greater cash flows and profits in the future.

One easy way to adjust the PE ratio is to look at available forecasts and take an average over a three-year period. According to Koyfin data, Microsoft is expected to post earnings per share of $11, $12.7 and $14.6 in fiscal 2024 through to 2026. This implies an average three-year PE of about 26 on mid-double-digit earnings growth.

An average three-year PE is an imperfect solution, and it also doesn't account for Microsoft's vast $111 billion cash pile. An alternative valuation metric used by analysts is EV/EBITDA, or enterprise

Chart: Shares magazine • Source: Refinitiv

value to earnings before interest, tax, depreciation and amortisation.

The traditional rule-of thumb is that an EV/EBITDA of 10 or below is attractive, while mid-teens multiples are not unusual for growth companies. Given Microsoft's reliable subscription income streams, high profit margins and excellent cash conversion, you would expect to pay a premium.

Microsoft's enterprise value stands at $2.35 trillion, based on its $2.46 trillion market value minus the $111 billion of net cash. This implies a one-year EV/EBITDA multiple of 20, based on the $117.8 billion consensus EBITDA for the year to June 2024.

But as with the PE ratio, the EV/EBITDA ratio doesn't account for Microsoft's forecast EBITDA growth, again projected in the mid-teens by analysts. Applying the same three-year average calculation would put Microsoft on a 17.5-times EV/EBITDA multiple.

ARE THE SHARES WORTH BUYING?

In short, yes. Microsoft is one of the world's highest quality businesses with a proven value creation track record over multiple years.

Its tools are critical to almost every business and millions of consumers are tied into its ecosystem. This should secure its revenue, profit, cash flows and dividends for years to come.

It is already one of the world's biggest players in cloud computing, which experts believe still has years of growth to run, while Microsoft is only scratching the surface in AI, and who knows what other opportunities will emerge in time.

What we do know is that Microsoft has the expertise, market positioning and the financial might to grasp any new ventures with both hands.

DISCLAIMER: The author of this article (Steven Frazer) and the editor (Daniel Coatsworth) own shares in Fundsmith Equity.

Find out how JPMorgan Global Growth & Income is performing ahead of the pack

This global best ideas portfolio is laser focused on companies' free cash flow

Latest statistics from the Association of Investment Companies' Global Equity Income sector shows one trust is by far the best 10-year share price total return performer thanks to impressive asset growth and strong investor appetite for its winning strategy.

JPMorgan Global Growth & Income (JGGI) or 'JGGI' for short, comfortably tops the table over that period, having returned 254% over the past decade. This is substantially ahead of peers including **Scottish American (SAIN)**, **Henderson International Income (HINT)** and **STS Global Income & Growth (STS)**, which have delivered 185%, 108% and 103% respectively.

JGGI's long-term investment strategy targets capital growth and an attractive dividend yield, thereby providing investors with the best of both worlds. This strategy has resulted in a consistent sector-leading long-term performance track record, with the trust successfully navigating volatile market conditions, which is why we added the name to our list of *Great Ideas* selections last September.

BUY INTO THE BEST GLOBAL IDEAS

Mergers with Scottish Investment Trust and JPMorgan Elect have contributed to the growth of JGGI's assets – totalling the best part of £2 billion at last count – which has catapulted the company into the FTSE 250 and given it greater scale, which allowed for a significant reduction in charges. In addition, the board's strict discount control policy has seen the trust return to trading at a slight premium, closer to its long-term average.

'When we do these things (mergers), we go through a little bit of a discount for a short period,' explains James Cook, who recently replaced Rajesh Tanna as co-portfolio manager to work alongside Helge Skibeli and Tim Woodhouse. 'It was about a quarter while we did the Elect merger, and then that pretty quickly went back to a premium.'

JPMorgan Global Growth & Income in a nutshell

AIC Sector	Global Equity Income
Share price	472p
Premium to net asset value	0.55%
Dividend yield	3.91%
Ongoing charges	0.56%

Table: Shares magazine • Source: The AIC, JPMorgan Asset Management, 25 July

Global Equity Income Sector - 10-year share price total return performance

JPMorgan Global Growth & Income	254%
Scottish American	185%
Invesco Select Trust - Global Equity Income shares	124%
Henderson International Income	108%
STS Global Income & Growth	103%
Murray International Trust	72%
British & American	−43%

Table: Shares magazine • Source: The AIC, data as at 25 July 23

GROWING FASTER THAN THE MARKET

He informs *Shares* that JGGI's objective is to provide superior total returns and outperform the MSCI All Country World index over the long-term by investing in the managers' best global ideas.

The trust pays quarterly distributions that are set at the beginning of each financial year and, on aggregate, the intention is to pay dividends totalling at least 4% of the fund's net asset value at the time of announcement. This can be topped up using the trust's capital reserves in the event of a shortfall.

Bottom-up stock pickers Skibeli, Woodhouse and Cook are focused on building a high conviction portfolio of 50 to 90 stocks, drawing on an investment process underpinned by fundamental research. 'This is a core portfolio,' continues Cook, 'so we want to be able to give a balance between growth and income which allows us to perform relatively well through these big style regimes.' This focus on identifying compelling individual investments rather than concentrating on any specific sector has resulted in a reassuringly diversified portfolio.

JPMorgan Global Growth & Income

Chart: Shares magazine • Source: Refinitiv

'What we are trying to achieve at a portfolio level is give you superior quality of earnings,' enthuses Cook, an investor in high-quality, cash-generative companies with strong balance sheets and 'high barriers to profitability, so your **Amazon (AMZN:NASDAQ)** of the world where a huge amount of capital has been spent in these businesses. Other companies wouldn't be able to spend anything close to that capital, and even if they did, the barriers to profitability would be even higher.

'We want to be able to find stocks with plenty of growth for years to come and get them at a better price than the market. That's the hard part, that's what makes us unique.'

One of the trust's competitive advantages is the managers' ability to tap into the analysis of JPMorgan's experienced global research team.

'I think our research breadth is unrivalled, we spend $150 million on fundamental research, we make over 5,000 company interactions a year and we're covering 2,500 stocks,' he says. 'And less than 3% of the stocks we look at make the final portfolio.'

WHAT'S IN THE PORTFOLIO?

Boasting a five-star Morningstar rating, JGGI is invested in technology giants including **Meta**

Leading sectors in JPMorgan Global Growth & Income's portfolio

As of 30 June 2023

Technology - Semi & Hardware	13.6%
Media	10.6%
Pharm/Medtech	8.7%
Technology - Software	7.9%
Financial Services	7.1%
Banks	6.3%
Retail	6.2%
Industrial Cyclicals	6.1%
Energy	4.3%
Utilities	4.2%

Table: Shares magazine • Source: JPMorgan Asset Management

Platforms (META:NASDAQ) Amazon and **Microsoft (MSFT:NASDAQ)**, the latter 'fast becoming the leader in cloud computing where we see enormous levels of growth for many years to go, and then you've got the additional AI kicker'.

Also in the top 10 are the likes of GPU designer **Nvidia (NVDA:NASDAQ)**, the world's largest contract chipmaker **Taiwan Semiconductor Manufacturing Company (TSM:NYSE)**, healthcare and insurance company **UnitedHealth (UNH:NYSE)**, payment processor **Mastercard (MA:NYSE)**, beverages behemoth **Coca-Cola (KO:NYSE)** and derivatives exchange **CME (CME:NASDAQ)**.

'We're very focused on free cash flow generation,' stresses Cook, 'more so than earnings because at the end of the day, shareholders get the free cash flow not the earnings.' Given this emphasis, the bulk of JGGI's investments are in high-quality franchises, but to give shareholders that balance of income, the trust also offers exposure to sectors such as utilities, which enhance the dividend yield and aids performance through market and economic cycles according to Cook.

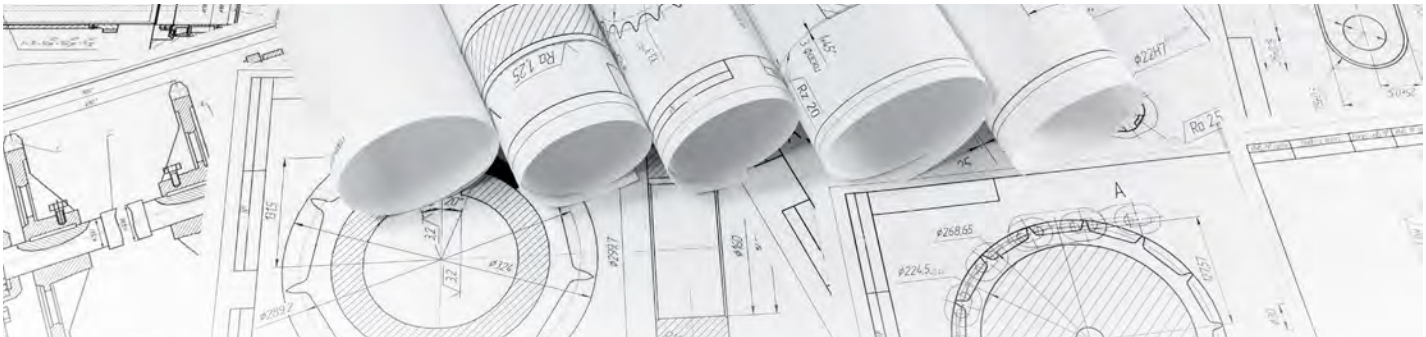
'Over the last four, five years, we've delivered through the cycle. We want to have that balanced portfolio, so our excess return is independent of the style regime we're in, so whether that is a growth or value regime, or risk-on, risk-off,' he explains.

Addressing the stake in Coca-Cola, Cook concedes the drinks colossus is relatively mature, but that gives the company 'great pricing power' and means the stock is a source of robust dividends. 'We haven't seen a huge amount of competition in that field compared to alcoholic beverages for example. A can of Coke is 70p versus say a £70 bottle of whiskey, so if the consumer does go through a recession, we know where they are going to be taking their money from first.'

Outside of the top 10, JGGI offers exposure to an array of names ranging from energy giant **Chevron (CVX:NYSE)** and luxury goods leviathan **LVMH (MC:EPA)** to a new holding, **Teradyne (TER:NASDAQ)**, which provides semiconductor testing solutions and the development of collaborative robots that are set to increase efficiencies across manufacturing processes.

Also nestling in the portfolio is ride-hailing company **Uber (UBER:NYSE)**, which the managers believe offers a diverse source of growth through its delivery business as well as a counter-cyclical play in a recession as that could create easy access to a growing supply of drivers.

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



How UK engineers have transformed to top the charts on the UK market

Ways to play this standout and increasingly high-quality sector

Over the last 15 years the electronics and electronic equipment space, home to some of the UK market's highest-quality engineering and capital goods firms, is the best performing sector in the FTSE 350 with an 11.7% compound annual return.

The industrial engineering sector is not too far behind with its own annualised return of 9.7%. For comparison, the FTSE All-Share's annualised return over the same period is just 3% (excluding dividends).

The engineering sector has performed well

Rebased to 100

Chart: Shares magazine • Source: Refinitiv

Many companies have transitioned from industrial engineering to the electronics and electronic equipment sector in recent times and this reflects a real-world shift into higher-tech niches as companies look to tap into themes like electrification and automation.

THESE ARE HIGH-QUALITY BUSINESSES

The UK engineering industry has come a long way in the last 30 years. In the 1990s they could be characterised as low-margin metal bashers producing commoditised products for mature economies. There has since been significant improvement with leaner, more technically skilled companies operating in a far more diverse mix of geographies.

This is reflected in valuations. Many engineering stocks are not cheap. What investors need to decide is whether the high ratings in the sector are justified and what a more pronounced downturn in the global economy might mean for earnings and sentiment.

For those prepared to take a long-term view there are plenty of excellent businesses which could continue to reward shareholders. Two attractive opportunities can be found among firms which have lagged the rest of the sector over the last decade but which are making changes which could allow them to play catch-up, namely **Weir (WEIR)** and **Rotork (ROR)**.

The wider transformation in the engineering sector is demonstrated by strong operating margins – with many companies generating margins in the mid-teens and some even in the 20s. This is a key metric to watch in the results of companies from the sector.

UK-listed engineering stocks

Company	Sector	Forward price to earnings ratio	Operating margin (%)	One-year change (%)	10-year annualised return (%)
AB Dynamics	Industrial Engineering	34	15.9	44%	32%
Judges Scientific	Electronic and Electrical Equipment	26	26.6	20%	21%
Discoverie	Electronic and Electrical Equipment	23	11.5	19%	17%
Halma	Electronic and Electrical Equipment	28	20.4	3%	16%
Spirax-Sarco Engineering	Industrial Engineering	28	23.6	0%	15%
Volex	Electronic and Electrical Equipment	12	9.3	−3%	12%
Renishaw	Electronic and Electrical Equipment	24	24.1	−7%	11%
XP Power	Electronic and Electrical Equipment	13	14.8	−28%	8%
Spectris	Electronic and Electrical Equipment	19	16.8	20%	7%
Oxford Instruments	Electronic and Electrical Equipment	22	18.1	12%	7%
Vesuvius	Industrial Engineering	10	11.1	34%	4%
Rotork	Electronic and Electrical Equipment	21	22.3	25%	3%
IMI	Electronic and Electrical Equipment	14	17.8	31%	3%
Morgan Advanced Materials	Electronic and Electrical Equipment	10	13.6	−7%	2%
Weir	Industrial Engineering	16	16.0	20%	0%

Table: Shares magazine • Source: SharePad

The finance director of fluid and motion control engineer **IMI (IMI)**, Dan Shook, explains that underpinning a push to increase its own margins from 17.8% to 20% is the company's pricing power, namely the ability to charge more without hurting demand.

He says: 'Our products aren't the biggest cost in the system, whether it's a petrochemical facility, power plant or in precision transport, we aren't the biggest part of the cost but there are great benefits in terms of run cost and safety. We only play where price is more inelastic.

'Where you're going to win is by bringing engineering expertise to those problems and challenges which customers face and solve them in a unique way which keeps business quite sticky and generates value.'

This description could be applied to several businesses in the sector and is a reason many have been able to sustain profitability despite inflationary pressures and an uncertain economic backdrop.

THE KEY PLAYERS

At the top of the tree for listed engineers are the makers of scientific instruments: **Halma (HLMA)**, **Oxford Instruments (OXIG)** and **Spectris (SXS)**.

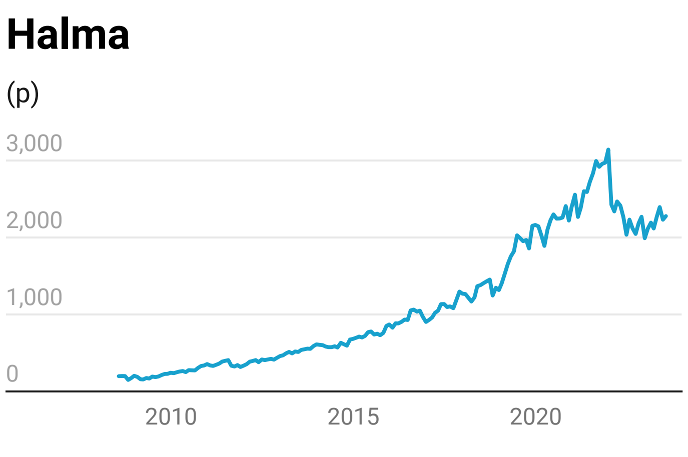


Chart: Shares magazine • Source: Refinitiv

Berenberg analyst Calum Battersby says: 'We view the scientific instruments sector as one of the highest-quality segments of the UK industrials universe. Halma, Oxford Instruments and Spectris generate higher (gross and operating) margins, higher returns and, typically, higher growth compared to the wider UK market.

'In turn, this comes from leading positions in a number of niche, non-commoditised equipment and instrument markets where the growth is typically tied to structural drivers, including improving healthcare, cleaner technology, superior materials performance and increased levels of environmental analysis.

'Over the medium term, this has resulted in significant outperformance over the wider market, which we believe can continue. Over the shorter term, while valuations have come down, they broadly remain elevated versus history, in a period when there are a range of known macroeconomic pressures that the companies are due to face.'

Along with Halma, the best performing large-cap engineering stock on a 10-year view is **Spirax-Sarco (SPX)**. The company makes products which help regulate the flow of fluids and steam. Spirax-Sarco has shone in this niche, allowing it to generate sector-leading margins. However, its first-half results on 8 August could present a test given a slowdown in demand from the pharmaceutical industry for the specialist pumps and fluid path solutions made by its Watson-Marlow division following the end of the pandemic.

Numis analyst Dominic Convey is still a believer in the longer-term potential of the business. He says: 'Notwithstanding the near-term Watson-Marlow headwind, we believe Spirax-Sarco is exceptionally well-positioned as a key enabler of industrial decarbonisation, with critical proprietary technology for the electrification of industrial heating and expect this multi-decade conversion to sustain the group's enviable record for long-term outperformance.'

A SKILLS GAP

A wider issue facing UK engineers is a growing skills gap. Though many of these businesses are international in focus, most still have some operational footprint in the UK.

According to the industry body Make's recent industrial strategy report, manufacturers have not just been contending with a shortage of highly technical skills, but a shortage of workers able to fulfil jobs in vocational roles like toolmaking as older workers retired early or were reluctant to return to work post-pandemic.

'Our metric for employment growth shows that since Q1 2020, manufacturers failed to meet their forecast recruitment figures in almost every quarter,' it comments.

The report notes two thirds of companies which contributed to the report attribute this situation to candidates lacking the required technical skills. It says this is both a potential constraint on growth and a driver of increased costs for the industry.

IMI has a graduate scheme which enables the company to bring in staff with more digital capability to work alongside seasoned engineers. Chief executive Roy Twite was even part of IMI's graduate programme himself in 1988.

The lack of skilled workers is potentially a larger problem for the smaller companies which do not

have the resources for a big graduate scheme like the one IMI runs. Nonetheless, some small and mid-cap firms have done extremely well. Most notably **AB Dynamics (ABDP:AIM)** – up more than 20-fold on the 86p at which it listed in May 2013. The company has benefited from its own investments in the business, boosting its capacity, as well as from serving an automotive industry in a state of flux and facing a wave of new regulation.

Three US-listed engineers

Rebased to 100

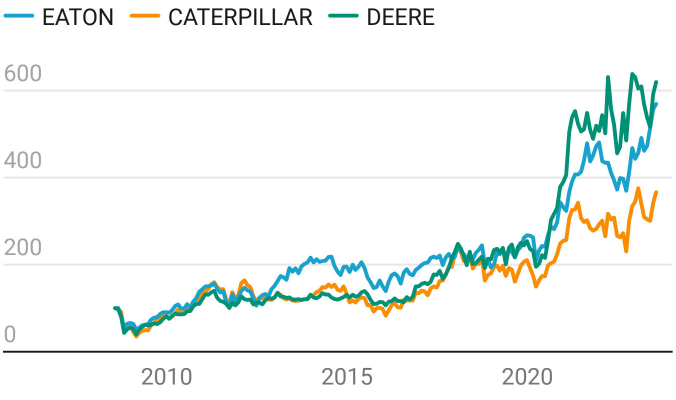


Chart: Shares magazine • Source: Refinitiv

OVERSEAS-LISTED ENGINEERING STOCKS

In a global context, all UK engineering firms remain relatively small. As in many other industries, the US is at the forefront.

Agriculture equipment specialist **Deere & Co (DE:NYSE)** and diversified industrial outfit **Caterpillar (CAT:NYSE)** are the big beasts but **Eaton (ETN:NYSE)** is perhaps the more interesting business. A global leader in industrial and electrical power management solutions the company is guiding for organic growth of 9% to 11% a year over the medium term.

Elsewhere, investment bank Morgan Stanley suggests European engineers might be unfairly neglected. It observes: 'We often encounter the perception that US industrial companies are higher quality than their European counterparts. We think this is up for debate.'

Some of the big names in Europe include French and Swiss electrical systems and automation and control firms **Schneider Electric (SU:EPA)** and **ABB (ABBN:SWX)**, and Sweden's **Sandvik (SAND:STO)** which specialises in tooling systems for metal cutting, materials technology, mining and construction.

There are several tracker funds offering specific exposure to the engineering sector but investors can gain access to the wider industrials space via a few investment products. **iShares MSCI Europe Industrials (ESIN)** offers exposure to several names mentioned in this article, alongside some big names in the aerospace, defence and general industrials sectors for an ongoing charge of 0.18%. A similar product tracking US-listed industrials is **SPDR S&P 500 Industrials (SXLI)**. This has an ongoing charge of 0.15%.

WHICH UK ENGINEERING SHARES SHOULD YOU BUY?

Over the last 10 years Weir and Rotork may not have delivered the sort of returns generated by some of their rivals but we think it could be a different story in the coming decade. The sale of Weir's oil and gas business has left it purely focused on the mining space. The stock trades on a price to earnings ratio of 16 times but we think this is justified.

Weir

Chart: Shares magazine • Source: Refinitiv

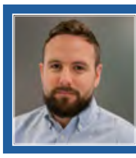
As Shore Capital analyst Akhil Patel observes: 'Population growth, the convergence of living standards, urbanisation, ore grade decline (i.e., more materials need to be processed to extract the same amount of metals/minerals) and the demand for metals/battery metals to support the global clean energy transition/decarbonisation all point in Weir's favour. Especially given the need for mining to become more efficient and reduce its carbon emissions.'

Weir is also a higher quality business following the disposal of the oil and gas arm, with higher margins and less volatility.

Rotork

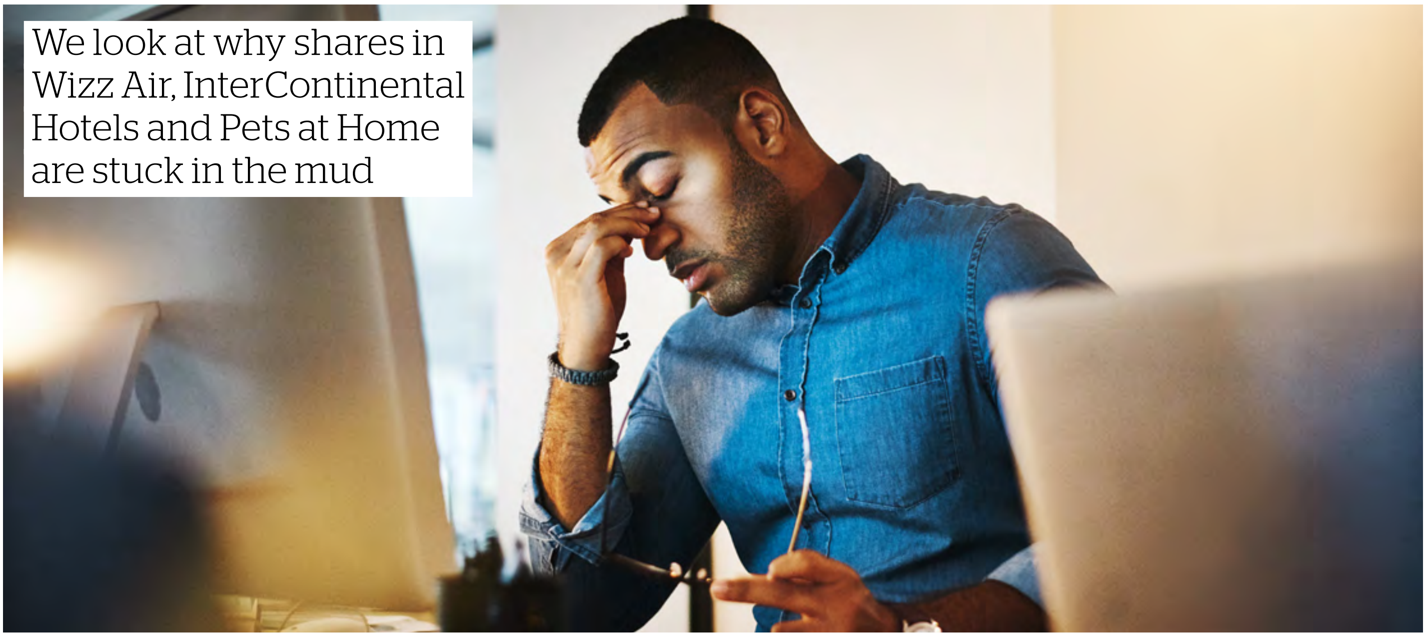
Chart: Shares magazine • Source: Refinitiv

Rotork, which provides solutions for the actuation, flow control and industrial markets, continues to have exposure to the energy sector but it could have a key role to play in the energy transition as it helps in areas like reducing methane emissions from oil wells.



By **Tom Sieber** Deputy Editor

Frustrated with a share price going nowhere? Here are reasons why they can trade sideways



It can be frustrating to watch share prices trade sideways for months. Nervous investors might question that something is going wrong with the investment case.

However, that isn't necessarily the case and there could be several reasons which explain lacklustre share prices. This article examines why it happens and highlights some factors which may give clues to what lies ahead.

WHY DO SOME SHARES DO NOTHING?

It is unrealistic to expect shares to outperform all the time. A lack of news flow can leave shares stranded as investors wait for new information to appear.

A strong period of outperformance is often followed by a quiet spell as shares consolidate gains and some investors elect to take profits.

This can be compounded by a delay in analysts upgrading earnings forecasts. Academics have long known about the effect; it means bad news travels fast and good news travels slowly.

It can therefore take time for consensus estimates to catch up and for positive news to be reflected in higher earnings estimates. Importantly, improving earnings revisions can be a trigger for institutional investors to buy.

Shares can also go quiet for non-fundamental reasons which are hard to identify and just part of the way markets work.

SHOULD INVESTORS WORRY IF A SHARE PRICE FLATLINES?

At some point, it is natural for investors to ask if the lack of share price movement is a situation they need to worry about.

It is difficult to be prescriptive, but it is useful to keep an eye on volumes traded. Quiet sideways moves within a channel typically happen on low trading volumes.

A marked increase in trading volumes accompanied by a breakout through the bottom of the trading range could signal big institutions selling out.

It is also worth keeping an eye on consensus analyst earnings revisions. When more than one analyst lowers their forecasts, it can be a sign of softer trading and potentially trouble ahead.

FLYING HIGH BUT FOR HOW LONG?

Central European budget airline **Wizz Air (WIZZ)** has been upbeat about its prospects in recent results, but its shares have drifted sideways for most of the year.

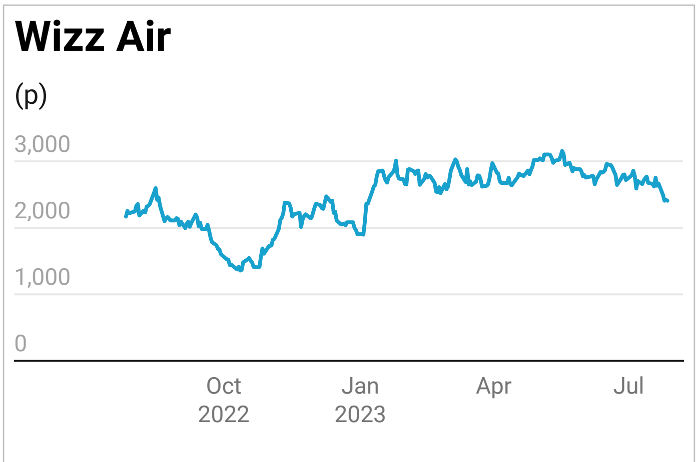


Chart: Shares magazine • Source: Refinitiv

However, it is worth noting that the share price performed very well in the tail end of 2022 so it's possible that investors simply got ahead of themselves, and the shares are consolidating strong gains.

We're already seeing a strong recovery in demand for air travel post-pandemic.

Wizz Air's earnings estimates for the year ending March 2024 are up nearly 50% since December 2022 according to Refinitiv data but estimates for the year to March 2025 looks far less convincing. Upgrades of only 5% suggest less conviction for earnings further out.

Shares in **Jet2 (JET2:AIM)** and **EasyJet (EZJ)** have displayed similar sideways share price patterns to Wizz Air, and all three have weakened in recent weeks as concerns grow about short-term disruption from wildfires in various popular tourist destinations.

HOTEL PRICES THROUGH THE ROOF

Crowne Plaza-to-Holiday Inn owner **InterContinental Hotels (IHG)** has drifted sideways since February in a narrow range.

Like the airlines the company has benefited from a return of tourism and business travel. InterContinental Hotels has seen a steady if unspectacular increase in earnings revisions since the start of 2023.

Industry experts have warned that US and European hotel rates are set to become more expensive over the next two years as supply has failed to keep up with demand. That is positive for hotel earnings.

Chart: Shares magazine • Source: Refinitiv

In the US supply is barely growing while tighter lending standards following the mini-banking crisis are making it harder for some developers to secure finance to build new hotels.

Average US hotel rates are around 17% higher than before the pandemic at $157 a night. In Europe the trend is even more stark with prices in Paris 50% higher while London prices are 30% above 2019 levels.

However, it is questionable how long customers can continue to fork out higher prices. According to an RBC research note US hotel bookings have shown negative year-on-year growth for the last three consecutive months.

ROLLS-ROYCE HAS BROKEN OUT OF ITS TRADING RANGE

A good example of a share trading sideways before breaking upwards through the upper band on a positive news trigger is aircraft engine maker **Rolls-Royce (RR.)**.

The shares traded in a narrow price range between 144p and 158p from early March until 26 July when the company announced strong first-half trading materially above consensus expectations, sending the shares up 20% to 182p.

The company, under new CEO Tufan Erginbilgic, said it expects underlying operating profit of £660 million to £680 million compared with consensus analysts' expectations of £328 million.

Furthermore, the company raised full year operating profit guidance by 39%, based on the middle of the new £1.2 billion to £1.3 billion range.

Erginbilgic has been scathing of Rolls' operating performance and pledged to transform the business by targeting inefficiencies and exiting low return parts of the business. The plan seems to be paying off earlier than investors and analysts expected.

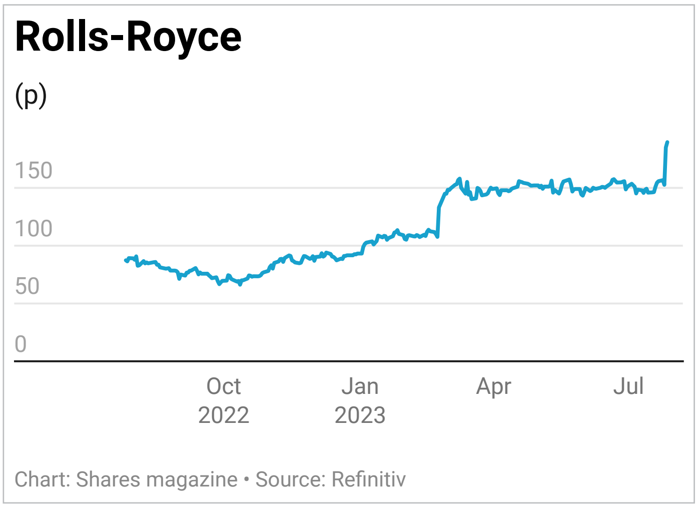


Chart: Shares magazine • Source: Refinitiv

KEEP YOUR EYES ON PETS AT HOME

After raising full year profit guidance at the end of January, shares in pet food-to-vet services specialist **Pets at Home (PETS)** jumped by around a tenth but since February they have moved sideways between 350p and 400p.

Full-year results published in May showed record sales while underlying pre-tax profit was up 8%. The company also revealed a new medium-term strategy to build the world's best unified pet platform.

Pets at Home is already the leading UK player with 24% market share of the roughly £7.2 billion pet care sector. The company is now aiming to scale its unique position where it is the only player that combines products, services and expertise across the full pet care market.

Once built the platform will be accessed via a unified pet care app enabling consumers to fulfil

Chart: Shares magazine • Source: Refinitiv

all their pet care needs, from booking surgical appointments to ordering repeat prescription deliveries and managing nutrition subscriptions.

Financially, the company is targeting 10% compound annual growth in pre-tax profit and driving higher operating margins by improving the sales mix with vet revenues growing faster than the group average.

Pets at Home looks well positioned to continue growing market share in an expanding market. However, the key sticking point is valuation.

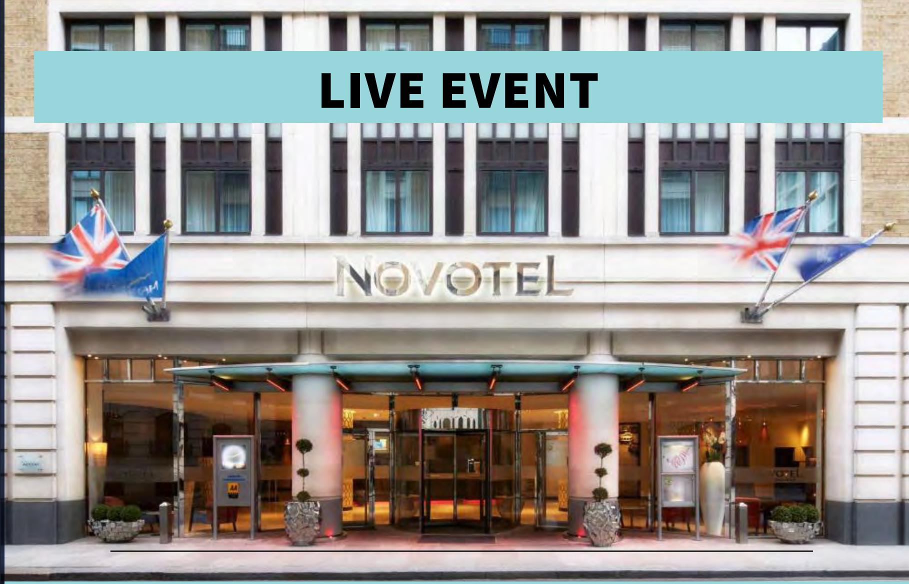
Trading on 18.9 times forecast earnings for the current financial year, the company will need to give analysts new reasons to upgrade earnings estimates if it wants the share price to break out of its current trading range.

A trading update is scheduled for 4 August and that could be the important catalyst to get the stock moving again. Good news could lift it out of the recent trading range, but bad news could go down like a lead balloon.

Just remember that stocks trading on high ratings (as is the case with Pets at Home) can see a large share price decline if they deliver even the slightest bit of bad news.

By **Martin Gamble** Education Editor

SHARES
INVESTOR EVENINGS



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UK stock performance is improving: time to get on board?

July could prove to be a turning point for the FTSE 100 and FTSE 250 indices

If you blinked, you might have missed it, but there was a flicker of life in the UK stock market in July. The FTSE 250 index of medium-sized companies jumped by almost 4% in one day, its best showing for over a year. The FTSE 100 also ended the month at its highest level since May.

In and of itself this isn't too remarkable; markets rise and they fall, capriciously and sometimes sharply. But this little spike might be worthy of some more attention, because of what prompted it: inflation. Or to be more exact, falling inflation.

On 19 July, the latest reading of the Consumer Price Index showed a drop from 8.7% to 7.9%, more than analysts expected. Domestic stocks soared on the news, with shares in some housebuilding stocks jumping by 10%.

Inflation remains way outside everybody's comfort zone, and that's still problematic. But this little episode shows that there may be some pent-up energy trapped inside the UK stock market after all.

IS THIS A TURNING POINT FOR UK STOCKS?

UK investors will be hoping this marks an inflection point, when markets finally start to believe that UK shares are oversold.

Recent commentary from the fund managers of **Temple Bar Investment Trust (TMPL)** suggested there was a compelling case for investors to consider rebalancing away from US equities and towards international equities, and in particular UK equities. This is perhaps not too surprising a viewpoint from a trust that invests predominantly in UK shares, but certainly the domestic stock market has been deeply out of favour for some considerable time.

While it has posted decent absolute returns so far in 2023, the FTSE All-Share has lagged behind international peers, especially the powerhouse that is the S&P 500.

The July fillip in share prices has put it back in the race, but it's still at the back of the pack. That might be easier to swallow if it didn't come on the back of a pretty disappointing longer term run.

According to Morningstar data, over 10 years the UK stock market has returned 72%, compared with 103% from the Japanese market, 110% from the European stock market, and a gasp-inducing 267% from the S&P 500 in the US, all in sterling terms. It is little wonder that UK fund managers think it's about time for some sunnier weather for UK stocks.

WHY THE UK STOCK MARKET IS SO CHEAP

The valuation of the UK stock market also looks attractive, especially when set against the US. The price to earnings ratio of the average stock in the FTSE 350 is currently sitting at 12.7 times the next

% Total return in 2023

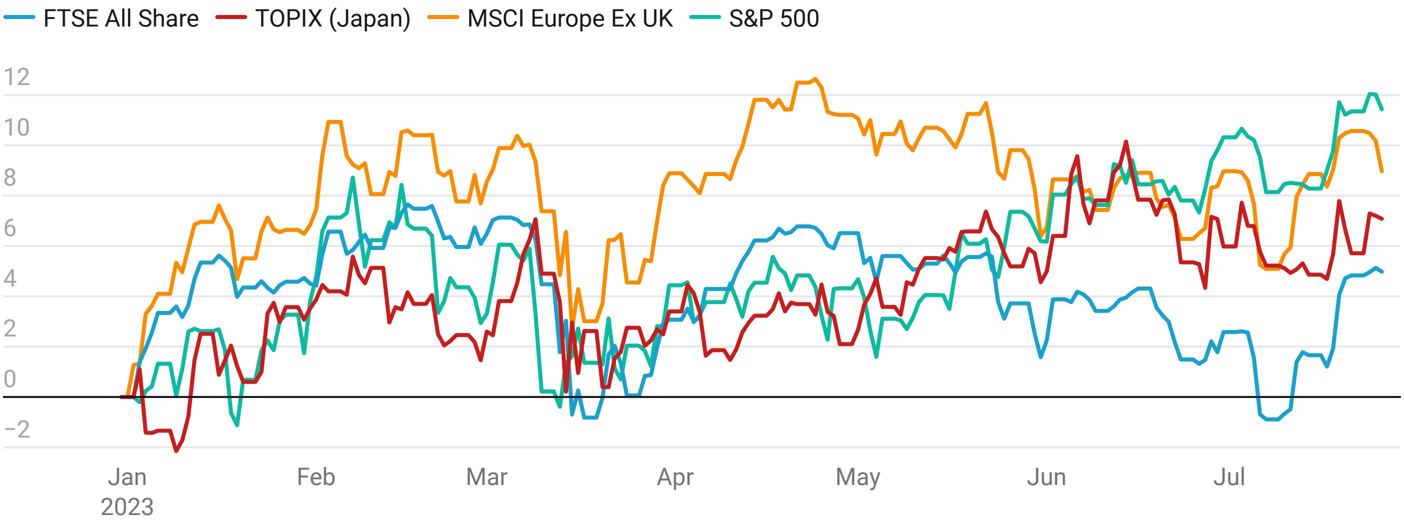

Chart: Shares magazine • Source: Morningstar total return in GBP

12 months of estimated earnings, compared to 18.5 for the S&P 500, according to Refinitiv data.

It's important to bear in mind the UK and US stock markets have a very different sectoral make-up though, and the old economy stocks which make up so much of the FTSE 100, like banks and mining companies, are expected to have a lower long term growth trajectory than the technology stocks that sit atop the S&P 500. This goes a long way to explaining the divergent valuations placed on the two stock markets.

Despite the valuation gap, an aversion to the UK has been a long-running theme, and it's been evident within both private and professional investor portfolios.

Retail investors have pulled £40 billion out of UK equity funds in the last seven and a half years. Given the rot started in 2016, it's hard to escape the conclusion that Brexit played a major part in triggering the exodus.

MORE INVESTORS ARE LOOKING GLOBALLY FOR OPPORTUNITIES

There are other factors at play too though. Investment flows have been affected not just by a push from underperforming UK equities, but also by the pull of shares elsewhere in the world, especially in the US where technology stocks have shown a clean pair of heels to other sectors.

UK investors could also be forgiven for unwinding a large portfolio position in UK equity funds, which has naturally become more diversified as the investment industry has provided more international funds for investment.

Even within the global funds which have proved so popular in the last few years, the allocation to the UK has been dwindling. This is mainly because the poor relative performance of UK shares, especially in comparison to the US, has reduced the proportion of the global market made up by UK companies. Hence why a global tracker fund has gone from holding 9% in UK equities 10 years ago

Retail fund flows £ millions

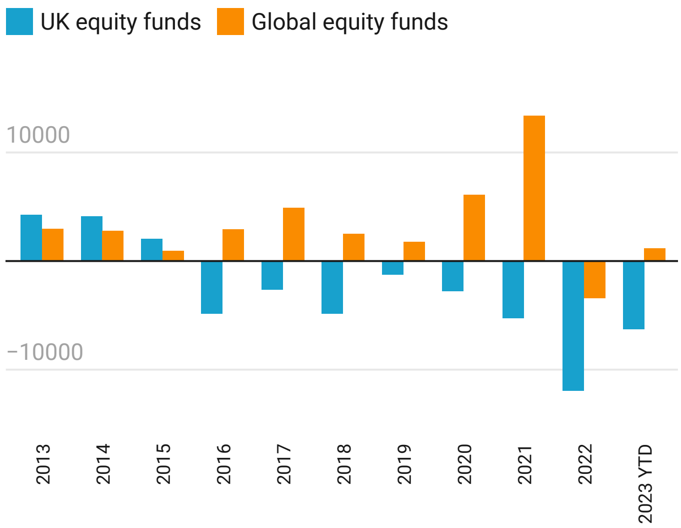

Chart: Shares magazine • Source: Investment Association

to just 4% today.

Global active funds have kept the faith a little more but have on average still substantially reduced the proportion they're willing to invest in the UK. These active managers are still benchmarked against the global stock market, and so can't keep much more invested in the UK without increasing their risk of underperformance.

It's possible these trends will abate, or even reverse, but it's by no means certain, especially seeing as it will take time for any better performance from the UK stock market to meaningfully turn the tide of investor sentiment.

Market trends can be deeply entrenched for long periods; just ask anyone investing in Japan in the nineties and noughties. If inflation continues to fall in the UK, we could see a bit more of a bump in the stock market.

Even so, investors who want to take a contrary view to the prevailing antipathy towards the UK do need to be patient, and willing for things to get worse before they get better.

% held in UK equities

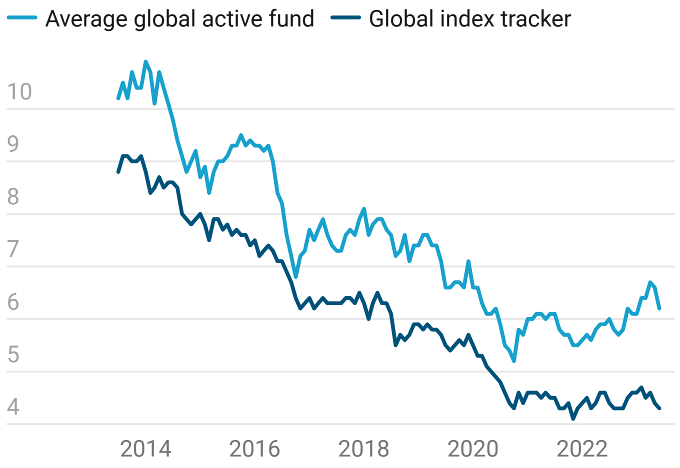

Chart: Shares magazine • Source: AJ Bell, Morningstar

Though one thing you can't argue is a feather in the cap of the UK stock market is the prevalence of dividend-paying companies, with the FTSE 100 forecast to yield 4.4% in 2024. So, at the very least investors are being paid to wait for a turnaround.

I learned about investing from conversations at the dinner table

Dinah explains why she finds investing fun and why it's important to talk about money

Twentysomething Dinah has an enthusiastic interest in investing: 'I began [investing] because I loved it and found it enjoyable. But now I'm investing to get on the property ladder, so that's my motivation. As much as I can, I want to buy a property in London and my timeframe is approximately 10 years – or shorter, depending on where house prices go.'

Having started at an intern at a private bank and wealth manager, she is now on its asset management programme and blogs about finance and investing.

She started her investment journey by putting money into two unlisted companies through equity crowdfunding platform Crowdcube.

'I had come across a British watchmaking brand, Warloe Watch. I met with the founders and realised I was more than happy investing a portion of my savings in that company. At the same time, a fintech app called Penfold which specialises in trying to make pensions accessible for everyone was fundraising. I invested in that too and boom, there went my savings,' she says.

DON'T BE AFRAID OF THE M-WORD

Dinah's primary inspiration for investing stemmed from her dad: 'Growing up, investing filled our dinner conversations. I know I am super lucky since this isn't a very British thing at all. We are all a little shy of the M-word [money].'

Dinah is keen to inspire others to take their first steps into investing, even on a basic level: 'I hope anyone reading this will take that first step and start talking about money since it is all around us. How can we be expected to manage it if we cannot even talk about it?'

She also reads a range of the financial press including *Bloomberg, The Wall Street Journal*, 'for opinions on the other side of the pond' and *The Times*.

PREFERENCE FOR INVESTMENT TRUSTS

Dinah mostly invests in investment trusts rather than specific stocks. 'I prefer these over funds since they can take on gearing to boost returns and their structure makes them far superior to their open-ended counterparts,' she says.

Holding specific investment trusts also helps her with the diversification element to her portfolio as her chosen trusts are spread over different geographies.

She also holds a little of her money in some stocks for 'fun'. 'It is a chance to do my own research [by investing in a handful of stocks] and test out all the theory from behavioural biases.

Examples of holdings in Dinah's portfolio

Investment trust	Amount invested
Baillie Gifford US Growth Trust	£800
Balanced Commercial Property Trust	£900
Keystone Positive Change Investment Trust	£1,000
VinaCapital Vietnam Opportunity Fund	£1,150
Henderson Smaller Companies Investment Trust	£1,800
Montanaro European Smaller Companies Trust	£1,900
JPMorgan Asia Growth and Income Trust	£2,000
Baillie Gifford China Growth Trust	£2,000
BlackRock Latin American Investment Trust	£2,000
Scottish Mortgage Investment Trust	£2,900
Henderson High Income Trust	£3,000

Table: Shares magazine • Source: Investor's own records

'A few months ago, I was lucky enough to invest in **Palantir Technologies (PLTR:NYSE)** and I've doubled my money. Sadly, there was only £100 in it and not more,' adds Dinah.

ESTABLISH YOUR INVESTMENT GOALS

Dinah strongly believes it is important to have investment goals to be a 'motivated' investor. These goals also dictate your investment horizon and risk appetite. Dinah says she has a 'high-risk tolerance' and 'a long-time horizon' when it comes to her portfolio.

'I hold a chunk in private companies – think of a risk scale 0-10, this is a 10. I know 99% of start-ups fail but this is money I am prepared to lose. In this basket I hold a few different companies ranging from fintech to agritech to watchmaking.

'When it comes to the stock market, I own several investment trusts. A few of my favourites are **Montanaro European Smaller Companies Trust (MTE)**, **Scottish Mortgage Investment Trust (SMT)**, **JPMorgan Global Growth & Income (JGGI)** – this is a trust that is globally diversified and gives you some income too.

'I also hold some bitcoin and cash in my portfolio that I use for investment opportunities. You know what they say, the best bargains come along when you have zero cash.'

INVESTING FOR THE FUTURE

'There is never a perfect time to invest and reading the media, you will find no shortage of gloomy press from inflation to interest rates,' says Dinah. She says an investor's job is to 'filter out the noise and face the uncertainty'.

'If there was no uncertainty there would be no risk. It is during the short run where all the nasty stuff occurs. Be brave and your future self will thank you.'

DISCLAIMER: Please note, we do not provide financial advice in case study articles, and we are unable to comment on the suitability of the subject's investments. Individuals who are unsure about the suitability of investments should consult a suitably qualified financial adviser. Past performance is not a guide to future performance and some investments need to be held for the long term. Tax treatment depends on your individual circumstances and rules may change. ISA and pension rules apply.

By **Sabuhi Gard** Investment Writer

Why must I show 15 years of earnings to consolidate my pensions into one pot?

It is important to know what it is required when transferring

I am trying to link up my various pension schemes into a single pension pot but my old provider has sent a questionnaire asking for my annual remuneration over the last 15 years. I have no idea how I would obtain this information or why it is important. Can you please explain?
Mark

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

I have sympathy with your situation, which sounds very much like a provider taking an over-the-top stance on regulations designed to protect savers from pension scams.

Pension scheme members usually have a 'statutory right to transfer' which means they can, by law, move their pension to another scheme or provider. However, to combat the risk of fraud, the Pension Schemes Act 2021 removed this statutory right unless certain conditions are met.

There are two conditions which pension providers are required to check. If either of these conditions are met, the statutory right to transfer exists and so the transfer must go through.

The first condition covers transfers to three different types of pension scheme:

- Public sector schemes
- Authorised master trusts (a type of pension scheme usually associated with the workplace)
- An authorised 'collective defined contribution' scheme (a new type of pension scheme where members' funds are invested collectively with the aim of achieving a target income in retirement)

The second condition applies to transfers to other types of scheme.

WHAT DO I NEED TO DO?

There are different requirements depending on the type of scheme. If you are transferring to an occupational pension scheme in the UK, you will be asked to demonstrate you have been employed by the scheme's sponsoring employer for at least three months.

You should be able to do this by providing evidence such as payslips, and a schedule of contributions paid by your employer. You certainly shouldn't need to provide employment evidence going back 15 years.

If you want to transfer to an overseas pension scheme then you will be asked to prove you are resident in the same jurisdiction as the scheme or that you have an employment link to the scheme.

For these transfers – and all other transfers, including to personal pensions like SIPPs – the second condition is met where the schemes' due diligence shows there are no 'red' or 'amber' flags.

RED FLAGS

If there is a red flag, your statutory right to transfer falls away and your scheme could prevent the transfer going ahead.

Red flags occur where:

- You fail to adequately respond to requests for evidence or information
- An amber flag has been raised and you haven't proven you attended a Moneyhelper guidance session (more on this below)
- An unregulated person has carried out a regulated activity in relation to the transfer
- You requested the transfer after receiving an unsolicited contact
- You have been offered an incentive to make the transfer
- You have been pressured to make the transfer

AMBER FLAGS

Where an amber flag is raised, you will be asked to attend a guidance session with Moneyhelper, the government-backed guidance service, on pension transfer scams.

Once you have done this, you will be given a unique identifier number by MoneyHelper that you can show as evidence you have attended the session.

Amber flags can be raised where:

- You have provided a substantive but incomplete response to a request for evidence or information
- The pension scheme from which you are transferring thinks some or all of the evidence provided may not be genuine, or that any required evidence may not have been provided directly by you
- The evidence does not demonstrate an employment link or residency link (only for a transfer to an occupational pension scheme or an overseas 'QROPS')
- There are high-risk or unregulated investments included in the scheme you are transferring to
- There are any unclear or high fees being charged by the scheme you are transferring to
- The structure of investments included in the scheme you are transferring to is unclear, complex or unorthodox
- There are overseas investments included in the scheme you are transferring to
- There has been a sharp or unusual rise in the volume of transfer requests to the same scheme or involving the same adviser and/or firm of advisers

While this might sound onerous, most pension transfers should still go through smoothly. If you feel your transfer is being held up unnecessarily or you are being asked to provide an unreasonable amount of information, speak to your pension provider in the first instance.

If they fail to address your concerns, you have the option of complaining to the Pensions Ombudsman, which deals with complaints relating to maladministration.

DO YOU HAVE A QUESTION ON RETIREMENT ISSUES?

Send an email to **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.

Index

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