STOCKS | FUNDS | INVESTMENT TRUSTS | PENSIONS AND SAVINGS

VOL 24 / ISSUE 34 / 01 SEPTEMBER 2022 / £4.49

SHARES

WE MAKE INVESTING EASIER

PREDATORS AND PREY

The businesses which could be ripe for a takeover and those hunting them down

JACKSON HOLE What Fed chair Jerome Powell's stance means for markets

Contents


SIPPs | ISAs | Funds | Shares
AJBell
Youinvest
RETIREMENT YOUR WAY?
GET INVESTING
Open our low-cost Self-Invested Personal Pension for total flexibility and control over your retirement with free drawdown.
youinvest.co.uk
Capital at risk.
Pension rules apply.
Recommended Provider Which? Investment Platforms May 2020
Recommended Provider Which? Self-Invested Personal Pensions July 2020
THE TIMES money mentor
CUSTOMER EXPERIENCE RATING
Investing & Pensions
GOLD AWARD
Autumn 2020

The benefits of long-term thinking: from energy to UK tech to your own investing

Decisions made with short-term expedience in mind can result in lingering regrets

The newly announced energy price cap will have provided a big jolt to many households around the country.

Contained in the current energy crisis is an important lesson about thinking and investing for the long term – a lesson which can be applied across multiple different spheres.

Back in December 2015 we ran a piece in *Shares* about the UK energy sector.

A then recent event in the UK grid provided us with a useful hook for the article – with a **National Grid (NG.)** warning of inadequate supply forcing Britain to turn to 'last resort' measures.

With back-up generation put into use, the wholesale market price hit £400 per MWh (megawatt hour) which, as we observed then, was around 10 times their usual rate.

We posed the question if this was a sign of things to come. Unfortunately it was. On 23 August the average day-ahead auction power price in the UK hit a record £539.59 per MWh.

The Russian invasion of Ukraine and the subsequent disruption to gas supplies has had a big impact and there have been lots of different factors which have led to this point.

But it was possible to see as long as seven years ago that the UK needed to do more to make its energy sector more resilient.

As we wrote back then: 'Years of under-investment and delays on energy infrastructure projects mean progress on the Hinkley Point C facility is now a national imperative. Another two projects of roughly the same size as Hinkley would be needed merely to replace the nuclear capacity expected to go offline in the next decade.'

Arguably little has changed in the intervening period. The article also highlighted a likely dependence on gas to bridge the gap between more polluting fossil fuels and renewables.

But **Centrica (CNA)** and the UK Government decided in their wisdom to close gas storage operations at Rough in 2017 when the supply of gas was plentiful.

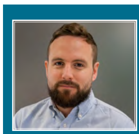
This decision is now being hurriedly reversed. But it's all very short term and a bit late in the day.

A similar example of short-term thinking could arguably be at play among the major institutional investors in some of the London market's dwindling list of technology companies.

The takeover of chip designer Arm by Japan's Softbank during a period when a Brexit-inspired plunge in the pound made UK stocks vulnerable is one example where shareholders thought, wrongly, that a bird in the hand was worth two in the bush.

And the recent approaches for software firms **Aveva (AVV.)** and **Micro Focus International (MCRO)**, assuming they go through, could tell a similar tale.

Your own investing should be conducted with a long-term view of events, assuming you still have the luxury of a decent amount of time before you need to access your investment pot. Don't make decisions in haste which leave you with lingering regret somewhere down line.



By **Tom Sieber** Deputy Editor

Stocks sink as Fed chair Powell looks to avoid mistakes of the past

US rates look set to increase 75 basis points again and could stay higher for longer

American writer Mark Twain famously remarked 'history doesn't repeat itself but it often rhymes'.

Federal Reserve (Fed) chair Jerome Powell's Jackson Hole speech to central bankers (25 August) has shown him to be a shrewd student of American economic history.

The hawkish nature of Powell's remarks sent stock markets tumbling, the Dow Jones Industrial Average, the S&P 500, and the NASDAQ indices fell by 3%, 3.3% and 4% respectively and European shares also fell.

The dollar strengthened, with the pound hitting a two-and-a-half-year low against its US counterpart. It now looks very likely the Fed will increase rates by a further 75 basis points at its next meeting in September (18 September)

Powell looks determined to avoid repeating the mistakes made by his predecessor Arthur Burns during the 1970s. During this period a policy of cheap money, or the setting of low interest rates, resulted in soaring inflation.

US inflation was eventually tamed following the appointment of Paul Volcker as chair of the Fed in 1979. Inflation peaked at 14.85% in March 1980 but fell below 3% by 1983. This was only achieved after Volcker raised the federal funds rate to 20% in June 1981.

In his speech Powell said the Fed's 'overarching focus right now is to bring inflation back down'.

Powell's remarks come after the Fed raised interest rates by 75 basis points at its last two meetings to leave the official funds rate at 2.5%.

Growth investors had hoped that Powell would adopt a more dovish approach (or in other words shift to slower rate increases or even pursue rate cuts next year).

This view had been predicated on the fact that the pace of US price increases declined in July as gas prices fell.

This brought down the annual inflation rate to 8.5%. July's inflation figure, though still high, represented a significant fall from the annual rate of 9.1% recorded in June and prompted market speculation that US inflation had peaked.

However Powell warned that there was 'no grounds for complacency with inflation, having run well above our goal for some time'.

'While lower inflation readings for July are certainly welcome. A single month's improvement falls far short of what the committee will need to see before we are confident that inflation is moving down.'

STAYING HIGHER FOR LONGER

Powell also signalled that a restrictive monetary policy characterised by higher interest rates was likely to last until at least the end of next year.

'Restoring price stability will likely require maintaining a restrictive monetary policy stance for some time'.

'The historical record cautions against prematurely loosening policy'.

In June Fed officials anticipated interest rates rising to 3.4% by the end of this year, and 3.8% by the end of 2023.

Money markets (which trade short-term debt) are currently implying that US interest rates peak at 4% early next year. [MGar]

China's behind-the-scenes easing has been good for investors

Specialist manager says local stocks could outperform into the end of the year

While UK investors have been fretting over the hike in household energy prices on one hand and commentary coming out of the Jackson Hole meeting of central bank governors on the other, the authorities in China have been quietly helping support global shares by easing monetary and fiscal policy.

Without any fanfare, the governor of the People's Bank of China has cut key lending rates, announced special loans for struggling property developers and 'encouraged' state-owned lenders to extend more credit.

In total, China announced 19 new policies last week intended to help support the economy including more than 1 trillion yuan ($146 billion) in new funding for investment and consumption.

The government is also helping state-run power generation companies to sell 200 billion yuan ($29 billion) of special debt in order to make sure the lights stay on this winter.

These moves come as global activity shows signs of slowing and China's economy itself limps along due to Covid-related shutdowns which have affected industrial production and more recently retail sales.

Dale Nichols, manager of the **Fidelity Special Situations Fund (FCSS)**, believes this easing of monetary and fiscal policy will set the stage for a positive second half of the year for the Chinese stock market.

'It has been a tumultuous year for China's markets with economic growth weighed down by the slowdown in the property sector and repeated lockdowns as a result of the country's zero-Covid policy', says Nichols.

However, due to its latest policy action there is now 'a huge divergence' between China and the rest of the world which Nichols believes is supportive for local equities.

Also, the heavy-handed regulation of technology companies seems to be easing which suggests the government has decided to become more accommodative given the sector is a key engine of growth.

Nichols expects earnings forecasts for Chinese firms to improve, unlike elsewhere in the world, as companies are able to push through price increases to offset their rising input costs.

In terms of valuation, he also believes the Chinese market looks cheap relative to other markets and its own history.

'While the discount versus the US, for example, is not as compelling as it once was, when combined with the positive earnings momentum story we believe this stacks up favourably for China's markets', he says.

One key theme he is following is consolidation: 'Many industries in China remain very fragmented compared to structures we see in the West, but the process of consolidation is clearly underway and it may have accelerated with the disruption from the pandemic.' [IC]

Chinese GDP (year-on-year % change)

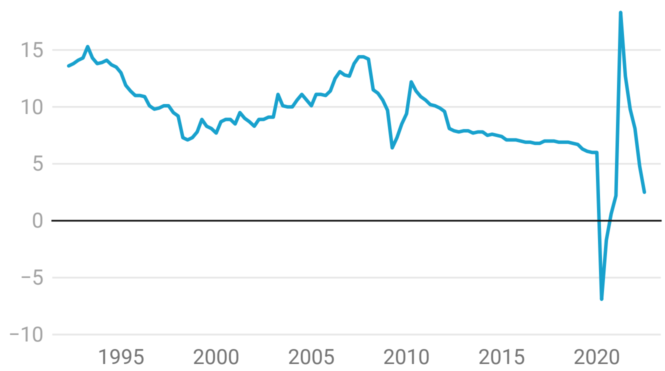


Chart: Shares magazine • Source: Refinitiv

Domino's Pizza will struggle to deliver tasty earnings as inflation bites

Jefferies' analysts highlight negative read across for the business following results from Domino's Australia

Shares in short-sellers' target **Domino's Pizza (DOM)** are down the best part of 50% year-to-date and there could be more pain to come judging by the experience of the takeaway firm's counterpart in Australia.

Investment bank Jefferies highlighted a negative read-across to Domino's UK following full year results (24 August) from **Domino's Pizza Enterprises (DMP:ASX)**, which holds the master franchise rights to the brand in Australia and runs the business in countries including New Zealand, France, Japan, Germany and Taiwan.

Annual results from Domino's Australia showed that higher inflation is proving difficult to mitigate in Europe and the broker sees this as 'further confirmation of the cost pressures faced by UK franchisees'.

COST PRESSURE INDIGESTION

Domino's Australia's same-store sales were down 1.3% in Europe, where it trades in Germany, France, Denmark and Benelux, worse than the flat result estimated by Jefferies.

And earnings before interest (EBIT) came in 17% below the Jefferies' estimate as the company struggled to mitigate the impact of inflation, faced a currency headwind and invested in its Danish business.

Jefferies explained that prices are still working through the system in Europe where inflation has been higher and more difficult to mitigate. Domino's Australia has had to digest increases in energy, labour, food, and construction costs since January 2022.

Surging inflation is a big problem for London-listed Domino's Pizza, which holds the master franchise agreement to own, operate and franchise Domino's stores in the UK, Republic of Ireland,

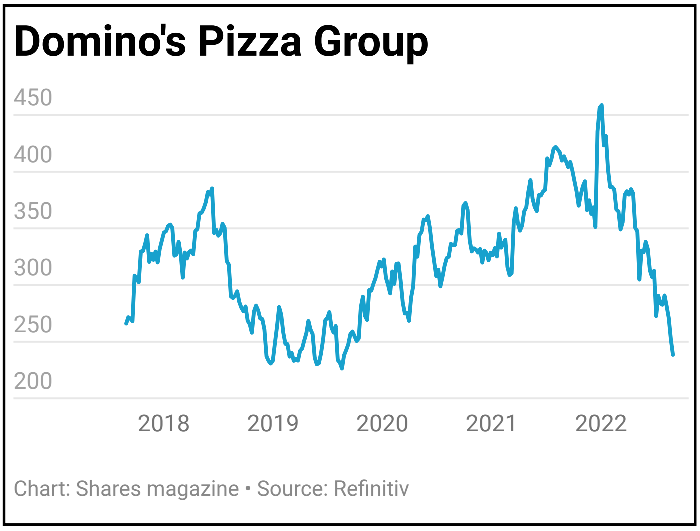


Chart: Shares magazine • Source: Refinitiv

Switzerland and Liechtenstein and has a controlling stake in the holders of the Domino's master franchise agreements in Iceland, Norway and Sweden.

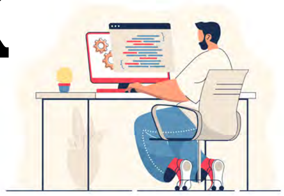
INCREASED FINANCIAL RISK

Domino's Pizza was a clear beneficiary of the pandemic when locked down consumers spent money on takeaways as affordable treats. Now people are able to dine out again Domino's position looks less robust and the cost-of-living crisis means many hard-pressed people simply won't fork out for a pizza delivery.

In its first half results (2 August), Domino's warned profitability is expected to be second half weighted due to the lag in passing through food cost inflation to its franchisees.

Following the numbers Liberum Capital warned: 'At a time when debt is now up to circa 2 times (£236 million), and we about to head into a major recession, the group is ploughing on with a further £20 million share buyback program increasing the financial risk'. [JC]

Weak markets leave UK tech exposed to bids



Several names are being targeted as already threadbare sector shrinks further

The UK-listed technology space faces being left threadbare as low valuations leave leading 'made in Britain' companies at the mercy of opportunistic overseas buyouts.

Enterprise software company **Micro Focus (MCRO)** last week (26 Aug) agreed to be taken over by Canada's **Open Text (OTEX:NASDAQ)** in a $6 billion cash deal, seeing the Micro Focus share price double. The Ontario-based company is offering 532p per Micro Focus share, a 99% premium to the previous day's closing price.

After five years of share price declines following the disastrous merger with HP Enterprises in 2017, Micro Focus shareholders can be forgiven for snapping Open Text's hand off. The company's share price had lost 90% of its value before the Open Text offer was announced.

This is the latest in a lengthening list of UK technology companies being targeted by overseas buyers. Two days earlier saw speculation confirmed that engineering software firm **Aveva (AVV)**, the UK's largest listed tech company by market capitalisation, could be swallowed by its 59% majority owner, **Schneider Electric (SU:EPA)** of France, sparking the stock to rally nearly 27%.

Cyber security **Darktrace (DARK)**, which uses artificial intelligence to help clients protect themselves from cyber criminals and hackers, has also attracted takeover offers. Its shares jumped almost 25% in the wake of confirmation that private equity firm Thoma Bravo is thinking about launching a takeover.

Rumours persist that rival offers could come from rival private equity or industry peers, pushing the Darktrace share price beyond 500p and suggesting that international investors saw the company as significantly undervalued.

Consumer cybersecurity company **Avast (AVST)** is closing in on its own multi-billion pound takeover, from the US's **NortonLifeLock (NLOK:NASDAQ)**. If these deals close, it would mean the UK stock market losing four of its six largest software companies, representing nearly £5.5 billion of revenues combined.

Healthcare tech firm **Emis (EMIS)**, worth around £1.2 billion, is also in negotiations after receiving an offer from **UnitedHealth (UNH:NYSE)** of the US.

The UK tech stock exodus comes despite the Government's claims that it would unleash London's equity markets to attract big tech companies. Some investors are still reeling from the short-sightedness that saw Cambridge's microchip designs champion Arm Holdings sold off to foreign owners in 2016, when Japan's Softbank paid $32 billion to deny investors the chance of compounded growth returns from the shares.

Fortunately for UK investors, accessing global tech stocks for long-term wealth creation has never been easier, with multiple fund and investment trusts options also available to retail investors. [SF]

Current UK tech takeover situations

Target	Bidder/ potential bidders	Status
Micro Focus International	Canada's Open Text	Micro Focus has recommended $6 billion bid
Aveva	Schneider	Speculation Schneider will buy the 41% of the business it doesn't already own
Darktrace	Thoma Bravo	Thoma Bravo is weighing a bid
Avast	Norton Life Lock	Deal first agreed in August 2021 looks close to completion after CMA provisional clearance

Table: Shares magazine • Source: Company reports, Shares magazine

Impact Healthcare REIT offers a welcome respite for weary investors

Business is underpinned by superior long-term earnings visibility and quality assets

Investors looking for a resilient, well-run, financially stable business to ride out the current uncertainty should look at **Impact Healthcare REIT (IHR)**. It invests in a diversified portfolio of residential and nursing care homes.

With an increasing number of elderly people needing care and a constrained supply of fit-for-purpose residences, the company is set to continue growing whatever happens in the wider economy.

MARKET OPPORTUNITY

People aged over 85 are the fastest-growing part of the UK population and make up the core client group for care homes.

According to the ONS, the proportion of the population over 85 years old in the UK is forecast to more than double over the next three decades from 2.5% in 2021 to 5.2% in 2051.

Research by social care consultant LaingBuisson predicts that up to an additional 93,000 beds will be required to satisfy this increased demand over the next 10 years, an increase of over 20% on demand today.

At the same time, the number of care homes in the UK has shrunk by 9% between 2010 and 2020 as older, obsolete buildings have been closed and replaced with larger, more modern homes.

Moreover, the top 10 independent operators have lost market share from 27% to 20% over the last decade and the number of sole traders also shrank while mid-sized operators, which make up most of Impact Healthcare REIT's tenants, dramatically increased their market share from 24% to 47%.

Due to the increasing demand for care and limited new capacity, fees have grown above the retail price index over the last 20 years and Impact Healthcare REIT's leases all include inflation linkage to protect it against rising prices.

IMPACT HEALTHCARE REIT
BUY
(IHR) 119p

Market Cap: £585 million

Dividend yield: 5.5%

Premium to net asset value: 2.4%

QUALITY CARE ASSETS

The group owns 131 healthcare properties, mainly residential care homes, with a total of 7,161 beds as of the end of June.

A key focus of its investments has been in homes dedicated to people with dementia, which make up close to 70% of all residents in care homes.

Sadly, around 850,000 people in the UK suffer some form of dementia, according to the Alzheimer's Society, with that number expected to rise to over one million by 2025 and two million by 2051.

The company's business model is simple, as managing partner Andrew Cowley explains: 'First of all we look for high-quality care providers who we can work with long term. The first question is always, have we got the right partner?'

The second thing Cowley and his team look to get right is the level of rent. 'The rent has to be affordable for the tenants, it's not in our interests for them to go bust. We would rather under-monetise our assets (i.e. charge the tenant too little) than the other way round.'

As long as the tenants are doing well, they won't be tempted to cut corners when it comes to the provision of care, adds Cowley.

The team looks to optimise the portfolio by selling selective assets and reinvesting the proceeds either in acquiring new properties or modernising existing ones.

In the first half of this year, the company acquired seven properties and exchanged contracts on a portfolio of three further properties adding 596 beds.

It also completed the internal refurbishment of a home in Harrogate and the upgrade of three homes in Northern Ireland, while there are ongoing upgrades at homes in Bristol and Carlisle and further projects are either in the planning or tender phase.

SECURE INCOME

Demonstrating the resilience of the business, Impact Healthcare REIT collected 100% of rent due during the first half – as it has every period since it floated in 2017 – with an 'average rent cover' among its tenants of 1.85 times during the 12 months to June, underlining its tenants' ability to manage the current inflationary environment.

The weighted average unexpired lease term across the portfolio was almost 20 years at the end of the half-year period, providing exceptional long-term visibility, with all leases subject to inflation-linked upward-only reviews.

Occupancy across the group's homes climbed to 85.4%, the highest since early 2020, which was better than management expected thanks to the ending of restrictions on personal movement, which meant people were more willing to move their elderly relatives into care.

The firm's underlying net asset value rose 13.7% – or 3.3% allowing for dilution from the recent capital increase – to 116.2p per share, driven by the market value uplift on its property portfolio, while pre-tax profit rose 88% on last year.

After dividends of 3.27p per share, which were 1.3 times covered by earnings, on a fully diluted basis the total accounting return for the first half was 6.2%, putting the company well on track to deliver its 9% annual medium-term total return target.

The group has one of the lowest gross loan-to-value ratios in the REIT sector at 23%, and 73% of its drawn debt was hedged against rising interest rate costs as of June.

Meanwhile, it has more than £110 million in available funds which it can use to continue investing in attractive growth opportunities for the future such as taking on a new tenant with an innovative approach to dementia care, as announced earlier this month. [IC]

The UK care market in figures (2020)

Type of care	Revenues
Nursing care homes	£8.07 billion
of which for-profit	£7.28 billion
Residential care homes	£7.49 billion
of which for-profit	£5.93 billion
NHS elderly care facilities	£1.07 billion
Local authority care homes	£690 million
Total market	£17.3 billion

Table: Shares magazine • Source: LaingBuisson, IHR, Shares magazine. Data correct as of 25 August 2022

Impact Healthcare

Chart: Shares magazine • Source: Refinitiv

Scope for outsized returns as Made Tech helps Britain go digital

MADE TECH
BUY
(MTEC:AIM) 35p

HIGHER RISK STOCK

Market Cap: £50 million

Market remains suspicious but there is a great little business waiting to emerge

Public sector digital technology company **Made Tech (MTEC:AIM)** has the potential to be a big part of Government plans to get public services online in future.

Set-up by founder and chief executive Rory MacDonald in 2008, it quickly developed a reputation for getting the job done, cutting its teeth on projects with the Home Office, DVLA, HMRC, Department for Education, Department for International Trade and the Ministry of Justice.

Soaring wage inflation for technical staff has been its big challenge this year, heightened by a need to use costly contract staff to meet its bulging £38.2 million order backlog. Investors didn't like the sound of that earlier this year, and the share price tanked from 120p.

The reality has been far better managed than the market's bleak predictions, with the company seeing growth accelerate. Made Tech saw revenue soar 120% last year (to May 2022) thanks to significant contract wins across healthcare, central, and local government organisations.

The reported £29.3 million was more than double the £13.3 million the year before, while adjusted underlying EBITDA (earnings before interest, tax, depreciation and amortisation) was £2.6 million. The company made a £500,000 EBITDA loss in the previous 12 months.

This year has got off to a great start too. Sales bookings jumped 115% to £51.1 million and the contracted backlog grew 133%. It also launched its own in-house training academy during the year, which should help ease hiring and wage issues down the line.

The company won new clients across central and local government, health and devolved administrations during the year, including a major two-year contract with NHS Digital, worth approximately £19 million. The company also flagged a Met Office contract, worth at least £7 million over two years, that was announced at the start of July.

Made Tech is typically right at the heart of these digital projects which makes revenue sticky, providing good visibility into the future.A limited stock market track record and the extreme stock volatility are reasons to be cautious. But there does appear to be substantial scope for share price re-rating as analysts, fund managers and ordinary investors become increasingly familiar with the ebbs and flows of the business.

Based on consensus data, Made Tech is expected to grow revenues by 60% and 55% this year and next, with EBITDA forecasts to more than double. That implies a 2024 price to earnings multiple of 5.5.

That tells us that Made Tech's potential has slipped past the wider market, creating a huge opportunity for ordinary investors to earn outsized returns if the company continues to execute as it has been. [SF]

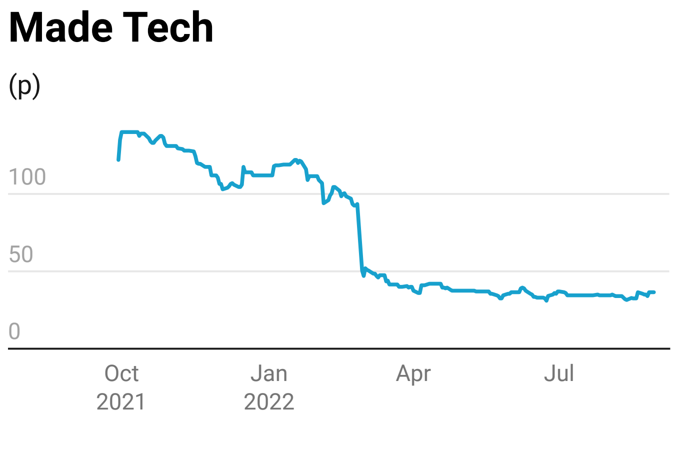


Chart: Shares magazine • Source: Refinitiv

How a bidding frenzy for music catalogues underlines Hipgnosis Songs appeal

Blackstone and KKR 's continued desire to acquire song rights highlights that this asset class is prized

HIPGNOSIS SONGS FUND
(SONG:AIM) 113.4P

Loss to date: -1.8%

We originally recommended buying investment trust **Hipgnosis Songs Fund (SONG:AIM)** on 18 June 2020 at a price of 115.5p.

We believed the trust would benefit from the growth in music consumption facilitated by streaming services like Spotify and Apple Music. In addition we liked the potential for growth via the acquisition of additional music catalogues.

The trust generates income through royalties every time a song from its catalogue which includes Ed Sheeran, Bon Jovi, Stevie Wonder and Beyonce is digitally downloaded, played on the radio, or feature in a film, TV show, advert or video game.

WHAT HAPPENED SINCE WE SAID TO BUY?

The shares are down marginally on the 115p price at which we recommended them.

However the share price fails to reflect a number of encouraging developments, including a positive regulatory ruling, and it is also worth remembering the stream of dividends paid in the interim (a key reason for holding the shares).

In January 2018 the Copyright Royalty Board decided that the amount the streaming services should pay for songwriter rates should increase from 10.5% to 15.1% between 2018 and 2022.

Several streaming companies appealed this ruling in March 2019, but in July 2022 they lost their appeal resulting in the implementation of the higher 15.1% rate.

WHAT INVESTORS SHOULD DO NEXT?

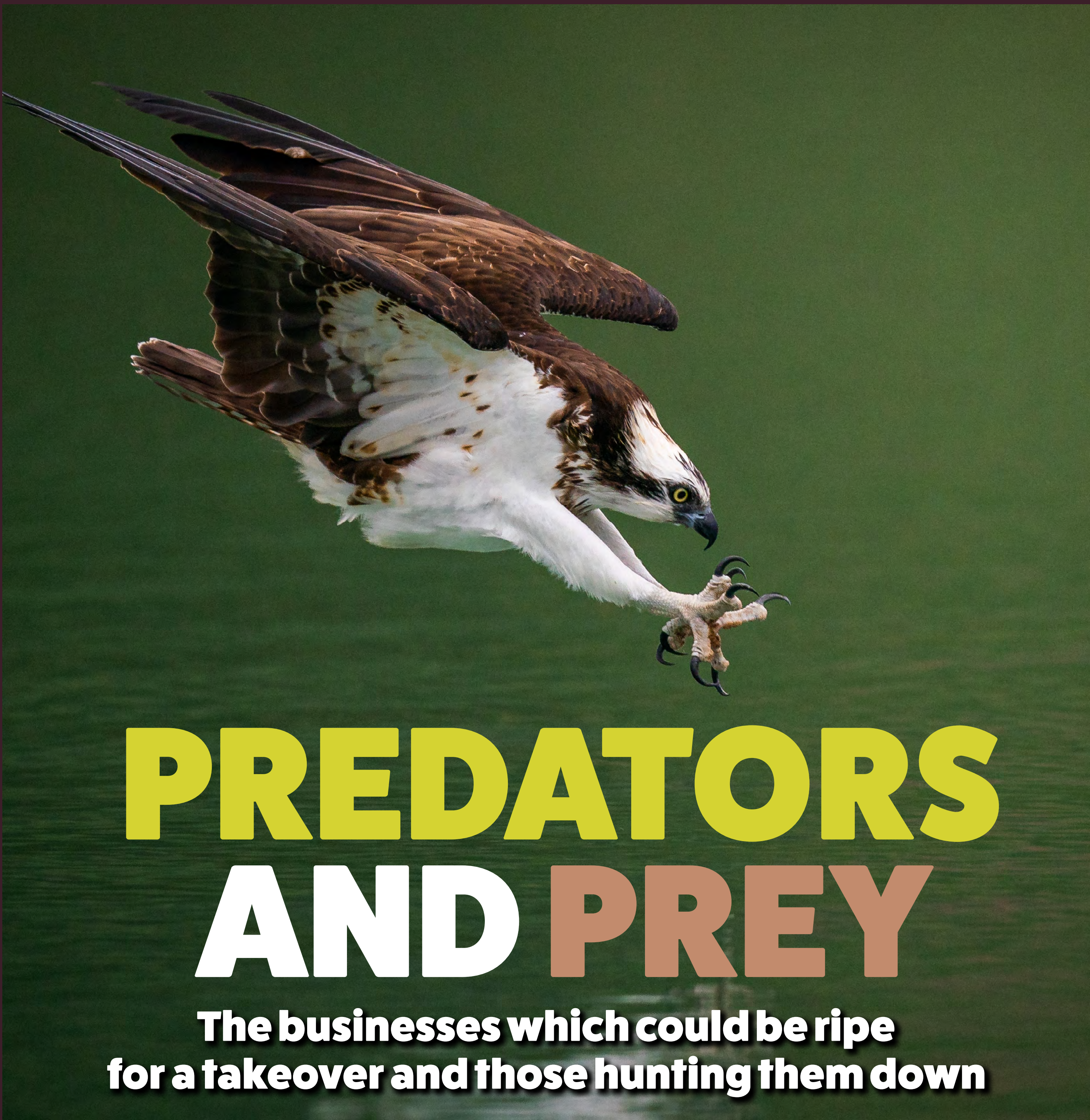
Investors should keep buying.

The trust has fallen 8% this year and trades at a 9% discount to net asset value (NAV), it currently yields 4.7%.

The financial appeal of music rights was highlighted in private equity firm Blackstone's decision in October 2021 to invest $1 billion to acquire music rights via a new private fund.

This followed a decision in early 2021 by its counterpart Kravis Roberts and Co (KKR) which acquired a majority stake in the catalogues of American band One Republic.

More recently Blackstone has been attempting to acquire Pink Floyd's back catalogue, further validating the insatiable investor appetite for music rights. [MGar]



PREDATORS AND PREY

The businesses which could be ripe for a takeover and those hunting them down

By **Martin Gamble** Education Editor

Geopolitical ructions and rising interest rates have seemingly failed to stem the appetite for global takeover activity according to analysis from consultants Earnest & Young (EY).

And the UK financial services industry recorded a seven-year high of 136 deals in in the first half of 2022, although their £8.6 billion combined value was 18% down on 2021 levels.

While a recent survey of UK M&A professionals conducted by data consultants Datasite pointed to increased optimism over the coming 12 months.

The latest big UK deal saw Canadian firm OpenText swoop for software firm **Micro Focus (MCRO)** in a $6 billion deal.

With UK shares looking relatively attractive against global peers and a huge war chest of private capital chasing deals, it seems reasonable to expect further UK takeovers in coming months. The average premium paid over the undisturbed price has been 38% over the past year.

While no one has a crystal ball, by uncovering the key trends driving corporate activity and using private equity insights from Dan Rasmussen, founder of Verdad Advisors, *Shares* highlights three potential takeover targets from a list of potential candidates.

Dan Rasmussen is the founder of an investment firm which specialises in applying private equity techniques to investing in public markets.

RESILIENT GLOBAL ACTIVITY

The first half of 2022 has seen 2,274 global deals worth a combined $2 trillion which is up 35% by value and 13% by volume compared with the average of the last M&A cycle between 2015 and 2019, according to EY compiled data.

Global vice chair of EY, Andrea Guerzoni commented: 'M&A activity was always going to go through a correction. But what we see is that unlike when Covid hit and deal activity came to a standstill, CEOs are still trying to look through the fog and are pursuing transactions that will help position their organisations for future growth.'

The SPAC (special purpose acquisition companies) mania seen in the first half of 2021 means year-on-year comparisons have suffered with deals down 27% by value and 18% by volume.

As the name suggests, a SPAC is a publicly traded company created for the purpose of acquiring or merging with an existing quoted company. There were 613 US SPAC listings in 2021 raising a total of $145 billion, almost double the amount raised in 2020.

According to the *Economist* there are more than 600 US companies still searching for a target.

In the UK the largest SPAC deal was the £254 million offer for advertising company **M&C Saatchi (SAA:AIM)** by **AdvancedAdvT (ADVT)**, run by tech entrepreneur Vin Muria.

CUTTING THEIR CLOTH

Companies seem to have quickly adapted to the new geopolitical realities, changing their focus rather than avoiding new deals entirely. Guerzoni continues: 'On the global stage while there is a strong appetite for cross-border deals, CEOs are more selective in who they do deals with, preferring to "friend-shore" their operations and pursue transactions with friendly pockets rather than applying a truly global approach.'

Arguably rising geopolitical tensions have accelerated the already high demand for IT security and cloud-based services and enterprise software which was a strong driver of deal activity in 2021.

While down 20% from a record first half in 2021 technology-focused deals are now at double the levels of the prior cycle and represent around a third of all deals. Surprisingly, the life sciences sector continues to lag despite the recent health crisis and significant availability of funds.

So far in 2022 the number of Life Sciences deals are down 58% year-on-year and 48% below the average of the last M&A cycle. That said, EY believes the rapid decline in biotech valuations from their 2021 peak bodes well for an 'uptick' in dealmaking for the sector.

PRIVATE EQUITY A MAINSTAY DRIVER OF M&A

Despite rising uncertainties and increased regulatory interventions private equity continues to be a key driver of corporate activity. Guerzoni says: 'Driven by both the vast amount of private capital available and rising interest rates, I expect the role of private equity to be even more fundamental to the global economy.'

According to investment consultants Bain & Co globally the private equity industry generated its highest ever deal value in the last year and a half, equating to $1.7 trillion.

Despite this staggering figure however, the total amount of 'dry powder' or unused cash sitting on the side-lines is $3.7 trillion across all fund types according to data provider Prequin.

DECODING PRIVATE EQUITY

Given the rising influence of private capital and the huge unspent cash sitting across the spectrum of private equity funds, it would be helpful to see the world through the lens of private equity professionals.

One such professional is Dan Rasmussen who left the private equity world to start his own hedge fund business, Verdad Advisors.

While studying the investment returns of private equity funds at Bain & Co, Rasmussen uncovered some startling facts about how the returns were achieved. The rich dataset covered 2,500 deals spanning 30 years.

Around 95% of leveraged buyouts (takeovers involving adding large amounts of debt to fund the transaction) involved companies with an enterprise value (EV) of less than $1 billion. EV represents the total value of a company including its debts and cash.

He discovered that 25% of the cheapest deals as measured by EV/EBITDA (earnings before interest, taxes, depreciation, and amortisation) accounted for 60% of profits. EBITDA is often seen as a good substitute for cash flow.

The most expensive 60% of deals accounted for only 10% of profits. The dividing line defining what is cheap turns out to be a EV/EBITDA below seven times. In theory a ratio of seven implies a buyer would get the purchase price of the whole business back in seven years.

According to Rasmussen the bulk of private equity returns came from deleveraging, not from superior operating skills. Every pound of debt repaid not only added value for shareholders, (more profit goes to shareholders) but significantly reduced the risk of financial ruin.

That, in turn increases the potential for a higher PE (price to earnings) ratio when the business is sold or taken public.

While Verdad's funds are not available to retail investors the insights provided by Rasmussen can be used as a base to identify potential takeover targets.

FINDING THE RIGHT TARGET

Using Stockopedia's software *Shares* has created a screen to identify possible takeover targets. The key financial inputs are EV/EBITDA less than seven times and a debt to EBITDA ratio of less than three times.

Given that historically most deals have involved relatively small targets, the screen applies to companies with an EV between £200 million and £8 billion.

Typically, private equity finances deals with significant debt. This not only lowers taxes (interest payments reduce pre-tax profit) but, as already discussed, allows value to be created as debt is steadily reduced.

Debt can only be reduced if a business generates sufficient cash after paying all its expenses including interest payments. Therefore, the final criteria used is a five-year average free cash flow compared with total assets of at least 10%.

On the radar: Shares UK takeover targets screen

Company	Market value (£ million)	EV / EBITDA TTM	FCF / Assets (%)
Go-Ahead	667	1.4	11.0
Ferrexpo	874	1.8	21.8
Serica Energy	1,174	2.6	11.1
Tremor International	526	2.6	14.0
Halfords	286	2.9	10.1
Central Asia Metals	398	3.0	12.3
Integrated Diagnostics Holdings	463	3.7	17.1
Card Factory	147	4.2	15.9
Centamin	1,081	4.2	14.0
Persimmon	**4,930**	**4.4**	**15.4**
ITV	**2,621**	**4.5**	**10.3**
JD Sports Fashion	6,017	4.7	14.6
Robert Walters	397	4.9	12.0
SThree	490	5.0	10.1
Pagegroup	1,462	5.1	15.7
Somero Enterprises	**246**	**5.3**	**29.4**
Forterra	575	6.1	11.9
Dunelm	1,436	6.3	23.2
888 Holdings	620	6.4	19.3
Andrews Sykes	221	6.9	17.2

TTM = Trailing Twelve Months. FCF = 5yr average free cash flow. EV/EBITDA = enterprise value to earnings before interest, tax, depreciation and amortisation.

Table: Shares magazine • Source: Stockopedia, Refinitiv

It is reassuring to find companies already involved in a takeover situation making the list of potential candidates. Oil and gas company **Serica Energy (SQZ:AIM)** recently received a second higher shares and cash offer from energy trading company **Kistos (KIST:AIM)** valuing Serica's shares at 425p.

Serica promptly rejected the potential offer on the grounds it 'significantly' undervalued the company. Serica's shares are up 81% year-to-date.

Bus company **Go-Ahead (GOG)** agreed a £15.50 per share takeover offer from Australia's Kinteic Holding and Spanish-based Globalvia Inversiones on 4 August.

SHARES' TOP TAKEOVER PICKS

ITV (ITV) 65.2p

ITV has been a perennial takeover target for years but changes to the landscape with the upcoming privatisation of Channel 4 might finally flush out some interest. London-based broadband and fixed telephony provider **Liberty Global (LBTY:NASDAQ)** is ITV's largest shareholder and could look to bolster its position.

A privatised Channel 4 would be free to make its own programmes as well as seizing the opportunity to sell the rights of its independently made programmes to other countries and studios.

The long-term structural shift away from scheduled TV consumption towards streaming is creating a premium for quality content. ITV could be seen as a prized UK asset as the global content market undergoes consolidation.

The latest rating data showed ITV dominating the big TV genres with three out of the four most watched dramas on any channel or streaming service. The company is on track to achieve its biggest year yet in streaming, notching up more than one billion streams.

The cash generative nature of business and low EV/EBITDA ratio make ITV an attractive target for private equity looking to consolidate the industry.

There is an intriguing opportunity to consolidate the UK content market by merging Channel 4 with ITV.

Persimmon (PSN) £14.84

Shares in the UK housebuilder have halved in 2022 on worries over rising interest rates and recession fears hitting the demand for property. **Persimmon (PSN)** trades on a lowly 4.4 times EV/EBITDA and yet has demonstrated strong cash flow generation.

The company looks ripe an unsolicited

approach from private equity which already has shown form and interest in the sector. According to analyst Clyde Lewis at Peel Hunt there have been eight sizeable deals completed over the last two years.

In 2021 McCarthy & Stone, St Modwen Properties and Sigma Capita were all acquired by private equity funds. Private equity firm Bridgepoint is reportedly putting Miller Homes up for sale with a price tag of £1 billion. It paid £650 million for the business in 2017.

Lewis believes there is likely to be further consolidation in the sector over the next few years.

Somero Enterprises (SOM:AIM) 449.5p

It is rather surprising to find concrete levelling equipment specialist **Somero Enterprises (SOM:AIM)** on the list of takeover candidates. Not because it is a bad business, quite the opposite – Somero has a quality business which is very cash generative, and it operates in a growth market.

The surprise is because it isn't often that good quality growth businesses can be purchased so cheaply. The company has financial attributes which make it an attractive target for private equity. The EV/EBITDA ratio of 5.3 is low and implies a relatively quick payback of five years.

Additionally, the company sits on £42 million of net cash which would make a debt funded acquisition even cheaper.

The company operates in markets which have sustainable tailwinds. As more and more people shop online, the demand for modern fulfilment centres and large warehouses grows ever larger.

Somero is no stranger to private equity interest, as CEO John Cooney revealed to *Shares* back in 2017 saying, 'they are poking around all the time'.

CASTING THE NET WIDER

Growth stocks are becoming more diverse, meaning stock-pickers need to embrace the unfamiliar, says Spencer Adair, manager of The Monks Investment Trust

Please remember that the value of an investment can fall and you may not get back the amount invested.

Anyone who thinks growth investing consists of simply loading up on a few mega-cap tech giants will be shocked by some of the companies in Monks' portfolio.

A Swedish oat milk producer? An American specialist in surgically implanted contact lenses? A female-friendly dating app? These businesses don't fit the digits-and-data growth stereotype, but they too hold big profit potential, according to Monk's manager Spencer Adair.

"What we're trying to achieve is a portfolio of the best global growth ideas from every corner of the world," he says. "We want to identify them early, hold them for a long time and let compounding work its magic."

The key, he says, is recognising that a few big digital platforms no longer hold a monopoly on hyper-growth. The range of double-digit growth companies has broadened, and Adair has cast his net wider to capture as many of them as possible.

Monks has broadened its view of what drives expansion. Like many growth portfolios, its holdings used to reflect two megatrends. One was the power of tech giants to disrupt traditional media and retailing. The other was the potential for surging consumption in emerging markets to propel favoured brands to new heights.

The problem is that these trends are maturing. They're unlikely to repeat the eye-popping results of their earlier years. To find new sources of growth, Monks has veered away from internet titans towards "earlier-stage, less certain, much more disparate, much less correlated growth drivers".

Some are no surprise – the shift to electric cars, for instance. Others include attempts to combat dementia, improve education and speed the shift to a more plant-based diet.

Among the more than 60 stocks that Monks classifies as disruptors are STAAR Surgical, which seeks to replace laser eye surgery with implantable contact lenses, and Denali Therapeutics, which is working on Alzheimer's drugs. Online education pioneer Chegg, and plant-based milk producer Oatly and Elon Musk's SpaceX aerospace venture also appear, as does Bumble.com, a dating app.

Adair's strategy for Monks will be tested in the years and decades to come. In the meantime, any manager whose portfolio spans both oat milk and space rockets can speak with authority on how variety brings opportunity, and with it, more chances of success.

Investments with exposure to overseas securities can be affected by changing stock market conditions and currency exchange rates.

The views expressed in this article should not be considered as advice or a recommendation to buy, sell or hold a particular investment. The article contains information and opinion on investments that does not constitute independent investment research, and is therefore not subject to the protections afforded to independent research.

Some of the views expressed are not necessarily those of Baillie Gifford. Investment markets and conditions can change rapidly, therefore the views expressed should not be taken as statements of fact nor should reliance be placed on them when making investment decisions.

Baillie Gifford & Co Limited is wholly owned by Baillie Gifford & Co. Both companies are authorised and regulated by the Financial Conduct Authority and are based at: Calton Square, 1 Greenside Row, Edinburgh EH1 3AN.

The investment trusts managed by Baillie Gifford & Co Limited are listed on the London Stock Exchange and are not authorised or regulated by the Financial Conduct Authority.

What high gross margins tell investors about the merits of a business

There's a lot that can be gleaned from looking at how much of a firm's revenue it keeps as profit

When **Adobe (ADBE:NASDAQ)** reported second quarter figures in June 2022 it unveiled earnings that beat forecasts, reporting $3.35 versus consensus estimates of $3.31. So far, so what? The market shrugged the results off – the share price dipped 1.2% to $360. Yet this was the latest in a long run of quarterly forecast beats that, barring a single period in 2018, stretch back to 2013.

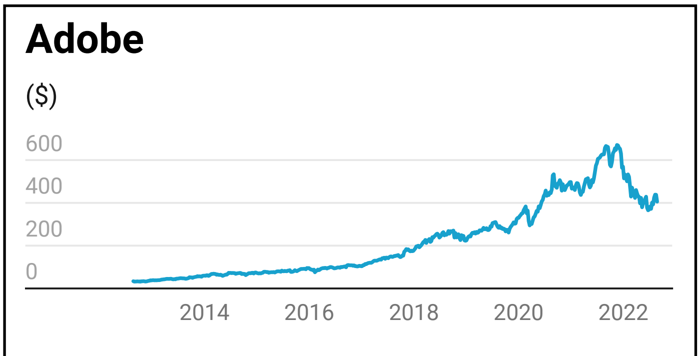


Chart: Shares magazine • Source: Refinitiv

Since then, Adobe's market valuation has surged to $190 billion as its stock rallied hard, up more than 760%, and that's after the extreme challenges presented this year.

The secret to this enormous wealth creation (or one of them) is the firm's high gross margins. These were 87.7% in Q2 2022, and in the five full years (to November) between 2017 and 2021, gross margins have averaged 86.6%.

A business that has high gross margins has much more of a buffer to handle adversity and rising costs. It usually means that the products or services sold are not only in demand but are often critical to clients. That gives them important pricing power, so as inflation has soared this year, putting up the price of doing business, companies like Adobe have been able to pass on these higher costs to customers through price increases. Adobe itself did just that in April.

It is why high gross margin businesses tend to attract higher stock market valuations than average.

GROSS MARGINS IN A NUTSHELL

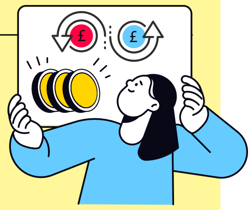
Gross margin, or gross profit margin, is a way of measuring the amount of profit a company has left after subtracting the direct costs associated with selling its goods and services. Things like raw materials, staff salaries and utility bills.

Gross margin is calculated by dividing gross profit by gross revenue and multiplying the figure by 100 to get a percentage. The percentage figure represents the portion of revenue that can be kept by the company as profit.

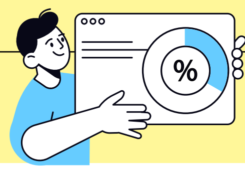
The higher the margin percentage, the more effective the company is in generating revenue for each dollar or pound of cost.

- **Gross revenue** is the total amount of money the company makes from selling its goods and services

- **Gross profit** is the amount of profit the business makes after all costs are deducted, such as manufacturing costs



- **Gross margin** is profit divided by revenue



Gross margin tells investors a few things. First, it tells them how much of a company's revenue (the total amount of money received) is kept as a profit. So, if the gross margin is 80%, it means the company has made 80p of profit from every £1 in revenue. This helps investors establish if a company is using its money efficiently.

Secondly, gross margins can give an insight into what shareholders might receive, as dividends are paid from profits. Lastly, it helps investors to compare competitor companies to each other.

Gross margin also offers useful insights for companies themselves. It can be used to measure production costs against revenue. If the gross margin is very low, the business may want to cut production and manufacturing costs to increase profits.

Sticking with Adobe, in much the same way that **Netflix (NFLX:NASDAQ)** sells streaming subscriptions to consumers, Adobe does the same to creative business customers. Once it has sunk the cost of developing a software product, its cost of new subscription sales is low, or marginal, as analysts call it.

It can be similar with online platform businesses, where the cost of new business can be marginal. **Autotrader (AUTO)** and **Trainline (TRN)** both averaged gross margins of more than 80% over the past 12 months, although **Moneysupermarket (MONY)**, which runs a similar online platform model, has gross margins of 69.1%, something investors might want to dig into before investing.

Investors can use gross margins to compare similar businesses, Adobe against **Autodesk (ADSK:NASDAQ)** say, which sells engineering design software solutions.

FTSE 350's highest gross margin businesses

	Gross margin
Sage	93.1%
Darktrace	89.4%
Ashtead	88.2%
London Stock Exchange	86.9%
Euromoney	85.8%
Auto Trader	83.9%
Ninety One	83.5%
Avast	83.5%
Indivior	83.3%
BAT	83.3%
Trainline	81.1%
Aveva	80.4%
888	79.5%
Network International	78.3%
Rentokil	77.1%

Table: Shares magazine • Source: Sharepad, average last 12 months

Small business accounting software supplier **Sage (SGE)** has trailing 12-month gross margins of 93.1%, according to Sharepad data. Its largest variable to that gross margin is likely to be technical talent recruitment and retention, and product development. Yet with nearly 94% of revenues recurring from products already available, these factors are unlikely to drag significantly on overall profits.

Adobe vs Autodesk

	Revenue ($ million)	Gross profit ($ billion)	Gross margin
Adobe	4,386	3,847	87.7%
Autodesk	1,170	1,053	90.0%

Table: Shares magazine • Source: Investing.com

GROSS MARGIN LIMITATIONS

Apple (AAPL:NASDAQ) is also (in part) a software company, but when we look at its gross margins, they compare poorly with Adobe and Autodesk. In the 2017 to 2021 full years (to 30 September), Apple averaged a 38.9% gross margin. The yawning gap between Apple and Adobe/Autodesk is because Apple makes most of its revenue by selling iPhones and other gadgets, hardware in other words, which require billions of dollars of components (microchips, circuit boards, batteries, glass etc) to manufacture.

Comparisons become even less useful across different industries because financial structures, production efficiencies, raw material requirements and the levels of competition are different.

Fashion retailer **Next's (NXT)** 42.6% gross margin is far below software company examples above because it has to contend with the impacts of rising manufacturing costs (energy, workforce wages) of suppliers and raw materials price hikes (wool, cotton, silk, leather), on top of its own cost of operating pressures.

That **Dr. Martens (DOCS)** trades on a 64% gross margin tells investors about the power of its brand, by contrast.

Supermarkets run on far thinner gross margins as they contend with all of the above, plus vicious competition as they battle for customers. The average trailing 12-month gross margins of **Sainsbury (SRBY)** and **Tesco (TSCO)** was 7.9% and 7.5% respectively.

There are even industries, property, utilities and financial services, for example, where gross margins are not meaningful.

Ultimately, gross margins are just one element of fundamental analysis that help investors to gain key insights into how reliable future profits are likely to be, and what decisions management might make down the line to improve a company's prospects.

By **Steven Frazer** News Editor

The one thing Terry Smith and Warren Buffett seek when picking stocks

Free cash flow yield can tell you a lot about a company's attractiveness

Seasoned investors should be familiar with Alfred Rappaport's view that 'profits are an opinion, cash is fact', yet a great deal of company analysis still relies on traditional measures of profits such as EBITDA (earnings before interest, tax, depreciation and amortisation) and EPS (earnings per share).

Rappaport argued that since bond holders valued their investments by discounting back future cash flows, equity investors should do the same with their investments.

Ultimately, profits are just an accounting principle whereas actual cash in the company's accounts determines how much it can invest to grow the business and how much it can return to shareholders.

WHY CASH MATTERS

While profits are a summary of a company's earnings on account after expenses, free cash flow comes from operating cash flow received and paid into the company's bank account.

The more cash a company has, the better its ability to invest in growth opportunities or to meet any unexpected claims or other liabilities.

In the same way we calculate a company's dividend yield by dividing the payout by the share price, expressed as a percentage, dividing the free cash flow per share by the share price gives us the free cash flow yield.

Highest FTSE 100 free cash flow yields

Based on 12-month trailing free cash flow yields, excludes financial companies and REITs. Data correct as of 23 August 2022

Company	Industry sub-sector	FCF Yield (%)
Vodafone	Telecoms Services	19
BP	Integrated Oil & Gas	18
Shell	Integrated Oil & Gas	17
Rio Tinto	General Mining	16
Imperial Brands	Tobacco	14
Schroders	Asset Managers	12
DS Smith	Packaging	11
JD Sports Fashion	Clothing Retail	11
British American Tobacco	Tobacco	10
Associated British Foods	Food Products	10

Table: Shares magazine • Source: SharePad

The higher the free cash flow yield the more solvent and therefore the more attractive the company is as an investment and vice versa.

Companies which generate lots of free cash flow don't need to go to their banks or their shareholders for money when they want to make an investment, whether they need new equipment or new premises or want to expand by buying another company.

In contrast, companies which need to borrow to grow their business run the risk that they amass too much debt and can't pay their interest costs on top of all their other expenses, sending them into bankruptcy.

DEFINING FREE CASH FLOW

Because not all companies operate in the same way, there are a couple of approaches to defining free cash flow.

The first, and simplest, is to go to the cash flow statement and pick out 'operating cash' (also referred to sometimes as 'net cash from operating activities') and 'capital expenditure'.

By subtracting capital expenditure – which covers any spending the company requires to maintain its business at the current level – from operating cash we get free cash flow.

The second method of calculating free cash flow is to take revenues and then subtract all the costs associated with generating those revenues, from cost of goods sold to operating costs, interest costs and the net investment in operating capital.

Where the calculations can get tricky is in defining the real level of investment needed to keep the company ticking over, namely before any growth investments.

Companies which own lots of fixed assets which they must maintain or replace face a constant drag on their cash flows, whereas companies which are 'asset-light' and mainly provide software or services need to invest much less in maintenance.

However, this has become a hot topic among investors in software stocks as it could be argued they need to invest constantly in their products simply to keep them up to date, so the issue isn't completely clear-cut.

STAKING A CLAIM

Terry Smith, who runs **Fundsmith Equity Fund (B41YBW7)**, is a long-standing advocate of free cash flow as a guide to investing.

'We take the view we own those cash flows,' says Smith. 'Free cash flow, whether it's used to acquire things, to invest further in the company or we

Theme parks often have high levels of capital expenditure as they must build new rides to attract customers and keep existing rides working. That can have a negative impact on free cash flow.

receive it in dividends, that's what we own.'

The Fundsmith boss says the fund's aim is to invest only when free cash flow per share as a percentage of a company's share price – i.e. the free cash flow yield – is high relative to long-term interest rates and when compared with the free cash flow yields of other investment candidates both within and outside of its portfolio.

'Our goal is to buy securities that we believe will grow and compound in value, which bonds cannot, at yields that are similar to or better than what we would pay for a bond.'

Unsurprisingly, legendary value investor Warren Buffett is also a keen watcher of free cash flow yields and typically likes to buy stocks with yields approaching double digits.

Chevron (CVX:NYSE), which Buffett started buying in late 2020 and now one of his top five public holdings, yields around 12% on a free cash flow basis even after a 35% rally this year thanks to the spike in energy prices.

Lowest FTSE 100 free cash flow yields

Based on 12-month trailing free cash flow yields, excludes financial companies and REITs. Data correct as of 23 August 2022

Company	Industry sub-sector	FCF Yield (%)
Smurfitt-Kappa	Packaging	2
Fresnillo	Gold Mining	2
Aveva	Software	1
Antofagasta	Copper Mining	1
Croda International	Specialty Chemicals	1
Dechra Pharmaceuticals	Pharmaceuticals	1
SSE	Electric Utility	1
Severn Trent	Water Utility	1
Melose Industries	Industrials	0
Flutter Entertainment	Casinos & Gaming	0

Table: Shares magazine • Source: SharePad, Shares magazine

FTSE 100 FREE CASH FLOW YIELDS

In the UK, oil giants **BP (BP.)** and **Shell (SHEL)** currently trade on 12 month-trailing free cash flow yields of 18.3% and 16.8% respectively, according to figures from SharePad.

This makes sense as the energy companies have stopped spending on developing new fields, under pressure from the environmental lobby, and are spending a minimal amount on maintenance while reaping the benefit of soaring demand and record prices, particularly for natural gas.

Imperial Brands (IMB) also scores highly on free cash flow yield as its products are bought in high volumes on a regular basis by millions of people worldwide, creating steady cash flows, while its maintenance spending is low, allowing it to invest in new generation products.

At the other end of the spectrum, with free cash flow yields of just 0.6% and 0.9%, are utility companies **Severn Trent (SVT)** and **SSE (SSE)** which use almost all their operating cash flow on capital spending and interest payments.

Disclaimer: The author (Ian Conway) and editor (Daniel Coatsworth) owns units in Fundsmith Equity Fund

Explaining SIPP tax relief: the big details you need to know

Shares looks at the limits on pension-related perks and how to claim them

One of the key benefits of pension saving is the ability to get upfront 'tax relief' on your contributions. Tax relief just means that your contributions are free from income tax.

The amount of tax relief you are entitled to will depend on the income tax band your pension contribution comes from. A basic-rate taxpayer paying 20% tax will therefore be entitled to 20% tax relief, a 40% taxpayer 40% tax relief and a 45% taxpayer 45% tax relief.

If you live in Scotland, you might be subject to different income tax rates and therefore be entitled to different amounts of pension tax relief.

100% OF EARNINGS LIMIT

The amount you can personally contribute to a pension annually and receive tax relief is limited to 100% of your 'relevant earnings'. So, if you have total relevant earnings of £15,000, the maximum personal contribution you can make, including tax relief, is £15,000.

If you don't earn an income, you are still entitled to tax relief at the basic rate (20%), although the maximum you can pay in each tax year (inclusive of tax relief) is £3,600.

There is also an overall 'annual allowance' which limits the total amount that can be paid tax efficiently into a pension each year. This annual allowance covers personal contributions, employer contributions and tax relief.

The annual allowance in 2022/23 is set at £40,000. If you breach the annual allowance, an annual allowance charge will be applied which aims to claw back the upfront tax relief you have received.

If you have flexibly accessed taxable income from your pension – either through drawdown or by taking an ad-hoc lump sum – you will be subject to the 'money purchase annual allowance' (MPAA). This reduces your annual allowance from £40,000 to just £4,000 and removes your ability to 'carry forward' any unused annual allowance from the three previous tax years.

In addition, if you are a very high earner you may be subject to the 'taper', which can reduce your annual allowance from £40,000 to as low as £4,000. If you are affected by the taper, your actual annual allowance will depend on your earnings. You can read more about how this works here.

There is also an overall 'lifetime allowance' which in 2022/23 is set at £1,073,100 – although some may have locked into a higher lifetime allowance by claiming a form of 'protection'. If you breach your lifetime allowance, you will be hit with a lifetime allowance charge.

You can read more about how the lifetime allowance works here.

EXAMPLE: Emma has an annual income of £60,000 and makes a pension contribution of £20,000 to a SIPP, which pays tax relief at source. She receives basic-rate tax relief upfront, meaning the £20,000 contribution is increased to £25,000 in her pension.

She is also entitled to claim higher-rate relief on the portion of her contribution that was in the higher-rate tax bracket. In 2022/23, the higher-rate tax band kicks in at £50,270, meaning Emma can claim higher-rate relief on the slice of her contribution above £50,270, which is £9,730.

She can therefore claim an extra £2,432.40 in higher-rate relief on this part of her contribution, alongside the £5,000 basic-rate relief she has already had paid into her pension automatically. The higher-rate relief will be paid via an adjustment of her tax code in the following tax year (2023/24).

HOW TO CLAIM PENSION TAX RELIEF

There are different types of pensions which claim tax relief in different ways. If you are contributing to a 'relief at source' pension scheme, such as a SIPP, then basic-rate tax relief will be added automatically. This means if you pay in £80, it will be topped up immediately to £100 via basic-rate tax relief.

If you pay tax at a higher rate than basic and are contributing to a relief at source scheme, you can claim back further tax relief via your tax return. In the case of the above example of an £80 contribution, a higher-rate taxpayer could claim an extra £20, and an additional-rate taxpayer an extra £25.

While basic-rate relief will be paid into your pension, any higher or additional-rate relief you claim back will usually be paid via an adjustment of your tax code the following year.

If you are contributing to a 'net pay' pension scheme, you will usually be granted all of your tax relief automatically. This is because your contributions come out of your gross salary before any income tax has been calculated. It's important to note that National Insurance will be deducted from your salary before your pension contribution is taken.

However, low earners risk missing out on pension tax relief if they contribute to a net pay scheme. This is because if you are a 0% taxpayer (i.e. earning below the £12,570 personal allowance) then the design of a net pay scheme means you will receive 0% tax relief.

The Government has committed to implementing a solution to this so-called 'net pay anomaly', but this won't be in place for a number of years.

EXAMPLE: Charles earns £20,000 a year and makes a £2,000 contribution to his workplace pension scheme, which pays tax relief on a 'net pay' basis. Because this contribution is taken from his pay before income tax has been calculated and Charles is a basic-rate taxpayer, he has received his tax relief – worth £400 – automatically.

You can also pay pension contributions via something known as 'salary sacrifice'. This, as the name indicates, involves giving up a portion of your salary, with your employer instead paying you a 'non-cash benefit' – in this case pension contributions.

This will mean you get your pension tax relief upfront, while also reducing employee and employer National Insurance contributions.

One thing to bear in mind when considering salary sacrifice is the impact it might have if you are ever made redundant. As your salary will be reduced, it is possible your redundancy entitlement will be reduced too. Taking less salary could also affect things like maternity/paternity pay, mortgage applications and some state allowances.

By **Tom Selby**
AJ Bell Head of Retirement Policy

EXAMPLE: Natasha earns £30,000 a year and enters a salary sacrifice arrangement with her employer. Natasha's salary will be reduced to £27,000 as a result, with her employer paying £3,000 into a pension scheme on her behalf. Tax relief has been added automatically.

Could BH Macro be the 'reassuringly expensive' Stella Artois of hedge fund trusts?

The absolute return specialist has an impressive track record and looks to deliver during periods of market stress

The market regards hedge fund Brevan Howard as one of the leading global macro absolute return investment managers.

Absolute return specialists aim to deliver a positive return to investors regardless of whether markets are rising or falling. They often own a mix of bonds and stocks as well as other asset classes and sometimes look to benefit from the value of assets falling as well as rising (a short/long approach).

Brevan Howard aims to combine rigorous research into the macro-economic backdrop with an uncompromising focus on risk management.

Its **BH Macro Fund (BHMG)** has a record of outperforming during bear markets and thriving during periods of foreign exchange and interest rate volatility.

During the worst 20 performing months for stocks over the fund's history, it has delivered positive returns in 17 of them.

TRADING AT A PREMIUM

The fund currently trades at a 14.7% premium to net asset value (NAV). This reflects its outstanding performance with total share price returns over one, three, five and 10 years of 25.5%, 63%, 126.2%, and 131.1% respectively. This compares with comparable returns for the AIC (Association of Investment Companies) hedge fund sector of 3.1%, 44.1%, 45.8% and 108.1%.

As a diversifier to shares and bonds BH Macro offers investors an interesting proposition in mitigating downside risk and delivering impressive returns during periods of stock market stress.

This is at a time when gold's safe haven credentials are being questioned and fixed income investments look increasingly fragile thanks to rising rates.

The Brevan Howard Master Fund (BHMF) is closed to new investors, so the listed vehicle is the only way to gain exposure. But there are three potential drawbacks that investors need to appreciate.

First, BH Macro charges significantly higher fees than traditional funds and investment trusts. Second, the fund can experience periods of underperformance. Muted foreign exchange and interest rate volatility contributed to the share trading sideways for a considerable portion of the last decade. Third, the underlying positions in the fund can be hard to decipher.

WHAT IS BREVAN HOWARD'S APPROACH?

BH Macro came to the market via an initial public offering (IPO) in 2007 and merged with BH Global (its smaller listed brethren) in 2021 to become the liquid £1.3 billion vehicle it is today. The fund is invested directly into the Brevan Howard Master Fund.

BHMF pursues a multi-trader model that

includes a combination of macro directional and macro relative value strategies, with exposures predominantly to global fixed income and foreign exchange markets.

A directional trading approach involves taking a view on the future direction of the market, while relative value strategies typically involve taking long positions in undervalued assets and short positions in overvalued assets, often in the same asset class.

There are peripheral exposures to other areas including stocks, debt and commodities. The way Brevan Howard tends to work is that each portfolio manager is given a strict mandate and an amount of capital with which to trade.

Risk management is key to the firm, and so if a trader successfully generates good returns within their mandate and risk tolerances, over time they are allocated a greater amount of capital. Trades are typically leveraged (borrowing money from brokers to make a portion of the trade), and might typically generate proportionately high returns if the trade works out, though this approach can also exacerbate losses.

COMPONENT PARTS OF THE FUND

1. **MF Core** (32%): multi asset class, macro, systematic and relative value trading. Multiple portfolio managers.
2. **Brevan Howard Alpha Strategies** (32.5%): multiple portfolio managers fund. Relative value and directional strategies in developed and emerging fixed income and foreign exchange markets.
3. **Brevan Howard AS Macro** (9.4%): Single portfolio manager, relative value strategies in developed market interest rates.
4. **Brevan Howard FG Macro** (9.7%): Single portfolio manager-multi asset class macro trading.
5. **Brevan Howard MB Macro Master Fund** (9.7%): Single portfolio manager, macro/ relative value strategies in Asia-focused interest rate and foreign exchange market.
6. **Brevan Howard Global Volatility Master Fund** (6.7%). Thematic Fund, multi-asset class macro, systematic and relative value trading.

BALANCING RISK AND REWARD

Brevan Howard is looking for asymmetry between risk and reward – or in other words looking for situations where the potential for gain is greater than the potential for loss.

This is illustrated by a recent example. In late 2019, in light of slowing economic data, BH was positioned to benefit from potential interest rate cuts by the Federal Reserve. At this time the market was pricing almost no probability of a Fed cut in early 2020, so the trade had good risk/reward asymmetry.

As news about the Covid pandemic started to pick up, BH felt that this would increase the probability of Fed cuts although the market pricing at that time not responded. In March 2020, as the impact of the pandemic became clearer and the Fed enacted 150 basis points of emergency cuts, the fund made significant returns.

As the tables overleaf show, the track record of BH Macro is impressive when compared to both its hedge fund peer group but also versus the three main capital preservation trusts. This outstanding performance has been cited as a justification for its fee structure.

IS IT REASSURINGLY EXPENSIVE?

In August 2021 Stella Artois attempted to capitalise on the surge in consumer demand for trusted brands with the return of its 'Reassuringly Expensive' tagline.

At the beginning of 2021 Brevan Howard

BH Macro performance versus other investment trust hedge funds

Trust	One-year net asset value performance	Three-year net asset value performance	Five-year net asset value performance	10-year net asset value performance
BH Macro	**34.4%**	**54.0%**	**104.1%**	**185.5%**
Third Point Investors	−0.1%	29.4%	47.0%	175.5%
Highbridge Tactical Credit	−1.0%	24.8%	25.4%	55.1%
Boussard & Gavaudan	3.1%	18.7%	16.4%	88.6%
Gabelli Mercer Plus	12.7%	3.6%	6.0%	N/A
Alternative Liquidity Fund	0.3%	−44.8%	−78.2%	N/A

Table: Shares magazine • Source: CityWire, 24 August 2022

BH Macro versus capital preservation trusts

Trust	One-year share price total return	Three-year share price total return	Five-year share price total return	10-year share price total return
BH Macro	**23.8%**	**63.8%**	**128.9%**	**130.0%**
Personal Assets Trust	−1.7%	20.1%	28.7%	63.5%
Capital Gearing Trust	2.7%	22.1%	35.7%	72.8%
Ruffer Investment Company	4.9%	14.9%	19.9%	91.1%

The disparity in performance figures for BH Macro in the two tables is due to total share price measure in this table compared to NAV measure in the other.

Table: Shares magazine • Source: Association of Investment Companies 24 August 2022

demanded a doubling in its annual management charges and a return to performance fees, threatening to resign from managing the investment trust if this wasn't forthcoming.

The fund manager had lowered its fees after shares performed in a lacklustre fashion for several years. Fees were broadly halved by cuts in 2016 and 2017. The dramatic increase in fees was approved a shareholder vote in March 2021, demonstrating the appeal of its robust performance.

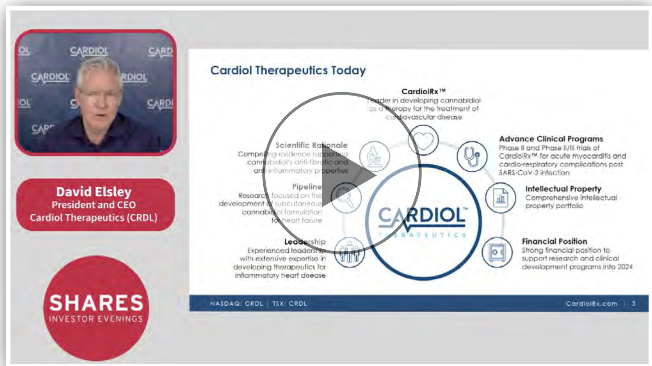
As a consequence the fund had an ongoing charge of 2.39% in 2021 according to the AIC – which added up to 3.06% once performance fees were included.

By **Mark Gardner** Senior Reporter

WATCH RECENT PRESENTATION WEBINARS

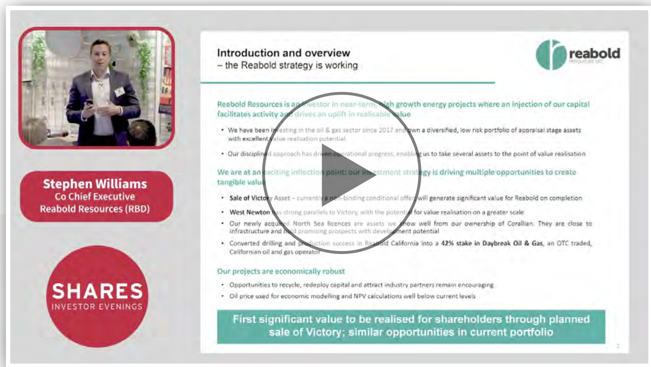
First Tin
Thomas Buenger, CEO

First Tin is led by a team of renowned specialists, First Tin is focused on becoming an ethical, reliable, and sustainable tin supplier in conflict-free, low political risk jurisdictions through the rapid development of high value, low capex tin assets in Germany and Australia. Tin is a critical metal, vital in any plan to decarbonise and electrify the world, yet Europe has very little supply.



Cardiol Therapeutics (CRDL)
David Elsley, President and CEO

Cardiol Therapeutics (NASDAQ: CRDL) (TSX: CRDL) is a clinical-stage life sciences company focused on the research and clinical development of cannabidiol as an anti-fibrotic and anti-inflammatory therapy for the treatment of cardiovascular disease.



Reabold Resources (LSE- RBD)
Sachin Oza, Co Chief Executive & Stephen Williams, Co Chief Executive

Reabold Resources (LSE- RBD) is an investment company in the natural resources sector. The principal activity of the company is an investment in pre-cash flow upstream oil and gas projects, primarily as significant minority interests in unlisted oil and gas companies or majority interests in unlisted oil and gas companies with non-operating positions on licenses.

Visit the Shares website for the latest company presentations, market commentary, fund manager interviews and explore our extensive video archive.

CLICK TO PLAY EACH VIDEO

SHARES SPOTLIGHT

www.sharesmagazine.co.uk/videos

DANNI HEWSON
AJ Bell Financial Analyst

Insightful commentary on market issues

The lessons from how past recessions affected stocks which can help now

Markets often price in downturns ahead of time but which shares perform best?

It is a well-worn line that 'time in the markets is better than timing the markets'. However true that is, it's hard not to wonder if there is more you can do to cushion your portfolio from the worst of what's coming down the line.

UK GDP vs FTSE All Share

rebased to 100

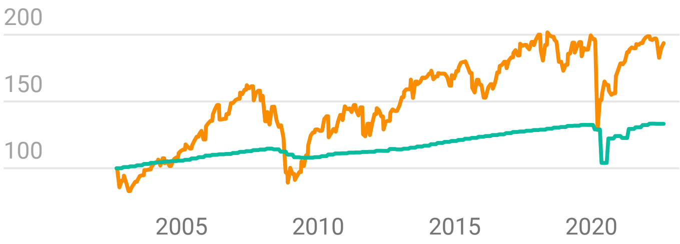


Chart: Shares magazine • Source: Refinitiv

Diversification is always smart but is there anything we can learn from past UK recessions to help you choose what to keep in your basket of investments, what to add and what to cut loose?

Recessions come in different shapes and sizes. The Bank of England is anticipating that the recession currently stalking the country will be long and shallow, more like that experienced in the 1990s or early 2000s than the short sharp shock that was the post-Covid recession. Though their forecasting skills have been questionable of late.

It takes two quarters of negative growth before a recession is technically signed off but market performance often flashes warning signs months before the backward-looking official data catches up.

Which stocks suffered the most as the UK economy began to shrink over the last two recessions, and which held up against the slowdown? Is there anything we can glean from

DANNI HEWSON
AJ Bell Financial Analyst

the data that might inform our choices as the UK faces its next downturn?

GREAT FINANCIAL CRISIS

Officially labelled on 23 January 2009, revisions show the economy actually begin to falter from April 2008. With the benefit of hindsight no one will be surprised to see house builders and construction companies like **Taylor Wimpey (TW.)** and **Howden Joinery (HWDN)** among those losing the most ground as lenders cut credit lines and Britain's property boom turned to bust.

Big pharma like **AstraZeneca (AZN)** and tech companies like **Micro Focus International (MCRO)** and online retailer **ASOS (ASC)** thrived, an interesting mix of growth and value stocks that mostly held onto their share price performance.

Once through to the other side it's clear there were opportunities for investors to make gains as the economy powered back up.

COVID CRASH

It was a similar picture in the run up to the 'Covid crash', though the 2020 recession was far, far deeper and far shorter than that seen in the wake of the financial crisis.

Top 10 best performers Q2 + Q3 2008		Post-recession performance Q3 + Q4 2009	Top 10 worst performers Q2 + Q3 2008		Post-recession performance Q3 + Q4 2009
Micro Focus International	50%	22%	Taylor Wimpey	−81%	16%
ASOS	41%	43%	Barratt Developments	−75%	28%
Drax Group	40%	−5%	Howden Joinery Group	−67%	110%
Telecom plus	31%	4%	Assura	−65%	0%
AstraZeneca	30%	9%	Redde Northgate	−64%	2%
Cranswick	27%	38%	Smurfit Kappa	−60%	70%
Admiral Group	26%	37%	Ferrexpo	−56%	48%
Oxford Instruments	24%	42%	Morgan Sindall	−55%	−13%
GSK	14%	23%	Moneysupermarket.com	−55%	51%
NCC Group	13%	20%	C&C Group	−54%	31%

Table: Shares magazine • Source: Sharepad

DANNI HEWSON
AJ Bell Financial Analyst

Insightful commentary on market issues

The special circumstances of this downturn means it is probably harder to draw conclusions for future recessions – with many of the top performers companies which enjoyed a direct benefit from lockdown restrictions and vice versa.

Most stocks enjoyed a post-recession surge whether they'd tumbled or not. Every downturn is different and the factors behind them can vary significantly but what can be relied on is every recession is followed by recovery and when sentiment flips markets can enjoy very strong gains leaving those who aren't invested for dust.

Top 10 best performers Q1 + Q2 2020		Post-recession performance Q3 + Q4 2020	Top 10 worst performers Q1 + Q2 2020		Post-recession performance Q3 + Q4 2020
Indivior	113%	31%	Hammerson	-74%	-32%
Premier Foods	85%	43%	Carnival	-73%	39%
CMC Markets	82%	46%	Aston Martin Lagonda	-70%	103%
Ocado Group	59%	13%	International Consolidated Airlines	-64%	8%
Plus500	49%	10%	Elementis	-64%	79%
Centamin	44%	-33%	Investec	-64%	16%
Scottish Mortgage Investment Trust	42%	48%	Provident Financial	-62%	74%
Allianz Technology Trust	37%	32%	SSP Group	-60%	29%
BH Macro	35%	2%	National Express	-60%	27%
Edinburgh Worldwide Investment Trust	32%	42%	TUI	-60%	20%

Table: Shares magazine • Source: Sharepad

Which is better as a retirement investment: property or a pension?

The key points to consider if you're planning for the future

The property market has been in boom times ever since the end of the financial crisis. A chronic housing shortage, ultra-low interest rates and government stimulus schemes have all helped to deliver exceptional returns from bricks and mortar in the last 10 to 15 years.

The average house price has risen from £168,400 in 2012 to £283,500 today, according to ONS data. That's a handsome return of just over 5% a year, before even accounting for any income generated.

The thriving property market has clearly led some savers to turn to buy-to-let to help fund their retirement, but the immediate future for house prices is not looking quite so rosy, with interest rates on the rise and recession in the post.

Nevertheless, it's hard to make a case that prices won't rise over a reasonable time frame, given there is a chronic shortage of housing in the UK.

How that compares with other investment options is difficult to forecast, but over the last 10 years, the global stock market, as measured by the MSCI World index in pounds and pence, has risen by more than 10% a year since. That's double the price appreciation of the average UK property.

The stock market is more volatile and will tend to fall further and faster in times of stress, but it will often outperform property. However, the returns from housing versus other assets is just the tip of the iceberg in terms of what property investors need to consider.

THE RISKS AND RETURNS OF LEVERAGE

Many property investors choose to boost returns by borrowing money from the bank to fund their purchase. This can amplify profits, because the debt stays level while house prices typically increase, and the rental income generally covers interest payments.

But this dynamic works in reverse if property prices fall. Your debt doesn't shrink, even though the asset you own has fallen in value.

Looking at historical data, a 20% drop in property prices is possible in housing market busts. If you're able to hold on for the long term, prices will almost certainly recover.

But another risk from mortgage borrowing is that interest rates rise, and your payments become unaffordable, or perhaps more likely, uneconomical. The extremely low interest rates we have seen for the last decade mean the rental received by buy-to-let borrowers has in most cases exceeded the interest paid on their borrowing. As interest rates rise though, that financial equation might not look so benign.

THE HIGH COSTS OF HOLDING PROPERTY

There are other punitive costs which need to be met, whether you have borrowed to invest in a property, or made a cash purchase. Legal fees, survey costs and stamp duty all take their toll on returns. Buy-to-let investors also face a 3% surcharge on top of normal rates of stamp duty, adding insult to injury.

There are ongoing maintenance costs, letting fees, landlord insurance and void periods to consider, which will also make a substantial dent in rental income, before factoring in any mortgage interest.

Looking at the rise in property prices and rental yields makes no allowance for all these costs, so it's not an entirely fair reflection of the returns that have been harvested.

The stock market compares very favourably in terms of costs to property. You can buy a tracker fund for negligible transactions costs, and then typically pay less than 0.5% a year in fund and platform charges, so more of the returns feed through to your bottom line.

TAXING QUESTIONS

Income and capital gains tax are also important to consider when weighing up a property investment. Rental income is taxed at your marginal rate of income tax, though you can deduct costs associated with running the property. This used to include the interest paid on a buy-to-let mortgage, but recent rule changes mean you can now only claim basic rate relief on that interest.

Capital gains on property sales are taxed at 18% or 28% for basic or higher rate taxpayers respectively, eight percentage points more than other assets. Unlike shares and funds, a residential property can't be put inside a pension or ISA, which allow stock market investors to receive investment income and gains free of income and capital gains taxes.

You pay income tax on withdrawals from a pension, apart from 25% of its value, which you can take as a tax-free cash sum. However, you also

receive tax relief on the contributions you make to a pension, and normally you'll receive employer contributions too, making a pension an extremely effective way of building up a retirement pot.

The fact you can sell down bits of your pension, or ISA, also makes the income you receive more manageable in retirement. If you want to take a bit more in one year you can sell some of your investments and withdraw the proceeds. If you want to take a bit less in another year to minimise your tax liability, you can just leave investment income in the tax wrapper. When it comes to a property, you can't generally sell bits of it, or turn the rental income taps on and off.

Using property as part of your retirement plan can be a successful venture, but it's no walk in the park. For most people, using pensions and ISAs to save for retirement will be preferable in terms of returns, costs and tax, not to mention the hassle factor.

Nonetheless, the familiarity of bricks and mortar will no doubt mean buy-to-let property continues to be used for retirement income purposes. But even if you're keen on this approach, make sure you do your homework and dive in with your eyes wide open, accounting for all the risks, costs and taxes first. Otherwise, you're probably in for a few nasty shocks.

By **Laith Khalaf**
AJ Bell Head of Investment Analysis

INDEX

KEY ANNOUNCEMENTS OVER THE NEXT WEEK

Full-year results:

2 September: Ashmore, Time Finance.
5 September: Dechra Pharmaceuticals.
6 September: Accrol, Alumasc, NCC, PCI-PAL. **8 September:** Duke Royalty, Genus, Sylvania Platinum.

Half-year results:

6 September: Capricorn Energy, Gamma Communications, Headlam, Inspired, Lords Group Trading, Luceco, Michelmersh Brick, The Pebble Group, Quixant. **7 September:** Equals, Tissue Regenix. **8 September:** Arecor Therapeutics, Cairn Homes, Destiny Pharma, International Public Partnerships, M Winkworth, Melrose Resources, MPAC, Sourcebio International, Spire Healthcare, Vistry.

Trading updates

6 September: Luceco. **8 September:** Safestore.

WHO WE ARE

EDITOR: Daniel Coatsworth @Dan_Coatsworth

DEPUTY EDITOR: Tom Sieber @SharesMagTom

NEWS EDITOR: Steven Frazer @SharesMagSteve

FUNDS AND INVESTMENT TRUSTS EDITOR: James Crux @SharesMagJames

EDUCATION EDITOR Martin Gamble @Chilligg

SENIOR REPORTER: Mark Gardner

CONTRIBUTORS Danni Hewson, Laith Khalaf, Russ Mould, Tom Selby, Laura Suter

COMPANIES EDITOR Ian Conway @SharesMagIan

ADVERTISING
Senior Sales Executive
Nick Frankland
020 7378 4592
nick.frankland@sharesmagazine.co.uk

PRODUCTION
Head of Design: Darren Rapley
Designers: Rebecca Bodi, Kevin Sharpe

CONTACT US:
support@sharesmagazine.co.uk

Website: sharesmagazine.co.uk
Twitter: @sharesmag

Shares magazine is published weekly every Thursday (50 times per year) by AJ Bell Media Limited, 49 Southwark Bridge Road, London, SE1 9HH.
Company Registration No: 3733852.