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Asset Value Investors (AVI) has managed the c.£1.1 bn AVI Global Trust since 1985. The strategy over that period has been to buy quality companies held through unconventional structures and trading at a discount; the strategy is global in scope and we believe that attractive risk-adjusted returns can be earned through detailed research with a long-term mind-set.

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\*One investment is the Japan Special Situations basket of 13 Japanese stocks as at 31 January 2020.

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# Doling out the dividends: are the best days almost over?

Various big name UK stocks intend to pay out billions of pounds in cash

**B**illions of pounds worth of dividends have been declared in recent weeks by names such as **Anglo American (AAL)**, **Rio Tinto (RIO)** and **Royal Dutch Shell (RDSB)**, meaning there is a cash bounty on its way to shareholders.

These companies, along with other big names declaring dividends including **Lloyds (LLOY)** and **Diageo (DGE)**, have benefited from economic recovery which boosts demand for their products and services. Billions of pounds will also be spent by many of these companies on share buybacks.

It begs the question as to whether we're at a turning point for these businesses, namely the start of a new growth phase. When companies have so much spare cash on their books, it has historically stirred boardrooms to go on a spending spree.

Lloyds announced a £390 million acquisition of financial services group Embark alongside its latest results to help strengthen its position in the retirement market, but the biggest dividend declarers of Rio Tinto and Anglo American aren't following the usual playbook for the mining sector.

Historically we've seen mining companies make lots of acquisitions in periods when commodity prices are high – such as now. A decade ago, the big miners were saddled with large debts after paying top dollar for acquisitions just before commodity prices started to fall. They've learned their lesson and are being cautious now, preferring organic rather than acquisitive growth.

'Historically this sector has been the architect of its own demise by overpaying for growth at the top of the cycle,' Royal London fund manager Richard Marwood told *Shares*.

**BP (BP)** and Royal Dutch Shell are benefiting from strength in the oil price, and Shell has just raised its dividend by 38%. In theory, both companies might be tempted to keep investing

in oil assets while the price is high. Marwood says that won't happen, adding: 'They've given themselves a mandate that won't really allow oil and gas acquisitions.'

A bigger concern is whether BP and Shell overpay for renewable assets in the race to transition away from fossil fuels to more environmentally friendly energy sources.

This raises an important point. A lot of companies are swimming in cash and handing lots of it back to shareholders. But isn't there a better use of that money, such as investing to improve operations or making the business fit for the modern age?

David Johnson, an analyst at research group Kepler, goes as far as suggesting the golden age of dividends could be nearing an end. He implies the new era of ESG – environmental, social and governance – might result in shareholders' interests no longer being put above those of other stakeholders, which could spell lower dividends.

Johnson also suggests that some of the traditionally big dividends payers, such as oil companies, could sell their prized cash-generating assets or be taken over, thereby reducing the pool of dividend stocks on the UK market.

It also worth considering that younger companies are putting less emphasis on dividends than older businesses as they choose to reinvest cash for growth. Over time that could set a new precedent for the level of dividends around the world.

One thing is certain: you must never take dividends for granted as companies can reduce or cut off that flow of money whenever they like.



By Daniel Coatsworth Editor



# Spot the common theme among UK takeover targets

Many bid recipients this year are 'nuts and bolts' businesses which provide goods and services to other companies

**T**here is a common theme in the current wave of takeovers involving UK stocks, namely that many of the targets operate in the business-to-business space and provide products or services to other companies.

Since the middle of July there have been more than half a dozen significant bids, most of which have been recommended by the boards of the target companies.

Parker-Hannifin's bid for component maker **Meggitt (MGGT)** is a classic example. The offer is pitched at a generous 71% premium to the closing market value before the bid went public, thereby minimising the likelihood of shareholders rejecting it and of a rival bid arising.

Meggitt's components are used in many different areas of aircraft and engine manufacturing, from cockpit instruments and engine parts to wheels, brakes and landing gear. Its products are complementary to those of Parker Hannifin, while its client base of airframe and engine producers is similar.

Likewise, Cobham's bid for **Ultra Electronics (ULE)** is all about putting together two manufacturers of essential components with a similar client base in the aerospace and defence industries where both companies are trusted suppliers.

In the software sector, **Sumo (SUMO:AIM)** – subject to a bid by China's Tencent – develops games for some of the most prestigious studios in the world. While it has its own intellectual property, most of what it does is end-to-end development for other companies.

**Audioboom (BOOM:AIM)**, which is also in a bid situation, operates a platform for hosting, distributing and monetising hundreds of top tier podcasts.

In business services, **Sanne Group (SNN)** – which has just agreed a bid by Apex – and **Equiniti**



EXAMPLES OF STOCKS THAT SCREEN WELL AS POTENTIAL PRIVATE EQUITY TAKEOVER TARGETS

Name	EV / FCF	EV / EBITDA	Net Debt / Assets Latest (%)
Dixons Carphone	3.7	5.3	17.3
DX Group	6.7	8.7	42.0
Halfords	4.1	5.4	25.6
Keller	6.1	4.7	15.6
Mears	3.7	6.8	22.5
Morgan Sindall	4.8	9.4	-18.9
Norcros	5.1	6.8	4.4
Renewi	6.5	6.8	33.3
Royal Mail	6.7	4.3	4.8
Speedy Hire	8.3	5.6	22.5

Source: Stockopedia. All data correct as of 2 Aug 2021

(EQN) – which agreed a takeover by Siris Capital back in May – both provide essential corporate administration services to the financial sector.

*Shares* has built a stock screen which looks for qualities desired by private equity, to try and spot potential takeover targets. The screen uses the following criteria: an EV/EBITDA multiple of less than 10, EV/free cash flow multiple of less than 10, net debt/asset ratio of less than 50%, and a market value of more than £100 million.

If we focus on business-to-business firms in the screen's results, the names which stand out are mostly involved in construction, infrastructure or logistics: **DX Group (DX.)**, **Keller (KLR)**, **Mears (MER)**, **Morgan Sindall (MGNS)**, **Norcros (NXR)**, **Renewi (RWI)**, **Royal Mail (RMG)** and **Speedy Hire (SDY)**. [IC]

# Investment trusts under scrutiny for Chinese tech holdings

London-listed investment vehicles have less exposure than you might think

Chinese authorities continue to bear their regulatory teeth with Tencent the latest stock to slump on chatter about Beijing seeking to wield its power. The social media and gaming technology giant saw its stock plunge as much as 10% at one point on 2 August.

Tencent is under fire over how it collects and keeps data on customers and for not stopping children who play its games for long periods of time. Its share price has fallen nearly 20% over the past month.

Many investors use Asia-focused investment trusts to access Chinese companies, yet research from Numis Securities shows that these collective investment vehicles are not as exposed to China's big tech firms as many might think.

Popular trust such as **Scottish Mortgage (SMT)**, **Fidelity China Special Situations (FCSS)** and **Baillie Gifford China Growth (BGCG)** own sizeable stakes in Tencent and Alibaba, two of the tech giants to come under scrutiny, yet tech stocks only represent approximately 20% of their respective portfolios.

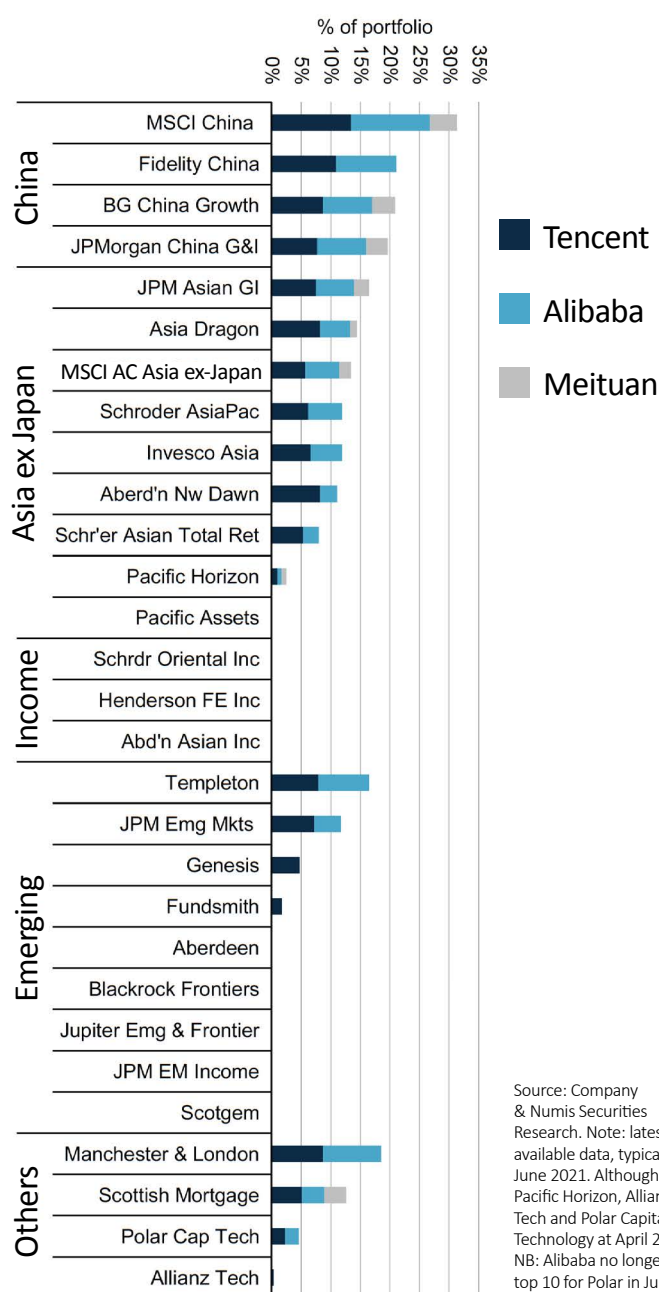
This compares to more than 30% tech exposure in the sector split of the MSCI China index, based on the Numis data.

However, many of China's biggest tech names, including Alibaba, Meituan and JD.com are classified by MSCI as consumer discretionary stocks, while the likes of Tencent and Baidu, for example, are classed as communication services companies.

The MSCI's information technology sector is worth just 6.55% of the overall mix, and not one stock from that sector is among the largest 10 contributors to its China index. [SF]

**DISCLAIMER: The author owns shares in Scottish Mortgage**

## ASIA PACIFIC, EMERGING AND SELECTED OTHER ICS – CHINESE BIG TECH EXPOSURE



Source: Company & Numis Securities Research. Note: latest available data, typically June 2021. Although Pacific Horizon, Allianz Tech and Polar Capital Technology at April 2021. NB: Alibaba no longer in top 10 for Polar in June.

# Lloyds on top for banking sector dividends

Shareholder rewards were a key focus in the latest banking results season

**L**loyds (LLOY) is the highest yielding mainstream London-listed bank following the latest quarterly results, offering a prospective 5.2% based on 2022 forecasts.

A clearer picture on dividends was a consistent feature of the banks' reporting season as the companies move on from the pandemic.

Despite the sector delivering consensus-beating earnings, the share price response to the latest results was mute. This is because many of the results were flattered by banks releasing larger than expected provisions for Covid-related bad debts which weren't needed.

These are one-off in nature and therefore there is a degree of scepticism regarding the long-term sustainability of earnings growth.

Moreover, the lending environment remains difficult given the anemic nature of interest rates.

Low interest rates compress net interest margins (the difference between the rate at which



## THE BIG FOUR BANKS: DIVIDEND YIELDS

	2021	2022
Lloyds	4.6%	5.5%
NatWest	4.0%	5.2%
HSBC	3.8%	5.1%
Barclays	3.4%	4.8%

Source: SharePad, as of 3 Aug 2021

banks fund their lending and the amount they charge customers to borrow), and this reduces banks' profitability.

This situation has prompted Lloyds to target expansion in the wealth management segment. Similarly, HSBC has been attempting to circumvent the inclement UK lending environment by focusing on Asia.

This strategy is yielding returns with strong growth in wealth balances, and promising signs of lending volumes and fee income. [MGar]

## Recovery in exhibitions business puts the spotlight on Informa

Media groups start to benefit as social distance restrictions are eased

THE LATEST RESULTS from **Informa (INF)** and **Relx (REL)** have pointed to an improving environment for the exhibitions segment of their businesses.

This marks a key change from the recent torrid trading environment. Covid travel-related restrictions, coupled with the need to socially distance, caused exhibitions to be

cancelled or postponed during the height of the pandemic. However, the rapid rollout of vaccines has enabled face-to-face meetings to resume.

This has resulted in a pick-up in activity for Informa in its core markets of America, China and the United Arab Emirates.

The number of combined

events being held by Informa in these regions is forecast to increase from 20 in the second quarter to 50 in Q3 and 60 in Q4. According to Informa chief executive Stephen Carter the group's exhibition business is anticipated to generate twice the revenue in the second half of the year than the first half.

The exhibitions business is a much leaner entity, following a series of cost cutting exercises. The experience of running virtual exhibitions during the pandemic has enabled the group to learn new skills and has created another revenue stream. [MGar]



# Robinhood shares act like a yo-yo, diving then surging

Its market debut was weighed down by regulatory concerns and having an anti-democratic dual share class

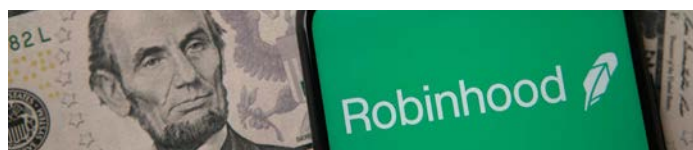
**I**nvestors initially gave stock market newbie Robinhood a big thumb's down, making it one of the worst performing new issues in years after the shares fell over 8% on their first day of trading on Nasdaq.

However, the stock has since acted like a yo-yo, surging to \$59.36 versus a \$38 listing price.

That will come as some relief to the former high frequency traders and co-founders Baiju Bhatt and Vlad Tenev.

The initial lack of investor appeal seemed to revolve around the controversial business model which could be under threat from a regulatory review investigating whether investors using the Robinhood app to trade are receiving the best prices.

In addition, Robinhood has come under scrutiny



for the gamification of investing, whereby it uses in-app prompts, rewards and bonuses to encourage frequent trading.

Robinhood doesn't charge its customers commission but sells aggregate orders to market makers which pay a fee for the flow of trades. Such practices are banned in the UK and Canada.

The company doesn't appear to have lived up to its mantra of 'democratising investing', given the dual share class structure of its listing which gives the founders 65% voting rights despite only holding 16% of the shares. [MG]

## Former Headlam boss seeks to repeat magic with Likewise

Fast growing floor coverings distributor to list shares on AIM

INVESTORS WHO LIKE to back proven management teams should note the 18 August AIM market debut of **Likewise**, the UK floor coverings distributor.

It was founded in 2018 by chief executive Tony Brewer who used to be CEO at Europe's leading floor coverings distributor **Headlam (HEAD)**. The latter's share price increased by 235% during the 16 years he ran the business.

Likewise has grown rapidly with the help of acquisitions and has

just raised £10 million to support ongoing growth plans. Brewer is joined on the board by fellow Headlam alumni Andrew Simpson, who is a non-executive director.

The Likewise trade brand is becoming well established in many parts of the UK and trading in 2021 to date has proved strong, with revenue per trading day exceeding £250,000 in both May and June.

Brewer insists the foundations are 'now in place to build a substantial business in the UK

flooring industry, maximising our relationship with our manufacturing partners, along with flooring retailers and contractors'.

Distributing both domestic and commercial floor coverings and matting, Likewise is looking to challenge the established industry players by providing customers, including large UK retailers, with a wide choice of flooring from multiple manufacturers across the globe at competitive prices.

Brewer says Likewise is 'now producing consistent profitability', which combined with tight working capital control has resulted in the company now being cash generative. [JC]

# Chemring's hidden jewel is a cyber security ace

The FTSE 250 defence group has an underappreciated growth opportunity

Investors often look for certain attributes when researching stocks to help spot the most attractive opportunities.

The list of desirable factors can include an improvement in a company's financial position, operational efficiency gains, niche skills with limited competition, and underappreciated assets which means a company could be considerably more attractive than its headline valuation implies.

FTSE 250 defence group **Chemring (CHG)** ticks all these boxes. It's a fascinating company which is often overlooked by investors who remain fixated on its troubled past. In doing so, they've missed the big turnaround that has resulted in a significantly more attractive business.

The firm also operates in a market that is the focus of takeover activity, with sector peers **Ultra Electronics (ULE)** and **Meggitt (MGGT)** both subject to bids.

## COMEBACK TRAIL

Chemring prospered during the Gulf War but suffered 10 years ago when troops were withdrawn from parts of the Middle East. A debt-fueled acquisition spree during its heyday didn't quite go to plan and it was left with various integration issues and a weak financial position.

The company sold off some



**CHEMRING**  
**BUY**  
**(CHG) 314p**  
**Market cap: £895 million**

operations, tapped shareholders for more cash and implemented a new strategy to improve cash flow and margins. Investment in its manufacturing assets has helped to drive operational improvements; better cash flow has driven down debt; and the countermeasures market has recovered, working in its favour as the market leader in this space.

Furthermore, it has made substantial progress repairing its reputation which was damaged by operational safety issues. The lost time injury rate has dramatically fallen, helped by investment in automation.

## SALES SPLIT

Countermeasures and energetics are forecast by investment bank Jefferies to account for approximately two thirds of Chemring's

sales this year. These include products that protect against guided missiles.

The remaining third of sales comes from sensors and information, namely equipment to detect and defend against improvised explosive devices and chemical/biological weapons.

Just over half of 2020 sales came from the US (54%), with the UK accounting for 29%, Europe 10% and Asia Pacific 4%. Chemring does a lot of work for the US Department of Defense, with other customers including the UK Ministry of Defence, law enforcement agencies and defence contractors such as **BAE Systems (BA.)** and Lockheed Martin.

## GOOD EARNINGS VISIBILITY

There are two parts of Chemring's business that

make it attractive from an investment perspective. The first is its involvement in the US Department of Defense's 'Programs of Record', which helps to provide long-term revenue visibility into the 2030s.

Chemring is already involved in several long-term contracts involving explosive hazard and biological detection and the company should hear by early 2022 if it has secured a place on a further contract involving chemical detection.

### CYBER SECURITY OPPORTUNITY

The second element of Chemring which really appeals is its involvement in cyber security via a subsidiary called Roke. **Odyssean Investment Trust (OIT)** holds Chemring in its portfolio and co-fund manager Stuart Widdowson calls Roke a 'hidden jewel'.

It is fair to say that only avid followers of Chemring may know about this operation, as the broader group does not get talked about as a cyber player.

In 2010, Chemring acquired Siemens' UK defence electronics unit called Roke Manor Research for £55 million. Since then, the business has been built up to specialise in artificial intelligence, the protection of networked systems, data

analysis and connectivity.

Roke is seeing double-digit growth in revenues per year and is incredibly important to Chemring's future success. Its role in the group effectively provides a chance for investors to access the cyber security theme at a discount relative to mainstream players.

### MEANINGFUL ASSET

'Good assets in the cyber security area can go for four to five times enterprise value to sales,' says Widdowson. 'Roke's turnover is around £80m. (On that multiple), that alone is worth almost half the market value of Chemring despite the fact it is only 20% of group revenues.'

'There aren't many high-quality cyber security companies left (on the stock market) as most have been gobbled up by bigger players. For example, Detica was bought by BAE for a hefty price. Roke is a hidden jewel in the business, definitely.'

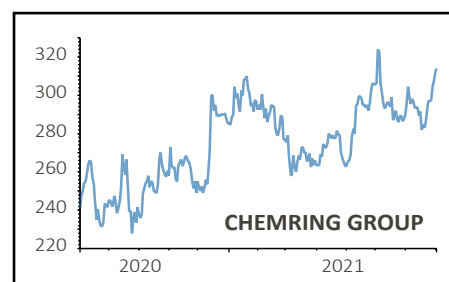
Analysts at Jefferies argue that if Roke was valued at six times enterprise value to sales – which is still less than a lot of pureplay cyber security companies – then it could feasibly account for more than 70% of Chemring's current enterprise value.



'A lot of growth for Roke has come from selling more into the UK Government,' says Widdowson. 'That is likely to continue, but the real opportunity is selling to commercial organisations, and to the US which is the biggest market.'

In 2020, Roke won its first significant contract in the US for electronic warfare services. 'We were told at the time that Roke was selected because the US purchasing organisation could not find anyone in the US who does what Roke does,' reveals the Odyssean fund manager. 'If they can continue that momentum, there is significant growth to go for.'

Chemring trades on 17.8 times forecast earnings for 2022. That certainly doesn't reflect the opportunity for Roke, which operates in a fast-growing market, nor does it represent a business that has been whipped into shape and is now enjoying higher quality earnings. It's time to buy the shares. [DC]



### Chemring: Financial and valuation overview

	2020a	2021e	2022e	2023e
Revenue	£402.5m	£414.8m	£434.5m	£457.1m
Pre-tax profit	£51.7m	£58m	£61.4m	£68.6m
EPS	14.77p	16.91p	17.69p	19.52p
Net debt	£48.2m	£46.3m	£34.1m	£11.6m
PE	21.3	18.6	17.8	16.1

Source: Jefferies, Shares

EPS = earnings per share, PE = price to earnings ratio (based on 314p share price)

a=actual, e=estimate



# The investment trust coming back to life with a new manager

Proven small cap stock picker Ken Wotton is reinvigorating Strategic Equity Capital

**A** 14% discount to net asset value at **Strategic Equity Capital (SEC)** suggests significant rerating scope remains at this concentrated trust of 20 carefully selected small cap names.

Since seasoned investor Ken Wotton took over as lead manager last September, the discount has narrowed, and we think an improved net asset value performance driven by portfolio changes offers a catalyst to bring the discount in further.

Focused on quality companies, the £191 million cap trust has seen three holdings receive takeover bids this year – **IDOX (IDOX:AIM)**, **Equiniti (EQN)** and **Proactis** – and other companies owned by the fund could potentially receive premium priced offers from trade and private equity buyers in the near term.

Following the appointment of Gresham House in May 2020 after a period of poor performance, Wotton was appointed lead manager in September to work alongside Adam Khanbhai and reinvigorate the trust's fortunes.

Wotton's experience working in a private equity environment meant he was well suited to Strategic Equity Capital's

investment strategy and he also boasts a superb long-term track record. His open-ended fund, **LF Gresham House UK Micro Cap (BV9FYS8)**, is the only IA UK Smaller Companies Sector fund to have delivered positive, absolute returns in each year since its 2009 launch.

Strategic Equity Capital's focus is on high-quality companies in attractive end markets which Wotton believes can materially increase in value through strategic, operational or management change.

The strategy now has a much higher level of engagement with management to create stronger businesses over the long term and uses private equity-based techniques to establish valuations, including a focus on cash flows and the potential value to a financial or trade buyer.

Wotton's review of the portfolio resulted in some changes to the holdings. 'We liked the strategy, but we felt its application could be more effective,' he told *Shares*, noting the trust now benefits from Gresham House's extra resource and extensive network of contacts.

The emphasis has shifted so that new investments are within



**STRATEGIC EQUITY CAPITAL**

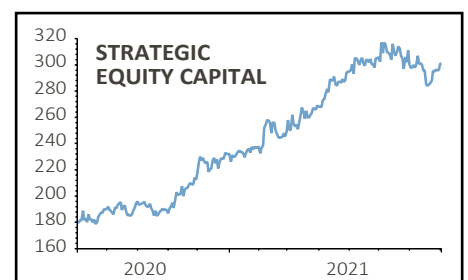
**BUY**  
[SEC] 301.5p

Ongoing charge: **1.1%**

the £100 million to £300 million market cap range, a sweet spot of under-researched companies, many trading on attractive valuations.

Companies on higher valuations in the £300 million to £1 billion cap range have been sold, with proceeds recycled into growth names in the £100 million to £300 million range.

Holdings include tenpin bowling operator **Ten Entertainment (TEG)**, **Fintel (FNTL:AIM)**, which proffers fintech and support services to the UK retail financial services sector, and estate agency operator-to-mortgage intermediary services play **LSL Property Services (LSL)**. [JC]



**CONVATEC**

(CTEC) 225.6P

**Gain to date: 10.2%****Original entry point:****Buy at 204.6p, 23 December 2020**

SHARES IN MEDICAL products company **Convatec (CTEC)** have dropped approximately 13% since reporting stronger than expected first half growth and lifting guidance for full year organic revenue growth.

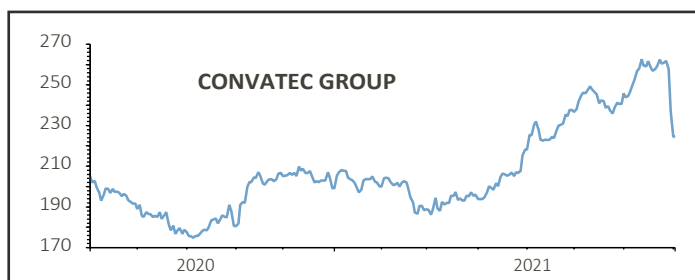


The share price reaction can be attributed to adjusted operating margin guidance being reduced by 0.5% to between 18% and 19% due to a mixture of cost inflation and additional investments into research and development as well as sales and marketing. Currency headwinds are expected to have around a 0.9% impact on reported margins.

The short-term headwinds over the next few months should prove temporary and must be seen in the context of the firm's medium-term goal of achieving sustainable profitable growth.

Underlying sales growth has been consistently above guidance for some time and second quarter organic growth of 7.4% was no exception and marked the fourth consecutive quarter of growth above the top end of guidance.

Consistently higher revenues allow the company to drive further growth by investing into sales, marketing and research and development, argues Numis Securities.

**SHARES SAYS: ↗**

Short term share price weakness has presented a good opportunity for long term investors. Buy. [MGam]

**TRACSIS**

(TRCS:AIM) 988P

**Gain to date: 56.8%****Original entry point:****Buy at 630p, 23 December 2020**

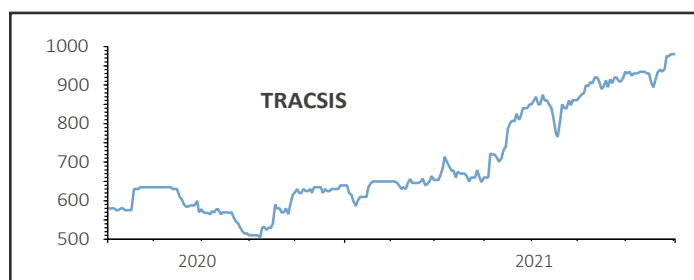
INVESTORS WHO followed our **Tracsis (TRCS:AIM)** pick for 2021 at the end of last year should be sitting pleased, with the share price setting new records in recent days and the stock now up 57% since we said to buy.

We predicted last December that 2021 could be a big one for the transport infrastructure and analytics software company and so it is proving.

The Williams-Shapps Plan for Rail in the UK is promising to be a strategic revolution that should provide Tracsis with excellent opportunities to bring its smart, technology-led innovations to all rail-using stakeholders.

The company has just won a significant expansion deal for its RailHub digital platform that allows railway workers to plan and deliver safer work on the network by providing better and more visual information. The new agreement will double RailHub's user base to over 30,000 individuals.

As a result of this large enterprise licence win, ongoing growth in rail technology, services and data analytics and a post-Covid recovery in business activity levels in its traffic data and events business units, Tracsis said it expected full year earnings before interest, tax, depreciation and amortisation to exceed market expectations.

**SHARES SAYS: ↗**

We anticipate a good second half of 2021 for Tracsis and believe the stock continues to earn its 20% premium rating to industry averages. [SF]

## HARGREAVES SERVICES

(HSP:AIM) 525P

**Gain to date: 64%**

**Original entry point:**

**Buy at 320p, 25 February 2021**

THE BASIS OF our buy call in February was that the firm had reached a strategic turning point, divesting its coal assets and becoming a focused, self-financing industrial and property services group.

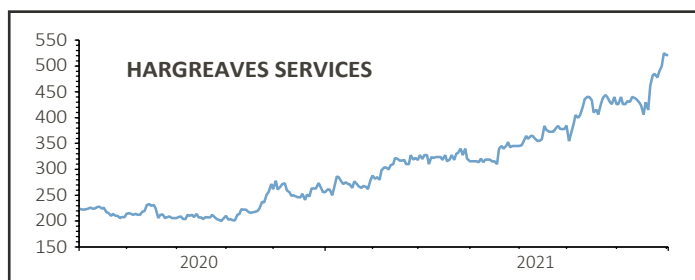
The cash received from the sale of inventories and the reduced working capital requirement thanks to exiting the coal business have transformed the firm's finances, meaning it no longer has any bank borrowing and can fund itself from its own cash flows.

At the same time, having kept an 86% economic interest in its German joint venture HRMS, the firm cashed in on strong commodity markets with a significant rise in pre-tax profits in the year to May, leading to the reinstatement of the ordinary dividend plus a special dividend.

The service businesses – which comprise an environmental, logistics and minerals division, materials handling and mechanical and electrical engineering, and earthworks and infrastructure – have continued to deliver reliable and growing profits.

The land business – which provides sites for residential and commercial construction in northern England and Scotland – is benefitting from strong demand for houses and warehouses.

With the core businesses performing well and the option to monetise its stake in HRMS and release further capital there is still much to like about the stock.



**SHARES SAYS: ↗**  
**Keep buying. [IC]**

## NESTLE

(NESN:SWX) CHF 114.70

**Gain to date: 14.7%**

**Original entry point:**

**Buy at CHF 100, 4 February 2021**

SHARES IN ICONIC food and drink-producer Nestle had a bit of a wobble after the firm reported a 10% increase in underlying first-half earnings but a small (0.2%) dip in its operating margin to 16.7%.

Like everyone else, Nestle is experiencing cost inflation in its raw materials but unlike many firms it is able to raise prices to at least mitigate some of the impact.

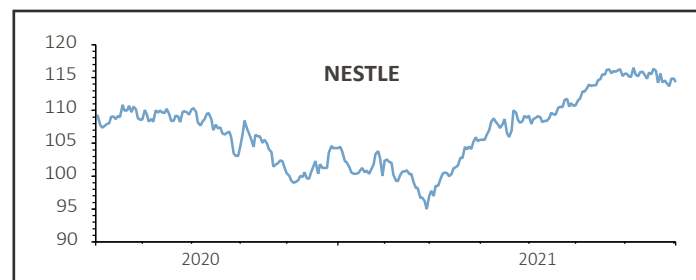
Organic sales growth was 8.1%, of which 6.8% was what the firm calls real internal growth – higher sales and increased market share – and 1.3% was thanks to higher prices. Moreover, the firm raised its full year sales growth forecast.

Headline sales were only up 1.5% to CHF 41.8 billion, as foreign exchange movements reduced revenues by 3.5% and divested businesses knocked another 3.1% off the total.

True to his promise when he took over, new-ish chief executive Mark Schneider continues to take the firm out of low-margin businesses and into direct-to-consumer markets.

The North American water business was sold for \$4.3 billion and the proceeds recycled into buying the core nutrition and supplement brands of The Bountiful Company.

Nestle's pet food business – makes up 15% of sales – was the biggest growth contributor in North America and Europe, and posted double-digit sales growth in China.



**SHARES SAYS: ↗**

**Nestle is a world-class business, we remain buyers. [IC]**





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# The big winners from the AI revolution

Machine learning is transforming the world and having a significant market impact

**A**rtificial intelligence or AI has both the ability to revolutionise business models and to create significant returns for shareholders who invest in the right AI plays.

The increasing availability of data sets coupled with the collapse in computing costs means that AI is now coming of age.

The breadth of tasks to which AI technologies can be applied is rapidly expanding. The companies that create leading proprietary data sets and AI tools around them will benefit.

AI has the potential to become the disruptive technology over the next 20 years.

In this article we will examine the trend and ways to take advantage of it.

**THE DEMOCRATISATION OF AI**  
Training AI (data is used to train an algorithm or machine learning model to predict the outcome

you design) is extremely computer intensive.

However, the emergence of the public cloud, dedicated AI chips and silicon specifically designed for such tasks have democratised the ability to run AI outside the large international companies.

The emergence of big data (extremely large data sets that can be analysed by computers to reveal patterns and trends) has played a critical role in facilitating the adoption of AI tools, given the significant amount of data required to train AI.

The proliferation of structured data which is ordered and can be analysed has also acted as a catalyst for the adoption and training of AI.

Structured data constitutes at best, 20% of available data. One of the reasons AI is so powerful as a tool is its ability to analyse unstructured data



Examples of companies involved in AI

ASML
Baidu
Cognex
iFlytek
Infineon
Microsoft
Samsung

Source: Morgan Stanley

(data which has not been tagged or structured). This was nearly impossible to do so previously.

## INTERPLAY BETWEEN MOORE'S LAW AND WRIGHT'S LAW

Recent analysis undertaken by Morgan Stanley has highlighted how disruptive innovation has been accentuated by the interplay between Moore's Law and Wright's Law.

The former maintains that the number of transistors on a circuit board doubles every two years.

The latter states that for every cumulative doubling of units produced, costs will fall by a constant percentage. It is only recently that the combination of cheap and democratised computing power had enabled

## COMPANIES EMBRACING AI

Company	Examples of applications
General Electric	GE uses AI to improve windfarm efficiency and reduce emissions by making coal-powered plants more responsive and flexible to grid requirements when renewable energy generation dips
Schlumberger	The company's software environment integrates AI and machine learning to allow faster and more effective decision making for clients in the oil and gas industry

Source: Allianz

the global adoption of machine learning tools.

Artificial intelligence and cheap computing power are the backbone of many of the disruptive technologies taking place within robotics, autonomous vehicles and medical diagnostics. Previously large and unstructured data pools had finite uses.

### THE DEMOCRATISATION OF COMPUTING POWER

The increasing importance of AI technologies has prompted firms including Google, Amazon and Microsoft to design chips that run their own deep learning tools (a subfield of machine learning, supporting algorithms that are inspired by the structure and function of the human brain, and called artificial neural networks).

And lots of competitors are creating increasingly powerful chips for cloud applications.

Cloud technology has enabled these interactions in computing and data analytics to be leveraged across a multitude of industries including the field of genomic testing that was previously unattainable.

### A CHANGING COMPETITIVE LANDSCAPE

The impact of declining computer costs coupled with the rapid improvement in modelling techniques and dramatically increased data volumes has made it significantly easier to establish a new brand at scale and disrupt markets.

Conversely, it is becoming increasingly challenging for incumbents to maintain their brand position. The simple

reality is that the adoption of AI is driving better performance. Companies who leverage AI-associated technologies are obtaining improved results at lower costs.

Digital leaders are now growing faster, selling better and creating products more quickly while saving costs and growing profits. AI is proving to be a critical tool in improving healthcare outcomes and informing better lending decisions for customers applying for credit.

### SECTORS AND COMPANIES TO WATCH

In a recent commentary entitled *Artificial Intelligence: Out of R&D and into the Workplace*, Xuesong Zhao, lead fund manager of the **Polar Capital Automation and Artificial Intelligence Fund (BF0GL54)**, maintains that semiconductor

equipment industries are an attractive way to play the proliferation of AI.

According to Xuesong, 'Semiconductor companies are likely to capture 40% to 50% of the AI technology stack representing the best incremental opportunity for the industry in a decade.'

Xuesong also believes that Alphabet and Microsoft – companies that have a clear lead in machine learning framework development (where machines can learn by experience and acquire skills without any human involvement) – are potential beneficiaries by offering AI capability as a service monetised by cloud computing.

#### AI-RELATED FUNDS

##### Funds:

**Allianz Global Artificial Intelligence (BDHSN20)** 3-year annualised performance: 31.5%. Ongoing cost: 1.13%.

**Polar Capital Automation and Artificial Intelligence Fund (BF0GL54)** 3-year annualised performance: 18.7%. Ongoing cost: 0.95%.

**Sanlam Artificial Intelligence (BYPF331)** 3-year annualised performance: 18.6%. Ongoing cost: 0.9%.

##### ETFs:

**L&G Artificial Intelligence (AIAG)** 1-year annualised performance: 28.3% Ongoing cost: 0.49%

**WisdomTree Artificial Intelligence (INTL)** 1-year annualised performance: 43.6% Ongoing cost: 0.4%

Source: Morningstar, FE Fundinfo

By Mark Gardner  
Senior Reporter



# Darktrace may be the most innovative cyber security play on the market

Fascinating opportunity but soaring share price and a long road to profit will not suit all investors

**F**rom shadowy enigma to the full glare of public markets, **Darktrace (DARK)** has emerged as one of the world's most innovative cyber security companies. This is a born in Britain technology success story and one that unusually chose to list in the UK rather than the US Nasdaq stock market.

Darktrace's share price jumped more than 40% on its stock market debut in April 2021, albeit the starting valuation was lowered due to investor concerns about one of the company's investors facing extradition to the US over fraud charges.

The shares were eventually priced at 250p for a £1.7 billion London listing, but the stock rallied in early trading to hit 355p, well above the 220p to 280p range set by its brokers when its investor roadshow began.

Since then, the share price has more than doubled, helped by substantially lifting guidance for the year to 30 June 2021 and also significantly ratcheting up its 2022 expectations.

## USING AI DEFENCE

Darktrace is one of the world's fastest-growing cyber defence companies and a leader in Enterprise Immune System



## The global cyber security market could rapidly increase in size

↑	2026	\$398.3 billion
		CAGR 14.6%
	2020	\$176.6 billion

Source: Facts & Factors Research

technology, a new category of cyber solutions based on pioneering Bayesian mathematics developed at the University of Cambridge, a mathematical way of applying probabilities to statistical problems.

The company addresses the challenge of insider threat and advanced cyber-attacks through its unique use of artificial intelligence to detect threats in real-time, as manifested in the emerging behaviours of the network, devices and individuals.

Analysts at Needham Research says: 'We think Darktrace is delivering the

most innovative application of artificial intelligence and security automation in the market today.'

Some of the world's largest organisations rely on Darktrace's adaptive, self-learning platform to spot anomalous activity, with clients in sectors including energy and utilities, financial services, telecommunications, retail and transportation. Its customers include property firm **British Land (BLND)**, clothing retailer Brooks Brothers, lender **Funding Circle (FCH)** and plus approximately 5,000 others from every corner of the globe.

This is a rapidly changing and fast-growing industry. Experts predict that by 2025 cybercrime could cost the global economy \$10.5 trillion a year, based on data from digital security firm Specops Software. That's almost \$20 million every minute.

In 2019, UK organisations hit by cyber-attacks faced an average

bill of £11.5 million, according to data from consultancy Accenture, although that's less than half the average cost to enterprise in the US, which was estimated at \$27.4 million.

This is not just the direct cost from hackers and the like, but also includes reputational damage, lost business and customers and industry fines, which can be steep, up to £17.5 million or 4% of annual global turnover under UK General Data Protection Regulation, also known as GDPR.

In an age of exponential data growth, digital safety and security has moved beyond the remit of an organisation's technology chiefs to become a boardroom-level issue.

## CONTROVERSIAL BACKING

Founded in 2013 by world-class machine learning specialists and operational government intelligence experts, Darktrace is backed by Invoke Capital, the technology investment company set up by tech entrepreneur Mike Lynch.

He founded UK data firm Autonomy and has been dragged into a long-running £4 billion legal battle after selling that company for \$11 billion to US tech giant HP in 2011. A year later HP wrote down the value by \$8.8 billion and alleged that Lynch artificially inflated the value of the group before the takeover.

Lynch sits on Darktrace's science and technology committee and there are several former Autonomy executives on board, including chief executive officer Poppy Gustafsson and chief strategy officer Nicole Eagan.

## Market forecasts for Darktrace (\$m)

	2022	2023
Revenue	367	493
Annual recurring revenue	471	548
Adjusted net profit	-44	-48
Net cash	285	254

Source: Berenberg estimates. June financial year end

This association may have put off some investors, but Lynch owns just 4.4% of Darktrace and analysts have now largely dismissed any residual reputational impact from the computer science expert.

What is far more likely to drive the share price moving forward will be Darktrace's growth trajectory and pathway to profit, and a level of patience will be required on the latter point.

Forecasts currently extend to the June 2023 full year and analysts anticipate net losses all the way despite strong sales growth.

When it joined the stock market in April, Darktrace guided that in the year to June 2021 annual recurring revenue growth would be within a range of 34% to 35.5% and that overall revenue growth would fall between 36% to 38%.

Darktrace actually delivered annual recurring revenue growth of more than 44% and overall revenue growth of more than 40%.

## OUTPERFORMANCE IMPLICATIONS

The better-than-expected annual recurring revenue allowed analysts to deduce a couple of important things. First, productive headcount

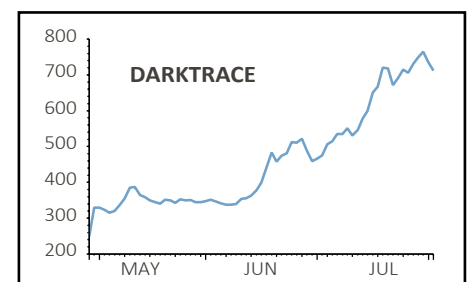
increased at a faster rate than expected, allowing the company to win more clients. Second, the company has been much better at upselling and renewing large clients. 'This is exactly in line with the company's stated focus on prioritising client wins,' says Berenberg.

Based on market forecasts, investors should expect annual recurring revenue growth in the 32% to 34% range this financial year, significantly up on previous 26.5% to 29.5% expectations on around 30% headline revenue growth.

This implies around \$45 million to \$50 million of net losses in the next two years, by which time analysts and investors should have a much clearer understanding of future profit potential.

Still, a lot could go awry, and we think there is likely to be quite a bit of share price ups and downs over the months ahead as news flow and trading updates emerge.

This possibility of intense share price volatility may leave many investors uncomfortable to back a business currently on a rough £5 billion enterprise value, or nearly 19 times this year's \$367 million (£264 million) of forecast sales.



By Steven Frazer  
News Editor

# NERVOUS

## ABOUT THE MARKETS?

We suggest **7 stocks**  
and **funds** that could  
protect your wealth

By Martin Gamble, Daniel Coatsworth,  
Ian Conway and Mark Gardner

**T**here are plenty of reasons to be more cautious about the markets despite the flagship US stock indices, the S&P 500, continuing to hit new highs.

Investor nervousness is increasing. Just look at how many companies have recently beaten earnings forecasts, but their share prices have fallen as the market worries about near-term pressures or the loss of momentum in parts of their business.

Valuations are looking excessive in areas of the market and the meme stock phenomena we saw earlier this year would suggest a lot of people are treating investing as gambling which is a dangerous sign.

There are clear signs of froth in the markets and we're also entering a seasonally choppy period for equities, so now is a good time to take a long hard look at your portfolio.

Rather than hide in cash, it would seem prudent to stay invested and merely adjust portfolios towards certain types of assets that could perform better on a relative basis if markets experienced a downturn. We offer some ideas later in this article.





# WORRYING SIGNS

Market pullbacks or price corrections are a feature of how stock markets operate, but as the old saying goes, no one blows a whistle at the top, and often corrections are only noticed when they are well into their stride.

Conventionally a 10% to 15% drop in price lasting anywhere from a few days to months is considered a market correction, while a 20%-plus fall is considered an official bear market.



## NEGATIVE EARNINGS YIELD

One intriguing indicator is the real earnings yield of the US market which has turned negative for only the fourth time since the 1980s.

This is a measure of inflation-adjusted earnings per share of the S&P 500 index divided by market value. Think of it as the reciprocal of the PE (price to earnings) ratio, adjusted for current inflation.

Up until the beginning of this year stocks weren't yielding much but at least offered more than government bonds. But since the start of the year US consumer prices have been rising fast and in June hit 5.4%, the highest annual rate in 13 years.

Historically, every time the real earnings yield dipped below zero the stock market then had a meaningful correction.

### S&P 500 vs Real earnings yield



Source: Lohman Econometrics, Bloomberg



## WIDENING HIGH YIELD SPREADS

The difference or spread between yields on debt issued by the highest and lowest quality companies has historically been a good measure of investor risk appetite.

The high yield spread has narrowed significantly since March 2020 after the US Federal Reserve said it would include buying corporate bonds as part of its coronavirus stimulus plan.



After reaching a low of 3.03% in early July, the spread has ballooned out to 3.5%. Widening spreads could reflect increasing financial stress among the weakest companies or waning investor risk appetite.

In either case, a widening high yield spread is another sign that equity markets could be in for a period of weakness.

### High yield spreads



Source: Fred, StLouisFed.org, Ice Data



## EXTREME VALUATIONS

While valuation indicators aren't good timing tools, investors should always take note of extreme readings.

The cyclically adjusted PE ratio, also known as CAPE, was created by Nobel Prize winner

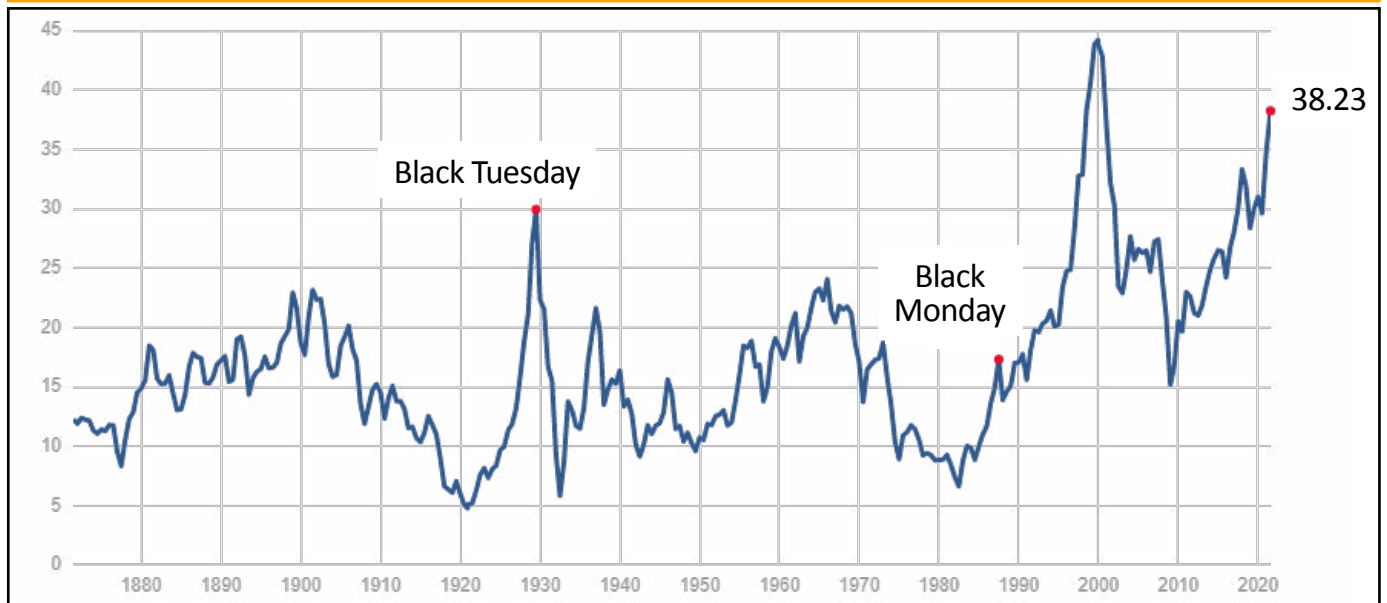
Robert Shiller and although the system has its detractors, the principles underlying it are sound.

The latest reading is the highest since December 1999 just before the dot-com bubble burst.

Likewise, the indicator popularised by investor Warren Buffett, based on looking at market capitalisation to GDP, recently hit a new all-time high.

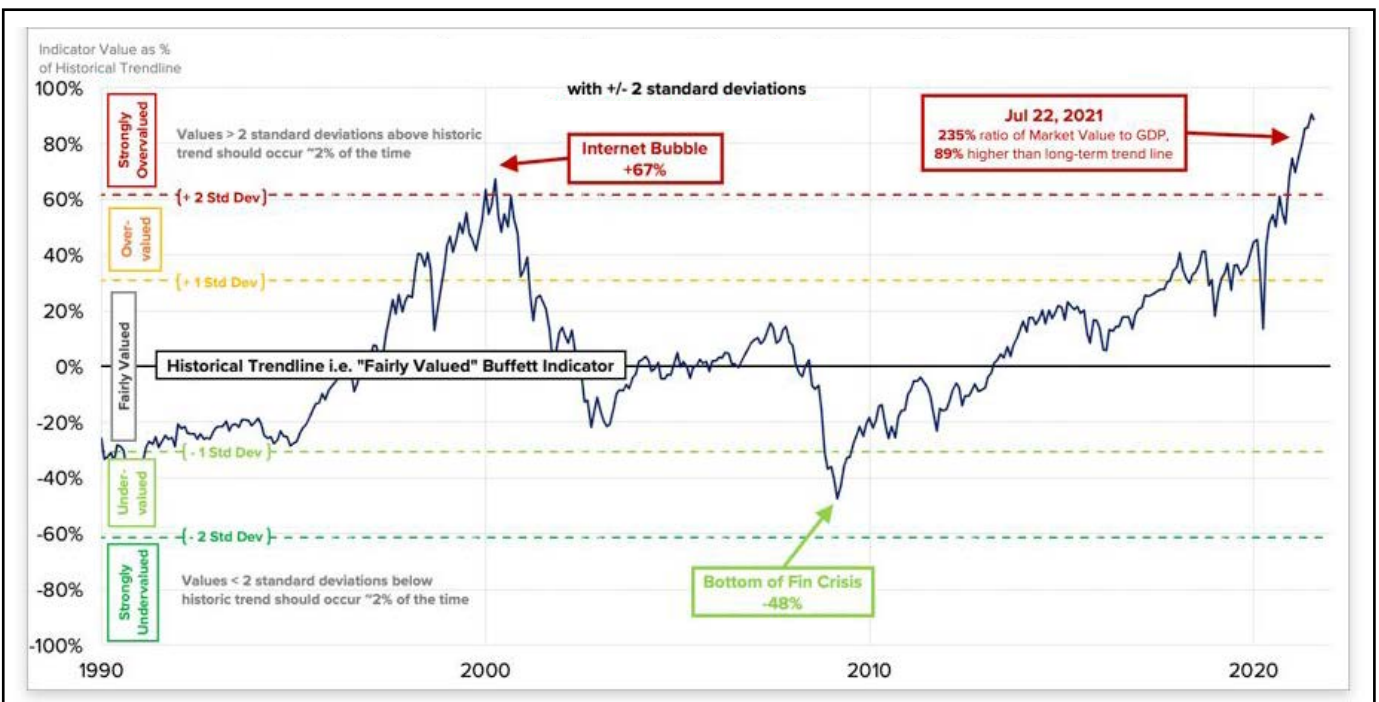
The explosive move from the lows in March last year is noteworthy and suggestive of irrational exuberance.

### Shiller PE



Source: Econ. yate. edu, Shiller

### Buffett indicator: Value vs. Historical Trend since 1990



Source: Currentmarketvaluation.com



#### INVESTING BEING TREATED LIKE GAMBLING

One driver of the market's steady climb has been the wave of younger people buying and selling shares for the first time.

This movement has been characterised by speculative money hoping for quick returns from companies with questionable qualities.

This trend has been accentuated by the FOMO (fear of missing out) dynamic and has been propagated by the increasing proliferation of stock-related chatter on social media platforms like Reddit and TikTok, with members of the



public masquerading as investment gurus. Snappy videos feature individuals talking about investing as if you are almost guaranteed to get rich.

Suggestions that you must be 'in it to win it' seem more like gambling as there is certainly very little talk about analysing a company's earnings, financial strength or valuation.



#### THE RISE OF THE SPACS

Another sign of increasing irrational exuberance has been the rapid growth in both Spacs – special purpose acquisition companies – and companies listing on the stock market.

Spacs are investment vehicles whose only

assets are cash. Their goal is to find a business to buy, and that target effectively reverses into the Spac as a much faster way of joining the stock market than the normal IPO route, which stands for initial public offering.

A lot of investors have rushed to own Spacs in the belief they will buy great companies, in doing so they have bid up the price of the acquisition vehicle significantly above the value of its underlying cash.

Finding suitable acquisitions hasn't been easy. Analysis by Goldman Sachs suggests that 400 US Spacs have a total of \$118 billion cash yet to be invested in deals.

## WHAT COULD TRIGGER A MARKET CORRECTION?

There are two potential triggers which could trip markets up. The first is a growth scare, as the Covid Delta variant continues to spread, slowing the rate of economic recovery.

The valuation of the US equity market suggests investors are expecting a swift economic recovery, so any slippage won't be taken well.

In this regard research from Bank of America highlighted that analyst expectations for GDP and earnings growth have stalled recently. If revisions go into reverse, watch out.

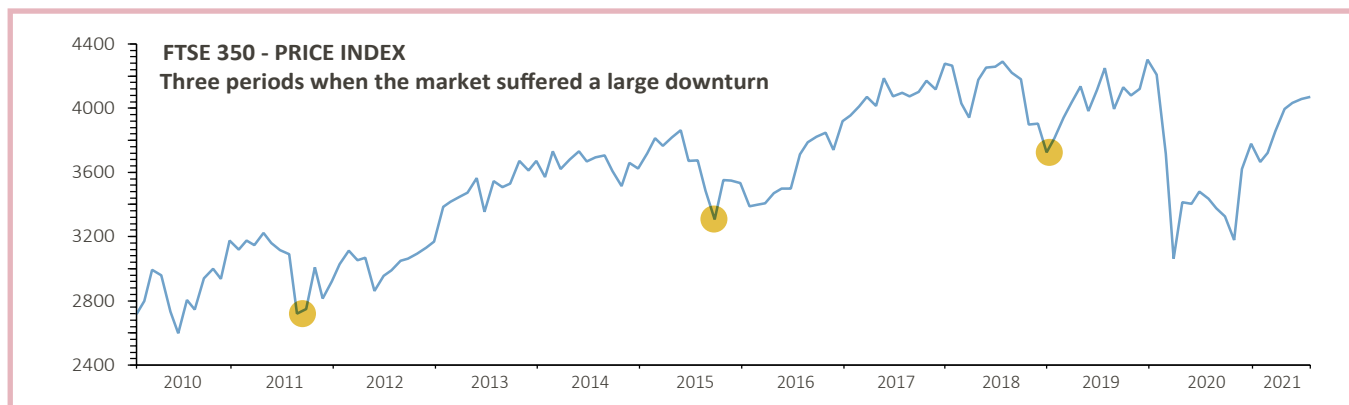
A second trigger is the chance that the Federal Reserve makes a policy mistake by letting core inflation get out of control, which would



push up interest rates and make equities look less attractive. So far, markets seem to have bought the case made by the Fed that current inflationary pressures are transitory.



## THE SECTORS TO OWN – AND NOT TO OWN – IF THE MARKET SELLS OFF



Towards the end of 2019, prompted by a sense that markets had got ahead of themselves, *Shares* looked at which sectors performed best in a market sell-off of 10% or more and which performed best in the subsequent recovery rallies.

We had no more inkling than the next person that a crash was around the corner, and due to the specific nature of the pandemic the sectors worst affected were different to those which history told us to avoid. However, assuming the next sell-off is 'normal' – that is, triggered by growth and/or valuation concerns – this guide should come in handy.

During the three periods surveyed – mid-2011, mid-2015 to early 2016, and late 2018 – the FTSE 350 index dropped an average of around 17% in the downturns.

Using data from SharePad, our research showed that the least affected sector during all three market downturns was beverages, followed by software and computer services, personal goods, pharmaceuticals, and healthcare services and equipment.

At the same time, beverages and computer software captured a lot more of the upside when the market rallied post-crash, which makes them copper-bottomed bets if we do get another big correction.

In contrast, the sectors not to own in a market correction, according to historical trends, are automobiles and parts, industrial transportation and banks, as not only did they underperform on the way down, but they also lagged on the way back up.

## WHICH STOCKS COULD BE AT RISK IN YOUR PORTFOLIO NOW?

If you believe that markets are heading for a correction, then it might pay to sell down any holdings in high beta stocks. High beta means they have greater sensitivity than the broader market, or in other words these stocks are more volatile.

While high-beta investments can outperform when the market is going up, losses can be greater than those of the market in a downturn.

Screening platforms such as SharePad will enable you to find a list of high beta stocks, either versus their sector or the overall market.

Example of high beta stocks at the end of July

included **Rolls-Royce (RR.)**, **Cineworld (CINE)**, **SSP (SSPG)**, **Carnival (CCL)** and **International Consolidated Airlines (IAG)**.





## WHICH INVESTMENTS MIGHT BE GOOD TO OWN IF THE MARKET STARTS TO FALL?

*Shares* has pulled together seven ideas for investments that have the right qualities to outperform the market in a downturn.

We've selected a mixture of stocks with defensive attributes, namely their products and

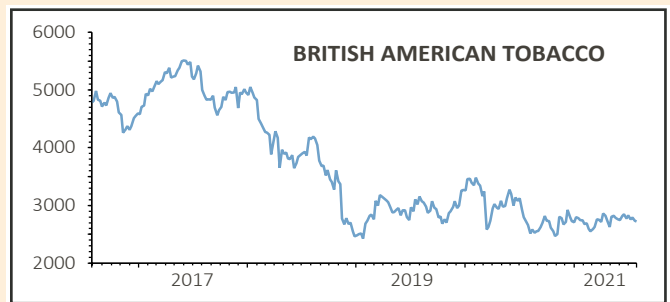
services will be in demand during both good and bad economic conditions. The list also includes a property investor that owns medical centres and two income funds which invest in high quality cash-generative businesses.

**British American Tobacco (BATS) £27.04**

BUY

Investing in a company that specialises in the production of combustible and non-combustible tobacco products may not align with your investment morals. However, for investors who can look beyond these ethical considerations, **British American Tobacco (BATS)** has been one of the leaders in tobacco innovation and trades on an attractive price to earnings multiple of 7.8 and offers a prospective dividend yield of 8.4% based on forecasts for the 2022 financial year.

Earnings growth for the group continues to



be underpinned by its considerable emerging markets exposure.

Cigarette customers are generally loyal to a specific brand and tobacco addicts would consider it non-discretionary spend. British American Tobacco has a reliable stream of cash flow, hence the generous dividend doesn't ring the alarm bells you'd normally find with a yield of that level (i.e. questions about the sustainability of the payment).

The key risks to consider are failure to make good returns from investment in next-generation products such as vaping and regulatory/political interference across the tobacco sector.

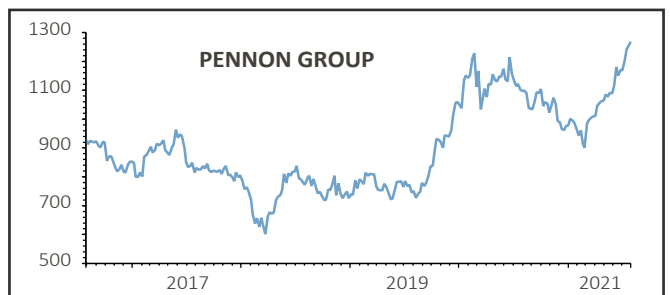
**Pennon Group (PNN) £12.65**

BUY

Following the divestment of waste management services company Viridor for £4.2 billion in July 2020, **Pennon (PNN)** is now a focused water and waste-water company.

Pennon's shares have a low beta which implies they should provide some protection in a falling market. Its services are non-discretionary with revenues remaining stable whether the economy is booming or contracting.

The shares offer a decent dividend yield of 3.3%, covered 1.5 times by earnings, and the company follows a policy of growing dividends in line with consumer price inflation plus 2%.

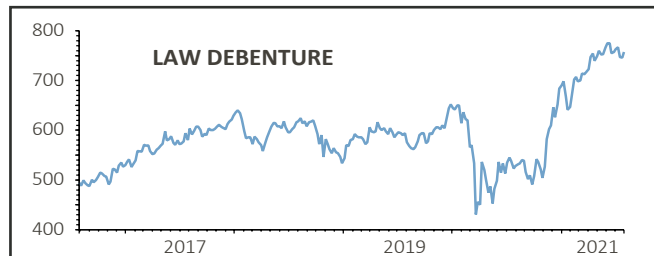


## Law Debenture (LWDB) 749p

BUY

Founded in 1889, **Law Debenture (LWDB)** is an investment trust with a twist. As well as owning a portfolio of quoted UK stocks, the company offers professional business services to large corporates, law firms and banks which provides a steady stream of income.

The investment portfolio is managed by James Henderson and Laura Foll of Janus Henderson Investors and aims for long-term capital growth in real terms, i.e. ahead of inflation, together with rising dividends.



Among the top five holdings are **Barclays (BARC)**, **Rio Tinto (RIO)** and **Royal Dutch Shell (RDSB)**, which are all increasing their shareholder returns significantly this year.

For the first half of 2021 the trust reported a net asset value total return of 16.7%, comfortably ahead of the FTSE All Share Total Return index.

## Primary Healthcare Properties (PHP) 160p

BUY

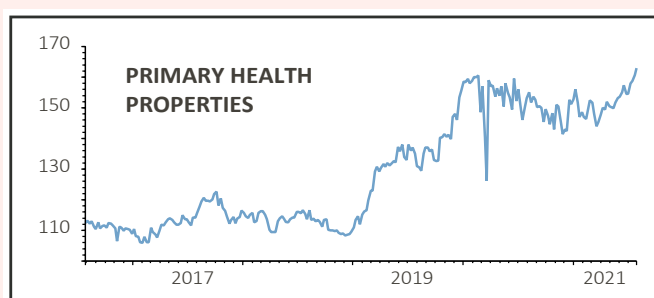
This is a real estate investment company which specialises in owning primary care facilities, almost all of which have their rent paid by the Government, meaning excellent visibility of revenues.

The primary healthcare sector played a crucial role in vaccinating patients during the pandemic. It is increasingly important in reducing the burden on hospitals as demographic trends mean more elderly patients with chronic illnesses.

Having recently brought the management of its estate in-house, costs are on a downward trajectory while rents are rising. During the first half of this year net rental income rose 4.5% while earnings rose 13%, enabling the firm to

increase its dividend for a 25th successive year.

The shares trade on a 37% premium to Numis' forecast net tangible asset value for 2021. However, we believe the stock is still worth buying given that earnings are uncorrelated to the market or the economy, most of its income stream is backed by the Government, and it offers a near 4% yield, making PHP a classic 'safe haven' for investors.



## Troy Trojan Fund (BZ6CNS3)

BUY

This fund is characterised by its distinctive method of investing that prioritises the avoidance of permanent capital losses. The team achieve this goal through cautious asset allocation and careful selection of high-quality companies.

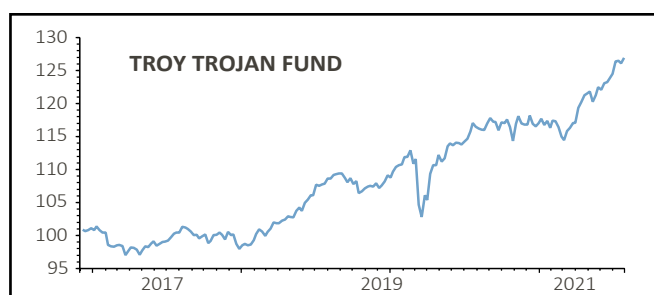
Another feature of the strategy is the ability for the team to invest wherever they see the best opportunities.

The investment objective is to achieve capital growth ahead of retail price inflation over five to seven years.

Over the past three years the fund has delivered a return of 24.5%, handsomely beating retail price inflation of 7.2% and the FTSE All-

Share total return of 6.3%, according to Lipper and Link Fund Solutions data.

The fund's largest allocations are equities (45%) and inflation protected bonds (32%). The top holdings outside of bonds include software giant Microsoft, Google's parent company Alphabet and gold bullion securities. The fund has an ongoing charge of 0.86% a year.



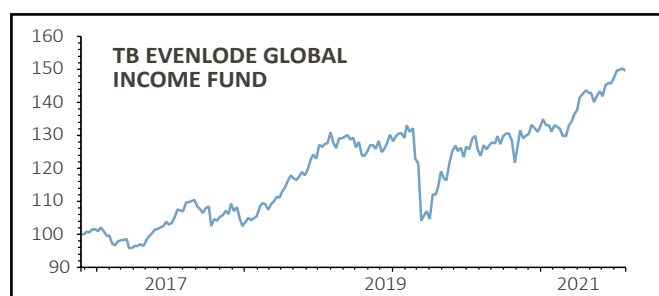
## TB Evenlode Global Income Fund (BF1QMV6)

BUY

Evenlode has a focus on high quality companies that can grow sustainably over the long term.

Through this sustainable growth, the companies should then be able to pay growing dividends over time, helping to compound long-term capital growth.

While the trade-off for this sustainability of income may be a lower yield (circa 2%), the potential consistency in the payments should make up for this.



In more difficult market conditions, investors will seek solace in stocks that have strong cash flows and that's exactly the type of companies which feature in Evenlode's portfolio.

Key holdings include Procter & Gamble which owns a broad range of consumer product brands including Pampers, Tampax, Ariel and Gillette; as well as Wolters Kluwer which provides professional information, software solutions and services in the health, tax, accounting, finance, compliance and legal sectors.



## Guinness Global Income Fund (BVYPNY2)

BUY

This fund has a concentrated portfolio of good quality, attractively valued companies, which offer a moderate dividend yield (the fund's yield is circa 2%) and good potential for dividend growth.

The managers seek out companies with at least 10 years of persistent high return on capital, strong balance sheets and the robustness to withstand economic shocks while delivering a sustainable, growing dividend.

The fund managers believe dividend payers outperform in the long term, and dividend growers even more so.

The fund typically has 35 equally weighted positions, which reduces stock specific risk. An equally weighted portfolio naturally gives



greater weight to small and mid-caps relative to a broad index where big caps dominate.

The top holdings include tobacco manufacturer **Imperial Brands (IMB)**, payroll processor Paychex and tech giant Microsoft.

**DISCLAIMER: Daniel Coatsworth who helped to write this article has a personal investment in Evenlode Global Income Fund.**

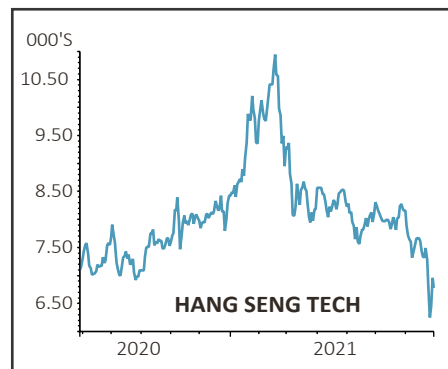


# Beijing clampdown could make investors reassess China exposure

We explain what's driven the China sell-off and how Asia-focused stocks, funds and investment trusts have been affected

**D**uring the final week of July, Chinese shares endured heavy selling with the CSI 300 index, the MSCI China Information Technology index and the Hang Seng Tech index plunging into negative territory for the year.

As a result, many popular open-ended China-focused



funds such as **Allianz China (BKFW2B5)** which has €11.1 billion of assets and the \$2.4 billion **Fidelity China Focus (B51RX72)** also saw their year-to-date returns turn negative.

The sell-off even spread to investment trusts, which don't have the same liquidity issues as open-ended funds when

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investors rush to sell. **Baillie Gifford China Growth (BGCG)** hit a low of 408p, down 23% on the year, while **Fidelity China Special Situations (FCSS)** fell to 342p, down 10% on the year.

Unsurprisingly, investors will be asking themselves whether this is all a storm in a teacup and if they should therefore use the sell-off to average down, or whether the investment case for Chinese equities has fundamentally changed.

### THE GREATER GOOD

The selling was caused by growing concern over the extent of Chinese state intervention in private sector businesses such as education, healthcare, property

## Big Chinese stocks are hammered



1 month to 2 August 2021

Source: Google Finance, refers to US listed version of each stock • Created with Datawrapper

and technology.

For months the Chinese government has been waging war on private businesses which it claims are profiteering at the expense of the broader public. It wants everyone to have access to affordable education, healthcare and housing (the 'Three Mountains') in its drive for social equality.

It also wants to reduce what it sees as financial risk, and it is deeply unhappy about the vast private data sets built up by tech firms such as Alibaba, Didi Global and Tencent, which gives them insights into the behaviour of large swathes of the population.

For now, the government isn't worried about the impact on the stock market, it is pursuing these

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*Actual Investors*



## How did the China sell-off affect investment trusts with Asia exposure?

Trust	Share price loss/gain*
JPMorgan China Growth & Income	-16.7%
Fidelity China Special Situations	-12.5%
Baillie Gifford China Growth	-11.4%
JPMorgan Asia Growth & Income	-7.9%
Templeton Emerging Markets	-7.4%
Genesis Emerging Markets	-7.1%
Asia Dragon Trust	-6.2%
JPMorgan Emerging Markets	-5.6%
ScotGems	-5.1%
Schroder Asia Pacific	-4.8%
Invesco Asia	-4.8%
Jupiter Emerging & Frontier Income	-4.7%
Henderson Far East Income	-3.9%
Pacific Horizon	-3.5%
Aberdeen New Dawn	-3.0%
JPMorgan Global EM Income	-3.0%
Fundsmith Emerging Equities	-2.7%
Mobius Investment Trust	-2.6%
Aberdeen Asian Income	-2.3%
BlackRock Frontiers	-1.9%
Schroder Oriental	-1.6%
Fidelity Asian Values	-1.5%
Pacific Assets Trust	-1.3%
Schroder Asian Total Return	-1.1%
Scottish Oriental Smaller Companies	-0.4%
Aberdeen Emerging Markets	-0.2%
Aberdeen Standard Asia Focus	0.6%

Source: Shares, Google Finance. Data 1 month to 2 Aug 2021

firms 'for the greater good'.

In education, the government says the private sector has been 'hijacked by capital'. It wants companies that teach the school curriculum to go non-profit and has barred them from listing their shares on a stock market or seeking foreign capital.

Education firms whose shares are already listed on a stock market such as TAL Education and Gaotu Techedu, which have large amounts of data on Chinese citizens, could be forced to delist from foreign exchanges.

The government has said it will continue to allow Chinese companies in other sectors to float in the US. However, reports circulated last week that ride-hailing firm Didi Global, which only listed in the US in June, was considering delisting to placate the authorities.

## \$1 TRILLION WIPEOUT

Since their February peak, shares in Chinese technology and education stocks have lost more than \$1 trillion in market value.

Overseas-listed Chinese shares have also been badly affected, with the Nasdaq 'Golden Dragon' index which tracks 98 of China's biggest firms listed in the US dropping 15% in just two days, wiping \$769 billion off its value.

The sell-off has extended to the bond and currency markets as fears spread that foreign investors were selling Hong Kong and Chinese assets across the board.

## VALUATION CONUNDRUM

The issue for investors is that it's hard, if not impossible, to price in regulatory risk, which in turn



### IMPACT ON INVESTMENT TRUSTS

Numis says the effect of the current issues in China will not be uniform across Asia-focused investment trusts.

‘We understand that Dale Nicholls of Fidelity China Special Situations had been trimming technology and healthcare holdings on valuation grounds over the last 12 months in favour of industrials and materials,’ it says.

‘In addition, he reduced internet-related names in recent weeks reflecting increased focus on competition regulation. However, it is perhaps surprising to see Fidelity China had the largest exposure to the tech-giants in the peer group at June, given a more value driven approach.’

Numis adds that Baillie Gifford China Growth and **JPMorgan China Growth & Income (JCGI)** have more growth orientated strategies and therefore significant exposures to tech stocks would be expected.

‘We would expect Baillie Gifford to remain focused on long-term growth opportunities and it has typically been willing to ride out periods of market volatility or use them as buying opportunities for its favoured stocks.’

Numis says the managers of **JPMorgan Asia Growth & Income (JAGI)** note that the Chinese government tends to go through periodic phases of regulatory crackdowns and that this should be expected. ‘They acknowledge that the technology sector will be impacted but they have conviction in their underlying holdings and may use recent falls to add to existing holdings.’

Direct exposure to Chinese education stocks is relatively low among investment trusts, with typically less than 1% of the portfolio for the select few trusts which do have relevant positions.

raises the question of how to value Chinese stocks. Moreover, there is no way of knowing how much more aggressive the authorities could get with listed companies.

If foreign investors decide they need a higher risk-free rate before they think about buying Chinese stocks, there is a good chance the market will be in the doldrums for some time to come.

Simon Edelsten, manager of the **Mid Wynd International (MWY)** investment trust, sold all but one of his Chinese holdings earlier this year.

‘Beijing appears to be stamping down on entrepreneurs it sees as putting their own interests before those of the state, but that has enormous implications for overseas investors who hold shares in Chinese companies,’ he says.

While there may be a ‘dead cat bounce’ in stocks, investors ‘should be checking what exposure they have to China and asking how comfortable they are with what looks to us to be enhanced political risk,’ he adds.

Andrew Ness, manager of the **Templeton Emerging Markets (TEM)** investment trust, called the government action ‘a one-time reset of regulatory paramountcy, similar to previous cycles in China’s economic development’.

He doesn’t expect Beijing to take a broader approach, but he agrees that ‘investor assessments of policy risk will undoubtedly rise as a consequence of these actions.’

Dale Nicholls, manager of



Fidelity China Special Situations, says while his investment trust has lowered its expectations for some stocks, many companies in the tech space are now trading at historical low valuations.

‘Investment is all about risk-reward and for many names, this is looking favourable after recent moves,’ he adds.

## CHAIN REACTION

To compound matters, there are concerns the US could impose restrictions on investments by US companies in Chinese and Hong Kong stocks, while demanding greater disclosure for those Chinese companies co-listed in the US.

At the same time, there are fears China could increase its scrutiny of foreign companies which it believes have hijacked other sectors, not just in the technology and education industries.

Few people seem to have spotted that Tesla has just designated its Shanghai facility a ‘primary export hub’, which suggests Elon Musk has read the runes and opted to avoid a run-in with Beijing, even if it means no longer focusing on selling cars to the Chinese market.

## TOO BIG TO FAIL?

The biggest sector in the Chinese economy is real estate. Technically, private individuals and companies are barred from owning land as it belongs to the state. However, since the 1980s local councils and municipalities have leased land to property firms for several decades in exchange for large upfront payments.

Evergrande Group is the



biggest property company in China, with over 230 million square metres of land in over 230 cities. It is also the largest issuer of US dollar-denominated sub-prime debt in the world, with a balance sheet of more than \$350 billion.

Its debt trades at less than 50c on the dollar, suggesting the company could default, after news broke that one Chinese bank had frozen some of its deposits and four more banks in Hong Kong had refused to grant mortgages on two of its apartment developments.

Next year, Evergrande must repay or roll over \$7.4 billion of maturing bonds, the majority in US dollars. With the shares down 66% already this year, the firm has cancelled a planned special dividend to conserve cash.

The firm is thought to own around \$80 billion in equity stakes in other, non-property related Chinese businesses, but as always equity is only worth what a buyer will pay. If Evergrande fails, it would send shock waves not just through the Chinese banking sector but through the global financial system.

## THE APPEAL OF INCOME

For investors who want to keep some exposure to the Chinese

market but would like some form of security, an income fund could be a good fall-back position.

The team at **Aberdeen Asian Income Fund (AAIF)**, which yields 4% and is sitting at a 10% discount to net asset value, are sanguine about the recent sell-off. They say: ‘Despite the events of the past week, we believe the private sector retains a critical role in ensuring the Chinese economy continues to innovate and prosper.’

‘Companies that can adapt to emerging regulatory frameworks and align with policy objectives such as digital innovation, green technology, access to affordable healthcare and improved livelihoods will continue to have a bright outlook.’

The investment trust has consistently avoided the large Chinese banks due to concerns over the reliability of dividends, and while it owns property stocks, its focus on companies with good visibility of revenues and solid balance sheets means ‘we do not, and never have, owned Evergrande,’ say the team.



By Ian Conway  
Senior Reporter



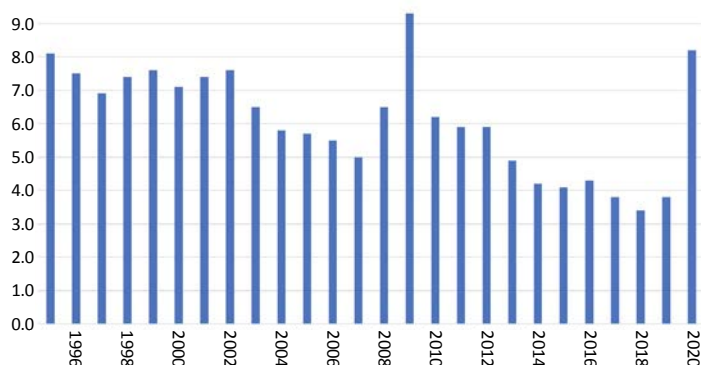


# Will a lack of skilled and willing workers derail the UK economic recovery?

We take a look at the latest figures as the furlough scheme nears its end

**S**unday 1 August saw the last taper of the Government's job retention scheme. For the final two months of furlough employers will have to stump up 20% of a worker's salary as well as paying pension and national insurance contributions. We've been here before and the last go-around forced the hand of employers and the result was hundreds of thousands of redundancies.

Redundancy rates in the UK per 1,000 employees



Source: ONS

This time is different. Restrictions have been removed in England and the vaccination programme is well underway with almost 90% of adults having received their first jab. This time the issue might not be too few jobs but too few workers, at least in the right geographical locations.

The latest data from the Recruitment and Employment Confederation shows the jobs market is stronger now than it was before lockdowns ravaged the economy. It tracks new jobs posted

and found that in the week to 18 July there were 194,000 new advertisements compared with 179,000 in the first week of March last year. Cities, long silenced, are dusting themselves off, flipping the closed sign to open and discovering that finding staff is a struggle.

Strip out the temporary 'pingdemic' that's disrupted businesses and decimated production lines and consider how Covid has upended the labour market. With shops and restaurants closed workers were either furloughed or sought employment in other sectors like manufacturing.

Some people moved either because they could no longer afford to pay the bills, or to take advantage of not having to go into the office, making it a pandemic perk.

## THE FIGURES SPEAK FOR THEMSELVES

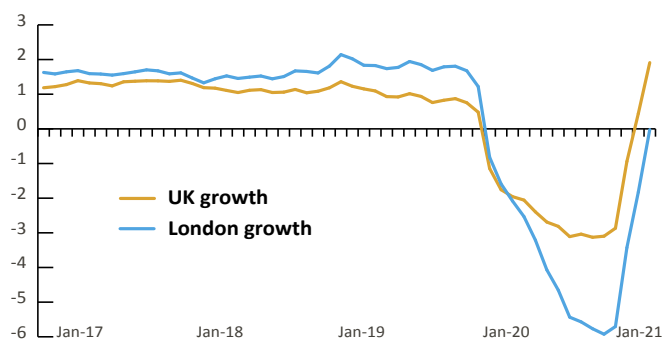
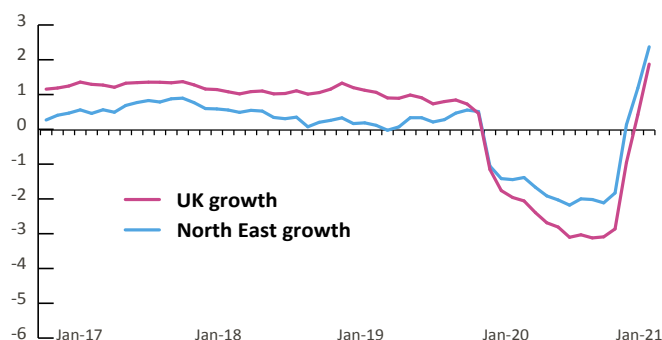
The latest PAYE figures illustrate the shift. Despite more than 200,000 fewer people being on payrolls in June than pre-pandemic, some parts of the UK actually have more workers than they did before the first lockdown.

Of those new job adverts analysed by the REC the lion's share of demand comes from London boroughs. The bright lights of the city that used to more than make up for the lack of space have dimmed and wide open green spaces have become a precious bargaining chip.

Investors need to pay close attention to how different sectors and businesses deal with the labour conundrum. Areas to watch include construction companies as they cannot afford to deal with a skills shortage when demand



## Regional employee growth has fallen across the UK over the last year, but has risen more recently



Source: ONS

is so strong. Hospitality chains will need to find ways to avoid cutting back on their service hours. Can they search out blossoming suburban high streets where staffing might be less constrained? City stalwarts may have to permanently embrace hybrid working as a hiring incentive which could be considered more lucrative to some employees than a hike in wages.

Tesco is so desperate for lorry drivers that it is offering a £1,000 joining bonus to lure people in. The Road Haulage Association (RHA) has estimated there is a 100,000 shortage in HGV drivers across the UK.

### FINANCIAL IMPLICATIONS

A tight labour market usually means wage rises and that has an impact on employer pension contributions and by extension Government coffers. There's also the prospect that the spectre of stagflation could push the Bank of England to

raise rates sooner rather than later, a major issue for firms carrying boat loads of Covid-related debt.

But recovery has slowed and the current hiring boom could fizzle out under autumn's grey skies. Sectors like travel and events carry deep scars and the summer salve won't be potent enough to overcome months of hardship. The latest figures from HMRC showed workers were still being added to furlough numbers in May as it became clear the season's earnings potential would be curtailed.

It is important to consider how many of the circa 1.9 million workers still being supported by the scheme in June are in 'zombie' posts? How many will fall on the 1.57 million active vacancies currently available? That's the calculation that every staff hungry company will be watching.

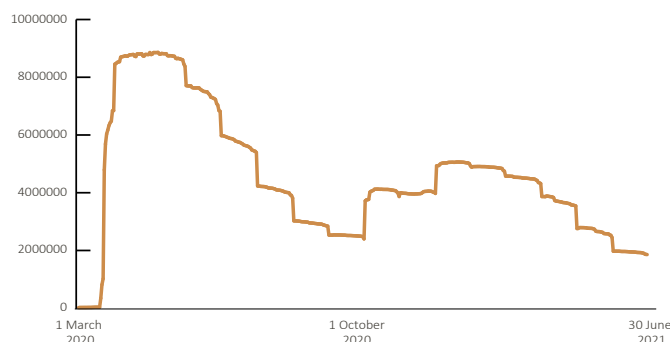
### CONCERNS OVER JOB SECURITY

One must question if Covid restrictions are really gone for good. Anecdotally we're told that a lack of confidence is preventing people from returning to sectors like hospitality because it still feels precarious.

Staff shortages weren't part of the conversation a year ago when unemployment had been predicted to peak at 10% but then the whole pandemic has thrown our lives and our economies on their heads.

The hiring boom might be viewed as a good thing but if jobs remain unfilled and businesses can't capitalise on what little reopening bounce remains then it could be just as costly as long lines at the job centre.

## Number of employees on furlough



Source: HMRC

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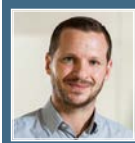
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# Which is better: a Junior ISA or a Junior SIPP?

We compare the differences between the two accounts

*My partner and I have just had our first child and we've been showered with all sorts of wonderful baby gifts. However, we're also keen to give our daughter a leg-up by saving into a Junior SIPP or a Junior ISA. Which one should we go for?*

**Simone (podcast listener)**



**Tom Selby**  
AJ Bell Senior  
Analyst says:

Paying into a long-term savings product might not be something a toddler, football-obsessed 10-year-old or grumpy teenager will thank you for today, but it can be an effective way to rocket-boost their finances.

By starting early, saving often and letting compound growth work its magic, even relatively modest monthly contributions can become a tidy nest egg by the time your daughter reaches her 18th birthday, in the case of a Junior ISA, or retirement in the case of a Junior SIPP.

## HOW DO JUNIOR SIPPS AND JUNIOR ISAS WORK?

If your child is under 18 up to £2,880 a year can be paid into a Junior SIPP on their behalf and the Government will instantly top it up with a 25% bonus, to a maximum of £3,600.

Just like a regular SIPP, any

investment growth the fund enjoys will be tax-free, with the money accessible when they reach the UK's 'normal minimum pension age' (NMPA). This is currently set at age 55 and is due to rise to 57 in 2028, with further increases possible before your child gets there.

The tax treatment of withdrawals is also the same as a regular SIPP, with 25% available tax-free and the rest taxed in the same way as income.

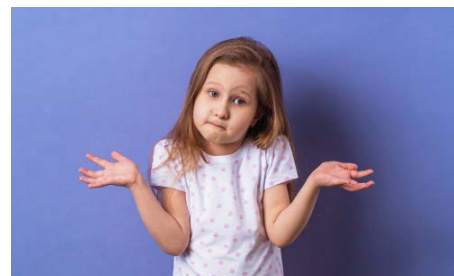
Up to £9,000 a year can be saved in a Junior ISA, although unlike a Junior SIPP there is no upfront Government bonus.

Investment growth is tax-free, and your child can take over managing the account from age 16. They won't be able to access funds until they reach their 18th birthday, at which point the Junior ISA will convert to a regular adult ISA. Any withdrawals they make will be tax free, but it's important to note you will no longer have any control over what they do with the funds.

## WHICH SHOULD I GO FOR?

Deciding whether to pay into a Junior SIPP or Junior ISA on your child's behalf is tricky and depends in part on your priorities.

If you want to give them an easily accessible pot of money



from age 18 which could be used towards a house deposit, for example, then a Junior ISA might be preferable.

However, if you'd prefer to look more long-term and turbo-charge their retirement savings then a Junior SIPP might be the best option.

And just like with regular SIPPs and ISAs, you might decide that a combination of a Junior ISA pot and a longer-term Junior SIPP pot is the most appropriate solution.

## 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.



# The reasons inflation could be short-lived

However investors shouldn't be complacent about the risks from rising prices



**I**nflation is one of the biggest puzzles bedeviling financial markets right now. It's rising, but central banks maintain that it's transitory, and so they're resisting raising interest rates to keep prices rises under control.

This is a conundrum for individual investors trying to work out how to protect their portfolios against rising prices and maintain some balance in their allocation to different sectors and assets.

## PANDEMIC HAS DRIVEN INFLATION

Inflationary risks have definitely become elevated since the pandemic hit, because of all the fiscal and monetary stimulus that's been thrown at the economy, but there are also some reasons to believe that the Bank of England may

be right in its forecast that inflation will remain contained.

The oil price, for instance, is a key component of inflation. Oil is currently trading at around \$75 a barrel, which compares to the \$20 a barrel it slumped to in the immediate aftermath of global lockdowns last year.

Clearly such a big rise in the oil price since then has a massive knock-on effect on the headline inflation figure, which compares prices today with prices a year ago. But to keep having a similar effect on inflation in the coming 12

months, we would need to see a similarly dramatic price rise between now and then.

That seems unlikely, because while economic activity will hopefully kick on from here, it's going to be very difficult to beat the jump from a locked down economy to an open one.

The same principle applies to wage growth. Latest figures from the Office for National Statistics show that in the year to May, headline wage growth was 6.6%, which is a worrying signal for inflation. Again, the pandemic has warped the figures though, which make it difficult to get a glimpse of the true picture.

## WHAT IS THE GOVERNMENT DOING?

We should also be mindful of fiscal policy. The Government really has thrown the kitchen sink at the pandemic and continues to do so. In the March budget, the chancellor announced £24 billion of fiscal giveaways for this financial year,



mainly in the form of support for businesses and consumers. That could well stoke inflationary pressures. But the hand that giveth will eventually taketh away.

From 2023 onwards, predominantly through the freezing of tax allowances and raising the rate of corporation tax, the chancellor will start pulling money back in to balance the books. By 2025/26 they will be clawing back £29 billion, simply as a result of decisions made in this year's budget. By taking that money out of the pocket of consumers and businesses, the chancellor will also be putting the brake on spending, and thereby inflation.

We certainly shouldn't downplay the inflationary risks faced by the global economy right now – they are very real. But the arguments between



inflation being contained and out of control are finely balanced.

## HOW DOES IT AFFECT PORTFOLIOS?

That's not necessarily the case for investor portfolios though. The low interest rate environment we've seen in the past decade or so has led to a ballooning in the value of assets that perform well in a low inflation environment,

and conversely might struggle if inflation takes off.

Chief amongst these are long dated government bonds, and also investments that can act as bond proxies, such as reliable blue chip companies like **Unilever (ULVR)** and **Reckitt Benckiser (RB.)**.

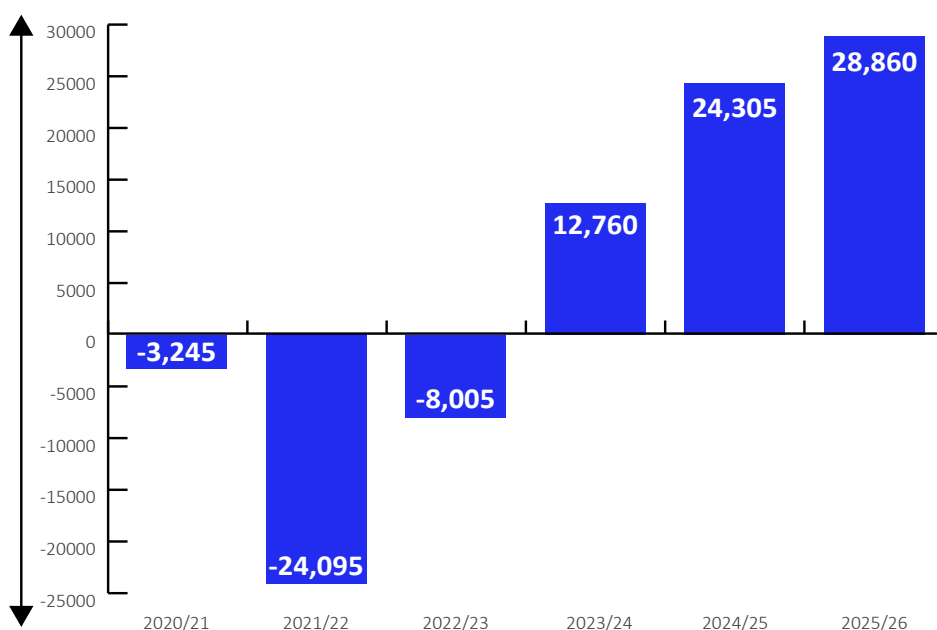
The benign inflationary environment has also created the perfect conditions for growth stocks, particularly in the tech sector, where the appeal of foregoing profits today in favour of profits tomorrow is not heavily eroded by high rates of inflation while you wait.

These investments may well still warrant a place in pensions and ISAs, but their strong performance means they may now make up an outsized proportion of portfolios, which potentially leaves investors at risk from an inflationary shock.

Some reallocation of profits may therefore be in order. The evidence both for and against inflation is finely balanced, and that suggests investor portfolios should be too.

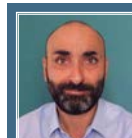
## Budget 2021 tax policy decisions

£m paid to the Treasury from taxpayers



£m paid from the Treasury to consumers and businesses

Source: AJ Bell



By **Laith Khalaf**  
AJ Bell  
Financial Analyst



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# The difference between two popular FTSE 100 ETFs

What sets apart these products from iShares and Vanguard?

**R**eaders often ask how they should choose between different exchange-traded funds covering the same underlying market so let's look at two products tracking the UK's flagship stock market index, the FTSE 100.

**iShares Core FTSE 100 ETF (ISF)** is the largest exchange-traded fund of this kind, with net assets approaching £10 billion. **Vanguard FTSE 100 (VUKE)** is the second biggest at closer to £4 billion. Both track the same index but there are a few differences.

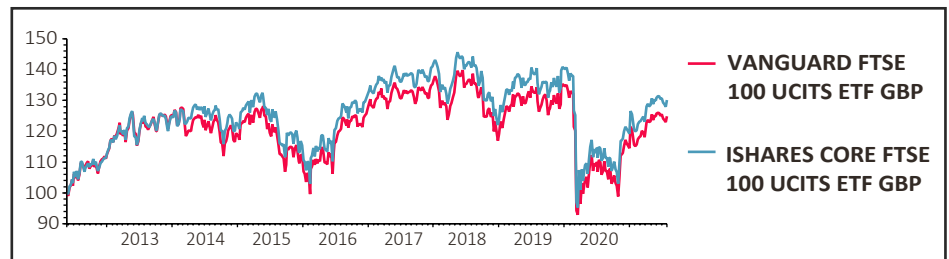
## DO YOU WANT INCOME PAID OUT OR REINVESTED?

Just as with traditional funds, ETFs have 'Inc' versions which pay out the income they receive from underlying holdings and 'Acc' ones which effectively reinvest income.

The Inc version of the iShares FTSE 100 ETF has the code ISF while the Acc version is CUKX.

For Vanguard's FTSE 100 ETF the Inc version is VUKE while the Acc one is VUKG.

Some ETFs replace the term 'Inc' with 'Dist' in the product name, meaning 'Distributing' – namely paying dividends in cash.



The first one is cost. A key reason why people buy ETFs is to get low-cost exposure to the markets. While an active fund might cost you 1% a year or more in fees, most ETFs have significantly lower ongoing charges.

The iShares product has an ongoing charge of 0.07%, while Vanguard's is 0.09%. Relatively small differences in costs can add up to a much larger differences over time.

Most FTSE 100 ETFs, including these two, directly invest in the constituents of the index to physically mirror its performance. But some ETFs are more complex and use contracts with investment banks to replicate an index rather than buying the underlying assets and are sometimes called swap-based ETFs.

## HOW CLOSELY DO THEY HUG THE BENCHMARK?

'Tracking difference' measures how far the performance of an ETF deviates from its benchmark. As ETFs are products constructed to mirror an index, this is an

important consideration.

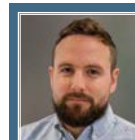
The tracking difference is calculated by subtracting the performance of the ETF from the performance of the index.

Between 30 June 2020 and 30 June 2021, the FTSE 100 delivered a return of 17.96%, while the iShares vehicle returned 17.88% and the Vanguard one 17.87%.

Using Refinitiv data to compare performance between the two since the inception of the Vanguard FTSE 100 product on 22 May 2012, the iShares product is up 30.1% while its Vanguard counterpart is up 24.9%.

Vanguard has lost out from having higher costs and perhaps not having the same level of efficiencies enjoyed by iShares and its larger scale of assets.

On this basis, and given its longer track record, it is not surprising that a higher volume of investors opted to track the FTSE 100 using the iShares ETF.



By **Tom Sieber**  
Deputy Editor



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## KEY ANNOUNCEMENTS OVER THE NEXT WEEK

### Full-year results

**9 Aug:** Hargreaves Lansdown.

### Half-year results

**6 Aug:** Contour Global, Hikma Pharmaceuticals, The Renewables Infrastructure Group. **9 Aug:** Clarkson, PageGroup, H&T. **10 Aug:** Abrdn, Gamesys, Georgia Capital, Marshall Motor, Derwent London, Flutter Entertainment, Zotefoams. **11 Aug:** Hill & Smith, RPS, Spirax-Sarco Engineering, CLS, Quilter, Hostelworld, 4imprint, Admiral. **12 Aug:** Aviva, Tribal, Entain, Glanbia, Vitec, Empiric Student Property, Silence Therapeutics, Coca-Cola HBC, Mears, Aris Bioscience, Empresaria. **13 Aug:** Thungela Resources

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