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VOL 24 / ISSUE 37 / 22 SEPTEMBER 2022 / £4.49

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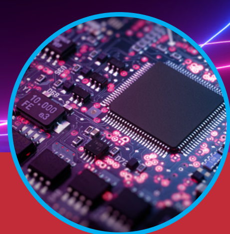
THINGS INVESTORS NEED TO KNOW NOW

The key issues that could move markets

FEATURE Which tech stocks are left on the UK market after takeover spree?



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This is how investors might deal with stagflation

It's worth looking back to see which assets did well or struggled when inflation was high and economic growth low

For months investors have feared a period of stagflation and the latest round of inflation figures would suggest this fear is closer to becoming a reality. Stagflation is characterised as high inflation and low or no economic growth. Investors would be wise to look back at previous periods of stagflation to spot the winners and losers.

World Bank chief economist Indermit Gill last week told *Reuters*: 'Six months ago we were really concerned about a slowing recovery and very high prices of some commodities, and now I think we are much more concerned about a generalised stagflation, which brings back really bad memories of the mid-1970s and the lost decades.'

The 1970s were characterised by an energy crisis, corporates hurt by higher costs and lower demand, and increased unemployment. Strikes were prevalent as workers felt hard done by. Sounds familiar? Many of these elements are motion today.

Back then, some of the best places to have made money were shares in energy companies and real estate owners. Gold was also a strong performer, yet this year the precious metal has not lived up to expectations. Last week gold fell to $1,654 per ounce, its lowest level in more than two years.

One argument is that gold is suffering because of growing competition from higher-yielding investments. For example, central banks are pushing up interest rates which lifts yields on bonds and returns on cash are improving. However, historically gold has not always fallen when interest rates go up.

Equity markets have struggled this year and that's directly linked to rates going up and a gloomier economic outlook. Investment bank Berenberg says bull markets need support from strong corporate earnings or liquidity, or preferably both. Neither are currently in play. 'Tighter money and earnings downgrades suggest extending headwinds will continue in the coming months,' it comments.

Being more cautious in the current environment might be wise and companies with defensive elements – i.e. their goods and services are in demand regardless of the economic environment – are natural places to look.

There are plenty of these types of companies on the UK stock market, which goes some way to explaining why the FTSE 100 has been the third best performing stock market index in the world year to date with 'only' a 2% loss, also helped by having lots of commodity producers benefiting from higher prices.

The best performing major index this year is Brazil's Bovespa (+4.9%) followed by Mumbai's S&P BSE 100 (+2.4%), whereas the S&P 500 index in the US is down nearly 19%.

The financial sector theoretically benefits from rising interest rates, yet investors need to balance potential rewards with the risks. Against the opportunity to make bigger margins and generally being well capitalised, banks risk a rise in bad debts during weaker economic periods.

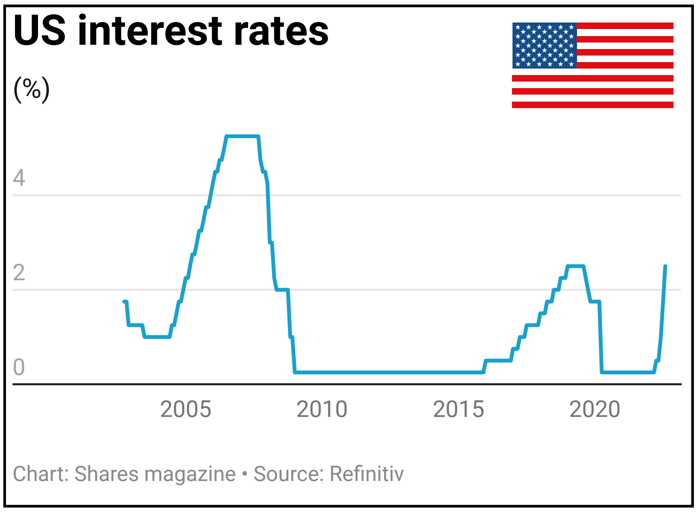
There are a lot of factors which could move markets, so it pays to stay on top of the moving parts. This [news story] and [this feature] provide more details on the key issues that matter.

Warning signals are mounting for markets as investors take fright

There have been an increasing number of negative developments in recent weeks suggesting an abrupt change to the economic outlook

During the summer months it seemed like markets were playing a game of chicken with the US Federal Reserve, viewing any sign of weak economic news as 'good' in the hope it may convince the central bank to pause or even reverse its policy tightening.

But the Fed has been resolute in its message and actions. Its focus is on price stability and until it sees evidence of prices coming down meaningfully it will keep raising rates. August's stickier than expected US consumer price inflation signaled more rate hikes are on the cards.



Research by the IMF (International Monetary Fund) shows that persistently high inflation can trigger an upward spiral in wages. This is a risk the Fed seemingly wants to avoid at all costs.

While the US central bank doesn't want a pronounced downturn, it is walking a tight line between slowing inflation and pushing the world's largest economy into outright recession.

Meanwhile other central banks have been singing from the same hymn sheet. The Swedish Riksbank surprised markets after hiking interest rates by a full percentage point (20 September) and warned more was to come.

Both the Bank of England and the European Central Bank are expected to continue increasing interest rates.

For the first time in decades it feels like central banks do not have investors' backs. Effectively investors are looking at a regime change for interest rates after decades of falling borrowing costs.

The question is can the global economy handle higher borrowing costs on top of rising inflation and slower growth?

PROFIT WARNINGS ON THE RISE

There is increasing evidence that higher interest rates are staring to bite after numerous companies issued profit warnings in recent weeks.

One of the most significant warnings has come from transport and logistics company **FedEx (FDX:NYSE)**. The firm is seen as a bellwether, giving advanced warning on the health of the global economy.

The company missed first quarter earnings estimates to the end of August by 33% and cut 2023 guidance.

Management laid the blame on slowing demand across the globe, creating a huge downdraft in its shares which fell 22% on the news, denting sentiment across markets.

What caught the attention was the suddenness of the slowdown. CEO Raj Subramaniam said: 'Global volumes declined as macro-economic trends significantly worsened later in the quarter, both internationally and in the US.'

The drop in FedEx had a knock-on effect across the sector with the shares of **UPS (UPS:NYSE)**, **Royal Mail (RMG)**, and **Deutsche Post (DPH:XETRA)** all registering weakness.

A related sector theme which seems to be becoming a notable trend is the slowdown in e-commerce activity. German warehouse equipment maker **Kion (KGX:XETRA)** warned (14 Sep) on third-quarter profits after citing supply chain shortages and a sharp increase in raw material and energy prices.

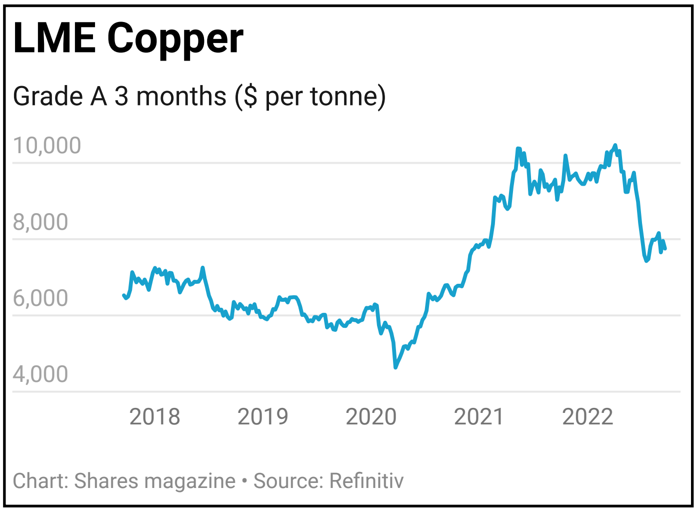
The company now expects adjusted net income to be in the range of €200 million to €310 million, well below the €674 million expected by analysts. Significantly higher material, energy and logistics costs combined with weaker demand also led peer robotics company **Autostore (AUTO:OSLO)** to issue a profit warning (14 Sep).

Shares in the Norwegian company fell 12% to new all-time lows after saying it experienced cancellations from some e-commerce clients. The weakness in robotics players servicing e-commerce has clear implications for UK online retailer **Ocado (OCDO)**. The shares fell 8% (14 September) after Credit Suisse downgraded the stock to underperform from neutral.

This followed a fall of 15% after its joint venture with **Marks and Spencer (MKS)**, Ocado Retail, lowered full year guidance. The company said a combination of cost headwinds and customers trading down is impacting margins.

COMMODITY WEAKNESS

Another bellwether providing insight into the state of the global economy is the price of copper, which is why it is often referred to as Dr Copper.



Demand for copper is closely related to the strength of the world economy and recent price action is potentially worrying. After peaking in March, the price has dropped by around 30% while mining shares have also weakened.

THREAT POSED BY QUANTITATIVE TIGHTENING

The Fed started to shrink the size of its nearly $9 trillion balance sheet on 1 June by $45 billion per month. Since the start of September, it has increased to $90 billion per month.

This is known as QT (quantitative tightening) and as the name suggests it is intended to tighten financial market conditions. It is a reversal of quantitative easing where the Fed purchased assets from banks to increase banking sector liquidity.

While the precise effect of QT is unknown, (the Fed doesn't provide guidance) it is generally thought to be equivalent to hiking rates. [MGam]

Why sentiment towards Netflix shares is starting to improve

Various analysts become more optimistic ahead of cheaper subscription tier launch and password sharing crackdown

Shares in TV and film streaming platform **Netflix (NFLX:NASDAQ)** are down 60% year-to-date amid a subscriber exodus and fears the streaming market is becoming oversaturated. However, sentiment towards Netflix is starting to improve after various analysts upgraded their ratings on the shares.

Netflix's new advertising-supported cheaper subscriber tier, combined with efforts to clamp down on password sharing, represent 'catalysts that can drive a material re-acceleration in revenue growth' according to Evercore ISI analyst Mark Mahaney, who has upgraded his rating on the stock from 'in-line' to 'outperform'.

With the planned launch of the advertising tier later this year, 'there is a clear catalyst on the horizon, and valuation is intrinsically attractive,' argues the analyst. Meanwhile, JPMorgan sees investor sentiment towards Netflix picking up, and Macquarie and Oppenheimer have also upgraded their ratings on the stock.

Netflix is embracing advertising after struggling to hold on to the supernormal subscriber gains generated during the lockdowns necessitated by the Covid pandemic.

The *Wall Street Journal* recently reported that Netflix projects the cheaper, advertising-supported tier could reach about 40 million viewers by the third quarter of 2023. This new subscription package will suit consumers struggling to pay for standard Netflix subscriptions as the cost of living soars around the globe. [JC]

What Mike Ashley's exit from Frasers board means for its future direction

Son-in-law already in place as CEO and he may look to take the retailer further upmarket

Four decades since starting his retail empire with a single sports shop in Maidenhead, Mike Ashley has announced plans to step down from Sports Direct owner **Frasers' (FRAS)** board.

While Ashley stepped down as CEO in May this year to become executive director, to all intents and purposes he was still seen as the man leading the way. Shares in Frasers slipped 1.6% on the latest news as the market largely took the development in its stride.

This could reflect the fact that Ashley will remain a key advisor, the major shareholder and current CEO Michael Murray is Ashley's son-in-law.

Murray's previous role as 'head of elevation' suggests he may take the group more upmarket, but this is a comparatively untested strategy compared with Ashley's previous focus on value.

It also might prove a challenge given an extremely weak backdrop for the retail sector amid tumbling consumer confidence and big pressure on household budgets.

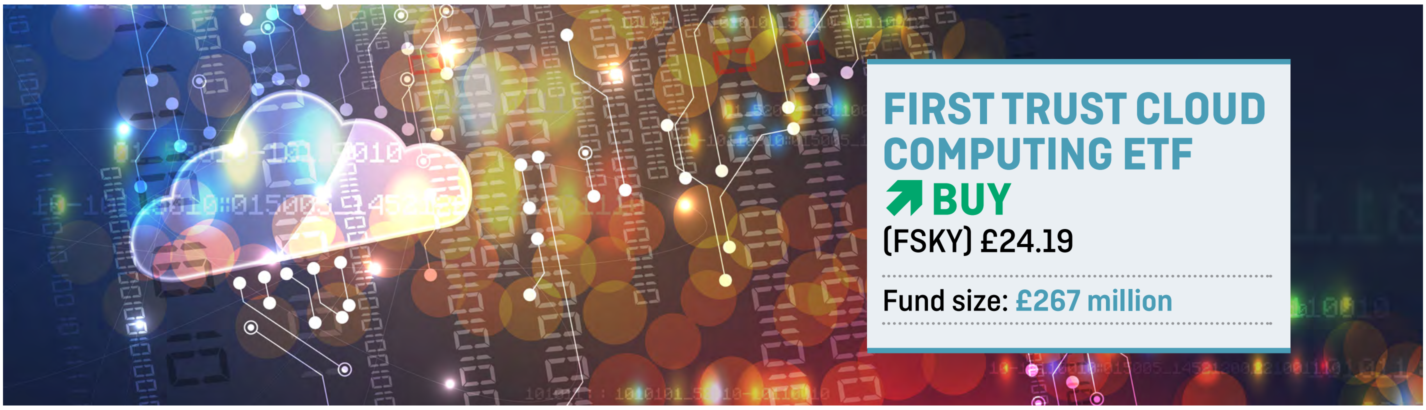
Fraser's record results for the 12 months to 24 April 2022 announced in July could be a hard act to follow, with guidance for pre-tax profit in the current financial year of £450 million to £500 million looking demanding.

Murray is also likely to pursue a less combative approach with the investment community than Ashley. [TS]

Cloud computing is a megatrend investors need in their portfolios

HIGHER RISK ETF

First Trust Cloud Computing ETF might have struggled this year, but longer term looks attractive



FIRST TRUST CLOUD COMPUTING ETF
BUY
(FSKY) £24.19

Fund size: £267 million

The emergence of cloud computing has been one of the most successful investment themes over the past decade, and it promises to create wealth for investors long into the future.

That's why we believe **First Trust Cloud Computing ETF (FSKY)** is not just a play for the next few years, as we (hopefully) recover from economic hardship, but for the next decade at least.

It's a simple, low cost way to get exposure to the key companies providing cloud computing services.

WHAT IS CLOUD COMPUTING?

Cloud computing involves the delivery of computing services such as servers, storage and databases over the internet ('the cloud'). Businesses around the world are adopting this method of working, which means big earnings growth for the companies providing cloud services.

Look at the top S&P 500 companies and you'll find it littered with businesses that are deeply embedded in cloud computing, helping drive the astonishing success of **Alphabet (GOOG:NASDAQ)**, **Amazon (AMZN:NASDAQ)** and **Microsoft (MSFT:NASDAQ)**, among others.

Apple's (AAPL: NASDAQ) gradual shift from hardware to software services and apps is one of the major reasons why investors have rallied behind the story in recent years and throughout the Covid outbreak. That has earned the business a $2.48 trillion price tag, making it the world's most valuable listed business.

Tesla (TSLA:NASDAQ), essentially a car maker and energy company, updates all of its in-car software via the cloud, and collects mountains of valuable driver data this way.

EARLY IN THE ADOPTION JOURNEY

Investors should not think cloud computing is a bus already missed; this is a growth theme widely predicted to have decades of expansion.

For example, Fortune Business Insights forecasts global cloud revenues will top $760 billion by 2027. That's bigger than Belgium's GDP last year, based on World Bank figures, or nearly twice the size of Denmark's.

This stunning growth trajectory implies annual average compound growth of 18.6% a year between 2020 and 2027, according to the Cloud Computing Market Size report put together by Fortune. The study estimated global cloud revenues were approximately $199 billion in 2019.

Yet as the eye-popping forecasts indicate, there is a lot more to come, say experts. 'Cloud is as hot

Worldwide cloud market share

	%
Amazon AWS	33%
Microsoft Azure	18%
Google Cloud	9%
Alibaba Cloud	6%
IBM Cloud	5%
Salesforce	3%
Tencent Cloud	2%
Oracle Cloud	2%

Table: Shares magazine • Source: Synergy Research, Statista, June 2020

a topic as ever, but the move by companies onto the cloud, in our view, is only the beginning of the digital revolution,' says Indraneel Arampatta, an analyst at technology website Megabuyte.

The Covid pandemic, various lockdown measures and the swathe of organisations that had been forced to work from home have simply accelerated a shift that was already happening.

Working from home naturally leans heavily on the cloud, with professional-level communications, including text, video and voice calls, needed as well as remote access to critical applications and super-fast mobile and broadband networks.

In a (largely) post-pandemic world, it has become clear that the cloud has touched massive swathes of our economy and society, with many of the changes to our day-to-day lives here to stay, from how we use financial services and order shopping to keeping in touch with people or consume entertainment. For example, **Netflix (NFLX:NASDAQ)** simply couldn't exist without the cloud.

FIRST TRUST ETF OPTION

The First Trust Cloud Computing ETF is one of the larger funds for this theme available to UK investors. It charges 0.6% a year and it takes stakes in each of its benchmark ISE CTA Cloud Computing Index stocks to mirror the performance.

Its investable universe, initially filtered for minimum market cap and free float limitations, is broken down into three buckets: pure plays, non-pure plays and broad technology conglomerates. This offers investors access to both the known and unknown names associated with cloud computing.

The portfolio applies a score to the different areas of the cloud universe – software-as-a-service, platform-as-a-service and infrastructure-as-a-service pure play firms. The ETF rebalances the portfolio quarterly, while it embraces less mature, smaller companies where others might stick to larger cloud plays.

For example, the average sales growth of companies in the First Trust Cloud Computing ETF is roughly four times that of the S&P 500. This means few of its fastest-growing investee companies feature in the S&P 500 at all.

Like many tech-related funds, performance has struggled this year as investors became worried about inflation and how high interest rates might go. This impacts how the market treats investments where future cash flows are likely to be much higher than they are today.

We can't rule out that performance will struggle for longer than we anticipate, although performance data seems to suggest good growth potential over a multi-year cycle.

The ETF's share price is down 25.5% this year, holding up marginally better than the Nasdaq Composite (down 27.1%). But the three-year gain of 23.9% is perhaps a better illustration through good years and bad. Since inception in December 2018, the ETF has increased by 44.3% in value. [SF]

First Trust Cloud Computing ETF

Chart: Shares magazine • Source: Refinitiv

This trust benefits from the race for businesses to be more energy efficient

SDCL Energy Efficiency Income Trust is in the right place at the right time

SDCL ENERGY EFFICIENCY INCOME TRUST

BUY

(SEIT) 114p

Market Cap: £1.27 billion

Companies are under pressure to cut costs, which means energy saving measures are a priority discussion in the boardroom.

One of the quickest and easiest ways to reduce energy usage and carbon emissions is to be more efficient in the way energy is used in the first place.

While building new nuclear power stations and wind farms may help to limit global warming, building them takes many years and the payback must be measured in decades whereas saving energy today has an immediate impact.

The global market for energy efficiency is worth an estimated $300 billion per year, and **SDCL Energy Efficiency Income Trust (SEIT)** focuses on reducing energy costs, usage and wastage in buildings, which represent around 40% of total consumption.

Supplying energy directly to buildings at the point of use rather than from the grid reduces costs and wastage which occurs through transmission and improves energy security.

As well as investing in projects which provide cheap, clean, reliable onsite energy by installing solutions like cogeneration plants and solar arrays, SDCL Energy Efficiency invests in projects to reduce energy demand inside buildings through the installation of LED lighting, low-energy heating and ventilation systems and better insulation.

LED lighting is one way for firms to save money, yet many organisations have yet to make the switch. The NHS, for example, is still using old-fashioned lights across three quarters of its estate.

'Energy efficiency has never been more valuable, it's about getting the same level of output using less energy,' says SDCL Energy Efficiency's investment manager Jonathan Maxwell.

Demand for efficiency solutions had been increasing as decarbonisation became a priority for governments and companies and fossil fuel prices started to rise, but the invasion of Ukraine in March was 'a watershed moment' for the industry says Maxwell.

'Energy prices have soared, and the structure of the UK and the European energy market has been challenged, so what was previously attractive has now become incredibly important given the high price environment,' he adds.

Moreover, the invasion of Ukraine has been a wake-up call in terms of European energy security, driving more companies to look at installing onsite generation to become more resilient, which in turn is 'a huge opportunity' for SDCL Energy Efficiency.

In terms of income, the trust is targeting 6p in dividends for the year to March 2023, a 7% annual increase, which translates into a 5.3% yield. The ongoing charge is 1% and the shares trade on a 5.2% premium to net asset value. [IC]

Disclaimer: The author owns shares in SDCL Energy Efficiency Income Trust.

SDCL Energy Efficiency Income Trust

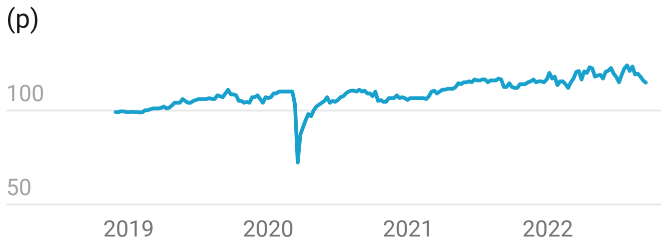


Chart: Shares magazine • Source: FE Analytics

AJOT
AVI Japan Opportunity Trust

Finding Compelling Opportunities in Japan

Asset Value Investors (AVI) has been finding compelling opportunities in Japan for over two decades. In 2018, AVI launched the c. £159m* AVI Japan Opportunity Trust (AJOT). Key to the strategy is to build relationships with company management actively working together to improve shareholder value. The depth of the investment team allows for ample resources to undertake deep and targeted engagements in a concentrated portfolio of 20-25 stocks.

Discovering overlooked and under researched investment opportunities requires a long-term approach. A five-year time horizon aligns the investment strategy with the interests of the management of the companies which enables us to unlock long-term value.

The companies we invest in have cash on their balance sheets and sound business models with either stable earnings or structural growth trends to ensure the corporate value is growing year-on-year. They include a variety of sectors, with strong exposure to the domestic Japanese economy.

AVI will propose shareholder resolutions when required but aims to find mutually beneficial solutions behind closed doors with the company management team. The strategy's first three years bears witness to the success of this approach with a strong NAV total return. Our aim is to be a constructive, stable partner and to bring our expertise – garnered over three decades of investing in asset-backed companies – for the benefit of all.

Discover AJOT at www.ajot.co.uk

*Net assets as at 31 March 2022

AVI
Asset Value Investors

THINGS INVESTORS NEED TO KNOW NOW

The key issues that could move markets

By **The Shares Team**

The considerable amount of noise in the markets means investors may struggle to get a grip on the different factors which might influence share prices in the near-term.

To help you better understand the key issues, we've rounded up six areas which could have a significant impact on markets for the rest of the year and into 2023.

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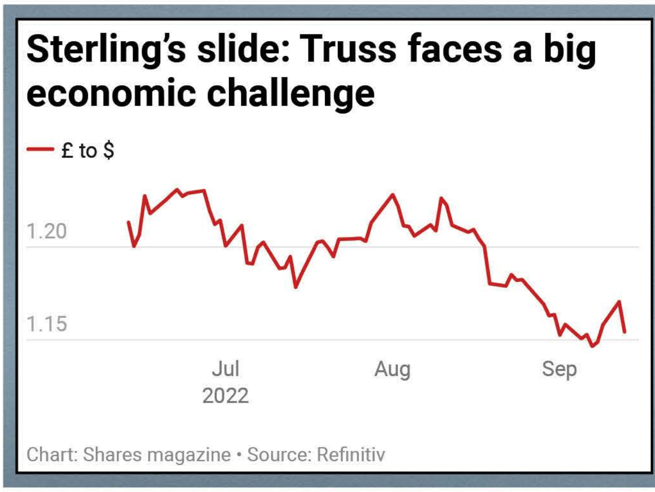
WHAT NEW PRIME MINISTER LIZ TRUSS MEANS FOR UK STOCKS AND STERLING



The tenure of Liz Truss in Number 10 started with a solution to the energy crisis. Businesses and consumers had been starved of certainty for weeks as the Conservative leadership crisis rumbled on, so immediate action was necessary when she took over from Boris Johnson.

Unfortunately, any further policy moves were then put on hiatus by a period of mourning after the death of Queen Elizabeth II.

News of an energy price freeze and support for businesses ahead of this momentous event was very welcome – even if reportedly companies might have wait until November to take advantage of the £150 billion support scheme.

The measures announced, including capping average household energy prices at £2,500, could take as much as 5% off peak levels of inflation according to the Centre for Economics and Business Research.

The key winner in sector terms so far is energy. Truss stuck to her guns on no additional windfall taxes to fund her energy package and announced plans to release more licences in the North Sea and withdraw the moratorium on fracking for shale gas.

Renewable energy producers could also breathe a sigh of relief on a windfall tax, though they still face a nervous wait to see if, as has been widely speculated, they might have to accept long-term contracts at fixed prices below current market levels.

A goal of being a low-tax economy fits with the new prime minister's apparent commitment to 'Laffer curve' economics – which works on the hypothesis that cutting taxes encourages growth and therefore increases total tax revenue.

Truss' decision not to wage an additional levy on the energy space has implications for sterling, particularly given her commitment to tax cuts. This is likely to result in a significant increase in government borrowing.

Another area to watch closely is the new Government's commitment to the independence of the Bank of England. Any hint there might be political interference in the central bank's decision making would be taken negatively on the currency markets.

Head of UK equities at Lazard Asset Management Alan Custis commented: 'The new Government faces significant economic challenges and it must act quickly to address them. It must demonstrate financial responsibility to prevent sterling continuing to slide and can do this by maintaining the independence of the Bank of England. Otherwise interest rates risk becoming once again a political tool.'

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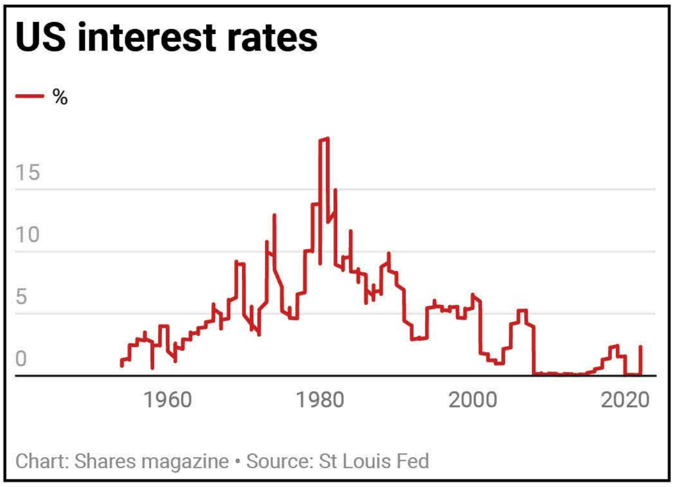
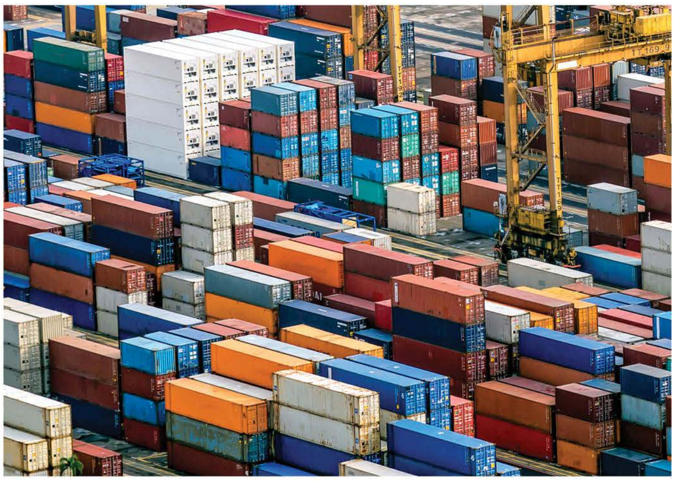
HOW HIGH MIGHT INTEREST RATES RISE IN THE US AND UK?





The prevalent investment narrative over the summer was that hawkish US central bank policy was a price worth paying to bring inflation down, despite the risk it would cause a recession.

Investors recognised the Federal Reserve had to regain the initiative and talk tough on rates. But there was a heated debate about how far the central bank would go amid signs of slowing economic growth.

That narrative was all but abandoned on 13 September with the release of August's US consumer price inflation data.

While year-on-year headline inflation cooled to 8.3%, it didn't slow as fast as expected while the Fed's preferred 'core' measure increased by 0.6% month-on-month, double the market forecast.

US stock markets registered their biggest one-day drop since the start of the pandemic. Meanwhile, US Treasury yields moved higher (and prices lower) with two-year yields moving above 3.8%, levels not seen since 2007.

The front end of the yield curve (short-dated bonds) jumped more than the long end, increasing the two-year/10-year yield inversion.

When two-year yields are above 10-year yields the curve is described as inverted which signals a heightened risk of recession.

Implied inflation expectations derived from the pricing of fixed income markets had been falling despite hawkish comments from the Fed.

This might seem odd, but remember markets are forward looking and the Fed can therefore influence the bond markets by broadcasting its intentions.

Both two and 10-year bond yields had backed-off from the year's highs before the latest inflation print.

Either the bond market believes the Fed will hike aggressively and successfully bring inflation down, or it believes the Fed is making a policy error.

One strategist in the latter camp is Jonathan Golub at Credit Suisse who said in a *Bloomberg* interview that the Fed is at risk of tightening policy too aggressively.

Golub points to signals in the US Treasury market where the one-year breakeven inflation rate is trading below 2%.

The measure is based on the difference between nominal yields and inflation-protected yields for the same maturities.

Golub asked, 'Why would the Fed unnecessarily drive us into recession, kill several million American jobs if in fact inflation is heading in the right direction?'

The latest inflation data has thrown the cat among the pigeons and leaves investors questioning whether inflation can fall fast enough to prevent an even more aggressive policy response.

It is now widely believed the Fed will push up interest rates to at least 4% by the end of 2022, its highest level since 2005. The central bank was scheduled to have issued its latest rate decision and new economic projections as this edition of *Shares* was being finalised.

UK interest rates are also expected to keep rising given that inflation remains high. The Bank of England publishes its latest policy decision today (22 September) and the consensus forecast is for rates to move from 1.75% to 2.25%. Market experts believe the UK rate could hit 4% by May 2023.

These rate hikes have major implications for consumers and businesses, principally a higher cost of borrowing and therefore less money left over to spend. [MGam]

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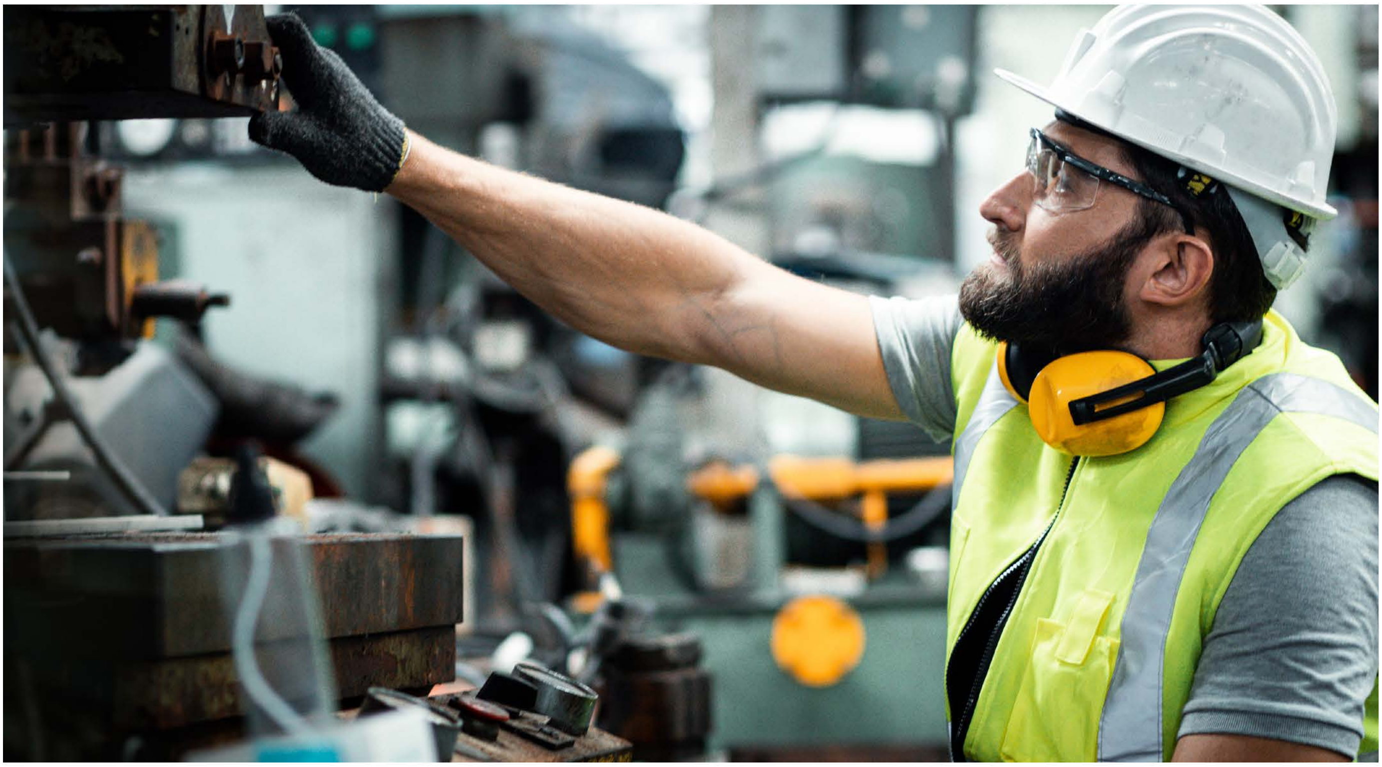
WHY ANALYSTS COULD BE TOO OPTIMISTIC ABOUT EARNINGS

Given a difficult macro-economic backdrop and the current squeeze on consumer spending, are analysts taking too sunny a view about earnings for both 2022 and 2023?

Morgan Stanley certainly appears to think so, arguing that consensus estimates for European earnings per share growth of 7% and 9% (stripping out the impact of the more volatile commodity sectors) are 'far too optimistic'.

According to US-based investment consultancy Yardeni Research, quoting figures from Refinitiv, average consensus earnings growth forecasts for constituents of the MSCI USA index stood at 8% for both 2022 and 2023 as of the beginning of September. And that's even after those forecasts had been trending down for several months.



Earnings forecasts for the US and Europe

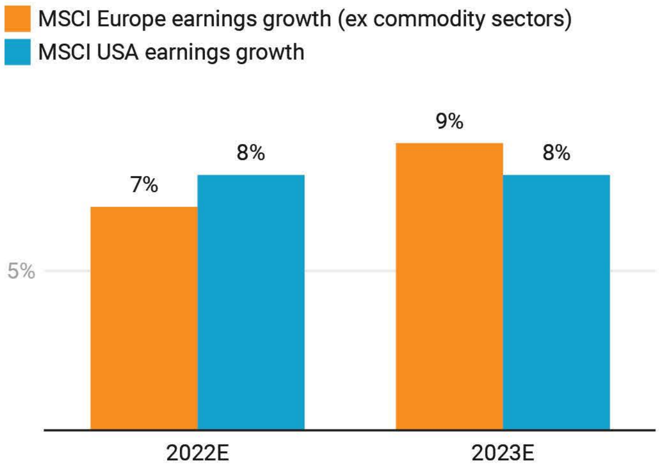


Chart: Shares magazine • Source: Europe earnings growth Morgan Stanley, 5 September 2022. USA earnings growth Yardeni Research, Refinitiv, 1 September 2022

As a very crude point of comparison the International Monetary Fund's latest forecast, published in July, anticipates GDP growth in advanced economies of just 2.5% and 1.4% for 2022 and 2023 respectively.

You can see why analysts might have been caught out by an extraordinary set of circumstances, not least the ongoing conflict in Ukraine and the wide variety of implications that has had, but also the Covid situation in China and the resulting impact on global supply chains. There are so many moving parts to consider that it would be difficult to keep up with all of them.

You can also understand why there is some healthy scepticism about such high levels of forecast growth. Though financial results to date, including the second quarter earnings season, have revealed a degree of corporate resilience, these are backward-looking and reflect only a part of the impact of the current inflationary pressures and slowing growth.

In terms of sectors which look particularly vulnerable, those with high levels of energy consumption may see the biggest pressure on profitability, such as engineering and construction.

A potential wildcard is the weather. While the mild start to autumn may be a blessing in terms of energy prices it could also have a negative impact on an already troubled retail sector, given the impact on sales of higher value items like heavy jackets and coats.

As Bank of America observed in a recent research note the weather has a real impact on results. As a point of comparison, it noted: 'The warm weather seen in the third quarter of 2018 brought a wave of profit warnings across the European apparel industry, and a steep increase in inventory.'

EUROPE UNDER SEVERE PRESSURE

Five commodity stocks account for 64% of European earnings upgrades in 2022

Contribution to year-to-date MSCI Europe index increase

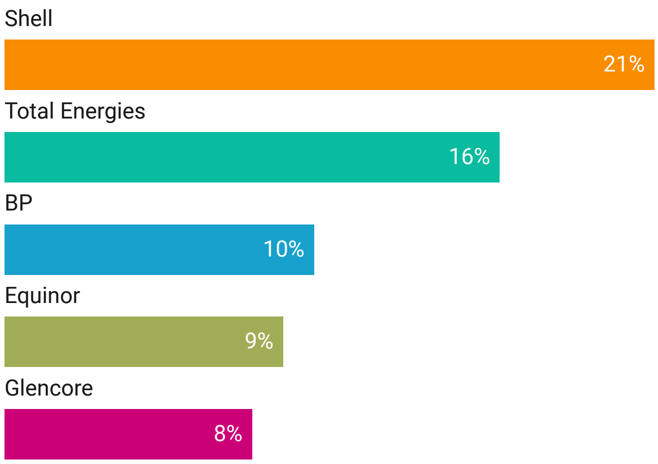


Chart: Shares magazine • Source: Morgan Stanley, 5 September 2022

Energy remains in focus across European equity markets as reports emerge that the Kremlin will continue to squeeze gas shipments across the Continent to maintain its pressure on the EU over the Ukraine conflict.

Radical times call for radical measures and European Commission president Ursula von der Leyen has a swoop on energy companies' profits in her sights and rationing measures to stem potential energy shortages. The EU has announced plans to cut gas consumption by 15% from August 2022 to March 2023.

Eurozone inflation accelerated to 9.1% in August, up from 8.9% in July, and topping market forecasts of 9%, preliminary estimates showed, with energy and food prices behind the rise.

'In the last couple of weeks alone, our economists have raised their forecasts for European Central Bank rate hikes and cut their GDP numbers to signal a deeper upcoming recession,' said Graham Secker, head of Morgan Stanley's European equity strategy team.

Last week (12 Sep), the ECB obliged, hiking rates by 75 basis points and several more rate rises are anticipated in the coming months, even if they are unlikely to be as large. 'This won't be the only rate hike and… there are several others coming,' confirmed ECB Governing Council member Edward Scicluna, governor of the Central Bank of Malta.

Naturally, this situation is heaping pressure on equity prices and after a brief rally in earlier in the summer, reality has reasserted itself over the past month with markets unable to escape a tricky macro backdrop characterised by central banks speeding up rate hikes into what is a deepening economic slowdown.

The Morningstar Europe NR index lost 5% in euro terms during August, but with a big difference across company styles, Morningstar said, with growth company shares suffering much more than value stocks. 'The large growth segment of our European style box lost 6.2% in euros, while the large value segment managed to limit the loss to 0.7%.'

The August report found losses from the likes of **ASML (ASML:AMS)** impacted heavily in the growth style's return, falling 12.5% in euro terms. In contrast, UK oil companies, for example, stood out among the value stocks. **BP (BP.)** and **Shell (SHEL)** gained 8.2% and 2.8% in euros respectively during August.

Data shows there has been a close relationship over the past 20 years between interest rates and equity valuations. When rates go up, price to earnings ratios on shares go down, so if we really are in the early stages of a rate rise cycle, look out for a further derating in shares.

'This suggests a high probability that PE ratios have further to fall,' said Morgan Stanley's Secker. His team expect the European economy to slow over the next couple of quarters. This will increase the pressure on corporate profits, which have been reasonably resilient so far this year, thanks to strong commodity sector upgrades and a material boost from the weakness we've seen in the euro and sterling trade.

'Our models are flagging large downside risks to consensus earnings estimates for the next 12 to 18 months and we are 16% below consensus by the end of 2023.'

This may seed the idea that defensive stocks over cyclicals are a better place for investors to hold their cash. It is quite possible that we will see a widening preference for sectors like healthcare, insurance, telecoms and utilities over automotive, capital goods, construction and retail.

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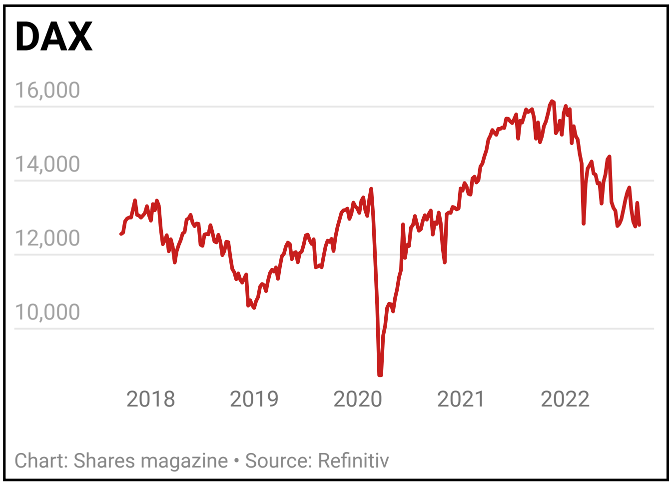
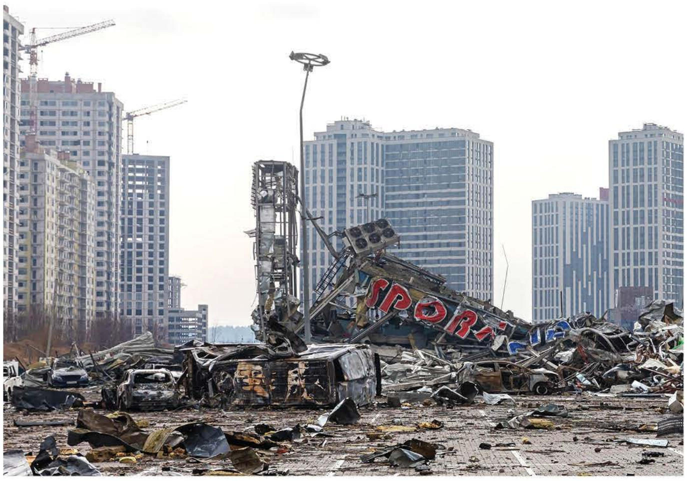
POTENTIAL MARKET IMPACT FROM UKRAINE CRISIS DE-ESCALATION





Ukraine's counter-offensive against Russia has changed the dynamic of the war and led some investment experts to speculate what might happen if we see a de-escalation of the crisis.

Since early September, Ukraine has taken back swathes of land and continues to put more pressure on Russia. While that has raised spirits that Ukraine will not be defeated, it also increases the risk Russia will fight back, such as doubling down on efforts to destroy vital infrastructure including power and heating systems. Indeed, a major dam in Ukraine was last week hit by missile strikes.

While still very early days, it is worth considering what might happen if the crisis became less severe and a ceasefire is declared. Investment bank Morgan Stanley says a de-escalation of the conflict would lead to a material rally in European equities – going some way to reversing the big losses seen this year, caused by the punishing impact of spiralling inflation and fears over recession.

In this situation, share prices would most likely be driven by stocks trading on higher earnings multiples, rather than material upgrades to earnings forecasts, says Morgan Stanley. It suggests trading Germany's DAX in the event of a crisis de-escalation, with the stock index likely to be reappraised by investors given it has already been beaten up so much.

'Germany has been the worst performing major country in Europe since the invasion started, posting its worst six-month relative underperformance in 20 years,' says the bank. 'From a top-down perspective, this underperformance seems justified given the domestic economy's heightened sensitivity to Russian gas flows plus the equity market's relatively high weighting to cyclicals.'

A lot of investors have placed bets that the DAX has further to fall, so good news on the Ukraine crisis could catch the market by surprise and a 'short squeeze' could amplify gains. Those betting the index will fall in value might be forced to buy the index to close out their positions if the DAX starts racing upwards, hence the term 'squeeze'.

One way to get exposure to this index is via **Lyxor DAX UCITS ETF (DAXX)**, an exchange-traded fund designed to mirror the performance of the DAX, priced in sterling. It has a 0.15% annual charge.

It is vital to understand that sentiment currently remains negative towards European equities and no-one knows when or if the Ukraine crisis will end, so buying the Lyxor ETF now is not a guaranteed way to make money.

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CAN CHINA BOUNCE BACK?

President Xi Jinping's zero-tolerance Covid policy and an overleveraged property sector are among the GDP downgrade drivers for China, where exports are providing less solace and the government is bringing tech companies under greater control.

Investment bank Nomura has trimmed its 2022 GDP forecast for the Middle Kingdom from 2.8% to 2.7%, while Ortec Finance says 62% of pension fund managers surveyed expect China to be in recession within 12 months.

Prospective investors must also weigh rising geopolitical tensions with Taiwan and the US, not helped by Nancy Pelosi's flying visit to the island.

Invesco's global market strategist Kristina Hooper points out China's latest Covid wave has led to greater stringency, yet so far the impact to economic activity 'seems much smaller than what we saw in the first half of the year as policymakers try to balance economic considerations along with virus control'.

While the risk of another downturn has risen, so have stimulus measures and Hooper anticipates more pro-growth policies could be announced as we get closer to the Party Congress in mid-October, 'and we expect that could lead to a Chinese stock market rally'.

Her optimism is shared by Dale Nicholls, manager of **Fidelity China Special Situations (FCSS)**, who believes we are 'likely to see less negative news in terms of additional regulation'.

Nicholls says he is also seeing increased messaging from senior government officials who are recognising the slowdown in the economy and implementing policies that are more focused on growth. He adds: 'It will be interesting to see the areas of the economy the Party will identify during the upcoming Congress. This is likely to translate into more fiscal and monetary easing, with additional focus on support to the property sector.'

The Fidelity money manager believes we are likely to see a continued divergence when it comes to monetary and fiscal policy in China relative to the rest of the world, particularly the US, which he reckons is likely to be positive for markets during this second half of the year.

Also arguing Chinese equities are poised for a rebound is Franklin Templeton's Michael Lai, who sees investor sentiment and valuations at 'unsustainable lows' and is positive on the relative case for the Chinese equity market's prospects moving into the latter part of 2022.

What went wrong with Naked Wines for the shares to lose 90%?

How the 'Netflix of wine' lost the plot in under a year

Last week saw shares in **Naked Wines (WINE:AIM)** slump 42% in a day to hit a 21-year intraday low of 84p.

Considering the stock traded close to 900p a couple of times last year thanks to the pandemic-driven surge in online consumption, this is a remarkable fall from grace.

Naked Wines

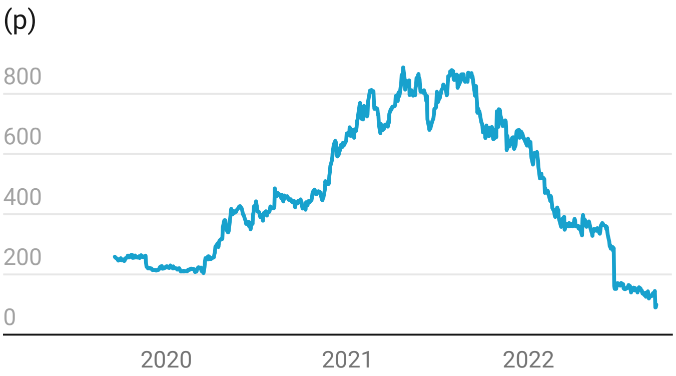


Chart: Shares magazine • Source: FE Analytics

So, what has happened to the business and why has its direct-to-consumer model fallen so far out of favour with investors?

At its peak, Naked Wines was one of the most-hyped stocks in the market and not just among UK investors.

Interviewed on *CNBC* last October, Glen Kacher, founder and chief investment officer of Light Street Capital, referred to the company as 'the Netflix of wine', sending the shares up more than 15% in a day.

Kacher, who bought a 9.9% stake in the business, called it 'the kind of opportunity you only find once every two or three years, where you can multiply your capital many times over the next five to 10 years'.

The company's chief executive Nick Devlin claimed at the time the addressable market in the US, the UK and Australia was around $25 billion to $30 billion, most of which was in the US.

Fast-forward to last week and the firm released an unscheduled trading update saying it was 'reviewing potential operational and financial plans for the next 18 months' in order to improve its profitability, rein in costs and improve its payback.

It also revealed it was 'in active discussions to address our credit facility to reflect any revised plan' but said it expected to have headroom to its second quarter covenant tests.

On the same day, non-executive director Pratham Ravi, who joined the firm on 25 August to represent 10% shareholder Punch Card Capital of the US (the second-biggest shareholder after Baillie Gifford with 13%), resigned after less than three weeks in the post.

Just a month before Ravi joined, the firm's chief financial officer resigned after Devlin warned investors there would be little to no sales growth this year and he was aiming for the business to break even at the operating level.

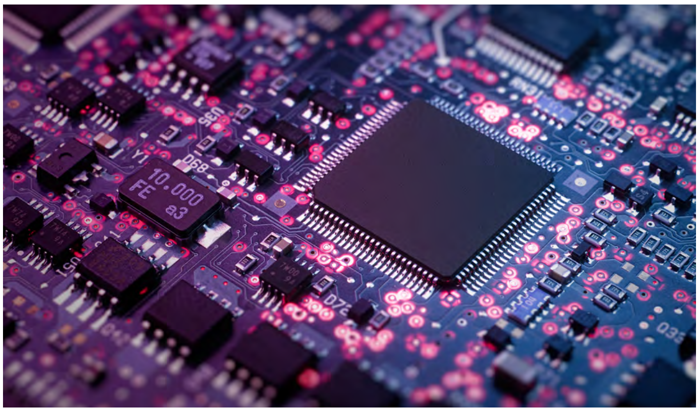
Liberum analyst Wayne Brown suggested last week's unexpected update 'could imply a smaller business in the future and reining in ambitions, which makes sense considering how poor key performance indicators are'.

However, 'the weak balance sheet, question marks around the covenants in Q1, liquidity and going concern issues and how the group will drive liquidity in Q2 suggest the trading update on 17 October could be rather negative,' he added.

The fact former CEO Rowan Gormley has been called back for a few months' advisory work would imply something strange is going on, suggesting that investors should brace themselves for some bad news. [IC]

What will be left of UK tech stocks after swathe of takeovers?

Larger companies are exiting the London market in numbers, but there remains a rich seam of opportunity among smaller firms



With engineering software company **Aveva (AVV)** poised to exit the stock market thanks to a takeover, it will mean losing the UK's largest 'tech' firm by market value, at £9.15 billion.

Aveva has been majority owned by French industrial group **Schneider Electric (SU:EPA)** since 2017 and this shareholder now wants the whole business.

That's a slightly different bid situation to most of the other tech takeovers we've seen this year and last. Investors have lost favour with growth stocks and the pound has fallen to a 37-year low versus the dollar, which has seen many high-quality UK technology businesses fall in value and left them exposed to overseas takeovers. And deals are coming thick and fast.

Identity data intelligence platform provider **GB Group (GBG:AIM)** is the latest UK technology company to catch the eye of potential buyers after Chicago-based private equity firm GTCR made a takeover approach.

If we include agreed buyouts for **Avast (AVST)**, **Micro Focus (MCRO)** and **EMIS (EMIS:AIM)**, the UK stock market stands to lose companies worth £21 billion that generated revenues of £5.35 billion in the last reported full year.

Private equity firm Thoma Bravo may have walked away from a deal to buy cybersecurity firm **Darktrace (DARK)**, but others might be lurking in the background, preparing alternative offers.

Investors interested in the exciting growth offered by many tech stocks should view takeovers as bad news. A bid may be pitched above the market price but losing these stocks from the market effectively robs investors of longer-term wealth creation opportunities.

TECH IN ALL SHAPES AND SIZES

Software and microchip companies are among the first places that investors associate with the tech space. Yet technology companies come in many shapes and sizes. The UK has a well-developed electronics sector, for example, with eight FTSE 350 constituents from the London Stock Exchange sector.

Technology manufacturers

	Market value £m
Halma	7,468
IMI	2,909
Spectris	2,906
Renishaw	2,543
Rotork	2,051
Spirent	1,613
Oxford Instruments	1,160
DiscoverIE	697
Morgan Advanced Materials	694
XP Power	373

Table: Shares magazine • Source: Sharepad, 16 September 2022

To many, these are manufacturing businesses, yet it is hard to argue that they are not tech companies too. For example, **Renishaw (RSW)** is a £2.55 billion world leader in metrology and spectroscopy. It owns hundreds if not thousands of industrial patents that make its equipment unique and best in class.

Oxford Instruments (OXIG) has hundreds of patents that protect its edge in scientific and healthcare kit and components. X-ray machines in hospitals and food safety checks, for example, would be virtually impossible without the £1.2 billion company's tools.

Tech consumers, or creators

Ascential	Media/events
Auction Technology	Online auction platform
Auto Trader	Motor advertising/sales
Baltic Classifieds	Online advertising
Bytes Technology	Software reseller/services
Computacenter	Software reseller/services
Darktrace	Cybersecurity
Kainos	Digital transformation
Moneysupermarket	Online finance portal
NCC	Cybersecurity
Sage	Enterprise software
Softcat	Software reseller/services

Table: Shares magazine • Source: Sharepad, 16 September 2022

Internet and mobile communications would be years behind were it not for the advanced testing solutions provided by £1.6 billion **Spirent (SPT)**. It works with governments, healthcare, defence, transport, retail companies and many of the world's largest telecoms suppliers.

TECH CONSUMERS OR CREATORS

According to Sharepad data, there are a dozen FTSE 350 software stocks including Belfast-based **Kainos (KNOS)**, the digital transformation specialist. In seven years, this Belfast University spin-out has seen its market value surge from £161 million to £1.7 billion, a 956% gain.

True tech investors would ignore **Auto Trader (AUTO)**, **Ascential (ASCL)**, **Baltic Classifieds (BCG)** and **Moneysupermarket (MONY)**, as they are not software companies at all, simply businesses that use technology.

Moonpig (MOON) used lots of tech buzzwords when it listed in February 2021. It called itself a 'platform', talked about its 'proprietary technology and apps' and said it leaned heavily on 'data science'.

Sounds all very tech-like yet what does it do? It prints bespoke greetings cards, the sort of thing a tech-savvy 12-year-old could do with Photoshop and a decent printer.

Moonpig was a good example of how the term 'tech' became a badge that many companies tried to wear in recent years. It became cooler to be about the internet of things than just things, but the recasting is seductive in more tangible ways. It implies faster growth, easy and cheap scalability, and better investment returns. That opens the door to pools of investment capital that might not otherwise be available, and can push stock valuations to extraordinary levels.

That's not to dismiss these companies. They each have their own investment pros and cons, but they aren't really tech.

SEPARATING THE UNIVERSE

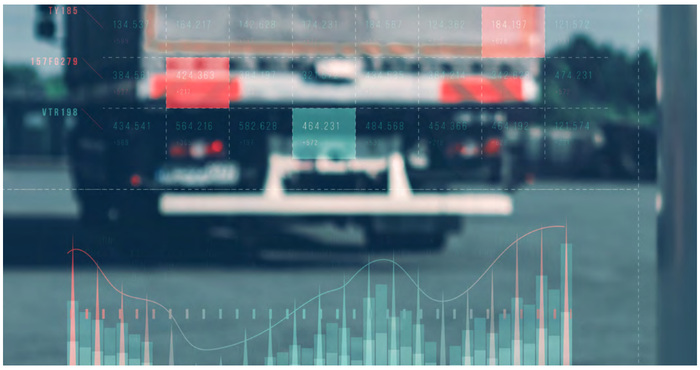
'At Blue Whale, we make a distinction between the users of tech and the creators of tech,' says Stephen Yiu, lead manager of the £825 million **LF Blue Whale Growth Fund (BD6PG78)**.

'We see lower barriers to entry for users of tech which decelerates growth as competition catch up. Creators of tech are better able to maintain their competitive edge and therefore enjoy sustainable growth for longer,' Yiu believes.

An even greater number of 'tech creators', as Yiu calls it, exist on AIM. Many investors still see the junior market as a collection of flaky firms without a penny of profit to their name, but that's not the case. In the AIM 100 index 18 tech companies have market valuations above £200 million, with meaningful revenues and, in most cases, gross profits.

As we mentioned earlier, GB and EMIS have enough about them to attract takeover interest, so there is clear interest in the wider markets for the potential of AIM-quoted businesses.

Companies such transport infrastructure and analytics software designer **Tracsis (TRCS:AIM)** should be relatively familiar names to *Shares* readers – it was one of our best-performing stock picks for 2021, up 57%.



Technology as a theme has fallen out of fashion this year, as has growth in more general terms, as high inflation and raising interest rates have impacted valuations.

Where investors may have been happy to pay 30 to 40 times earnings in the past for consistent 15% to 20% yearly growth, they're currently prepared to pay much less.

However, Covid has demonstrated that technology is a vital function in our daily lives, almost on a par with light and heat. Businesses across every sector, from fashion to finance and food to fabrication today rely on technology to run. This means that tech is unlikely to stay passé with investors forever.

AIM 100 index tech stocks

	Revenues £m	Gross Profits £m
Gamma Communications	482.5	228.5
Kape	619.0	214.7
GB	299.5	171.9
EMIS	176.9	152.0
CentralNic	621.6	118.5
FD Technologies	294.6	106.1
Accesso Technology	132.0	96.4
Boku	62.3	63.4
Thorpe FW	117.9	55.4
IDOX	69.9	45.1
Strix	129.1	43.8
Devolver Digital	135.2	39.2
Tracsis	698.0	34.8
TinyBuild	64.5	34.0
DotDigital	62.6	28.6
Learning Technologies	554.5	26.7
Big Technologies	47.3	26.7
Seeing Machines	54.8	20.8
IQE	165.0	17.6

Table: Shares magazine • Source: Sharepad, Yahoo Finance, 16 September 2022

DISCLAIMER: The author own units in Blue Whale Growth.

By **Steven Frazer** News Editor

New Investments Ready to Propel Autonomous Vehicle Technology Forward

Autonomous Vehicle (AV) technology has improved dramatically in recent years, supported by large investments from auto manufacturers and tech companies. Given how important expanding consumer acceptance is to AV adoption, safety is a reliable gauge of progress.

AV TECH ADVANCING, BUT MORE WORK REMAINS

An AV's ability to operate without human input depends on its level of sophistication, and can be thought of as a progression across five levels[1]:

LEVEL 1 (DRIVER ASSISTANCE) The driver controls most driving functions, but under certain conditions, the vehicle may be able to adjust cruise control speed or stay in a lane.

LEVEL 2 (PARTIAL AUTOMATION) The car can accelerate/decelerate on its own and perform basic steering functions. Driver is still responsible for directing navigation like exiting a highway, changing lanes, or turning on a new street.

LEVEL 3 (CONDITIONAL AUTOMATION) The car can monitor the driving environment and accelerate, turn, or brake, but still expects human intervention when alerted.

LEVEL 4 (HIGH AUTOMATION) The car can control all driving aspects and operate without intervention, but only under certain conditions.

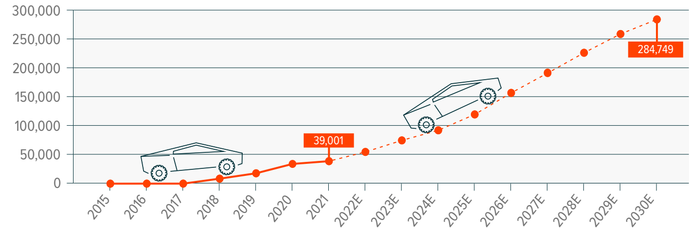
LEVEL 5 (FULL AUTOMATION) The car is fully autonomous and requires no human input to operate in all driving conditions.

AV technology in the market today ranges between Levels 1 and 3, incorporating degrees of basic automation. Though fully autonomous vehicles haven't hit the roads yet, the technology has made significant strides. AVs are collecting and processing billions of data points from an array of cameras with sensors and radar systems, which are both more sophisticated and affordable than earlier iterations. Also, advanced driver-assistance systems, including adaptive cruise control and self-parking, are now increasingly available in even low to mid-range models.

AVs use the data that they collect to continually improve the AV network's driving skills and reduce the instances of software disengagement events and accidents. General Motors' (GM) Cruise model currently averages more than 39,000 miles driven before triggering a disengagement event, which is a situation in which the autonomous system stops working, and requires the operator to manually take control of the vehicle to correct a potentially unsafe activity.[2] At current learning rates, GM's AV technology could approach an average of 300,000 miles between disengagements by 2030 – a length exceeding the expected lifespan of a typical vehicle.[3]

CRUISE SELF-DRIVEN MILES PER DISENGAGEMENT

Source: State of California Department of Motor Vehicles. (2022, January 3). 2021 autonomous vehicle disengagement reports [Data set].; Global X Wrights Law on Autonomous Driving Stoppage Forecast based on data from State of California Department of Motor Vehicles, 2022.



Notes: E = Estimated

While we are seeing progressive gains in AV safety, there is considerable room for improvement in the years ahead, as highlighted by the chart above. To collect the data needed to demonstrate better-than-human performance, AVs would need to drive approximately 275 million miles.[4] Reaching that distance would take 100 AVs driving 24 hours a day, 365 days a year, at an average speed of 25 miles per hour for more than 10 years.[5, 6] However, testing times can be reduced by combining real-world tests with "model-in-the-loop simulations." These simulations consist of running vehicles through algorithms that cover every possible scenario to ensure that the AV system can make the right decisions.[7]

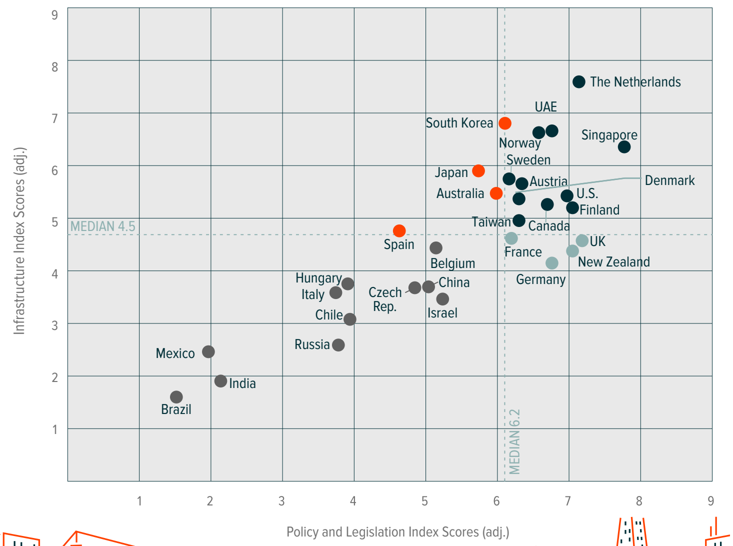
INFRASTRUCTURE & POLICYMAKERS PLAY A KEY ROLE

To operate effectively, AVs require high-quality roads, clear signage, and expansive data networks.[8] In the chart below, we evaluate the "readiness" of different countries based on the conditions created by policymakers and existing infrastructure:

- Countries in the top right corner scored highest on AV infrastructure and favourable regulation, led by the Netherlands and Singapore.
- The United Sates scored well on road quality, and could be primed for improvement after the passage of landmark federal infrastructure packages in 2021 and again in 2022.[9, 10]
- Surprisingly, Israel scored poorly on AV infrastructure and regulation, despite its leading-edge tech sector.

AV COUNTRY READINESS INDEX SCORES FOR POLICY AND LEGISLATION VS INFRASTRUCTURE SCORES

Source: Global X Analysis; Richard Threlfall, Autonomous Vehicles Readiness Index, KPMG International, 2020



Another challenge for the AV industry's growth trajectory is consumer adoption as technology is actively evolving. Generally, there's a high correlation between AV regulation and consumer acceptance, as is the case in the United States and Finland, for example. On the other hand, Japan and Austria have fairly low consumer acceptance scores relative to their performance in other areas, such as regulation, infrastructure, and innovation.

THE OUTLOOK IS BRIGHT

With automakers, tech companies, and suppliers across the AV supply chain investing in and advancing self-driving technology, we expect AVs will continue to become safer and more road-ready. Mass adoption will take time, but for investors interested in exposure, early commercial use cases such as robotaxis are already emerging.

AVs have the potential to revolutionise public transportation by reducing traffic congestion, the need for parking, and overall travel costs for consumers and companies alike. In our view, companies that have the technology and economies of scale in place will likely be well-positioned as AV technology proliferates, having secured market share and future revenue streams. ✕

This document is not intended to be, or does not constitute, investment research as defined by the Financial Conduct Authority

RELATED ETF

DRVE: The Global X Autonomous & Electric Vehicles UCITS ETF seeks to invest in companies involved in the development of autonomous vehicle technology, electric vehicles ("EVs"), and EV components and materials. This includes companies involved in the development of autonomous vehicle software and hardware, as well as companies that produce EVs, EV components such as lithium batteries, and critical EV materials such as lithium and cobalt.

Capital at risk. The value of an investment in ETFs may go down as well as up Prospectuses and Key Investor Information Documents (KIIDs) for this ETFs is available in English at https://globalxetfs.eu/funds/drve/

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[1] Car and Driver, "Path to Autonomy: Self-Driving Cars Levels 0 to 5 Explained," Oct 2017.
[2] Global X Analysis of data derived from: State of California Department of Motor Vehicles. (2022, January 3). 2021 autonomous vehicle disengagement reports [Data set].
[3] Ibid,
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[10] Kasperowicz, L., & Walker, D. (2021, October 21). The state of federal highways and bridges [2019 study]. AutoInsurance.org.

RUSS MOULD

AJ Bell Investment Director

Insightful commentary on market issues

The 'Rule of 20' is back and it tells us a lot about current markets

It uses the rate of inflation to help establish whether a stock or index is cheap, expensive or fairly valued

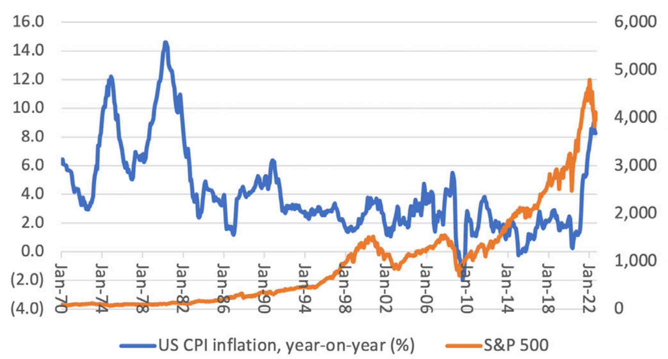
The old saying that buying higher-risk investments guarantees higher returns is one of investing's biggest fallacies. If buying higher-risk assets ensured higher returns all the time, then they would not be high-risk, would they, because of the certain premium returns?

The best way to get the best risk-adjusted return from a security is to pay a low valuation for it, because that hopefully manages the downside risk and leaves potential for upside. Investors do not get paid for taking risk in a willy-nilly fashion. They get paid by seeking out value, as part of their risk-management process.

Alas, valuing a single company or an entire stock market is more of an art than a science and there is no 'right' answer but one yardstick seems to be coming back into fashion after a lengthy period out in the cold.

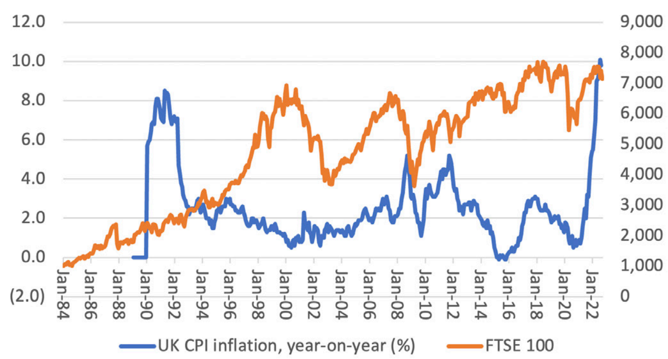
This is the so-called 'Rule of 20' and it is getting a new airing because it makes inflation one of its key considerations when it comes to establishing whether a single stock or benchmark stock index is cheap, expensive or fairly valued.

Is the latest surge in inflation a threat to equities in the US ....



Source: US Bureau of Labor Statistics for inflation data, Refinitiv data

... and the UK?



Source: Office for National Statistics, Refinitiv data

HIGH FIDELITY

The origins of the 'Rule of 20' are shrouded in mystery, but the legendary US fund manager Peter Lynch is thought to have been an active proponent when he was managing Fidelity's

RUSS MOULD
AJ Bell Investment Director

Magellan fund with such distinction from 1977 to 1990.

Lynch, also well-known for his assertion that the acronym IPO stood for 'It's Probably Overpriced', argued that a fair multiple, or price, for a stock was 20 minus the rate of inflation.

For example, if a stock or index was trading on 11 times earnings and inflation was 2%, then the theory would be that there could be some value to be had. Conversely, a market or company that was trading on 18 times earnings when inflation was 8% was seen as overvalued.

Investors could then debate whether it was best to use historic or forward (forecast) earnings, especially given the notorious unreliability of analysts' forecasts, at least for cyclical and economically-sensitive industries.

NUMBER CRUNCH

The current rate of inflation in the US is 8.3%, according to the US Bureau of Labor Statistics. Applying the Rule of 20 means a fair price to earnings multiple for the US equity market is 11.7 times.

Oh, dear. The S&P 500 index stands, at the time of writing, at 3,901 and Standard & Poor's analysis is looking for earnings per share of $210 for 2022. That implies a PE of 18.5 times, to suggest the US equity market is way, way overvalued – by as much as 35% to 40%, even assuming that $210 earnings forecast is any good.

The situation looks a little less black if 2023 forecasts are used. S&P expects $240 in earnings next year, to put the S&P index on 16.3 times forward earnings. That is still too high by some 30%, unless earnings forecasts start to rattle higher very quickly, or inflation starts to tumble. The bad news is earnings forecasts are leaking lower in the US right now, not moving higher.

In the UK, the prevailing rate of inflation is 9.9%. That implies the FTSE 100 should trade on 10.1 times forward earnings. For 2022, the FTSE 100's £2 trillion market cap and 2022 consensus earnings forecasts for a net profit of £192 billion put the index on just 11.3 times forward earnings.

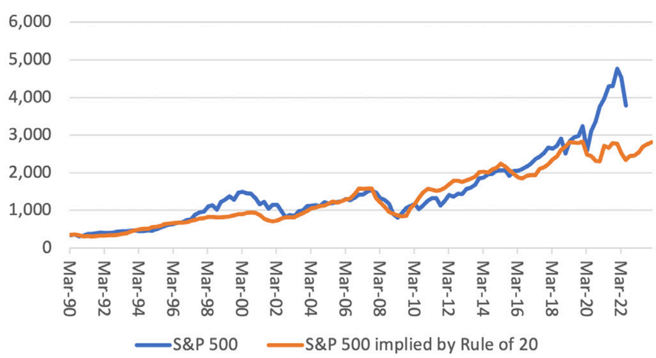
For 2023, analysts' aggregate net profit estimate for the FTSE 100 stand at £200 billion, to put the UK's benchmark index pretty much at fair value – again unless earnings estimates rise, or inflation falls. Investors must decide for themselves whether either scenario is likely and therefore whether UK equities represent good value or not.

INFLATIONARY PRESSURE

The reliability of, and volatility in, earnings forecasts again explains why this is more of an art than a science. If earnings boom, then US and UK equities may be cheaper than thought. A deep recession could mean that earnings collapse.

Nor can the 'Rule of 20' be seen as a clinical market timing tool. It suggested that US equities were overvalued from late 1997 but it took investors two (frenzied) years to get the message and the rule has been warning of danger since early 2020.

Rule of 20 suggests US equities are looking overvalued



Source: Standard & Poor's earnings forecasts, US Bureau of Labor Statistics for inflation data, Refinitiv data for S&P 500 index

However, the methodology does at least permit the investor to factor inflation into their thinking. It will also help them to understand why rampant inflation had such a devastating impact upon share price performance in the 1970s, when equities were viciously derated, and why disinflation proved such a powerful driver of stock market gains in the disinflationary 1980s, 1990s and 2010s.

How to ensure your dividends from property funds are reinvested

There are pros and cons to compounding interest via funds and trusts

For investors who want to compound the high yields available on some property funds and trusts by reinvesting their dividends, there are a few differences between the two asset classes which they need to consider before starting out.

Open-ended property funds usually give shareholders the option to automatically reinvest their dividends by offering accumulation units.

REITs (real estate investment trusts) on the other hand are required by law to pay out 90% or more of their tax-exempt earnings as well as 100% of any property income distributions received from other REITs rather than reinvest them, making the

A selection of property-related funds and ETFs with accumulation versions

Fund / ETF	Yield (%)
FP Foresight Sustainable Real Estate Securities A Acc GBP in GB	3.8%
CT Property Growth & Income I Acc in GB	3.2%
SJP Property L Acc in GB	3.0%
Premier Miton Pan European Property Share C Acc GBP TR in GB	3.0%
Abrdn UK Real Estate Platform 1 Acc GBP in GB	2.9%
L&G Global Real Estate Dividend Index I Acc in GB	2.8%
L&G UK Property I Acc in GB	2.3%
SPW Multi-Manager Global Real Estate Securities B Acc GBP in GB	2.3%
Abrdn Global Real Estate Ret Acc GBP in GB	2.3%
iShares Global Property Securities Equity Index (UK) D Acc in GB	2.1%
First Sentier Global Property Securities B GBP Acc in GB	1.9%
Fidelity Global Property W Acc in GB	1.4%
Schroder Global Cities Real Estate Z Acc in GB	1.0%

Table: Shares magazine • Source: FE Analytics, 15 September 2022

investor do the leg work.

However, there are other pros and cons to each model, not least liquidity, costs and tax considerations, so *Shares* has prepared a handy guide.

FUNDS AND ETFS

When we refer to funds in this article, we are talking about open-ended investment vehicles whose assets can rise and fall depending on capital flows as opposed to closed-end funds such as investment trusts where capital is considered 'permanent'.

This makes a big difference when looking at property as an asset class, as investors who were exposed to the sector during the financial crisis and more recently during the coronavirus crisis will remember only too well.

In both instances, dealing in funds run by big insurance firms like **Aviva (AV.)** and **Legal & General (LGEN)** aimed at the retail market had to be suspended to stop investors pulling their money out because these funds couldn't quickly liquidate any of their assets to meet daily redemption requests.

During the coronavirus crisis, even funds with monthly or quarterly redemptions aimed at institutional investors had to close their doors due to lack of liquidity.

ETFs or exchange-traded funds tend to be more liquid than open-ended funds and typically have lower fees, but those that invest in fixed assets like

Examples of real estate investment trusts

Trust	Yield
Regional REIT	9.4%
Custodian REIT	5.5%
UK Commercial Property REIT	5.2%
Supermarket Income REIT	5.0%
LXI REIT	4.3%

Table: Shares magazine • Source: FE Fundinfo, Association of Investment Companies. Data as of 15 Sept 2022 property are less liquid than those which invest in stocks or bonds.

With those caveats in mind, investors who want to compound their dividends from property funds can buy what are known as accumulation units as opposed to income units. These can be found with both open-ended funds and some ETFs.

As the name suggests, dividends are accumulated and reinvested in the fund rather than being distributed.

However, unless the units are held in a tax wrapper such as an ISA or a SIPP (self-invested personal pension), the reinvested dividends are considered to be a 'notional distribution' according to HMRC and are subject to the level of same income tax as the income units.

As a result, once reinvested dividends exceed your tax-free dividend income allowance of £2,000 you will have to start paying income tax.

Also, unless the units are held in a tax wrapper such as an ISA or SIPP, when you come to sell them you will pay capital gains tax on any increase in value which exceeds your annual allowance, which is £12,300 for the current tax year.

Capital gains tax is payable on the value of the accumulation units when they're sold, minus the original investment and any income accumulated.

Therefore, holders of accumulation units should keep a record of all their 'notional distributions' so that when they come to sell, they can work out how much of the sale proceeds are capital gains and are liable for tax.

The same holds for ETFs which pay dividends, regardless of whether you physically receive income, or it is reinvested in the fund.

REINVESTING VIA REITS

While real estate investment trusts must pay out the vast majority of their profits as dividends, you can reinvest that money as long as your custodian or platform allows it.

Most platforms offer the option to reinvest dividends, although there is typically a small fee for doing so.

For example, AJ Bell charges £1.50 per deal, so if your regular dividend is £100, for example, then the cost of reinvestment is small. If your dividend is only £5, however, you must question if you want to spend 30% of your dividend money on fees.

Dividends from REITs are known as a PID or 'property income distribution' and are normally paid after the trust has deducted withholding tax at the basic rate of income tax (currently 20%) which it pays to HMRC on behalf of shareholders.

Trusts can also offer non-PID dividends from taxed income on activities other than lending, and they can issue 'scrip' dividends or 'bonus' shares which allows the company to keep hold of its cash and shareholders to increase their stake without any additional cost.

Scrip dividends are treated like any other kind of investment income so for tax purposes, unless the trust is in a tax wrapper, you need to make a note of the 'cash equivalent' which you would have received if you hadn't been given new shares.

DISCLAIMER: AJ Bell referenced in this article is the owner and publisher of Shares magazine. The author (Ian Conway) and editor (Daniel Coatsworth) own shares in AJ Bell.

By **Ian Conway** Companies Editor

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.

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What should I do when my fund manager departs?

Sudden departures are a red flag, but there are other considerations before you press the 'sell' button

On 5 September, asset manager **Abrdn (ABDN)** announced that veteran and very successful fund manager Harry Nimmo will retire from the firm and the industry at the end of 2022 after the best part of four decades with the company.

The news will have certainly set the nerves of investors in **Abrdn UK Smaller Companies Growth Trust (AUSC)** and **Abrdn UK Smaller Companies (B7FBH94)** jangling, given that Nimmo has been the architect behind their success.

While the surprise departure of a well-regarded fund manager is a red flag, there are many different reasons why successful stock pickers elect to leave their investment management firm and fund.

Often, they simply retire after a long and successful stint managing a fund or investment trust. In other instances, they are given the boot by their asset management firm, or the independent board in the case of an investment trust, following a period of poor performance. Or they might be poached by a competitor or resign to set up their own fund management boutique.

When a fund manager who has forged a particularly strong track record exits stage left, it is tempting to immediately sell your fund units or investment trust shares. However, it is important not to panic and to take your time and assess the situation. As the old aphorism states, 'act in haste, repent at leisure'.

> **"Brunner is now on its third manager in two years"**

CHANGE AT THE TOP

There has been a fair bit of fund manager turnover this year. For example, Sam Vecht has been appointed as lead portfolio manager of **BlackRock Latin American (BRLA)** and will be supported by Christoph Brinkmann following the news Ed Kuczma is stepping down as manager.

Shares in global investment trust **Brunner (BUT)** languish at a 14.7% discount to NAV as investors fret over the threat of a world recession as well as lead manager Matthew Tillett's unexpected decision to step down in July and resign from asset manager Allianz.

He was only appointed as lead manager of the trust in May 2020. Christian Schneider, who has previously worked in tandem with Tillett, has taken over as Brunner's interim lead manager for a minimum of six months until a permanent lead manager is appointed.

Other recent changes include Hamish Baillie stepping down as co-manager of capital preservation trust **Ruffer (RICA)**, as well as the departure of the portfolio managers on investment trust **Ecofin US Renewables Infrastructure (RNEP)**.

In the funds universe, the impending retirement of long-serving stock picker Hideo Shiozumi presents investors in the capital-growth-focused **Martin Currie Japan Equity (B8JYLC7)** with the dilemma of staying put or selling out. His successor has big shoes to fill since Shiozumi boasts 45 years of experience in Japanese equities and has presided over a distinctive investment approach since the 1990s.

Martin Currie Japan Equity in GB

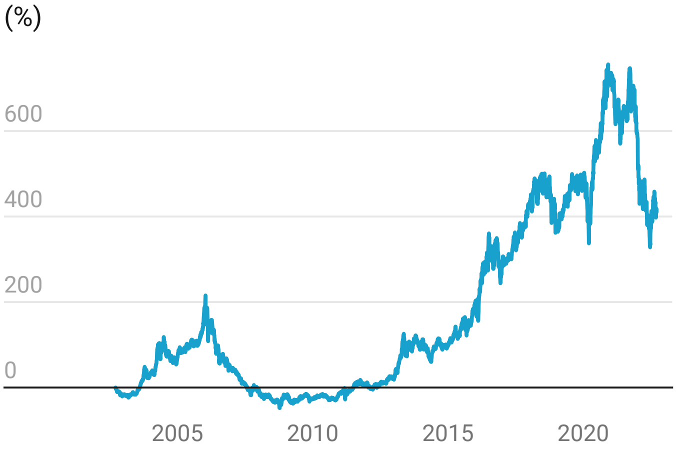


Chart: Shares magazine • Source: FE Analytics

WHAT SHOULD YOU DO IN THIS SITUATION?

The first thing to do when a successful manager leaves is to think carefully about how the fund was managed. Did they manage the fund on their own or was it managed via a team approach?

If the portfolio in question will continue to be managed in the same way, it may be suitable to stay with the fund.

However, if you feel the fund approach will change, it may be worth considering selling your units or shares. And if you plan to follow the fund manager to their new employer, if they're changing jobs and running another fund, make sure it will be managed in the same way.

If the fund manager relied on a large and well-resourced team of co-managers and analysts, their departure might not have a major impact on the overall strategy. Conversely, if they were running the fund on their own – which is what you often get with so-called 'star managers' – then the departure is a more serious threat.

WHAT IF I STICK WITH THE FUND?

In this situation, you'll need to evaluate the new fund manager, be it an internal or external hire. Ask yourself, has the investment management firm drafted in a seasoned manager with a strong reputation in the industry and experience with a similar strategy, or has the firm decided to give the opportunity to a young manager themselves?

Many asset management firms like to promote analysts to fund managers as the next part of their career development. Yet while they will be familiar with the investment philosophy of the firm, managing money for investors requires a different skill set to pure equity analysis.

You should also weigh up whether the new fund manager's style fits snugly with the vehicle's existing investment strategy or not. If it doesn't, you might see changes in the investment approach in the months and years ahead, which may result in the fund deviating from your objectives or sitting uncomfortably with the rest of your portfolio, which means it might be better to sell up and move on.

For instance, if an established income or value manager is appointed to run a growth fund, this could be problematic as the approaches can be very different.

IMPACTING THE RATING

James Carthew, head of investment companies at research group QuotedData, says there are some funds that appear to be inextricably linked with an individual manager.

'In those circumstances, their departure will inevitably affect the rating,' he explains. 'A good recent example might be **Independent Investment Trust (IIT)**, where, in the face of manager Max Ward's intended retirement, the board opted to merge the trust into **Monks (MNKS)**, which operates with a similarish style, rather than find a replacement manager.'

Another example is **Rights & Issues (RIII)**, for years synonymous with Simon Knott, who announced his retirement in June. 'In this case, the board opted to pass the management of the trust over to Dan Nickols at Jupiter, offering those investors that wanted it an exit via a 10% tender offer,' says Carthew. 'It has also been buying back stock – about 1.8% of the trust since the decision was announced.

Rights & Issues Investment Trust

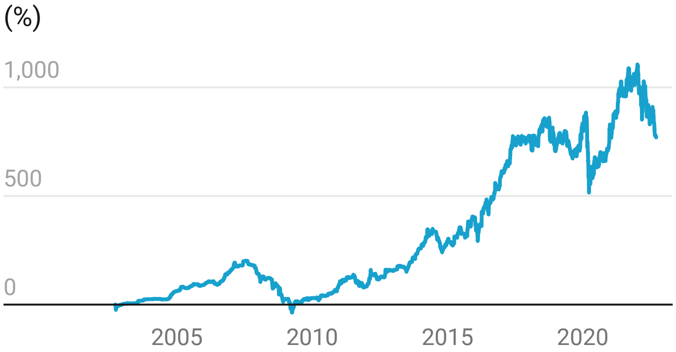


Chart: Shares magazine • Source: FE Analytics

'The discount has been widening over the past 12 months and, so far, the news has not had much of an impact on that. We are waiting to see the results of the tender offer (to be announced at the end of September) to gauge investors' appetite for remaining in the trust following the management change.'

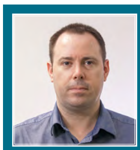
The QuotedData expert stresses that each situation will be different. 'Often, as in the case of Harry Nimmo, the retirement of a manager will have been anticipated by the board and the management company well in advance and a co-manager will have been working alongside the outgoing manager for some time, to ensure a smooth handover and a continuation of management style.'

NIMMO'S SUCCESS

Numis Securities says Nimmo (*pictured*) is among one of the longest serving managers in the sector, taking over as lead manager in 2003. It says performance during his tenure has been 'exceptional', with Abrdn UK Smaller Companies Growth Trust producing NAV total returns of 930% (13.1% per year) compared with 315% (7.8% per year) for the Numis Smaller Companies (including AIM but excluding investment companies) index.

'Given his tenure it is not a surprise to see him retiring and we believe the transition appears well-managed. Harry stepped back from his role as global head of smaller companies in 2020 to focus solely on portfolio management, while Abby Glennie, who will become sole lead manager, has been part of the team since 2016 and co-manager since 2020,' notes the broker.

'Accordingly, we would not expect to see radical changes in approach given that she is well-integrated into the management team and its philosophy, however it will be interesting to see how she performs given potential sectoral headwinds. Abrdn UK Smaller Companies Growth Trust has been one of the weaker performers year-to-date, reflecting its growth-focused approach.'



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

I want to transfer my pension. Why do I have to pay for financial advice?

It's important to understand the rules if you're thinking about moving your retirement savings pot

I have an old pension policy with a 'guaranteed annuity rate' attached, which I'm told is quite valuable. I want to transfer it to a new provider so I can access the money flexibly, but I've been told I can't unless I speak to – and pay for – a financial adviser. How can this possibly be the case? It's my money.
Anonymous

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

Reforms first introduced in April 2015 gave people with DC (defined contribution) pensions freedom and choice over how they access their retirement pot.

From age 55, savers with these pensions can take an income to suit their needs through drawdown, access ad-hoc lump sums direct from their pot or use their fund to buy an annuity. You can also mix and match these options to suit your needs. The age at which you can first access your pension in this way is due to rise to 57 in 2028.

However, not all pensions can be accessed flexibly. If you have a DB (defined benefit) pension, your retirement income is paid by your employer based on the number of years you have been in the scheme and your earnings. Because a DB pension gives you a right to an income rather than a pot of money, it cannot be accessed directly in the same way as a DC pension.

If you have a funded DB pension (where the scheme in which you belong holds assets to pay income to members) you can request a 'transfer value' and have the option of moving this to a DC scheme. If your fund is worth £30,000 or more, you will need to take regulated financial advice before transferring. If you are a member of an 'unfunded' public sector pension scheme, you are not able to transfer out.

As you have found, it is not just DB pensions which come with an advice requirement for members wanting to transfer out.

Older-style pension plans sometimes come with a guaranteed annuity rate attached. This means your retirement income is guaranteed to be a certain percentage of the fund. You could often get considerably more income than buying an annuity on the open market. Because this percentage is guaranteed, the £30,000 advice requirement applies.

While I appreciate it might be frustrating to have to take regulated advice before moving your pension, the requirement is in place for a reason. Guaranteed annuity rates are often extremely valuable and, although there are circumstances where a transfer can be in someone's best interests, giving up these guarantees is a decision that shouldn't be taken lightly.

If you're struggling to find an adviser, this Moneyhelper directory is a good place to start.

DO YOU HAVE A QUESTION ON RETIREMENT ISSUES?

Send an email to **asktom@sharesmagazine.co.uk** with the words 'Retirement question' in the subject line. We'll do our best to respond in a future edition of *Shares*.

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

Higher interest rates are good for savers but watch out for tax

There's an easy way to avoid the taxman taking a bite out of your returns

Cash savers are celebrating as a rates war has broken out in the savings market, meaning they are getting a much better return on their money than they were a year ago.

The Bank of England has raised the base rate from 0.1% in December 2021 to 1.75% in August and is expected to raise rates by either another 50 or 75 basis points at its next meeting today (22 September).

While these rate rises haven't been welcomed by anyone with a mortgage or other debt, they've given a real boost to anyone with cash savings. Various smaller and challenger banks have successively raised the interest rates they offer on their accounts in order to draw in new business.

YOU CAN NOW GET MORE THAN 2%

Before the Bank of England rate rise last December, the top paying easy-access account offered 0.65% interest, but now the top account is paying around 2%. Competition in the fixed rate savings account market is even fiercer, according to Moneyfacts, with the average one-year bond now paying 2.29% which is the highest rate in a decade.

While this is good news for savers, there is a potential tax hit waiting in the wings. In 2016 the government introduced a new tax break

for savings income, which meant that basic-rate taxpayers could earn £1,000 in savings income before they had to pay tax on it, while higher-rate taxpayers had a £500 allowance. Additional-rate taxpayers had no allowance. These allowances have remained the same since the tax break was introduced.

This personal savings allowance meant cash ISA use dropped off a cliff – there was no need for a tax-efficient account if you weren't going to be paying tax on those savings anyway. But since then two things have changed: firstly, rates have risen so people's savings are generating more interest and secondly, more people are being pushed into the next income tax break, cutting their tax-free savings allowance.

HOW DOES THIS WORK IN PRACTICE?

Let's look at interest rates first. When the base rate was 0.1%, if your savings were earning that amount of interest a basic-rate taxpayer would need to have £1 million in savings to hit that limit. Clearly that is going to be a tiny proportion of the population.

However, with the top easy-access savings account now paying around 2% that same basic-rate taxpayer would only need to have £50,000 in savings to hit the limit.

The fixed-rate savings market is paying even more, which means you'd need to have even less in savings to hit that limit. For example, the top two-year bond pays 3.55%, which means a basic-rate taxpayer would only need around £28,000 in savings to hit the limit.

On top of this, the government hasn't increased the earnings level at which different rates of income tax are due, and more people are being pushed into the higher-rate tax band (or into the additional-rate band thanks to pay rises). This means their savings allowance is cut to £500, or to nothing if they hit the additional-rate band.

At the top easy-access rate of 2% a higher-rate taxpayer would need to have £25,000 in savings before they hit their new, lower £500 tax-free savings limit.

IS THERE A SOLUTION TO THIS TAX HIT?

Put money into an ISA. Individuals can put up to £20,000 across these types of accounts each year.

However, cash ISAs often pay lower interest rates, so savers will need to do their sums to work out whether it's worth picking a higher paying non-ISA account and paying tax on their savings interest, or putting it in an ISA and accepting a lower rate.

BEWARE THE FIXED-RATE SAVINGS ACCOUNT

Competition is fierce in the fixed-rate savings market, as banks offer higher rates in return for people locking up their money for longer. But before you're drawn into the great deals on offer, you need to think carefully.

If you lock in a rate now, you'll miss out on any interest rate rises that happen during that period for which you fix. This is always something you need to consider, but it's particularly important now because we're expecting more interest rate rises in the coming months.

The current expectation from markets is that rates will rise to around 3.75% by the end of this year and potentially hit a peak of 4.5% in late 2023.

No-one has a crystal ball to work out exactly what will happen and when the best time to fix is, so it's a personal decision on whether you'd rather have the certainty of the rate locked in now, or park your money in an easy-access account before fixing at a later date. Other people might decide to opt for a shorter fix, such as for one year, so they can hopefully get a higher rate in a year's time.

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

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KEY ANNOUNCEMENTS OVER THE NEXT WEEK

Full-year results:

23 September: European Opportunities Trust. **26 September:** Finsbury Food. **27 September:** Transense Technologies. **28 September:** Avingtrans, Blancco Technology. **29 September:** Allergy Therapeutics, CAP-XX, McBride, Physiomics.

Half-year results:

26 September: Concurrent Technologies, CPP, Devolver Digital, Immotion, Likewise, LungLife AI, Microlise, Next Fifteen Communications, SpaceandPeople, Xpediator. **27 September:** AG Barr, Animalcare, Boku, Billington, Diaceutics, Digitalbox, ECSC, Ergomed, Fireangel Safety Technology, GENinCode, Instem, Lifesafe, NAHL, The Mission Group, Mortgage Advice Bureau, Serica Energy, Tinybuild, Yu Group. **28 September:** Boohoo, Everyman, Intercede, Skillcast. **29 September:** Angle, Bango, Celadon Pharmaceuticals, Crestchic Directa Plus, Next, Novacyt, Synairgen. **30 September:** CMO, Dignity, DP Eurasia.

Trading updates

30 September: Pennon.

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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.