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# SHARES

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as lockdown resumes?**



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Mattik | Nice, 2018

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Capital at risk



# Big oil's dividend dilemma

Smaller rivals arguably have more room for manoeuvre on pay-outs

**O**n 29 October **Royal Dutch Shell (RDSB)** provided the market with a positive surprise, increasing its dividend by 4% as it booked a larger than forecast third-quarter profit.

However, before we get too excited by the dividend hike, it is but a ripple in the ocean when you consider the pay-out had been cut by two thirds back in April.

While profit of \$955 million might sound impressive in isolation, it was less than a quarter of the total a year earlier.

Its rival **BP (BP.)** also did a better than expected with its third quarter numbers (27 Oct) but its own profit of just \$86 million is worth putting in context.

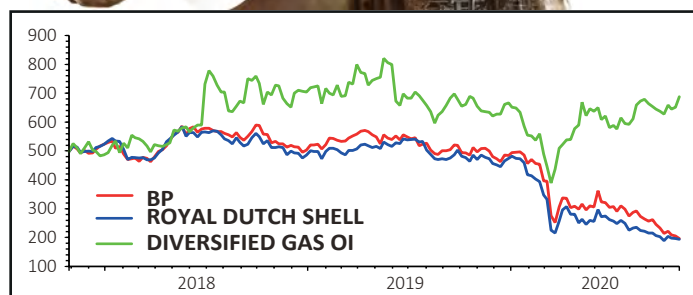
Just think about the amount of manpower, expertise, time and resources which were put in to achieve a profit of less than \$100 million. It employed some 70,100 people as at December 2019 – though it has announced job cuts since – and operates in nearly 80 different countries across the globe.

When you consider the exposure of BP and Shell to an oil price which recently dipped back below \$40 per barrel on lockdown fears and a ramp up in Libyan production boosting industry supply at a time when demand is fragile, it is little wonder their shares are trading at generational lows.

You must remember these companies are having to gradually move out of oil and gas and into greener alternatives under pressure from governments, regulators and investors and the cost of this transition is likely to impair their dividend-paying capacity in the coming years.

Further down the food chain, oil firms are not facing quite such an acute problem. The same day Shell announced its 4% dividend increase, **Diversified Gas & Oil (DGOC)** – a recent entrant to the FTSE 250 – raised its own pay-out by 7%, building on a 7% increase in the previous quarter. According to Investec forecasts, the stock trades on a dividend yield of around 10%.

Diversified Gas & Oil focuses on low-cost, mature

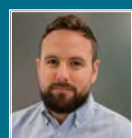


natural gas fields and it looks to grow output through acquisitions, using the cash flow from this production stream to fund its dividend.

There are a handful of other small cap oil and gas firms which pay dividends of varying generosity, **Jadestone Energy (JSE:AIM)** and **Serica Energy (SQZ:AIM)** paid maiden dividends in 2020. There are others who have talked about paying dividends in the future including **Touchstone Exploration (TSE:AIM)**.

Many small and mid-cap oil and gas stocks have been shunned by the market thanks to weak returns, a lack of exploration success and questionable corporate governance – to name just three negative factors.

Perhaps in the future more companies will go down the low-cost production route and use that to fund the dividends which could get investors back on board.



By **Tom Sieber** Deputy Editor



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# Stocks soar despite US election chaos with Congress gridlock likely

Markets experience wild swings as voting results start to be counted



**S**tock markets have reacted positively to the US presidential election race despite it becoming clear it could take a matter of days before the result is known.

The biggest fear for investors is a contested outcome, with Republican candidate Donald Trump claiming electoral fraud and threatening to go to the Supreme Court to stop the counting of votes.

Both Trump and Democrat candidate Joe Biden have declared victory before the outcome is revealed.

But one thing the market seems clear on is that there'll be a mixed Congress again, with the Democrats looking likely to hold onto the House of Representatives and the Republicans the Senate.

The certainty of this alone saw markets rally on 4 November, with the FTSE 100 swinging from the red at the start of the day to record a gain of over 1%, with France's CAC 40 and Germany's DAX 30 likewise gaining over 1%, though traders cautioned that dealing volumes were low – something that could lead to more volatility ahead.

All three major indices on Wall Street also opened strongly as the S&P 500 traded 1.2% higher, while the Dow Jones advanced 0.4% and the tech-heavy Nasdaq soared 2.3%.

A gridlock in Congress like the last four years will benefit technology stocks in particular, as it means even if Biden wins, it will be a lot more challenging for him to push through the tax reforms and changes to antitrust law that he's promised in his

campaign, things that would all negatively affect big tech.

Clean energy stocks on the other hand recorded big falls, as a gridlocked Congress also means Biden is far less likely to be able to push through his \$2 trillion infrastructure and clean energy spending plan should he become president.

'The two main equity sectors impacted by the election outcome are technology and energy,' says Peter Garnry, head of equity strategy at Saxo Bank. 'A Trump victory would most likely be bad for green energy stocks although the current price action in Europe does not suggest a big divergence between oil and gas and green energy stocks.'

'Status quo' or a weak Biden presidency is on the margin positive for US technology stocks as it means there is no path to change the GILTI tax rate which is the one that is applied to foreign income derived from intangible assets,' he adds.

Cyclical stocks exposed to the US such as industrials traded lower with concerns over what a gridlocked Congress would do for the economy and the reduced likelihood of very large fiscal stimulus, with the US dollar also trading higher on lower fiscal stimulus expectations, while US government bonds got a boost as investors used them as a hedge against a contested outcome.

Gold did not follow suit thanks to the rise in the dollar, with demand for gold tending to decrease when the dollar rises as it becomes more expensive in other currencies.



# How 'Lockdown 2' news impacted the markets

*Shares* examines how companies and sectors were impacted by the announcement of a second lockdown

**L**ondon's blue chip benchmark index seemingly took the imposition of a new England-wide lockdown in its stride, the FTSE 100 finishing 2 November with a 1.4% gain to 5,654 points, helped by a weaker pound.

However, the more domestically focused FTSE 250 fell by 0.2% as investors fretted over the impact of Boris Johnson's latest lockdown on the non-essential retailers, pub companies and leisure groups that are dependent on consumer footfall and spending.

The FTSE's positive moves on in the immediate aftermath of the lockdown news may seem surprising, given that ING economist James Smith forecasts the restrictions will knock roughly 6%-to-7% off of November's GDP. Yet investors should remember that roughly three quarters of the FTSE 100 generates its earnings overseas, so the news is less of a blow to the blue chip benchmark index than one might think.

In addition, 'Lockdown 2' is only supposed to last for a month, whereas the first one was introduced on an open-ended basis back in March, and isn't going to be as restrictive as the UK's original pandemic-induced economic deep-freeze.

Another factor at play was that the FTSE 100 was at a six-month low ahead of the announcement. The week running up to the lockdown announcement saw five straight days of losses and October marked it the worst monthly performance for the index since March.

Hopes for a speedy recovery from the pandemic had already been eroded with bad news priced in.

## LOCKDOWN LOSERS

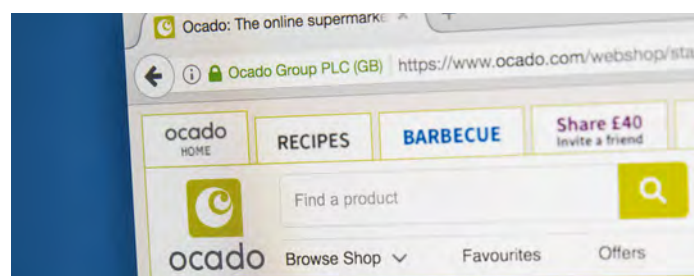
Unsurprisingly, news of the imposition of a fresh lockdown during the run-up to Christmas, and due to last from 5 November to 2 December, sent shares in footfall-dependent retail, travel and leisure stocks lower.



As our table (overleaf) shows, with pubs and gyms having to close during lockdown 2, the likes of pub group **Young's (YNGA:AIM)** and **The Gym Group (GYM)** were friendless, while **PPHE Hotels (PPH)** fell 7.2% on worries hotel demand will plummet once again. Embattled **Ted Baker (TED)** tumbled 11% on fears the new lockdown will derail the brand's recovery efforts, while office services outfit **Restore (RST:AIM)** was 8.6% down over the two and a half days amid concerns that the latest shutdown could delay office removal work.

## YOU WIN AGAIN

Conversely, winners from the first lockdown caught a bid once again, among them online retailers such as web-based white goods seller **AO World (AO.)** and musical instruments purveyor **Gear4music (G4M:AIM)**. **Ocado (OCDO)** was also in demand after delivering another earnings guidance upgrade and as investors bet its technology for online





EXAMPLES OF SHARE PRICE RISERS	GAIN*	REASON
AO World	11.3%	Lockdown shifts more demand online
Gear4Music	11.3%	Another potential beneficiary of online demand
Fresnillo	8.2%	Investors turn to gold in times of trouble
Ocado	6.6%	Upgraded earnings guidance
McColl's	5.9%	Convenience store demand could increase in lockdown
Avacta	5.9%	Investors expect higher Covid-related demand
ASOS	5.5%	Could pick up more business from people stuck at home
Bloomsbury	5.3%	Book demand soared during lockdown #1, will this repeat?

EXAMPLES OF SHARE PRICE FALLERS	LOSS*	REASON
Ted Baker	-11.0%	Recovery efforts could be derailed by lockdown #2
Restore	-8.6%	New lockdown could delay office removal work
PPHE Hotels	-7.2%	Hotel demand likely to plummet near-term
Gym Group	-5.7%	Gyms have to close during lockdown #2
Young's & Co	-4.5%	Pubs have to close during lockdown #2
The Works	-4.0%	Its large physical store estate will go into hibernation
Jet2	-2.2%	Travel industry continues to be hit by restrictions

Source: Shares, SharePad. \*From 30 Oct 2020 market close to midday 3 Nov 2020.

grocery systems would be in greater demand.

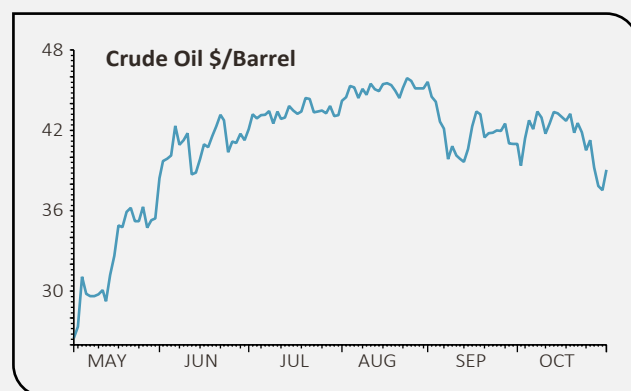
Elsewhere in retail, B&Q-owner **Kingfisher (KGF)** was in demand as investors factored in another splurge in DIY-related spending, as was general merchandise discounter **B&M European Value Retail (BME)**, as investors bet its winning value proposition will continue to resonate with cash-strapped shoppers during the difficult weeks ahead.

**McColl's (MCLS)** was marked up on the basis that its neighbourhood stores will see increased demand during the second lockdown, while over in the mining sector, **Fresnillo (FRES)** firmed 8.2% on the basis that investors turn to gold during turbulent times.

## FOOD, GLORIOUS FOOD

Companies playing an essential role in keeping the nation fed also caught a bid, with supermarkets **Tesco (TSCO)**, **Sainsbury's (SBRY)** and **Morrisons (MRW)** rising as investors priced in bumper demand for groceries over the near term.

And with the emphasis back on eating at home, investors also showed a strong appetite for shares in lockdown 1 winners **Premier Foods (PFD)** and pork-to-poultry producer **Cranswick (CWK)**.



## OIL SLIPS LOWER

The imposition of renewed lockdowns in England and other countries put pressure on the oil price with the Brent benchmark still trading below \$40 per barrel at the time of writing. The market apparently pricing in the impact on demand of new restrictions on travel and wider economic activity. This, combined with an increase in output from Libya, means the stakes keep being raised ahead of OPEC's meeting to determine the fate of current production quotas on 30 November.

# Alibaba left with bloody nose as Ant IPO shelved at the 11th hour

Regulator raises questions over digital finance giant's ability to meet disclosure and listing conditions

**C**hina's online shopping giant Alibaba saw more than \$75 billion wiped off its market value after the shock late postponement of Ant Group's initial public offering (IPO).

Ant had been set to go public on the Hong Kong and Shanghai exchanges today (5 November) in what would have been the largest public markets listing ever. The Chinese digital finance giant had hoped to raise around \$34.5 billion.

Alibaba's fortunes matter to UK investors given it is widely held by several fairly prominent investment trusts (see table).

The company behind top Chinese payment app Alipay, had intended to sell 11% of the business to new investors, which would have valued the entire business in the region of \$313 billion. Chinese billionaire Jack Ma, the founder of both Alibaba and Ant, would have retained his 50% stake in Ant, while Alibaba owns 33% of the business.

But Ant's IPO plans were thrown into chaos on Tuesday (3 November) after the Shanghai regulator raised questions over the digital finance giant's ability to meet disclosure and listing conditions. The listing was pulled just a day after Jack Ma and other Ant executives were hauled in for what the exchange called 'supervisory interviews'. In a following statement, the Shanghai exchange referred to 'other major issues, including changes in 'the financial technology regulatory environment'.

Demand for Ant stock has been sky-high with more than five million retail investors across mainland China having placed an estimated \$2.8 trillion worth of orders, according to the *Wall Street Journal*. Ant terminated its institutional book building in Hong Kong early, signalling huge demand from fund managers also.

With the Ant IPO now stalled, and any revaluation

of Alibaba's stake on hold, Alibaba will need to look for other ways to recover lost market value.

Online shoppers in China could ride to Alibaba's rescue with records expected to be shattered for the amount of money spent on Singles Day this year.

Singles Day is the world's largest online sales festival. Since then, the event has grown in popularity not just in China but around the world.

Celebrated on 11 November, Singles Day is seen by many investors as a proxy for consumer spending in China.

Alibaba retail sales share was more than half the estimated \$60.4 billion spent across all Chinese retail websites over the 24 hour spree in 2019.

That's double what Amazon generates in an entire month, according to a report by consulting firm Bain & Company. Amazon's Prime Day event last month is predicted to have generated around \$9.9 billion, according to eMarketer data.

## UK investment trusts with biggest exposure

Trust	% of portfolio in Alibaba
Fidelity China Special Situations	15.6%
Manchester & London	13.6%
Schroder Asia Pacific	8.9%
Schroder Asian Total Return	7.2%
Scottish Mortgage	6.1%
Pacific Horizon	4.6%
Polar Capital Technology Trust	3.7%
Alliance Trust	3.2%
Monks Investment Trust	2.5%
F&C Investment Trust	1.3%

Source: FE: Fund Info

# Horizon Discovery and LiDCO surge on agreed takeover bids

Boost for biotech sector as two UK-listed names receive premium bids

**T**he announcement of second lockdown measures in England gave biotechnology shares involved in Covid-19 testing another a boost with **Avacta (AVCT:AIM)**, **Omega Diagnostics (ODX:AIM)**, **Genedrive (GDR:AIM)** all registering gains.

However these moves were overshadowed by the 110% gain in gene cell engineering company **Horizon Discovery (HZD:AIM)** and the 75% gain in blood flow monitoring firm **LiDCO (LID:AIM)** which both received takeover offers. The premiums offered in these transactions suggests the industry sees the market as undervaluing some biotech firms.

Horizon Discovery shareholders received an all-cash offer of 185p per share cash offer worth £296 million, representing a 108.3% premium to the closing price on 30 October of 88.8p. The directors

of Horizon unanimously recommended the offer.

The buyer is US based life science firm **PerkinElmer** which generates revenues of \$3.4 billion and has a market capitalisation of \$14.4 billion. The company said it had received acceptance from 21.1% of Horizon's shareholders.

Meanwhile LiDCO shareholders received an all-cash offer of 12p per share from Masimo Corporation, valuing the company at £31.1 million and representing a 77.8% premium to a 30 October closing price of 6.75p. The board have recommended the offer with Masimo having garnered agreement from 37.7% of LiDCO's shareholders.

Masimo is a Nasdaq listed global medical technology company with a market capitalisation of \$12 billion.

## New rules on ISAs to crimp demand for property funds

HMRC considers banning new investments by retail investors

AS THE SAGA over the liquidity mismatch in open-ended property funds – which offer daily prices but in practice need months to sell assets to pay back investors who want their money – rolls on, the Financial Conduct Authority (FCA) suggested in August that investors give funds a 90-day or 180-day 'notice period' if they wanted to redeem their investment.

However, last week HMRC

countered, saying the FCA's proposal 'runs contrary to the ISA legislation which requires account holders to be able to access the funds or transfer them to another ISA within 30 days of making an instruction to their account manager', making property funds ineligible investments.

Rather than banning ISA investors from holding property funds altogether, the department

is considering a 'middle way' to mitigate the impact on ISA account holders and managers, allowing them to keep existing investments in open-ended funds within an ISA while prohibiting new investments in such funds.

It warns: 'This type of property fund needs to hold a significant cash balance otherwise it might not have time to sell properties to pay investors who can request their money back at short notice. If a fund runs out of cash, this can cause it to suspend dealing.'

The FCA's consultation period ended on 3 November while, HMRC has given investors and managers until 13 December.





# Fundsmith

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### % Total Return

12 months ending September	2020	2019	2018	2017	2016
Fundsmith Emerging Equities Trust	-1.6	-2.4	+5.6	+0.4	+16.4
AIC Global Emerging Markets Sector	-10.9	+4.3	-0.8	+13.3	+30.0

Source: Financial Express Analytics

# Buy this newly-listed gold giant for lower risk and high rewards

Wheaton Precious Metals is unique in the London market and well-placed to thrive at the current gold price

**J**ust like buses, two come along at once. No sooner had Canadian gold giant **Yamana Gold (AUY)** come back to the London market, another big player has joined the fray.

And while there is always risk with mining stocks, this one could be an even lower risk way to play the rising gold price, but still with the potential to offer excellent returns given its business model and the elevated gold price environment which doesn't look like subsiding anytime soon.

**Wheaton Precious Metals**



**WHEATON PRECIOUS METALS**

**BUY**

(WPM) £37.25

Market cap: **£16.3 billion**

(WPM) joined the London market in a secondary listing last week, accompanying its primary listing in Toronto and dual listing in New York.

The firm has taken full

advantage of the rising gold price this year, and seen its shares in New York and Toronto gain over 60% year-to-date.

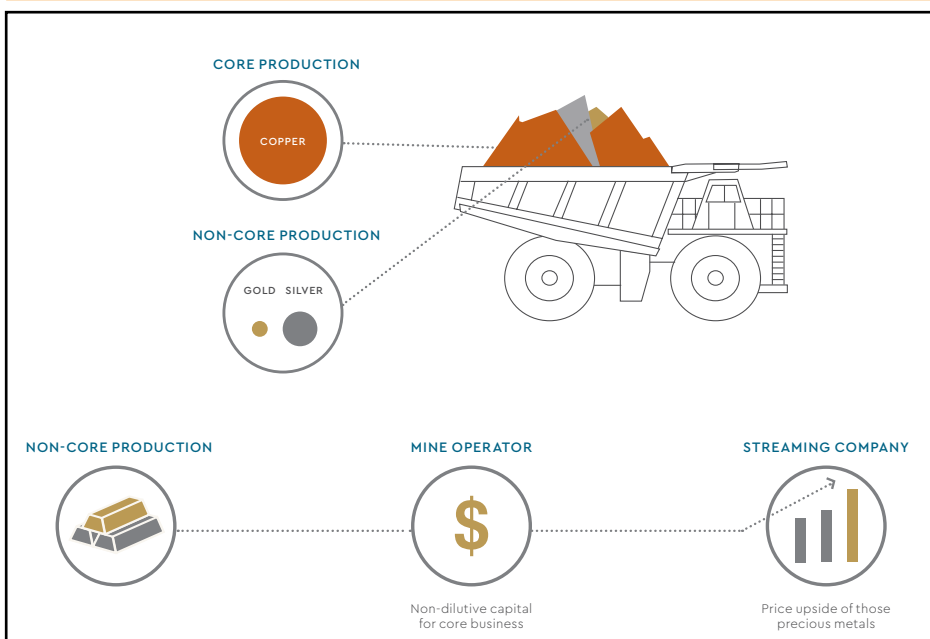
## STREAM OF PROFIT

The £16.3 billion market cap company is a precious metals streaming company, meaning it provides money to miners to help them build their mines, and in return takes a percentage of what the mine subsequently produces, but doesn't take on the risk of building and operating a mine.

The only other such type of company on the London market is **Anglo Pacific (APF)**, but this is far smaller at a £195 million market cap and isn't involved in commodities like gold and silver. It focuses on copper, nickel and zinc but still most of its money from coal.

Mining streaming companies generally don't have the best

## How it works: Precious metals streaming



Source: Wheaton Precious Metals

reputation in the industry, and in the past have been seen as something of a lender of last resort, with desperate miners only turning to them if they can't fund a project through an equity raise or bank debt.

But this is not the case with Wheaton at all. The company only partners with big players like Vale, the world's largest nickel producer, for example or **Glencore (GLEN)**, the FTSE 100 mining giant. Other partners include gold giants Newmont and Barrick Gold.

### UNIQUE MODEL

It has a pretty unique business model which helps set it apart. Take its deal with Vale for example. Wheaton paid \$3.1 billion to help it build the Salobo mine in Brazil, the country's largest copper deposit. In exchange, Wheaton then takes 75% of the gold coming out of the mine (gold is a by-product of copper) at a price of \$300 per ounce.

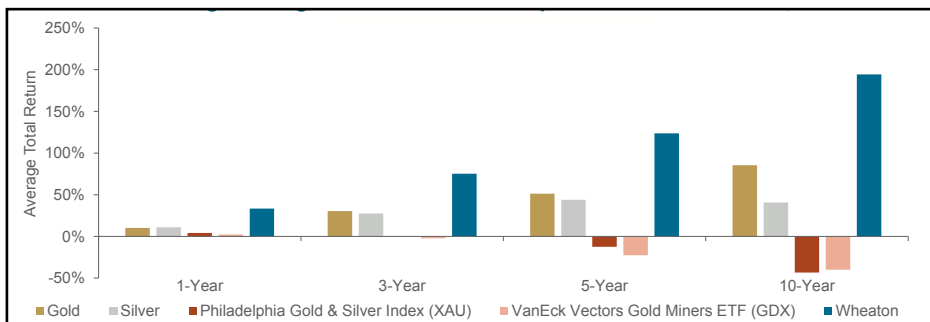
The benefit for Wheaton is obvious, given that under the terms of the deals it strikes it is allowed to then sell that gold at spot price, which at the moment is around \$1,900 an ounce, meaning its gross profit margins can be huge.

In the new contracts it is signing with partners, Wheaton has agreed to buy gold off them at 20% of the spot price.

While in addition to being able to get money for a selling non-core asset and focus on producing copper, where the likes of Vale claw back some of the value is in how much they get Wheaton to pay upfront.

Speaking to *Shares*, Wheaton's

### Total average rolling multi-year return comparison as of October 13, 2020



Source: Wheaton Precious Metals Corporate Presentation, October 2020.

CEO Randy Smallwood says the company is 'really focused on the technical side', and when valuing a potential project has a team of geologists that 'goes into projects, tears them apart and rebuilds them – then we come up with our vision as to what's possible'.

He adds: 'It's a discounted cash flow model where we discount on political risk, corporate risk – how strong is our partner's balance sheet – resource risk. We take all of that into account and then we try to come up with a dollar amount. And then the negotiations begin.'

Smallwood also emphatically rejects the idea Wheaton is any way a lender of last resort, and says streaming is becoming a more mainstream way of financing for mining companies now.

He says, 'When the mining company CFOs (chief financial officers) need to raise capital, everyone now considers streaming... We don't have to do a lot of business development anymore.'

### SHINING IN 2020

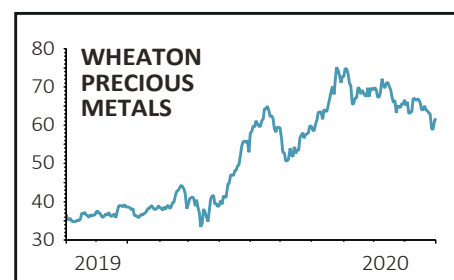
So far this year the company's model has helped it take

significant advantage of the rising gold price.

In the six months to 30 June Wheaton reported an operating profit of \$212 million, compared to a \$40 million loss in the same period last year, on the back of a higher realised gold price.

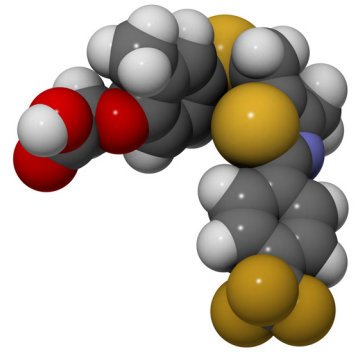
The company has low fixed costs (for example it employs around 40 people) and so was able to generate an operating margin of 42%. It also generated operating cash flow of \$329 million, a 45% increase year-on-year.

Wheaton focuses on gold in particular as well as silver, but it also has small interests in cobalt and palladium, with the price of the latter in particular having soared in the past few years and up and around 25% in dollar terms this year. Overall Wheaton has 23 long-term purchase agreements with 17 miners across 30 mines.





# The market is far too pessimistic on GlaxoSmithKline



Investors are not giving the company any credit for the significant changes made to its structure and focus

**S**urprisingly shares in pharmaceutical company **GlaxoSmithKline (GSK)** are trading below their March lows and have underperformed European and US peers by 18% year-to-date.

The shares trade on a PE (price-to-earnings) of 11.4, roughly half of the valuation of peer **AstraZeneca (AZN)** while the company has a dividend yield of 6.1% based on the 80p per share payment that the company has committed to maintaining. Although, it's worth pointing out that some analysts are sceptical and expect dividend cover to be tight in 2021.

We believe the cash generating nature of Glaxo's business as well as the increasing strength of the cancer franchise and growing vaccine business make the current price an attractive risk-to-reward proposition.

## LEADING VACCINE FRANCHISE

Glaxo is global vaccine manufacturer with a leading 32% share of the \$30 billion a year market, throwing off strong cash flows.

As well as strong positions in childhood vaccines, meningitis and the flu, Glaxo's most successful vaccine in the last couple of years has been

## GLAXOSMITHKLINE

**BUY**

(GSK) £13.21

Market value: **£65.6 billion**

for shingles which is a painful condition caused by the reactivation of the chicken-pox virus.

The company's vaccine Shingrix has proven to be 90% effective in the over 50's age group and analysts at Liberum expect Shingrix to be a key driver of the vaccine division through to the end of the decade. New manufacturing capacity is due to come on stream in 2023 which will see the drug distributed in markets outside the US, especially China. US sales this year are expected to be around \$2 billion.

## GROWING ONCOLOGY FRANCHISE

The second growth driver not priced into the shares is the potential of the cancer franchise which has a strong pipeline thanks to the \$5.2 billion acquisition of Tersaro. Liberum forecasts that revenues will grow from under \$500 million towards \$4 billion over the next decade.

Key to reaching these

projections will be the performance of ovarian cancer drug Zejula and its Blenrep drug for treating multiple myeloma, a type of bone marrow cancer, a market worth around \$20 billion a year. The drug has completed phase three trials and gained approval in the US in August.

## UNLOCKING VALUE IN CONSUMER HEALTHCARE

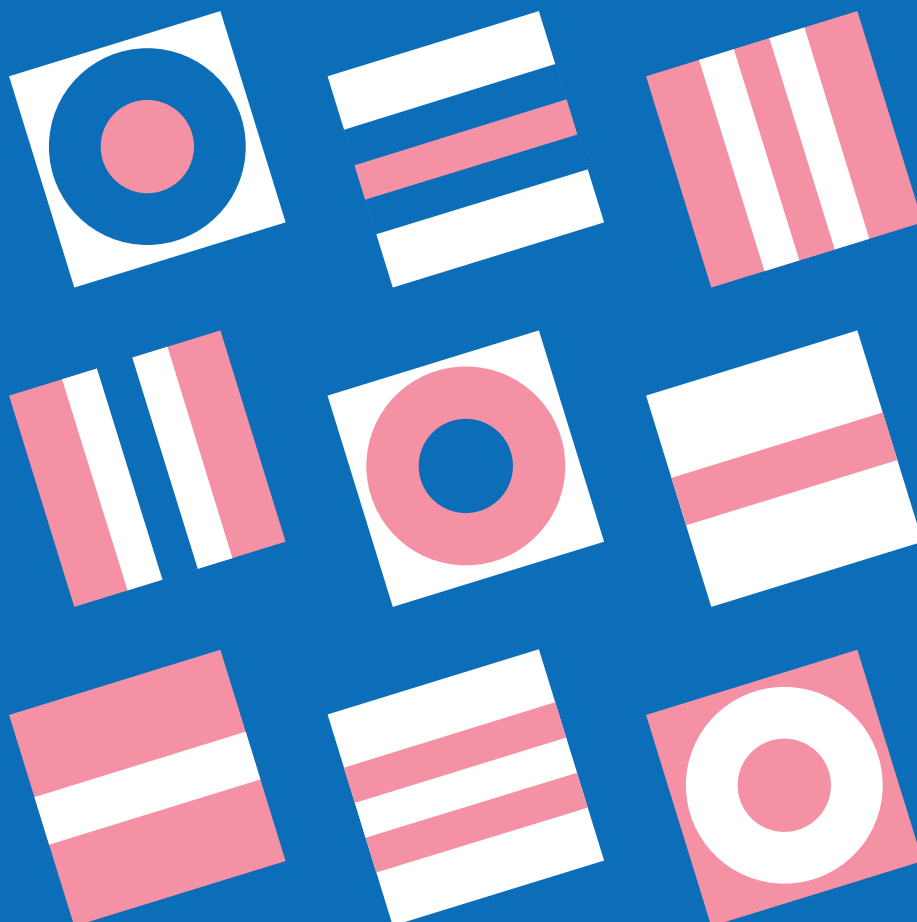
In 2018 Glaxo and Pfizer agreed to merge their respective consumer healthcare businesses with annual revenues of \$9.8 billion, with a view to spinning-off the unit sometime in 2022.

Glaxo has targeted annual cost savings of \$500 million while incurring cash costs of \$900 million which would be covered by a divestment of assets of up to \$1 billion. The goal is to double operating margins to mid-20's by 2023.

**UPDATE: The original article incorrectly had the share price at £12.21. The price at the time of writing was £13.21. We have updated the data including PE and yield. We apologise for any confusion.**



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## MICROSOFT

(MSFT) \$202.33

**Gain to date: 22.6%**

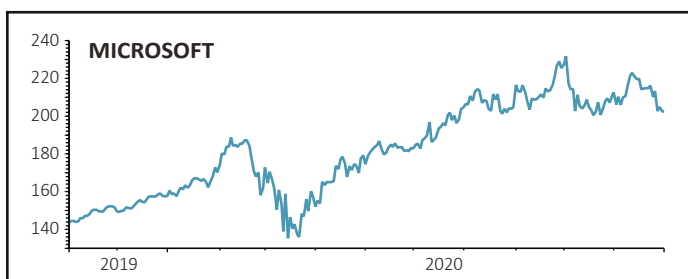
**Original entry point:**

**Buy at \$165, 9 April 2020**

**MICROSOFT (MSFT)** CONTINUES to make a mockery of forecasts as the wheel of fortune rolls its way. As we predicted back in April, work from home during the pandemic continues to spark rampant demand for its core software, cloud services, communication and gaming products, helping the world's largest software company batter third quarter estimates.

In Late October the company reported fiscal first-quarter earnings to 30 September of \$13.9 billion, or \$1.82 a share (EPS), up from \$1.38 a year ago and blasting past analysts' EPS projections of \$1.54. Revenue hit \$37.2 billion, up from \$33.1 billion a year ago and beyond the \$35.8 billion consensus estimate.

What this shows is that, operationally, the company remains in clover and that the stock has justifiably earned its near-23% gains to date. True, guidance for the Christmas run-in was on the conservative side but it is largely price to earnings (PE) compression that accounts for the more recent soggy stock performance, the full year 2021 multiple down from 34 to 28 over the past couple of months.



### SHARES SAYS: ↗

Microsoft remains a core long-term holding for investors, and is still a buy.

## STENPROP

(STP) 123p

**Gain to date: 5.1%**

**Original entry point:**

**Buy at 117p, 10 September 2020**



OUR POSITIVE CALL on industrial property investor **Stenprop (STP)** is off to a steady start.

Stenprop is moving towards being 100% invested in multi-let industrial (MLI) – essentially small, purpose-built industrial units in urban areas.

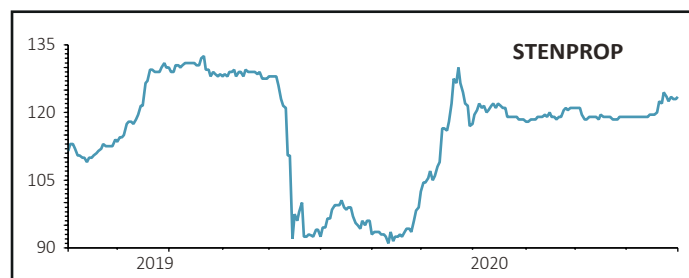
The company announced on 23 October that it had collected 80% of rent due for the December quarter.

For the full year to date, the company had collected 88% of rents due since April and agreed to defer a further 1% until a later date.

Like-for-like passing rent in the second quarter rose 2.5%. Occupancy levels in the MLI portfolio rose to 93.3% as at 30 September, up from 92% at the end of June.

Broker Numis says: 'The progress on asset rotation is encouraging with management building on its impressive track record of profitable disposals.'

'The acquisition programme has commenced and we note the bullish comments about the strength of the pipeline which bode well for the ongoing transition of the business to c.75% MLI by 2021 rising to 100% MLI by 2022.'



### SHARES SAYS: ↗

We still see plenty of value. Keep buying.

**YAMANA GOLD**

(AUY) 450p

**Loss to date: 2.2%****Original entry point:****Buy at 460p, 22 October 2020**

'significantly enhancing' to its future growth prospects.

Wasamac is not yet in production, but according to a feasibility study from 2018 once up and running it could produce 142,000 ounces of gold a year at a very promising all-in sustaining cost of \$630 per ounce.

MINER **YAMANA GOLD (AUY)** has expanded its portfolio of assets after agreeing a deal to acquire all the shares in smaller rival Monarch Gold that it doesn't already own for \$114 million in cash and shares.

The deal gives Yamana access to the Wasamac gold project in Canada, which is around 100 kilometres from its Canadian Malartic mine.

Yamana says the project has the potential to be an underground mine capable of achieving the same scale, grade, production and costs as its Jacobina mine in Brazil and Canadian Malartic asset, and believes the acquisition is

Having a good range of producing assets is crucial for a mining company to limit any risks in case they encounter operational problems at a particular project, and while the Wasamac project is not yet in production, it could be soon.

Monarch filed a project notice, the first step in the mining permit application process, in November 2019 and the process usually takes between 18 and 24 months.

**SHARES SAYS:** ↗

**We are encouraged by this deal and remain bullish.**

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# AMAZON:

## CAN IT KEEP WINNING AS LOCKDOWN RESUMES?



By **Steven Frazer**  
News Editor

*We consider the buy and sell case*

**T**here are not many stocks that can hold a candle to the staggering returns earned from Amazon and we continue to see the business as a long-term winner and a stock worth owning to benefit from the accelerating digitisation of society and the economy.

Over the past 10 years it has delivered an average 34.5% a year trouncing the meagre low single-digit average returns from the FTSE 100.

To put it another way, \$5,000 invested in the shares a decade ago would now be worth more than \$90,000.

If you had put five grand into the broader market your returns would be no match – something like \$10,000 from the S&P 500. For UK investors, the FTSE 100 would have turned a £5,000 investment into just £6,850, based on Morningstar data, barely beating inflation.

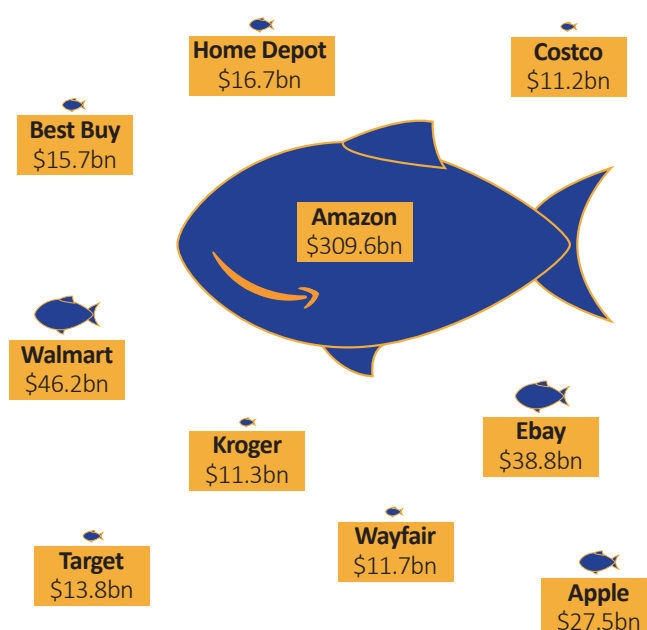
The company has turned founder Jeff Bezos into the world's wealthiest man, worth tens of billions.

Given the company's sheer scale and track record, the company has a large retail investor following – it is the third most popular overseas stock on AJ Bell's Youinvest platform, for example. That makes it natural for investors to wonder if Amazon can keep on growing robustly and

continue to handsomely reward shareholders.

Without getting bogged down in the history, Amazon was set-up by Bezos in Seattle, US, in 1994 selling mainly books and CDs. It has since grown into one of the world's biggest online marketplaces selling millions of products and providing various entertainment services,

### The big fish in the online shopping pool\*



Source: Emarketeer, Visual Capitalist. \*Estimated e-commerce sales 2020

such as streaming TV, music and games. It also operates the largest cloud computing infrastructure business in the world, Amazon Web Services, or AWS for short.

Operating performance is split into three categories; North America, International and AWS.

### A LOCKDOWN SUCCESS

There are few, if any, bigger winners from the Covid-19 pandemic, and leaving aside the obvious and ugly side of the virus, the world's biggest online marketplace and cloud computing provider has made hay by the bale-load during 2020.



Third quarter 2020 revenues and earnings per share (EPS) topped \$96.1 billion and \$12.37, smashing estimates pitched at \$92.5 billion and \$7.38 respectively. Net income rose to \$6.3 billion vs \$2.1 billion in the same quarter a year before despite spending significant amounts on coping with the virus.

In total, Amazon has incurred more than \$7.5 billion in incremental Covid-related costs in the first three quarters of 2020, and expects to run-up an extra up another \$4 billion bill in Q4 as it bolstered staff numbers by 175,000 to cope with surging demand and manage social distancing rules.

Amazon has to balance large scale hiring with the health and safety of all its employees and ensuring that appropriate quarantine and sick pay is provided, said Alison Porter, co-manager of **Janus Henderson Global Technology Leaders Fund (0771607)**.

'Online delivery is becoming an essential service for the elderly and those self-isolating',

and more popular with the widespread introduction of social-distancing.

This was true before the pandemic and online shopping already had its claws sunk deep into consumer behaviour, but the virus has added jet fuel to pace of adoption. Pre-pandemic, just 16% of US retail sales were online, said Gary Robinson, manager of the **Baillie Gifford US Growth Trust (USA)**.

'To my mind, online shopping is clearly superior to bricks and mortar retail', he said. 'You get access to lower prices, better selection and is more convenient', he said. So while online shopping had been already growing, 'it's been a slow and steady grind – that's what lockdown changed', said Robinson.

### THE COST OF ONLINE SHOPPING

Amazon continues to invest heavily on fulfilment centres, TV shows and movies, grocery, AWS, India expansion and other areas. In India, the company is making massive investments (about \$5 billion worth, according to some estimates) to build a logistics network that would cover the entire country. It also recently announced plans to ramp-up in Latin America.

This is theory, should be great for revenue and possibly earnings, as it opens up its marketplace to hundreds of millions of new potential consumers. Last year's \$0.23 EPS is forecast to hit \$0.33 in 2020, and rapidly increase to around \$0.45 and \$0.63 over the next two years.

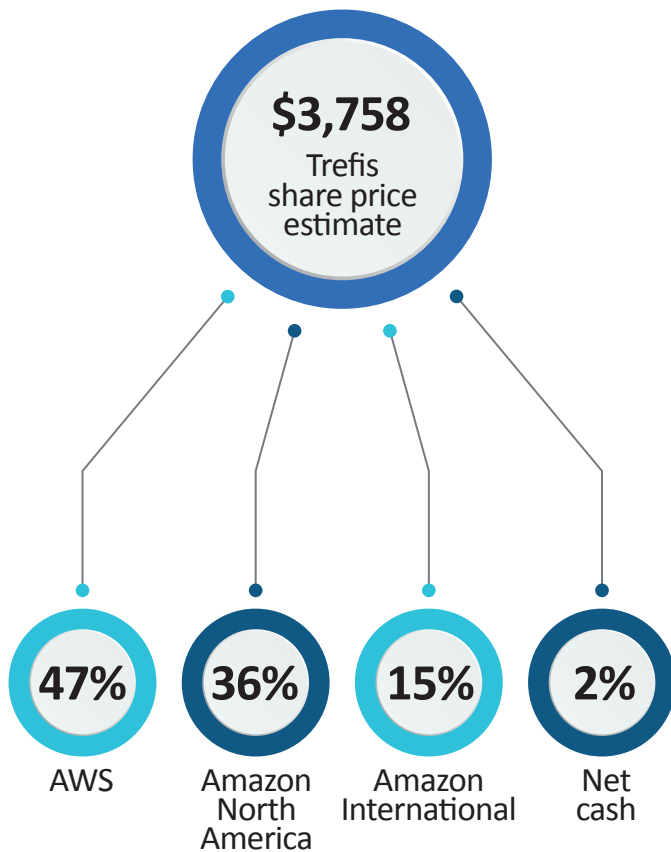
'The issue is the risk to those earnings as Amazon has a habit of deciding not to make money and returning to a very low level of profitability', points out Richard Windsor of the Radio Free Mobile analysis website.

This is apparent in Q4 guidance where revenue expectations are ahead at \$112 billion to \$121 billion (mid-point \$116.5 billion versus £116 billion forecast) but the earnings before interest and tax (EBIT) forecast range of \$1 billion to \$4.5 billion (\$2.75 billion mid-point) is well behind Refinitiv consensus of \$5.4 billion.

Running massive distribution and delivery networks is very expensive and most operators make precious little profit from them, Amazon is no different. This implies huge investment in staff and other network costs to meet demand could come at the cost of global margins.

Net profit margins have risen quickly since

## Building a \$3,758 price target



Source: Trefis. Refinitiv consensus price target \$3,787.50

2015's 0.6%, but stalled last year at 4.1%, and it remains to be seen if 2020's average 5.3% margin can be maintained given the huge investment. That said, starting from a low base means even small improvements in efficiency can have a big impact on profits.

This is exactly why Amazon has invested so much into drones and automated driving technology, to push down its biggest operating cost – staff salaries.

'This is where the risk lies in Amazon and the shares are pricing in steady profit generation with no sudden slips,' said Windsor.

However, analysis shows that Amazon's historical income statement growth and balance sheet growth have diverged. 'Revenue growth has paralleled asset growth; earnings growth has exceeded equity growth', say analysts at Price Target Research (PTR), a Seattle-based firm.

According to their calculations, annual revenue growth has been 23.6% per year against 29.4% in total assets, while average annual EPS growth of circa 40% outstrips 'equity growth of 27.5% per year', they claim.

While PTR's number crunching comes out lower than Morningstar's 34.5% average share price return over the past decade, as we stated earlier, both figures are significantly below earnings expansion, which helps explain the PE compression from triple-digits in recent years.

'With future capital returns forecasted to exceed the cost of capital, Amazon is expected to continue to be a major value builder', said PTR's analysts.

## GROWTH ENGINE AWS

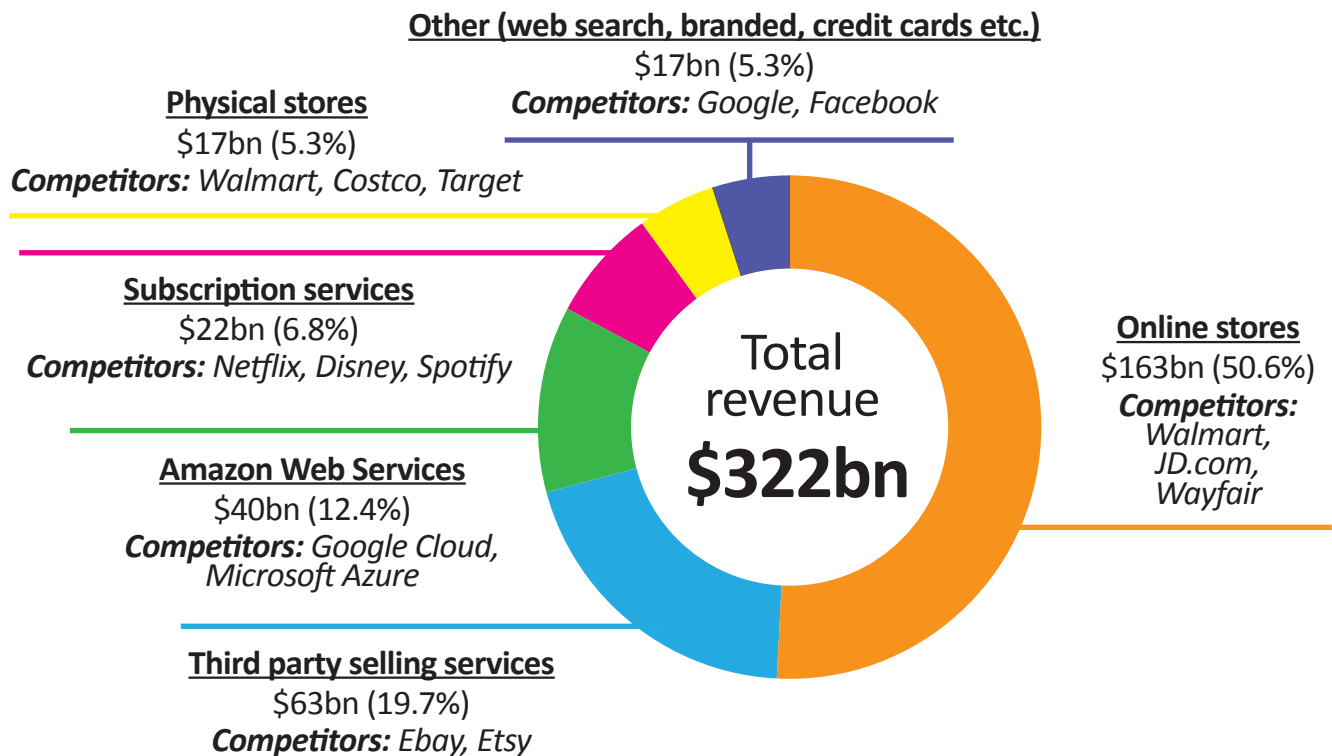
Amazon Web Services (AWS), its fast-growing cloud infrastructure business that helps massive customers like Facebook, Netflix, Twitter, Disney and multiple government agencies, saw revenue jump 29% to \$11.6 billion from \$9 billion, subscription services grew 32% year-on-year during Q3, the highest growth so far in 2020.

These two most recent quarters in the high 20s percent growth have followed four in the 30s and 10 in the forties, according to Megabuyte analyst Philip Carse, although he notes that the incremental new revenues of \$793 million was the second highest, eclipsed only by the \$955 million added in the seasonally busy fourth quarter of 2019.





## Amazon's revenue model with net sales (year to June 2020)



Source: Amazon, Shares

'AWS represented 12% of Amazon sales but 57% of operating profit', Carse calculates.

Subscriptions include annual and monthly fees from Amazon Prime members, plus audiobooks, digital video, digital music, e-books, and other non-AWS subscription services.

Yet despite a blowout quarter that steamed past forecasts the stock actually fell about 2% in after-hours trading on the day they were announced (29 Oct), implying a share price of \$3,151.04.

This cuts to the chase of the investment decision that investors must grapple with; can Amazon keep up this type of growth and, is that enough to justify the valuation?

Amazon stock is currently changing hands on a next 12 months price to earnings (PE) multiple of 72.4, according to Refinitiv data, way above the 21.7 industry average.

Effectively, Amazon subsidizes the growth of its lower-margin North American unit and its unprofitable international retail operations with AWS' profits. That's the opposite of Alibaba's business model, which subsidizes the growth of its unprofitable cloud business with its higher-margin core commerce revenue.

AWS profits enable Amazon to consistently

sell its products at low prices while expanding its ecosystem with brick-and-mortar stores (including Whole Foods and Amazon Go), streaming media platforms, and cheap hardware devices.

All those efforts strengthen Amazon Prime, which surpassed 150 million paid members globally at the end of 2019.

Amazon Prime's discounts, free shipping options, digital services, and other perks lock shoppers into its e-commerce ecosystem and prevent them from buying products from rival retailers. Therefore, Prime's growth buoys the long-term expansion of Amazon's online marketplaces, which still generate the lion's share of its revenue.

'I think the EPS story is going to accelerate; Q4 EPS could be nuts', said Chaim Siegel in September, an analyst at US broker Elazar Advisors. Yet in the wake of the recent numbers his mood had changed. 'I do think this is a great play for Q4 and stay-at-home but I no longer have the EPS upside to make this a buy', he said.

Short-term pivots like this understandably create confusion for ordinary investors, which is why it is so important to take the bigger and longer-run picture into account given the hefty valuation.



## Amazon key forecasts

	2020	2021	2022
Revenue (\$m)	378,162	447,103	521,624
Net income (\$m)	17,599	23,422	33,993
EPS (\$)	34.0	45.1	63.6
Net income margin (%)	4.65	5.23	6.51
FCF (\$m)	27,197	43,471	56,079
ROE (%)	26.5	28.4	28.6
ROIC (%)	24.6	31.4	34.0
PE (x)	89.3	67.3	47.7

Source:Refinitiv

Jeremy Gleeson, who has run the **AXA Framlington Global Technology Fund (B4W52V5)** since 2007, accepts that some technology businesses fail to warrant their inflated valuations, but that Amazon is not one of them.

‘Many of the firms we hold – even Apple and Amazon – are not mature businesses’, he said. ‘They are still in growth mode so their earnings are not yet at an optimal level. It’s the potential they offer that is exciting.’

### OPPORTUNITIES FOR MORE GROWTH

‘We see two potential catalysts for shares over the next 12-month period,’ said Tom Forte of institutional research house DA Davidson, ‘stronger than expected operating results from the company’s cloud computing efforts, which we believe remains the primary driver of its share price and its increasing mix of highly profitable third-party sales’.

Healthcare is another area that could create substantial value in the years ahead after its 2018 acquisition of Pillpack, the online pharmacy and medication delivery service.

‘We see Amazon exiting Covid-19 with a much larger healthcare related effort, which could be a long-term driver of sales and profits’, said DA Davidson’s Tom Forte.

‘While the margins may appear low, it is the massive revenue base and continued growth

that the market has continuously rewarded, and is likely to continue to do so.’

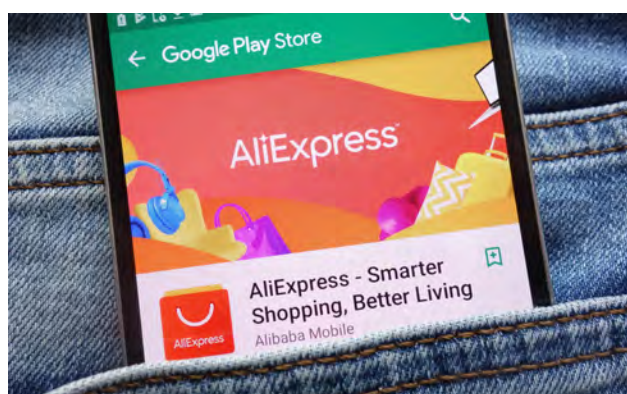
‘One of the most striking things to me is how early we are in digital transformation’, says Baillie Gifford’s Gary Robinson, and the opportunities for growth for years to come from well-funded, dominant businesses like Amazon are both large and long-term. *Shares* firmly believes that investors should have exposure to these trends and that Amazon is among the best stock selections to play this theme.



### Amazon’s four guiding principles

- Customer obsession rather than competitor focus
- Passion for invention
- Commitment to operational excellence
- Long-term thinking

## AMAZON'S RIVALS PROFILED



**ALIBABA (BABA) \$304.69**

China's answer to Amazon, and in some areas, its superior (such as a better digital blend between physical stores and online sales). Alibaba operates China's largest e-commerce platforms Taobao and Tmall, and while it has expanded elsewhere in Asia, its enormous home market remains all-important. Ambitious plans include two billion users of its digital ecosystem by 2036 helped by savvy digital vertical investments into things like smart logistics, payment services, cloud computing, online marketing services, travel booking, music and video streaming. Listed in New York and Shanghai, the stock is substantially cheaper than Amazon on a PE of 28, although that likely reflects potential governance issues around its Chinese roots.

**EBAY (EBAY) \$47.63**

A possible blast from the past, Ebay became a superstar stock during the dot.com era with its online auction platform but failed to keep up with growth hopes. Recent years have seen the company emerge to some degree from Amazon's shadow with its own online marketplace, although its rate of growth remains miles behind its larger rival, illustrated by its discounted 12-month PE of just 13.

**MERCADOLIBRE (MELI) \$1,214.05**

Argentine online marketplace that has grown into the Latin American leader, becoming the first tech company from the region to list on Nasdaq in 2007. Lots of local expertise comes in handy across a region beset with transport

difficulties from often poor infrastructure, which should give it a huge advantage over outsider rivals, including Amazon.



**SHOPIFY (SHOP) \$925.43**

Shopify is riding the illustrious e-commerce wave caused by the coronavirus, as more businesses have moved to online sales in 2020 than over past 14 years, according to one analyst, and Shopify has been able to make the most of this. The company runs tools across a platform that makes going digital super easy for retailers and other consumer-facing businesses, catapulting Shopify towards first ever profits this year. It's been one of the best-performing stocks in an industry dominated by Amazon and since its \$17 per share IPO five years ago its stock has soared 5,300%-plus, giving an eye-watering PE of 317.

**TWILIO (TWLO) \$278.97**

Operates in the UCaaS space, or unified communications as a service. This basically means enterprises to embed things like instant messaging, automated call answering, email and more into their own online operations easily, paying for Twilio tools on monthly subscription. The stock has jumped 170% so far in 2020 as the pandemic has supercharged the scramble from both old and new customers to update their operations for a new digital age. Any prospective investors would need a long-run view as it will take several years to grow into a PE currently at 2,700!



## FUNDS TO GAIN AMAZON EXPOSURE



### **JANUS HENDERSON GLOBAL TECHNOLOGY LEADERS (0771607) £31.49**

About 3% of the fund's £1.16 billion of assets are tied up in Amazon stock, helping returns beat its Technology and Telecommunications Investment Association (IA) benchmark by nearly 12% over five years. Also a big investor in Alphabet, Apple, Microsoft and Facebook.



### **AXA FRAMLINGTON GLOBAL TECHNOLOGY (B4W52V5) 799.2P**

The £1.21 billion fund is run by Jeremy Gleeson, a popular choice with retail investors thanks to a track record of benchmark beating performance over three, five and 10 years. Its Amazon stake isn't as large as some other funds, with approximately 2.3% of assets invested across a broad range of household names and less familiar stock, including Visa, PayPal, Apple and Qualcomm.

### **BAILLIE GIFFORD LONG TERM GLOBAL GROWTH (BD5Z0Z5) £11.46**

A very popular pick with ordinary investors from the highly-rated Baillie Gifford stable. As the name suggests, suits those taking a five year view or more in the hunt for super-normal returns, Amazon is its second largest selection at 7.76%, and its longest running stake. Tesla remains its biggest bet, while Alibaba, Tencent and Shopify are also among its largest stakes.



### **POLAR CAPITAL GLOBAL TECHNOLOGY (B42W4J8) £60.99**

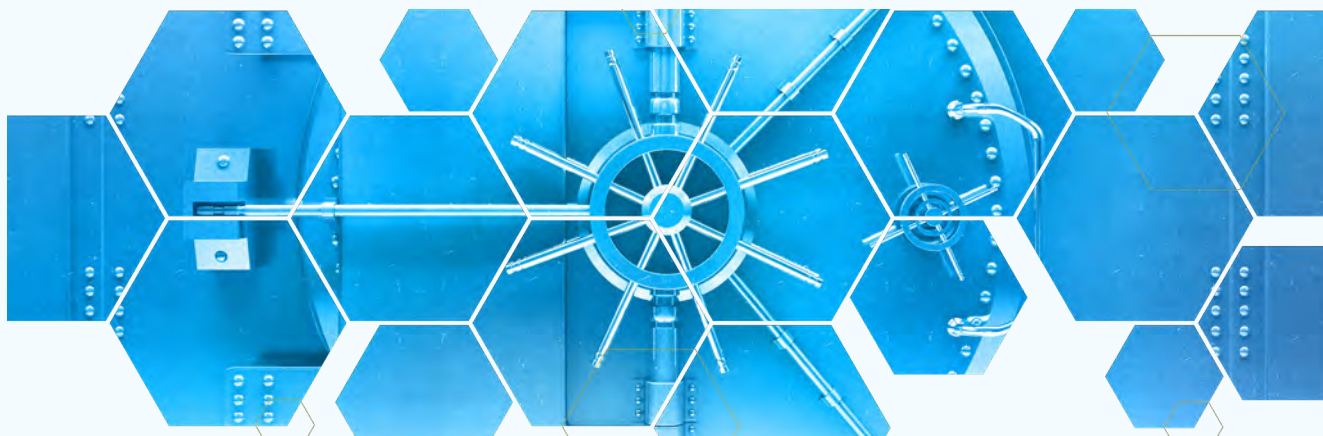
Run by the respected Ben Rogoff/Nick Evans team at Polar, the fund's performance has been knockout, smashing its benchmark over three and five years and returning more than 300% since 2015. It's Amazon stake stands at 2.95% currently and sits alongside a who's who of big capo tech names, including Apple, Alphabet, Facebook, Samsung, Alibaba and Tencent.

### **NATIXIS LOOMIS SAYLES US EQUITY LEADERS (B8L3WZ2) 368.51P**

Like the Baillie Gifford vehicle, this fund makes a big play on Amazon's future growth potential with 7.5% of its £1.45 billion assets in the stock, its biggest single stake. Another impressive five year performer, returning 149.4% from its mainly US-based portfolio. Alibaba, Nvidia and Visa also in the portfolio.

**DISCLAIMER: AJ Bell is the owner of Shares magazine. Tom Sieber who edited this article and its author Steven Frazer own shares in AJ Bell.**

# *It was the Best of Times, it was the Worst of Times*



The first sentence of Charles Dickens' *A Tale of Two Cities* could have described the cyclical nature of financial markets as much as the extremes of that time. Those who bought equities or corporate bonds in March this year, at the height of the pandemic, will, outside a small number of sectors have done very well.

A number of banks, including Nordea Bank, Scandinavia's largest, and First Republic Bank, 12th largest in the US, are trading higher than at the turn of the year; the likes of Intact Financial Corp (Canadian property and casualty), Progressive Corp (US personal lines insurer) and Hong Kong Exchanges and Clearing are also higher.

The financial sector, which encompasses banking, insurance, stock exchanges, asset managers and consumer finance companies among others, has underperformed global equity markets by c22% since the start of 2020. Understandably, investors have been focused on the crisis 'winners', most notably technology companies.

Banking and insurance are incredibly attractive if done well. If an insurer underwrites risk well, it will make profits from policyholders' premiums as well as income from investing those premiums alongside other investments it holds on its balance sheet. Similarly, if banks underwrites risk well, they could earn attractive returns over an economic cycle.

However, share prices of banking and insurance companies have been hit hard by COVID-19, the latter over concerns around claims from travel, events and business interruption policies. The latter were hit on rising loan loss

provisions thanks to company failures and unemployment thanks to government-imposed lockdowns.

Nevertheless, for some classes of business insurance rates are rising at their fastest rates for many years, with commentators referring to the most attractive market in over a decade. Similarly, the banking sector has changed materially over the past 10 years with capital levels rising substantially. Therefore, banks were more robust and able to provide significant support to customers at the beginning of the pandemic.

Today, many banks trade at levels only seen during the global financial crisis when their solvency was in question – which it is not today. We believe earnings are likely to jump sharply over the next few years as economic recovery continues thanks to global fiscal and monetary stimulus, as the COVID-19 crisis abates and dividends/buybacks restart.

The sector remains unloved and undervalued but, as we have seen many times before, expect the unexpected. In *A Tale of Two Cities*, Sydney Carton, a dissolute English lawyer, finds redemption. Along with other value stocks that have performed poorly, investors may well look back in 12 months' time and see COVID-19 as the catalyst. Despite the dark times, the outlook is looking more and more positive while the recovery potential remains substantial.

**Nick Brind**  
Co-fund Manager, Polar Capital Global Financials Trust  
15 October 2020

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# What investors should do after the latest correction

Is there worse in store for markets as the Covid-19 second wave arrives?

**O**ctober is often referred to as 'the cruellest month', as it tends to see more than its fair share of abrupt market sell-offs, including famously 1929 and 1987.

A study of the Dow Jones index going back to 1896 shows that volatility, as measured by the standard deviation of daily moves, is statistically much higher in October than in any other month. And with the whole of the UK in some form of lockdown, there is little reason for sentiment to improve much in November.

## A MONTH AGO EVERYTHING LOOKED BRIGHTER

It was almost inevitable that, just as investors had begun to relax in September and life seemed



to be getting back to something like normal – coronavirus cases falling, the world economy getting back on track, Europe having passed its stimulus bill

and Democrat candidate Joe Biden the clear favourite to win the race White House – markets went into reverse last month and the FTSE 100 broke below its 5,800 'support', plumbing the levels of late April.

There's a theory that October's volatility stems from the fact it falls just before the US presidential and mid-term elections, but even taking only the first and third years of a presidential cycle it is still the most volatile month by some margin.

To be fair, the FTSE hardly had the bit between its teeth when the sell-off started: having rallied just over 50% from the 18 March low in a matter of eight weeks, it spent the summer repeatedly flirting with the

## The sectors which have done best and worst since the market's summer high

Sector	Performance since 12 August (%)
<b>BEST</b>	
FTSE 350 Leisure Goods	14.2
FTSE 350 Electronic & Electrical Equipment	0.9
FTSE 350 General Industrials	0.2
FTSE 350 General Retailers	0.15
<b>WORST</b>	
FTSE 350 Oil & Gas Producers	-28.7
FTSE 350 Aerospace & Defence	-22
FTSE 350 Life Insurance	-21.7
FTSE 350 Food Producers	-15.5

Source: SharePad, data as at 30 October 2020.



6,000-point level before settling into a 200-point range.

### TECHNOLOGY RETURNS UNDER PRESSURE

Meanwhile, US indices like the S&P 500 and Nasdaq Composite had not just passed their pre-crisis levels but were making new all-time highs.

In fact it wasn't *that* long ago that Apple shares were trading at \$135, making it the most valuable company in the world with a market value of more than \$2 trillion. Today they may trade 16% below their highs, but they are still above where they were a month earlier.

Is there worse to come? With the final shape of any Brexit deal still to be finalised, and the direction of the pound therefore still an unknown, it's tempting to say wait and see.

What's most interesting is that US tech stocks, which were seen by many as a 'safe haven' trade when volatility is rising, have failed to step up to the mark this time meaning there have been few hiding places.

### IT'S BEGINNING TO LOOK A LOT LIKE CHRISTMAS LOCKDOWN

With France and Germany introducing emergency restrictions, several Spanish regions closing their borders, Wales and Scotland under localised controls and England back in a full national lockdown, surfing a second wave of infections could prove trickier than first time round. With the chart over the page showing how different types of investment

### Selected capital preservation investment trusts' performance

Trust	10-year share price total return (%)
RIT Capital	90.8
Ruffer	38.6
Personal Assets	68.5
Capital Gearing	68.5

Source: AIC, data as at 29 October 2020.

asset are becoming increasingly correlated.

Like technology, many healthcare stocks have been priced for perfection in recent months and offer little in terms of 'margin of safety'.

Banks may be cheap, and are having a moment in the sun as investors lick their lips at the prospect of (much-reduced) dividends from next year, but ultimately lending is a cyclical business and interest rates are not helping them.

Putting aside fewer provisions isn't the same as growing, and if the housing market stalls there really is nothing to cheer about for them – or for the housebuilders, builders' merchants or equipment rental firms.

Travel and hospitality stocks

are a no-go zone, with few exceptions, and energy stocks – like the banks, cheap but not very cheerful – are vulnerable to falling crude prices if industrial activity and global trade slows.

A 'tin hat' portfolio of supermarkets, tobacco, utilities and other 'must-have' rather than 'nice-to-have' products and services could be a sensible strategy, although these type of defensive stocks are often categorised as 'value' and are likely to get left behind in the event that the herd switches back to a 'growth' mentality.

### DO NOT PANIC

In the final analysis, investors should consider one thing above all else. That is not being tempted to do too much, too



## FEATURE

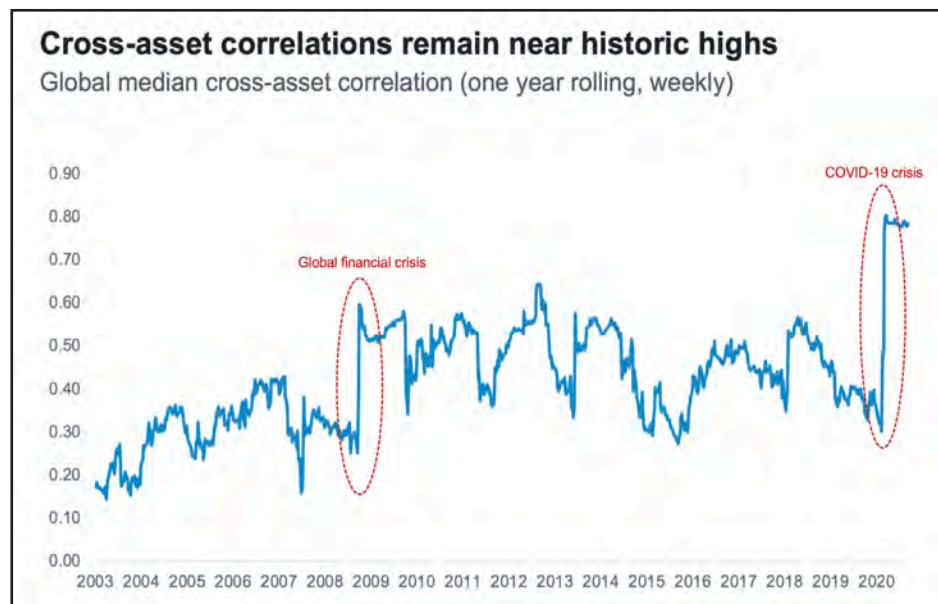
quickly with their portfolios – the lesson from the sell-off in March was that anyone who crystallised losses by panic selling in March would have been kicking

themselves three months later as stocks staged a rapid recovery.

It may also be best avoiding trying to pick stocks in such an uncertain environment and go

for ESG (environmental, social, governance) funds, which have proven themselves to outperform in down markets as well as up markets, and capital preservation funds which aim to minimise the impact of volatility by owning a mixture of assets such as precious metals and bonds, alongside equities.

You could also consider holding a bit more cash than usual which, should provide some protection against further market volatility as well as giving you the opportunity to take advantage of opportunities when they come about.



Source: Fidelity International, Bloomberg, International Monetary Fund. October 2020



By Ian Conway  
Senior Reporter



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UK Individual Shareholders Society

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**NOVEMBER 2020**

TITLE	Type of event	Date	Link to register
PRIVATE EQUITY	Investing Masterclass	10 Nov 2020	<a href="https://bit.ly/2HFKI36">https://bit.ly/2HFKI36</a>
SILENCE THERAPEUTICS (SLN)	Company Webinar	11 Nov 2020	<a href="https://bit.ly/3moNybQ">https://bit.ly/3moNybQ</a>
SHORTING STOCKS	Investing Masterclass	26 Nov 2020	<a href="https://bit.ly/34CSofi">https://bit.ly/34CSofi</a>
CERILLION (CER)	Company Webinar	30 Nov 2020	<a href="https://bit.ly/34sSypP">https://bit.ly/34sSypP</a>

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# Cash flow is a figure that can't be fudged

We explain why cash flow is so crucial and how investors can calculate free cash flow yield

**I**n the latest instalment in our first-time investor series, we outline the importance cash flow plays when weighing a company's financial health and future prospects.

'Cash is king' is the oft-quoted mantra of entrepreneurs and investors alike.

The reason is the cash a company generates cannot be fudged or flattered, unlike revenue, profits and earnings per share. Furthermore, a company's capacity to generate positive cash flow and maximise long-term free cash flow (FCF) determines its ability to create shareholder value, and running out of cash is one of the most common reasons why businesses fail.

### BACK TO BASICS – WHAT IS CASH FLOW?

Cash is the money in the bank that a company owns, whereas cash flow is the cash a company generates in a given period and is the operating profit adjusted for non-cash items such as depreciation and the investment made in working capital such as inventory, creditors and debtors.

Put simply, cash flow measures how much money is moving into and out of a business during a given accounting period. Analysis of cash flow



provides management teams and investors with a snapshot of the amount of cash coming into a business, from where, and the amount flowing out.

Positive cash flow, defined as ending up with more liquid money on hand at the end of a given period compared to what was available when that period began, is the lifeblood of a company.

It enables a firm to pay its debts, settle any debts, reinvest in growing the business and return money to shareholders, while also providing a buffer against future financial challenges such as a downturn.

In contrast, negative cash flow indicates that a company's liquid assets are actually decreasing.

Companies with a high operating cash flow, or with cash flow that is in an upwards trend, are generally considered to be in rude financial health, and typically more highly prized by investors.

### A PROFITABLE COMPANY CAN RUN OUT OF CASH

Counterintuitive as it may seem, a company that is profitable can still run out cash, as cash and profit are different things. Whereas cash is the money a company has in its bank account and represents its liquidity, profits can include sales a company has made but hasn't been paid for yet.

The key difference is that while profit shows the amount left over after all expenses have been paid, cash flow indicates the net flow of cash in and out of the business.

### THE IMPORTANCE OF FREE CASH FLOW

Free cash flow is important to investors because it shows how much actual cash a company has at its disposal. When a company services its debts, pays dividends or invests in equipment, it needs cash to do so.

If it has a large amount of excess cash, depending on the

industry, it might be able to ramp up production, spend on earnings-enhancing acquisitions or return money to shareholders.

Free cash flow is the amount of cash that a company has left over every year to pay its lenders and shareholders. It is essentially a group's cash profits and is called free cash flow because the company is free to do anything it wants with it.

One of the best characteristics of free cash flow is that it is difficult to fudge using 'creative' accounting. This cannot be said for other key metrics such as earnings per share (EPS) and profit, which can be inflated by the use of one-off items, or even revenue, which can be booked in the accounts before the cash has even been paid by a company's customers.

Infamous construction and support services company Carillion, which went into liquidation in 2018, was performing such a trick, and putting in low bids to win government contracts on wafer thin margins, which meant if customers delayed paying it would be in big trouble.

The shortfall in cash caused by the company not getting paid on time or in contractual disputes meant there was an increasing shortfall of the cash needed to meet its day-to-day obligations. In hindsight, the demise of Carillion is not that surprising as without cash the company was forced to rely on its lenders who had grown concerned with its mushrooming debt levels. They cut the lines of credit to the company which led to its ignominious failure.



## Calculating Dunelm's free cash flow

	FY 2020/£m	FY 2019/£m
<b>Net cash generated from operating activities</b>	<b>244.1</b>	<b>174</b>
Capex (net of disposals)	-24.9	-19.6
Net interest	-1.3	-1.6
Interest on lease liabilities	-5.5	
Repayment of lease liabilities	-37.7	
<b>Free cash flow</b>	<b>174.7</b>	<b>152.8</b>

Source: Dunelm

## CALCULATING FREE CASH FLOW & FCF YIELD

Perhaps the easiest way to determine free cash flow is to subtract a company's capital and operating expenses from its operating cash flow. This latter information can be found in financial statements under headings such as Consolidated Statement of Cash Flows under the section Cash flows from operating activities.

We've provided an example above in the form of statements from cash generative homewares retailer **Dunelm (DNLM)**, which despite the pandemic, generated improved free cash flow of £174.7 million (2019: £152.8 million) in the financial year ended 27 June 2020.

Once the free cash flow figure

has been calculated, some fund managers like to use the free cash flow yield.

Expressed as a percentage, free cash flow yield is calculated by dividing a company's free cash by its enterprise value (its market capitalisation plus any net debt or minus net cash).

It is often used by private equity firms, which typically employ borrowing to finance deals, when sizing up an acquisition, and is also a useful metric for equity income investors as it can indicate a company's ability to maintain its dividend or even increase its pay-out.



**James Crux,**  
Funds & Investment  
Trusts Editor

# Next generation Japan



***Nicholas Price, portfolio manager of Fidelity Japan Trust PLC, discusses recent key political and economic developments in Japan. He outlines how an increased focus on digital transformation is impacting the landscape and creating new opportunities across both public and private markets.***

Japanese equities are second only to the US in posting the highest returns of any major region since 2012, but still remain significantly under-owned by international investors. This is mainly due to the commonly held view of Japan's economy as stagnant and low growth.

On the political front, however, the country has managed a smooth transition to a new leader and key economic policies are largely a continuation of the supportive stance pursued by the previous administration. In an uncertain world, with its wealth of under-researched companies, Japan represents a significant source of potential alpha (excess return relative to its benchmark) for long-term investors.

## **Online shift**

One of the biggest changes that we've seen over recent months has been the move to online and digitalisation - a trend seen globally. However, this shift is significant in Japan as Japanese companies have long been laggards in e-commerce and digitalisation. The current crisis has highlighted the need to be much more resilient and corporates are now rapidly increasing their spend on digital transformation initiatives. We are also seeing a big push from the government, with major policy initiatives in this area. For instance, newly appointed Prime Minister Yoshihide Suga has pledged to establish a new agency tasked with handling digital transformation policies.

Against this backdrop, we believe that companies that can supply some of the services to facilitate corporate Japan's digital transformation offer attractive growth opportunities. Additionally, companies in areas such as

online services, e-commerce and educational software that can benefit from changes in the way we work, shop and play look interesting.

## **Buying the dip**

We had anticipated that the shift online would accelerate and that stocks in this area could potentially see a lot of upside. As a result, in the early stages of the pandemic when many of these stocks - especially in the small-cap software as a service (SAAS) area - were oversold, we considered this to be a unique buying opportunity.

We also looked at companies with strong balance sheets that were temporarily hurt by the spread of the Covid-19 pandemic, but that are well positioned to recover and grow their businesses as restrictions are lifted. Key examples here are domestic services companies, particularly in leisure industries.

During the crisis, we also increased the level of gearing as we wanted to take advantage of stocks that were oversold when compared to their long-term growth prospects. Having said that, I do not expect gearing to increase further and as stocks approach their target prices, this gearing level will decline over time.

## **Digging deeper**

The trust has the ability to invest up to 10% of the portfolio in unlisted companies, and we continue to look for early stage ideas, particularly among fast-growing services and internet-based companies, as well as innovative medtech names. One such unlisted name



offers an online consumer to consumer (C2C) platform where users can buy and sell knowledge, skills and experience from those who are willing to teach these activities for a fee. This company has seen enormous growth as people are finding second jobs and working from home, so we see this as an area that will benefit considerably in the medium-term.

The above examples highlight to good effect the size and diversity of the opportunity set on offer in Japan. Notably, just over one-third of the 3,800 listed companies are not well covered by sell-side analysts, especially in the mid to small-cap space. Being on-the-ground means that we see a lot of the new ideas and business models that are coming to market first-hand.

This creates opportunities for bottom-up managers like me, who are willing to do the leg work and identify the most attractive investment cases. It is pleasing that we have managed to capture this potential for investors over my first five years in charge of the trust, delivering a share price return double that of the index.

### Outlook

During my five year tenure as portfolio manager, we have seen two major challenging periods. The period following the US election in 2016 and more recently the Covid-19 crisis when the market moved temporarily away from small-cap growth stocks.

Going forward, the key issues will be the speed with which we exit from the current crisis, the extent of the cyclical recovery, and finally the mid-term inflationary outlook due to the scale of monetary and fiscal stimulus globally.

We believe volatility may continue in the near term, but this is also allowing us to invest in strong growth companies at very attractive valuations, and we remain positive on the medium-term for growth stocks in Japan.

The Trust will continue to be driven by bottom-up stock picking to identify, ahead of most other investors, the next generation of great growth companies in Japan.



## PERFORMANCE OVERVIEW OF FIDELITY JAPAN TRUST PLC

	Sep 15 - Sep 16	Sep 16 - Sep 17	Sep 17 - Sep 18	Sep 18 - Sep 19	Sep 19 - Sep 20	PM tenure
<b>Fidelity Japan Trust NAV</b>	35.9%	21.7%	26.7%	-3.9%	23.5%	18.4%
<b>Fidelity Japan Trust Share Price</b>	29.9%	28.7%	28.4%	-3.7%	25.9%	20.3%
<b>Comparative index</b>	32.2%	12.6%	12.6%	-0.3%	2.4%	9.7%

### Past performance is not a guide to the future.

Source: Fidelity International, Morningstar, 30 September, 2020. Basis: bid-bid with income reinvested, in GBP, net of fees. Index: Tokyo Stock Exchange TOPIX Total Return Index. Tenure: 5 years annualised %

### Important information

Past performance is not a reliable indicator of future returns. The value of investments and the income from them can go down as well as up so you may get back less than you invest. Investors should note that the views expressed may no longer be current and may have already been acted upon. This information is not a personal recommendation for any particular investment. If you are unsure about the suitability of an investment you should speak to an authorised financial adviser. The shares in this investment trust are listed on the London Stock Exchange and their price is affected by supply and demand. The investment trust can gain additional exposure to the market, known as gearing, potentially increasing volatility. This trust invests more heavily than others in smaller companies, which can carry a higher risk because their share prices may be more volatile than those of larger companies and the securities are often less liquid. Changes in currency exchange rates may affect the value of an investment in overseas markets. Reference to specific securities should not be construed as a recommendation to buy or sell these securities and is included for the purposes of illustration only. The latest annual reports, key information document (KID) and factsheets can be obtained from our website at [www.fidelity.co.uk/its](http://www.fidelity.co.uk/its) or by calling 0800 41 41 10. The full prospectus may also be obtained from Fidelity. Fidelity Investment Trusts are managed by FIL Investments International. Issued by Financial Administration Services Limited, authorised and regulated by the Financial Conduct Authority. Fidelity, Fidelity International, the Fidelity International logo and F symbol are trademarks of FIL Limited.

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# Know your fund: Fidelity Global Special Situations isn't giving up on value

Popular with retail investors, this Fidelity fund looks to strike a balance between growth and value

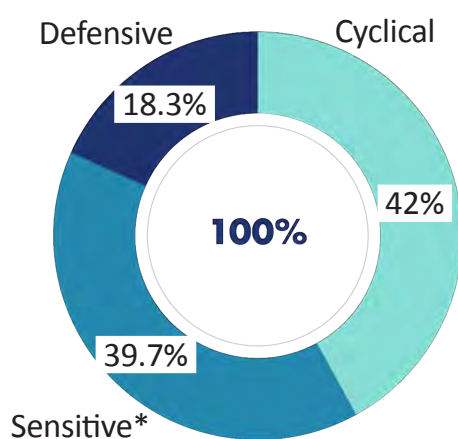
**'S**pecial situations' is a term that typically describes beaten-down stocks, companies beset by problems but boasting compelling turnaround potential, although this style of investing actually encompasses so much more than recovery bets.

One portfolio badged as such is the popular **Fidelity Global Special Situations (B8HT715)**, a highly-diversified open-ended fund managed by experienced Jeremy Podger and associate portfolio manager Jamie Harvey, which had 104 long positions and 16 short positions at last count.

The fund has notched up impressive five and ten year annualised returns of 14.57% and 11.6% respectively by using a valuation-focused approach to identify companies with significant potential for share price appreciation. This can be because the valuation is too low or because the market fails to recognise the company's future growth prospects, or both.

The portfolio is divided into three categories of 'special situations': corporate change, exceptional value and unique businesses. Corporate change

## Portfolio breakdown



Data as at: 31 July 2020. \*Defined by Fidelity as industries which ebb and flow with the overall economy but not severely so

candidates offer the potential for a fundamental shift in value, with catalysts linked to near-term restructuring, merger and acquisitions or spin-off activity.

Exceptional value companies can deliver earnings growth in excess of market expectations, potentially driving a dramatic re-rating, whereas unique businesses are typically firms with a dominant industry position, strong growth, cash flow and pricing power.

## GOLD BLEND

As Podger told *Shares* in a recent Zoom exchange, this stylistic balance aims to ensure that the fund delivers returns

for investors even in a low growth environment.

Built from the bottom up, Podger's portfolio is primarily driven by stock selection. 'We don't want style, or sector, or region to dominate the performance. We want the fund to be primarily driven by stock selection, and we achieve that through blending these things.'

'Since 2012,' recounts Podger, 'all three categories have added value compared to the broad benchmark and they've done well against value and growth indices as well.'

'In the last two years, value has definitely lagged the benchmark and it is incredibly difficult because of the polarisation of the market to get positive relative performance out of value names.' Podger has been trying to do just that by being 'creative about where we look for value'.

Yes, the fund's stated objective is to invest in undervalued companies with recovery potential that isn't fully recognised by the market, but it is so much more than a book of turnaround tales, offering investors exposure to everything from mega cap growth to 5G cycle beneficiaries such as

semiconductor stocks and post-Covid-19 winners such as cloud businesses and payment service providers.

Top 'net long' positions as of 30 September included FAANG names Amazon, Microsoft, Apple and Alphabet, as well as T-Mobile, Japanese electronic components supplier TDK, prized for its profitable battery business and the turnaround potential of its sensors division, not to mention payments play (and Worldpay owner) Fidelity National Information Services.

Over the past year, Podger concedes short positions have detracted a bit of value, 'but over the last eight years they have been fairly consistent in adding a bit of value'.

### DON'T GIVE UP

Given its balanced portfolio, Fidelity Global Special Situations is 'pretty well-equipped' for a change in the style leadership of the markets, if and when that comes.

Podger honestly thinks that 'many value stocks are so attractively valued that just by staying where they are – buying back stocks, paying dividends, improving margins a bit post-Covid – some of these stocks are going to give you great returns.'

'Now is not the time to give up on value at all, even if you can't see the normal catalysts which are higher interest rates, higher bond yields, faster underlying economic growth. So many of these stocks are just so cheap that you need to have representation.'

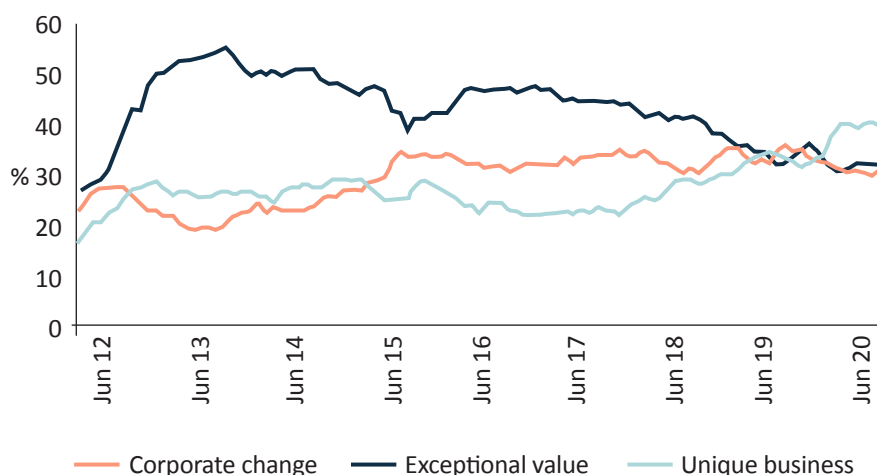
### TAKING PROFITS

Fidelity Global Special Situations

### Exposure to different categories

As at 30 September 2020

Category exposure over tenure (%)



Source: Fidelity International, as at 30 September 2020.

has taken some profits on more highly-rated stocks such as Apple and Tesla, names that have done well this year.

During lockdown, Podger took advantage of a fall in the share price to buy Amazon 'at a cheaper price than we could have got it in 2018. On a free cash basis the valuation made a lot of sense. I think it is more challenging now – we have taken a few profits but that stock has done very well for us'.

He worries some of the 'second-line growth stocks' are 'starting to get too expensive', such as Zoom, a name he doesn't own. 'There's been a lot of money thrown at the market and a lot of it has gone into concept stocks helped by retail participation. In some ways this is a replay of what happened in the tech bubble.'

Podger has to be very careful at this point 'that we are picking the winners because a lot of these companies have very little earnings. Some of

the new software companies are spending a lot on the sales part of their organisation and that keeps them from going into profit'.

He notices 'a kind of fascination with the new' in the current market and thinks 'the option value in a lot of these shares is over-inflated and there will be a lot of disappointment further down the road'.

Fidelity Global Special Situations is active in the IPO market. Coffee maker JDE Peet is among its 2020 purchases, though the valuation-focused fund passed on Snowflake as it was 'too much for us to back in terms of the price'.

The Fidelity money manager doesn't like being part of 'hugely hot IPOs' because they 'are going to get to valuations that are completely unjustifiable.'

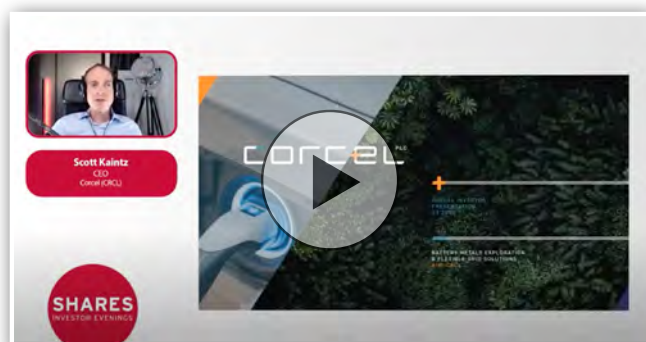


**James Crux,**  
Funds & Investment  
Trusts Editor





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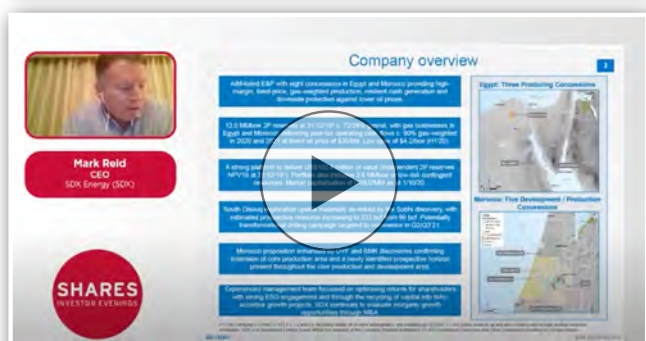
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# Why it helps if chip stocks show some sizzle

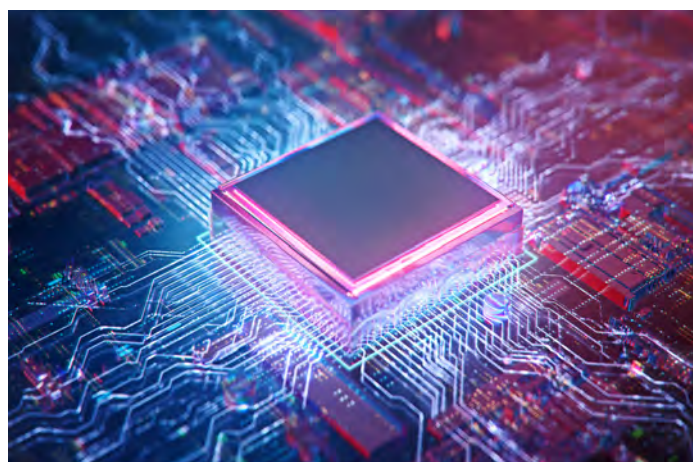
Should you be worried by the SOX index losing momentum?

**T**he heavyweight sextet of Alphabet, Amazon, Apple, Facebook, Microsoft and Netflix are not the only names that matter in the broad technology sector. Granted, Amazon and Apple are among the 20 best performers in America's benchmark S&P 500 index so far this year, but so are several other tech or tech-related firms, notably silicon chip makers Nvidia and Advanced Micro Devices.

This is a marked contrast to the woes of the oil sector, which provides no less than 12 of the 20 worst performers in the S&P 500.

That will not stun too many investors after the oil price's swan dive, and the strong showing of silicon chip stocks should not be such a surprise in some ways either. After all, the semiconductor industry is worth over \$400 billion in annual sales and not one of smart phones, cars, computers, servers, smart meters or anything else electronic you can think of can function without them.

The importance of the semiconductor industry is evidenced by how it can point to a compound annual sales growth rate of 8% over the past



40 years, albeit with some big swings and roundabouts along the way.

As a result, investors should really pay attention, although it is not easy to do this through the lens of the UK stock market, which is all the poorer for the disappearance over time of ARM, ARC, CSR Imagination, PureWafer and Wolfson. **IQE (IQE:AIM)** is one of the few listed players relevant to this space left on the UK market.

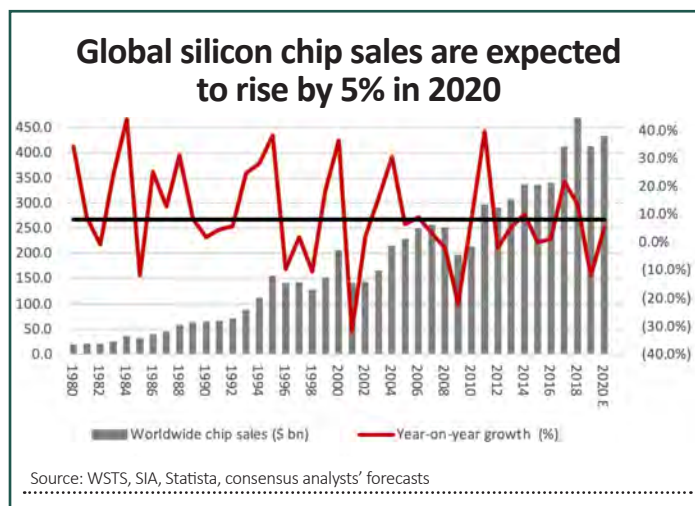
Investors must look Stateside for their fill of chip stocks and the Philadelphia Semiconductor index, or SOX, means this can be done with ease. All but of a couple of the benchmark index's 30 members hail from the US and it can be tracked for free on the internet.

## SCRATCH AND SNIFF

As a scratch-and-sniff test, the SOX has two uses. The first is as a barometer for economic activity.

The sheer ubiquity of silicon chips means they are a fair proxy for economic growth and broader end-market demand.

A consensus forecast of 5% sales growth in 2020 looks good given the broader economic backdrop





## RUSS MOULD

AJ Bell Investment Director

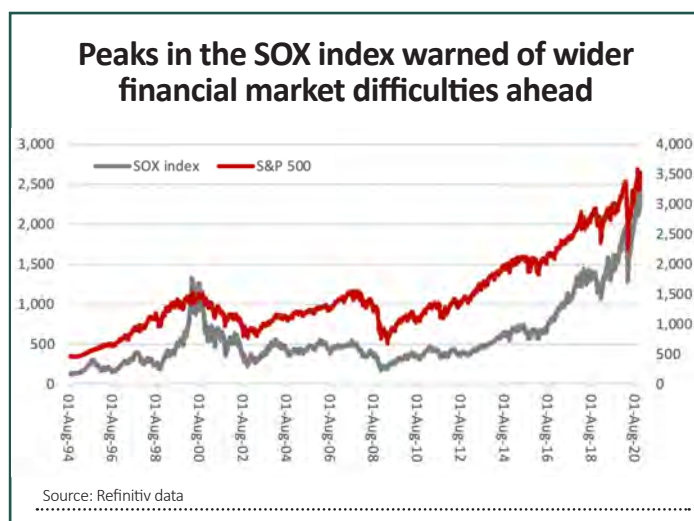


Insightful commentary on market issues

and is testimony to how chip sales are getting a boost from the pandemic, thanks to higher demand for servers and cloud computing capacity, bandwidth-providing telecoms equipment and laptops and home computing.

Beyond such mega trends, the members of the SOX index are driven by product and inventory cycles – their order books will be among the first to notice any subtle shifts in customer behaviour which may be indicative of a wider economic trend that is coming around the corner in a few months' time.

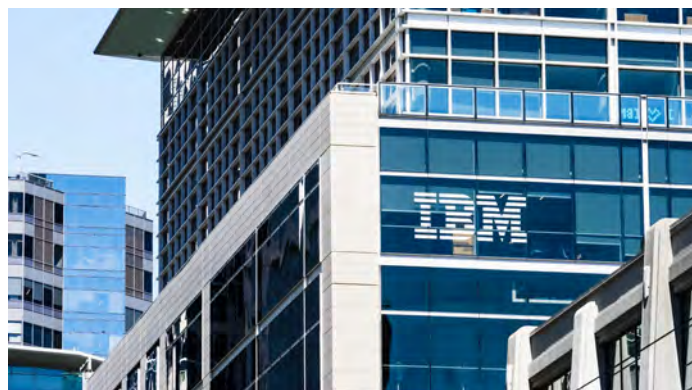
The second is as a guide to market risk appetite. Chip stocks are traded as momentum and growth stocks, doing well when earnings estimates are going up and badly when they are going down. In addition, the SOX can be fair guide to stock markets more generally. The index peaked before the wider US stock market in both 2000 and 2007; and bottomed before headline indices such as the S&P 500 began to find their footing in 2002 and 2009.



### CORPORATE CONUNDRUM

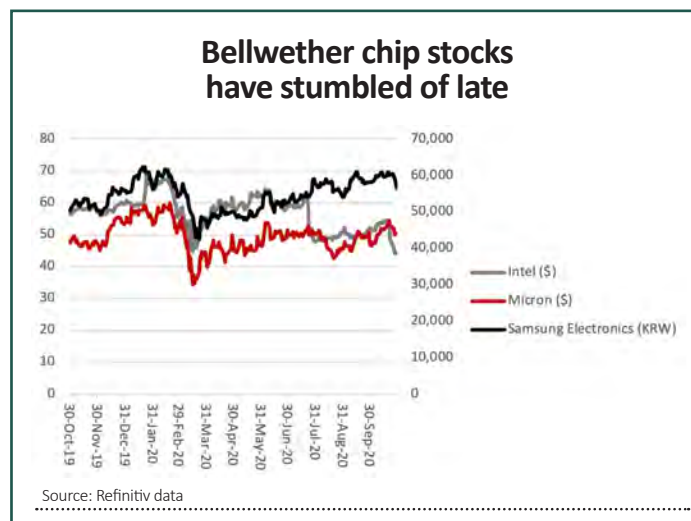
The SOX has had a stunning run in 2020, reaching a new record high, to further exemplify how financial markets have feasted off central banks' monetary stimulus, fed off hopes for fresh fiscal stimulus and sought to peer through the pandemic to an eventual economic upturn.

Yet the indicator has just rolled over in the past month or so, weighed down by cautious



comments from leading constituents such as Intel and Micron, as well as Asian chip-making giant Samsung. All three cited weaker future demand for servers thanks to an inventory pile-up.

Coming after gloomy commentary from Cisco, IBM and German enterprise software specialist SAP, all of whom flagged growing corporate caution when it came to spending money, there is perhaps a growing danger of a double-dip recession as companies cut back even further due to the uncertain outlook.



It is not just corporate tools which contain silicon chips, but consumer gadgets too, so as we head into the Christmas selling season it will be interesting to see if the SOX starts to sag or whether it can maintain this year's strong run. It is always possible that dramatic further action from central banks renders such fundamental analysis largely irrelevant, at least when it comes to share prices.



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# Why fund investors are under-allocated to the US and does it matter?

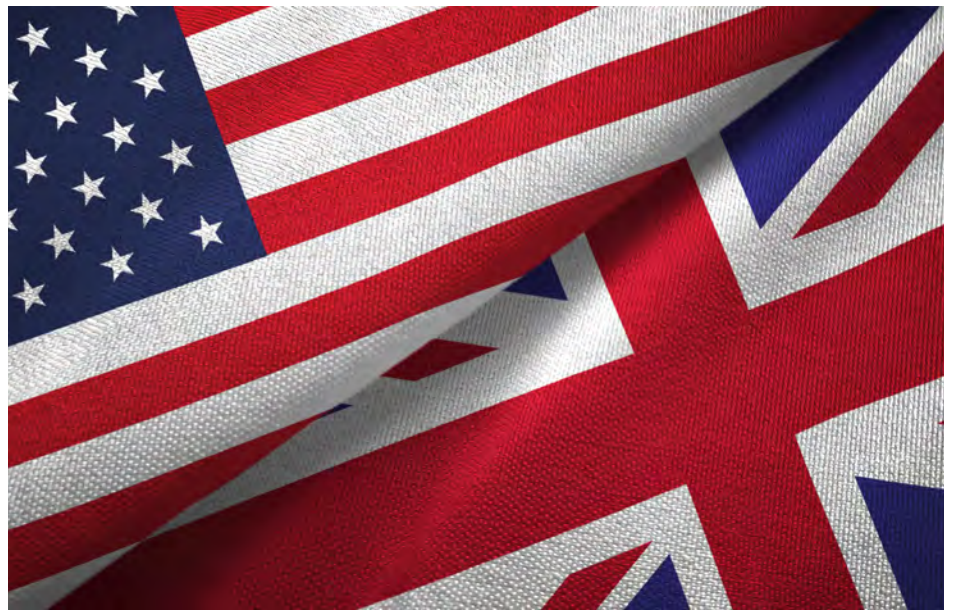
Holders of collectives still have a big bias towards UK stocks

**I**t's been a cruel ten years for investors in this country, who have watched the US stock market go from strength to strength while our home market brings up the rear. This is particularly galling because the typical fund portfolio is significantly underweight the US, and overweight the UK.

While the US stock market has turned £1 into over £4 over the last ten years, the UK market has turned that same £1 into just £1.60. Meanwhile the typical fund portfolio is around 30% underweight the US, and 37% overweight the UK.

## PERFORMANCE GAP

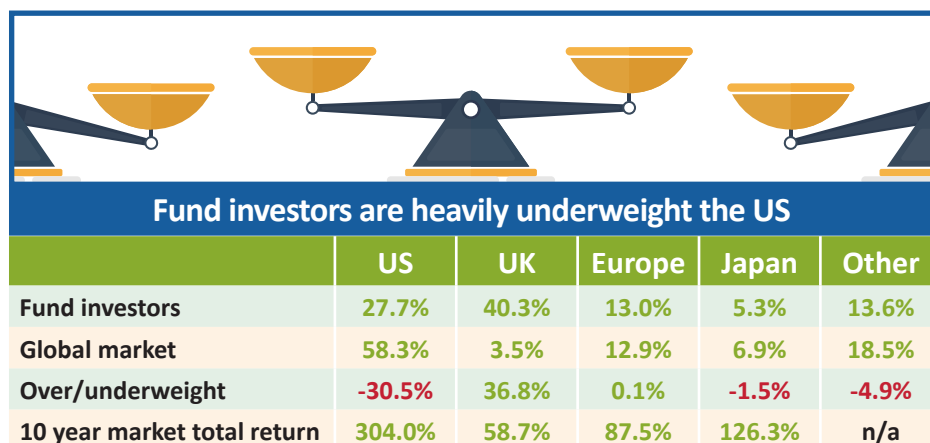
The performance gap between the US and UK markets can in large part be attributed to currency effects, the overhang of Brexit, and the sectoral



composition of the indices. The biggest companies in the US stock market are new economy tech titans, while the top end of the Footsie is packed with cyclical stocks in oil, mining and financial sectors, which have found it tough going of late.

In recent years investors have sold out of UK funds, but this sector still tops the charts in terms of the amount of assets invested, followed closely by global funds. There are longstanding reasons for the funds market being skewed to the UK over the US, not least the fact that the UK market has historically been a great source of dividends for income seekers.

Even fund managers in the global sector, with a worldwide remit, are underweight the US. Of the 210 funds we analysed in the sector, 170 were underweight the US market compared to its weighting of 66.5% in the MSCI World Index of developed markets. This goes some way to explaining why the IA Global



Sources: FE, Morningstar, IA, MSCI. Market returns in pounds sterling.



Sector has underperformed the MSCI World Index by around 45% over 10 years.

Again there are reasons why global fund managers are underweight the US market. It's a well-analysed market, and adding value through stock selection is therefore theoretically harder than in the UK. Seeing as it makes up two thirds of the global stock markets of developed countries, you also have to have a very high conviction in that market to put that much of your portfolio there.

### DRIVING FORWARDS

While it's undeniable that the US stock market has been the place to be over the last ten years, looking in the rear-view mirror isn't the best way to navigate if you're planning on driving forwards.

The US might well continue to shine if the strong keep getting stronger. The likes of Amazon, Apple and Netflix have thrived in the pandemic, and while valuations look lofty, that's been

the case for some time, and that hasn't stopped investors turning a healthy profit. What's more, a shake up in the US market can be expected to dampen markets around the globe, so if you're negative on the US, it's hard to be positive on other markets.

However the valuation of the US stock market is extremely elevated, according to the Shiller CAPE ratio, despite the pandemic wreaking havoc on global economic growth. It takes a brave investor to shrug that off and go overweight the US stock market, particularly seeing as that means putting over two thirds of your portfolio in US stocks.

Meanwhile the UK has at least been pretty badly beaten up and valuations look more reasonable. Things could get worse before they get better for the UK market however. A Brexit trade deal could strengthen the pound, which would dampen any returns from the international-facing blue chips of the FTSE 100.

That would be even more

of a drag on US returns for UK investors though. More problematically, with the pandemic looking like it's set to get a firmer grip over the winter, the cyclical industries in the UK market could continue to find themselves battling a weakening economic picture.

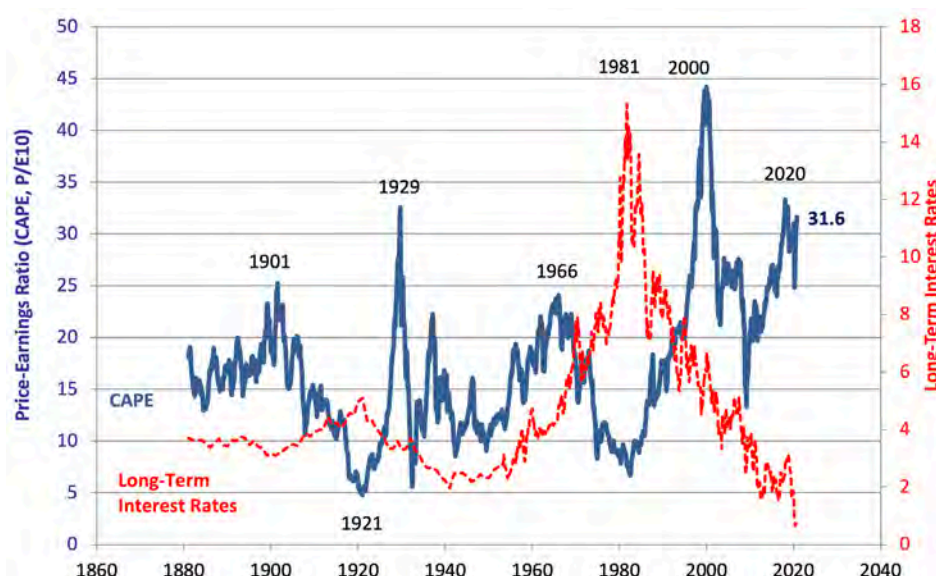
Investors needn't pay too much attention to the weightings in the MSCI index, unless they're overly concerned with performance relative to that particular benchmark, the investment equivalent of FOMO (fear of missing out).

### DOWNSIDE RISK

What's most important to investors is getting a decent absolute return without taking too much risk. In that regard there is some downside protection in the low valuation of the UK stock market, and some downside risk in the premium on US stocks. Any slip ups by the US tech titans in delivering growth will likely be punished harshly by the market.

Dividends are also still not a priority for US companies, which like to reinvest for growth, or return cash through share buybacks. The yield on the S&P 500 currently stands at a little over 2%, while on the FTSE 100 it's getting on for 5%. That's important for income seekers clearly, but UK growth investors can also take comfort from reinvesting those dividends year in year out to boost long run total returns.

### US stocks trade at a premium valuation



Source: Robert J Shiller



By **Laith Khalaf**  
Financial Analyst



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# Is it worth making up national insurance shortfall to get a state pension?

Our resident pensions expert deals with a query about accessing this entitlement

*My wife turned 65 in August, which I believe is before the state pension age increased to 66 (in October)? She was also born in Japan but became a British citizen after living in the UK for more than 14 years. She has recently applied for a small pension from Japan.*

*After checking her National Insurance (NI) contributions, she only has seven years' NI contributions and currently will not receive a UK state pension. However, she does have the option to pay additional voluntary contributions making this up to a maximum of 14 years. I have checked this informally (over the phone) with HMRC and the Pension Advisory Service.*

*I worry about parting with such a large amount and my questions are:*

- *Should she have qualified for the state pension at 65 or is 66 correct?*
- *Making the additional contributions seems to be a good choice (she is in excellent health) - are there any pitfalls to look out for and how do we pay? When is the latest we can pay (funds are currently invested)?*

**Matt**



**Tom Selby**

AJ Bell

Senior Analyst says:

Let's start with your wife's state pension age (if she were to qualify for the UK state pension). As I've mentioned in this column before, the state pension age has been rising since 2010 and now stands at 66 for men and women. It is expected to rise to 67 by 2028 and 68 by 2039.

Anyone born from 6th October 1954 onwards now has a state pension age of at least 66. As your wife was born in August 1955, she will therefore become eligible to receive the state pension on her 66th birthday in August 2021.

The 'new' full flat-rate state pension is worth £175.20 a week in 2020/21, but to qualify for this you need to be a UK resident and have a 35-year National Insurance (NI) contribution record.

You need at least a 10-year NI record to qualify for any state pension (although a deduction will be made if you have an NI contribution record lower than 35 years). They do not have to be 10 qualifying years in a row.

Note that you can usually only pay for gaps in your NI record from the past six years. However, as your wife was born after 5th April 1953, she has until 5th April 2023 to pay voluntary contributions to make up for any gaps between April 2006 and April 2016.

The rate for 'Class 3' NI in

2020/21 is £15.30 a week, so if your wife needed to buy exactly three years of missing NI at this rate it would cost £2,386.80.

The main things to consider before going down this road include your wife's current NI record and whether buying extra NI will increase her state pension entitlement and your wife's health.

Before going ahead you should contact the [Future Pension Centre](#) to double-check buying extra NI will boost your wife's state pension. You should also consider speaking to a regulated financial adviser to discuss the available options.

If you do want to go ahead, you can buy Class 3 NI credits online [here](#).

## DO YOU HAVE A QUESTION ON RETIREMENT ISSUES?

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

Please note, we only provide information and we do not provide financial advice. If you're unsure please consult a suitably qualified financial adviser. We cannot comment on individual investment portfolios.

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Eric Zurrin, CEO

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# How paying off debt can transform a company's share price

Why companies can re-rate as they reduce their borrowing

**A**mong the stock market's most spectacular share price appreciation stories of recent years is **Premier Foods (PFD)**. The cake, gravy and cooking sauces maker known for brands including *Mr Kipling*, *Bisto*, *Ambrosia*, *Sharwood's* and *Loyd Grossman*.

Languishing at 19.4p in March, Premier Foods' shares are now priced at 95p, having enjoyed a stunning re-rating thanks to improving earnings momentum as well as a transformational deleveraging of the balance sheet which combined to resurrect this erstwhile corporate zombie.

## WHY PREMIER FOODS RE-RATED

Investors typically react positively to a material reduction in a company's debt pile, as this usually de-risks the business, lifts strains on its cash flow and sometimes makes a group more desirable to potential suitors, a



point which the 2019 takeover of cheese and spread maker Dairy Crest by Canada's Saputo helps to illustrate.

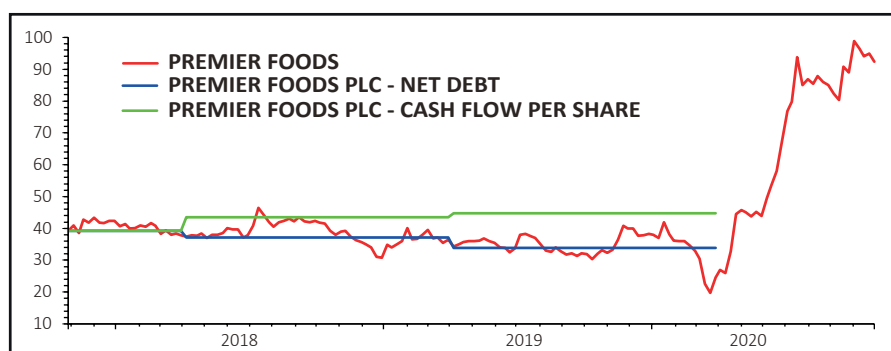
Dairy Crest's 2015 sale of its loss-making dairies operations to Muller transformed the business, providing an exit from the troubled UK dairy industry, removing a considerable cash drain and also reducing leverage, making it a less problematic acquisition for Saputo to stomach a few years later in 2019.

*Shares added Premier Foods*

to our *Great Ideas* list in April this year at a 41.45p entry price, drawing confidence from the positive momentum in the business and the share price alike. We had long held a bearish stance on the food producer due to a debt mountain and pension black hole which were huge factors in a lack of free cash flow; Premier Foods had become a lifeless zombie, unable to invest in its assets and competitive position.

Our interest followed a transformational pensions agreement that reduces future contributions and frees up cash for reinvestment in what is now a significantly de-risked business with the scope to start paying dividends in the future.

Combined with strong trading driven by marketing and innovation spend and a



Covid-19 tailwind – lockdowns have stoked bumper demand for meal preparation items including cooking sauces, gravy and baking ingredients – this refinancing has completely turned sentiment towards Premier Foods around.

Results for the year to 28 March revealed trading profit at the top end of market expectations as well as a £62 million net debt reduction, lowering Premier Foods' leverage ratio to 2.7-times, beating its previous 3-times target. And more recently, Premier Foods revealed (6 Oct) its intention to redeem £40 million of £130 million of outstanding bonds, in addition to an £80 million redemption completed in June. The move is expected to save up to £2 million a year in interest costs.

Shore Capital nudged up its estimates yet again following the news, while also pointing out that if Premier Foods' 49% investment in Hovis is sold, 'then Premier will deleverage further and quicker still, so augmenting the re-rating process'.

## THE IMPORTANCE OF FREE CASH FLOW

Smart investors love companies that produce plenty of free cash flow (FCF), which signals a company's ability to pay down debt, pay dividends, buy back stock, and fund the growth of the business organically or via acquisition.

Investors searching for the next Premier Foods could begin by scrutinising the table, where we have compiled a list of companies that not only carry debt, but which enjoy material free cash



## Deleveraging candidates

Company	Net gearing (%)*	Enterprise value/free cash flow trailing 12 months
Imperial Brands	319.7	9.2
Next	537.3	12.9
Evraz	408.5	8.6
G4S	300.0	10.0
IWG	743.9	9.3
Centrica	373.3	4.9
Contourglobal	1132.2	8.5
Firstgroup	275.1	6.1
Clipper Logistics	748.2	13.4
Wincanton	1016.3	6.7
Go-ahead	211.0	2.1
Renewi	314.6	12.6
Raven Property	338.0	12.0
Superdry	252.2	5.8
Mears	337.0	7.6
DX Group	312.2	5.9
Premier Oil	543.1	4.6

Source: Stockopedia, 29 October 2020

\*Note: net gearing defined as total debt minus any cash divided by the book value of equity from latest accounts

generation that *could* enable them to pay borrowings down within a reasonable time frame.

However, it is very important to stress these should be considered candidates for further research not guaranteed winners. Cash flow can easily be interrupted if business takes a turn for the worse – which in turn could imperil firms' ability to service their debts placing them at the higher risk end of the spectrum for investors.

Names in the list include the likes of tobacco manufacturer

**Imperial Brands (IMB)**, trading on a lowly forward price-to-earnings (PE) ratio of 4.7 and an 11.3% dividend yield according to Refinitiv data.

This combination of a low earnings multiple and a high yield implies the market is very sceptical over Imperial's ability to maintain its profitability and cash flow, and thus its dividend-paying potential, over the long term, due to the regulatory pushback on smoking, increased public health awareness and disappointing sales from its

next generation product (NGP) portfolio.

Another deleveraging candidate is **Centrica (CNA)**, the British Gas-owner whose shares have more than halved from around 90p at the start of the year to 39.3p. At these

levels, Centrica swaps hands for a grudging prospective price-to-earnings ratio of a shade over eight times prospective earnings for 2020 and 2021.

Tellingly, the shares rallied in July after Centrica agreed to sell its North American business,

Direct Energy, in a \$3.63 billion deal, to US energy supplier NRG Energy. Set to complete in the current fourth quarter, the disposal will significantly ease Centrica's balance sheet borrowings – net debt rose 18% to £2.8 billion during the first half of the year, although free cash flow improved by 74% to £750 million – and make a 'material' contribution to its defined benefit pension schemes.

Also on a deleveraging path is Anglo-Dutch waste treatment firm **Renewi (RWI)**, where first half trading and cash came in 'materially' ahead of management's Covid-19 adjusted expectations.

Core net debt, excluding IFRS 16 lease liabilities, at the end



## WHO IS YOUR COMPANY BEING RUN FOR?

WHEN INTEREST rates are low and business conditions are healthy it is tempting for companies to add some debt to their business which amplifies returns on equity. If done in a prudent way debt financing can make good business sense, where it provides access to growth through investment in new capacity or acquiring a new business.

The trade-off for shareholders is that some 'interest costs' are deducted from profits that otherwise would go to them in the form of dividends or better still in terms of growth, be reinvested in the business. Debt has the additional advantage of reducing taxes paid and increasing after-tax profits available for shareholders.

However, when companies go too far down the debt

route, the relationship between shareholders and debt holders can become more confrontational. Bondholders are only concerned with getting the interest (also called a coupon) paid on time and having their capital returned. They don't receive any benefit from growth of the business apart from potentially higher cash flows to better service debts.

Banks, creditors and bond investors are higher up the legal pecking order when it comes to bankruptcy proceedings, potentially leaving shareholders out of pocket. Even before it gets to that point, banks and bondholders can start calling the shots such as forcing management to abandon dividend payments.

An increasingly desperate management may be forced

into raising more funds via shareholders, reducing their economic interests, if they don't cough up their share of the funding.

*Shares* has screened for companies where it appears debt holders are calling the shots. We looked for companies where profits cover interest costs less than two times, net debt to equity above is 150% and the Altman-Score is below 1.2. This is a measure designed to predict bankruptcy.

Ignoring utilities and bus companies which generally run with higher debts because of perceived visibility of revenues, the most vulnerable companies on these measures are British airways owner **IAG (IAG)**, office space company **IWG (IWG)**, furniture retailer **DFS (DFS)** and hospital group **Spire Healthcare (SPI)**.



of August amounted to €407 million, down by €50 million since the March year, which is encouraging. Furthermore, leverage is expected 'to remain below 2.9 times as at 30 September 2020, with significant headroom against the adjusted covenant of 5.5 times', according to Renewi, which also stressed that pandemic-induced 'levels of customer insolvency have so far remained low'.

## AND KEEP AN EYE ON

Other stocks with potential to deleverage balance sheets include **Mothercare (MTC)**, transformed from an ailing brick and mortar retailer into a global baby product brand

manager, which remains in talks to refinance its outstanding debt, as well as the unloved **NewRiver REIT (NRR)**, where asset disposals are helping the company to meet deleveraging targets.

Digital specialist fit fashion purveyor **N Brown (BWNG)**, the business behind the *JD Williams*, *Jacamo* and *Simply Be* brands trading on multiple of forecast earnings.

A targeted reduction in debt is now 'underway and continuing' at N Brown, where chief executive Steve Johnson holds sway. Thanks to the retailer's focus on cash generation, tight cost control, reduction in capital expenditure and the suspension of the dividend, together with a smaller debtor book, N Brown has

'started its objective of reducing its level of indebtedness'.

In the six months to 29 August, net debt was reduced by 17.3% to £411.1 million, and management expects year-end net debt to be in the range of £380 million to £400 million. Though the dire retail backdrop means there could well be further pressure put on its cash flows, broker Shore Capital believes N Brown is 'a comfortably liquid business and has remained so through a more than significant balance sheet shock'.



**James Crux,**  
Funds & Investment  
Trusts Editor

## GUINNESS GLOBAL INNOVATORS FUND

\*Simulated past performance. Performance prior to the launch of the Guinness Global Innovators Fund (31.10.14) reflects the Guinness Atkinson Global Innovators Fund (IWIRX), a US mutual fund with the same investment process since May 2003.

For 17 years, we have invested in areas where advances in technology or innovative thinking have been creating pioneering, profitable business models.

Many of these emerged from the explosion of the internet in the 1990s. We invested in the companies that were building the technology to facilitate this explosion, such as Microsoft and Apple, then later in the companies that supplanted entrenched ways of doing business: Amazon, Netflix, Facebook, Google. We also identified innovation outside of technology – in industries including advanced healthcare, robotics, and consumer goods.

We recognised that not all innovators are made equal – that many new entrants would fall by the wayside. We believed then, as we do now, that our particular approach – buying and holding a concentrated, equal-weighted portfolio of quality companies with innovation in their DNA – would prove fruitful.

The results have been considerable, as is reflected in our fund's performance against the IA Global Sector over multiple periods.

Our approach has enabled the fund to navigate the market turbulence created by COVID-19 successfully. Almost every company in the portfolio is poised to emerge from the current economic environment with its prospects enhanced, not hindered.

We have a proven track record of success behind our thinking around innovation. If you favour our approach, this fund will make a sound addition to the growth allocation of your equity portfolio.

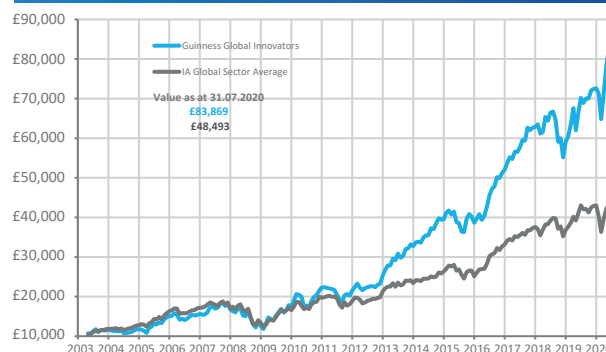
Risk: Past performance is not a guide to future returns. The value of your investments can fall as well as rise. You may not get back the amount you invested. Fund returns are for share classes with an Ongoing Charges Figure (OCF) of 0.99%; returns for share classes with a different OCF will vary accordingly.

**GUINNESS**

ASSET MANAGEMENT

Guinness Asset Management Ltd, authorised and regulated by the Financial Conduct Authority (223077). Calls will be recorded

### Total return\* from £10,000 invested from launch of strategy 01.05.2003



Source: Financial Express, 0.99% OCF

### % Total return\* vs IA Global Sector Average to 31.07.2020 in GBP

Period	Fund	Sector	Quartile
<b>YTD</b>	<b>14.1</b>	1.0	<b>1st</b>
<b>1 Year</b>	<b>24.2</b>	5.4	<b>1st</b>
<b>3 Years</b>	<b>46.2</b>	23.6	<b>1st</b>
<b>5 Years</b>	<b>112.9</b>	63.1	<b>1st</b>
<b>10 Years*</b>	<b>378.2</b>	157.7	<b>1st</b>
<b>Launch of strategy</b>	<b>726.8</b>	333.3	<b>1st</b>
<b>12 month return</b>			
<b>June 20</b>	<b>24.2</b>	5.4	<b>1st</b>
<b>June 19</b>	<b>3.4</b>	7.5	<b>4th</b>
<b>June 18</b>	<b>13.9</b>	9.1	<b>1st</b>
<b>June 17</b>	<b>32.2</b>	23.7	<b>1st</b>
<b>June 16</b>	<b>10.2</b>	6.7	<b>3rd</b>

## KEY

- **Main Market**
- **AIM**
- **Fund**
- **Investment Trust**
- **Overseas Share**

Alibaba 9, 23



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Anglo Pacific 12

AO World 7

AstraZeneca 14



Avacta 10

AXA Framlington Global Technology Fund 22, 24

B&M European Value Retail 8

Baillie Gifford Long Term Global Growth 24

Baillie Gifford US Growth Trust 19

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Cranswick 8

DFS 47

Diversified Gas & Oil 3

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Stenprop 16

Ted Baker 7

Tesco 8

The Gym Group 7

Touchstone Exploration 3

Twilio 23

Wheaton Precious Metals 12

Yamana Gold 12, 17

Young's 7

## KEY ANNOUNCEMENTS OVER THE NEXT WEEK

### Full year results

**11 November:** Beximco Pharmaceuticals.

**12 November:** WH Smith.

### Half year results

**9 November:** Totally. **10 November:** DCC, Electrocomponents, Land Securities, Oxford Instruments, Renewi, Zoo Digital. **11 November:** Braemar Shipping Services, Great Eastern Energy, Great Portland Estates, Renold. **12 November:** B&M European Value Retail, Enteq Upstream, Mediclinic International, National Grid, Norcross, Picton Property Income, QinetiQ, Volex.

### Trading statements

**10 November:** Meggitt, Persimmon. **11 November:** Flutter Entertainment, JD Wetherspoon, Taylor Wimpey, William Hill. **12 November:** Vesuvius.

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