STOCKS | FUNDS | INVESTMENT TRUSTS | PENSIONS AND SAVINGS

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SHARES

WE MAKE INVESTING EASIER

THE PLAN FOR THE REBORN **WOODFORD INCOME FOCUS FUND**

TIME TO SELL OIL?

Climate change is putting pressure on the sector

STARK WARNING FOR **SIRIUS MINERALS** SHAREHOLDERS

Fundsmith's annual letter is essential reading

Manager Terry Smith has some fascinating things to say about value versus growth investing

In much the same way Warren Buffett's annual letter to Berkshire Hathaway investors is eagerly awaited every year for its pearls of investing wisdom, Terry Smith's letter to **Fundsmith Equity (B41YBW7)** investors has also become an annual publication worth savouring.

His tenth letter has just been released and it contains some fascinating insights into quality versus value investing.

Most fund managers provide commentary in their annual report on performance as well as the odd snippets into their thinking in monthly factsheets. Both Buffett's and Smith's annual letters go one step further by drilling down into the subject matter and letting the authors wax lyrical about certain topics.

I would urge all investors – whether or not you are an investor in the fund like me – to read the latest Fundsmith letter as you could learn a lot from it.

One powerful point in the letter highlights what the fund manager believes to be the flaws of value investing as a strategy. Smith, who likes to invest in companies with high quality characteristics, says most stocks with low valuations attractive to investors are not good businesses.

On the occasion that someone does actually buy a decent company on a low valuation, they may sell that stock when it has re-rated to a fairer valuation and will need to find something else that is undervalued, he argues.

'This activity obviously incurs dealing costs but value investing is not something which can be pursued with a "buy and hold" strategy,' Smith says.

'In investment you "become what you eat" insofar as over the long term the returns on any portfolio which has such an approach will tend to gravitate to the returns generated by the companies themselves, which are low for most value stocks.'

Smith quotes Charlie Munger, Warren Buffett's business partner, who has previously said it's hard

for a stock over the long term to earn a much better return that earned by the underlying business.

He said: 'If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return — even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with one hell of a result.'

Celebrating its tenth year this November, Fundsmith certainly seems to be hinting at delivering the potential Munger alluded to. It has delivered 391% total return since it launched in November 2010; a record high achieved this week.

Thanks to its clear communication and easy-to-understand owners' manual, investors know what they are getting with Fundsmith. It won't always deliver superior returns, yet anyone with a long-term approach should take comfort in owning this fund.

If you want to pick holes, Fundsmith could consider cutting fees as the fund gets bigger – in line with the strategy adopted by many other funds – and it could also be more transparent on the full portfolio. Those issues aside, it's fairly easy to see why this is one of the UK's most popular investment products.

By **Daniel Coatsworth** Editor

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What should investors do with Fevertree after share slump?

The stock is now trading at a three-year low as UK sales growth struggles and it reveals more US investment plans

A very disappointing trading update has left investors wondering what to do with premium tonic seller **Fevertree Drinks (FEVR:AIM)**. Its shares dived 27% to a three-year low of £14.53 on 20 January after missing earnings expectations for 2019.

Sales to 31 December were up just 10% to £260.5m. In November the company had forecast annual sales of £266m to £268m while the consensus according to Reuters Eikon was £263m. Worse, full year earnings will likely be 5% below the previous year due to a lower operating profit margin.

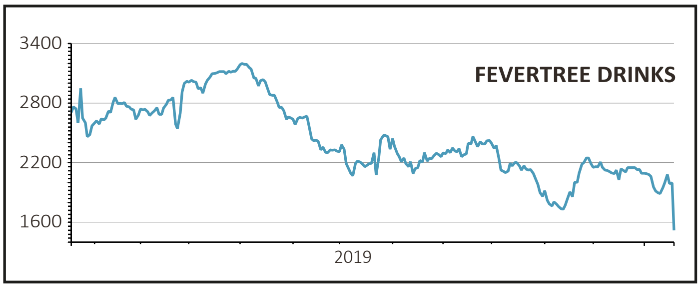
The major reason for the sales and earnings shortfall was the lack of a rebound in UK supermarket and shop sales in the final quarter. After a summer of tough comparisons, hopes were high that the firm would see a pick-up in sales over the festive period.

Stripping out the first-half numbers, it looks as if UK sales from July to December were down 5% to £71.9m.

Conservatively, management are forecasting no improvement in the first half of this year but softer comparatives in the second half should mean a return to growth at some point.

In contrast to the UK, sales in Europe, the US, Canada and Australia were strong. European sales accelerated in the second half to drive full year growth of 16% against 13% in the first half, although the year-end was below expectations.

The US market delivered ‘a particularly encouraging performance’ last year, generating a 33% increase in full-year sales against 31% in the first half. However the firm is investing heavily ‘to unlock the wider potential of this very significant market’, which in practice means lowering prices, so net revenues will grow more slowly than forecast this year.



Early investors in Fevertree who are still in the money will be tempted to bank their gains after this latest disappointment. For anyone who bought the shares in the last two years though, the question is should they buy more at the cheaper price, cut their losses or do nothing?

Assuming there is no first-half rebound in UK sales it is hard to see the shares going up much in the near-term unless there is a takeover offer from one of the big drinks or consumer goods companies. Profit warnings often come in threes so there may be more bad news to come.

We are really disappointed by the latest update, having been big fans of the stock for some time. However, fundamentally we still believe this is a good company.

Long-term investors who still believe in the business should await the actual results in March for an update on current trading rather than be panicked into selling by past results.

Disclaimer: The author Ian Conway owns shares in Fevertree Drinks

Sirius Minerals chairman issues stark warning to shareholders

Investors could lose all of their money if takeover deal is not approved, he warns

Shareholders in potash miner **Sirius Minerals (SXX)** need to vote on a 5.5p cash per share takeover offer from mining giant **Anglo American (AAL)**.

At least 75% of shareholders need to approve the offer for it to proceed. Sirius chairman Russell Scrimshaw says takeover failure could see the business go into administration or liquidation, adding that the Anglo offer 'is the only feasible option' for the potash mine development to proceed.

Documentation connected to the offer will be sent to Sirius shareholders within the next four weeks.

Should the takeover happen, any Sirius shareholders using the cash proceeds to reinvest into Anglo shares should appreciate that they would be getting exposure to many different commodities than just potash. Anglo American is the world's largest producer of platinum and is also a major global producer of copper, nickel, diamonds and iron ore.

Sirius' potash project would only make up a small amount of Anglo's interests in the near-term. Anglo implies it will stick to Sirius' current development schedule for the first two years of owning the company, thereby ensuring the project will benefit the local community in Yorkshire and the UK as previously guided.

Senior managers at Sirius including chief executive Chris Fraser will remain with the business under Anglo's ownership for at least one year after a successful takeover. Sirius' shares would delist from the stock market if the deal goes ahead.

Palladium price doubles in seven months

The precious metal is going up faster than gold

MORE EXPENSIVE THAN gold, the price of a precious metal called palladium has rocketed in the past few months.

This week the metal topped $2,500 an ounce and is changing hands for double what it cost just seven months ago.

A critical component in catalytic converters, palladium demand is going up around the world as carmakers respond to government rules tackling pollution from petrol vehicles.

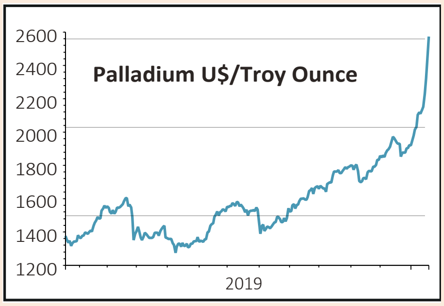
At the same time, supply from South Africa – one of the world's biggest palladium producers – has dropped sharply as its mining industry suffered from the worst power outages in a decade due to heavy rain and flooding.

That's led to a big supply deficit, set to hit 540,000 ounces in 2020 and 589,000 ounces in 2021 according to HSBC.

In a research note last year, Morgan Stanley said palladium prices could carry on rising until mid-2020 at least, with the market moving deeper into backwardation, a situation where futures trade below the spot price.

Examples of stocks and funds involved in palladium include FTSE 100 diversified miner **Anglo American (AAL)** and **Sylvania Platinum (SLP:AIM)** which focuses on platinum group metals platinum, palladium and rhodium.

Relevant exchange-traded funds include **WisdomTree Physical Palladium (PHPD)**.



Consistent sales growth puts spotlight on Premier Foods' recovery story

The Mr. Kipling cake maker has positive momentum, but it also carries a mountain of debt

Despite tough domestic grocery market conditions, Mr. Kipling-to-Bisto maker **Premier Foods (PFD)** has now delivered 10 consecutive quarters of sales growth in the UK. The shares have had a good run since November 2019 but the company is still saddled with a reputation as a corporate 'zombie' due largely due to its massive debt pile.

UK sales grew by 3.6% in the third quarter. Biggest brand Mr Kipling proved the star turn, although seven of Premier Foods' eight largest brands have grown market share.

There should be a marked increase in cash generation should earnings increase and finance charges reduce (as forecast by analysts), supporting higher marketing spend behind its brands, in turn potentially driving further sales and profit growth.

Premier Foods' more predictable cash generation is providing funds for much-needed new product development, including a move into plant-based products, but more importantly, for paying down debt.

The food producer has spent the past decade trying to resolve its debt burden and pension deficit. A new management team led by Alex Whitehouse (CEO) and Colin Day (chairman) expects the net debt-to-EBITDA ratio to reduce to 3 times by March 2020, after which Premier Foods could start paying dividends.

A stubbornly high net debt pile, £492.9m as at 28 September 2019, plus pension responsibilities, are the collective millstone around Premier Foods' neck. This overstretched balance sheet has long-constrained Premier Foods' ability to market its brands, prevented dividend restoration and acted as a poison pill for potential suitors. That said, takeover offers from US spice giant McCormick & Co were spurned in 2016.

Peel Hunt forecasts adjusted pre-tax profit growth from £77.7m to £82.7m for the year to September 2020, ahead of £87.4m in 2021 and £94.5m in 2022. Based on this year's 7.5p earnings per share forecast and a 36.75p share price, Premier Foods trades on a very low price-to-earnings (PE) ratio of 4.9. This discounted rating prices in concerns over shifting that sizeable debt mountain.

Additional fodder for bears include subdued consumer spending and input cost inflation, not to mention the growth of the discounters, a part of the grocery market where Premier Foods is less represented compared to the big supermarkets.

The company is soon expected to announce the results of strategic and pension reviews. This might involve selling one or more of its key brands, although Peel Hunt doesn't believe it has received an approach at an acceptable price so the review outcome might simply be to keep everything.

BULL POINTS

- Market leading brands
- Improving cash flow generation
- Overseas growth scope

BEAR POINTS

- Onerous debt and pension obligations
- Subdued grocery market
- Competition from private label suppliers/ rival brands

Ranking the FTSE 100 on its commitment to ESG

Many firms talk a good game, but some of London's 100 largest companies do a lot more than others

A lot of companies talk a good game when it comes to sustainability and climate change, but how many of them actually do what they say they're going to do? We now have some idea.

Research platform Tortoise Media has ranked all 100 companies in the FTSE 100 index against the UN's Sustainable Development Goals. Called the 'responsibility index', it measures the gap between what companies say and what they do – the talk versus the walk – highlighting the range of corporate commitment to people and the planet.

Often seen as the darling among sustainability-focused investors, consumer goods giant **Unilever (ULVR)** comes out on top in the rankings.

Tortoise Media highlighted the firm's nearly 50/50 gender representation at senior management level, plus the fact it sends zero waste to landfill in the top 21 countries it operates in. It also has the lowest levels of energy consumption per employee among firms in the index.

Bottom of the pile was **Scottish Mortgage Investment Trust (SMT)**, which doesn't use any environmental, social or governance (ESG) criteria and ranks low on sustainability according to Morningstar.

But the trust does hold stocks like electric vehicle makers Tesla and Nio and scores well with Morningstar when it comes to the carbon emissions produced by the companies it holds.

Most responsible FTSE 100 companies	Least responsible FTSE 100 companies
Unilever	Scottish Mortgage
Diageo	DCC
Vodafone	Melrose Industries
British Land	Intertek
AstraZeneca	NMC Health
RELX	EasyJet
WPP	Evraz
ITV	International Consolidated Airlines
GlaxoSmithKline	DS Smith
BT	Hikma Pharmaceuticals

Source: Tortoise Media

The 'responsibility index' measures the gap between what companies say and what they do

IT'S GOOD TO TALK

Software supplier **Sage (SGE)** is the most 'humble' company on Tortoise's responsibility index, sitting in the top 10 after taking strong action to advance social responsibility, yet being in the bottom 10 for talking about it.

Melrose Industries (MRO) was called out for being the least transparent. It failed to report on more than two thirds of the 10,000-plus data points Tortoise Media looked at when compiling the index, staying silent on areas such as employee diversity, training and wellbeing.

RACE TO THE TOP

Alexandra Mousavizadeh, economist and partner at Tortoise Intelligence, called for FTSE 100 firms to start a 'race to the top'.

She says: 'The appetite from consumers, clients and shareholders for irresponsible corporate behaviour is diminishing. It is two minutes to midnight and we need this index to identify the gap between PR talk and real action.'

The research found that 3.1m FTSE 100 employees, out of 4.8m in total, work for companies who haven't committed to paying them a UK Living Wage of £9.30 an hour.

In 2018, 419m tonnes of CO_2 equivalent were released by FTSE 100 companies, 55m tonnes more than produced by the entire UK, with nearly a third of FTSE 100 companies having a rising carbon footprint.

The FTSE 100 contributes almost £1.8bn in charitable and community investments a year, six times higher than Oxfam's annual spending, for example. But the research found that this spending from FTSE 100 companies equates to just £1.39 on average for every £1,000 earned.

GENEROUS COMPANIES

Of all the FTSE 100, broadcaster **ITV (ITV)** is the most generous, donating £13.94 for every £1,000 of its revenue. The next highest is wealth management business **St. James's Place (STJ)**, donating £8.15 on average for every £1,000 of revenue.

The companies with the biggest gap between their 'talk and walk' on environmental and social responsibilities are miner **Glencore (GLEN)**, oil and gas giant **Royal Dutch Shell (RDSB)** and packaging firm **Mondi (MNDI)**.

Breaking it down by sector, in supermarkets **Tesco (TSCO)** came out on top thanks to its 'rigorous' approach to responsibility reporting and action taken on staff training and poverty.

Lloyds (LLOY) was top of the banks for its climate performance, while in the energy and extractive industries utility provider **SSE (SSE)** was best ranked as it had the lowest emission per employee.

Burberry (BRBY) topped the fashion sector, despite being criticised for burning millions of pounds worth of unsold clothes to protect its brand, thanks to the fact it obtained 58% of its energy from renewable sources in 2018/19.

AstraZeneca (AZN) ranked highest in big pharma, performing well on both its commitments and actions with a relatively high representation of women (44%) at senior management level.

In travel and leisure, **InterContinental Hotels (IHG)** came out on top for its 'thorough reporting' on environmental measures, which even covers composting, while it has also made the largest improvement compared to the other travel companies in the index when it comes to emissions intensity.

RANKING SUPERMARKETS

TESCO

It is top of the supermarkets, thanks to its rigorous approach on responsibility reporting, backed up by strong action on staff training and poverty.

SAINSBURY'S

MORRISONS

OCADO

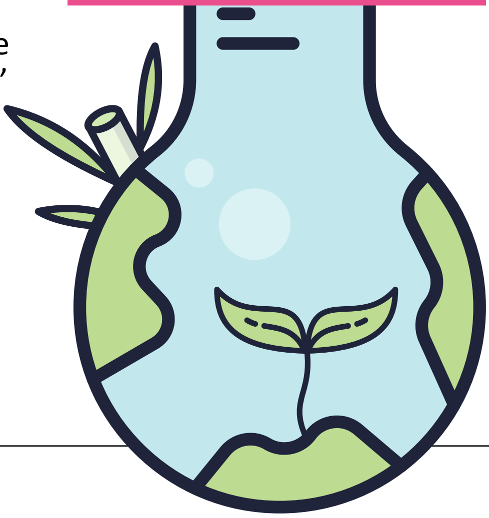
RANKING FASHION

BURBERRY

Despite being criticised for burning millions of pounds worth of unsold clothes last year to protect its brand, Burberry performs well in the climate category. In 2018-19, the fashion company obtained 58% of its energy from renewable sources.

NEXT

JD SPORTS



GREATER FOCUS ON ESG

The responsibility index comes after a report by index provider MSCI on ESG issues, which found that trends for 2020 include investors using alternative data to spot companies taking the lead on climate change.

It also foresees that 'ESG storms the CFO's office, elbowing its way onto the bottom line as financiers get creative with ways to bind ESG criteria to their terms of capital, introducing a plethora of corporate borrowers into the wide world of ESG.'

While in property, MSCI reckons greening the property portfolio will move from a nice-to-have reputation booster to an imperative in the face of a looming 'brown discount' if real estate investors don't kick-start their journey to zero carbon.

M&G shares could make you a lot of money

Investors may be missing a trick and ignoring M&G's unique positioning and growth potential

We think most investors haven't woken up to the value creation potential on offer from financial group **M&G (MNG)**.

Its shares are starting to move upwards following a demerger from **Prudential (PRU)** last year and it is now a member of the FTSE 100.

A study by Deloitte and The Edge reported that since 2000, spin-offs have generated 10 times the average gain of the MSCI Index during their first 12 months independent of the parent.

Interestingly, M&G trades on nine times forecast earnings while offering a dividend yield of 7.5%. The PE rating looks too cheap given the company's unique positioning and growth potential.

M&G has £341bn of assets under management and administration, around 5.5m retail clients and over 800 institutional clients. The distribution platform is global and serves 28 markets from 20 offices.

What may come as a surprise is that funds under management have doubled over the past 10 years. This has been driven by growth in third party mandates in retail as well as institutional funds. But the standout performer has been the PruFund, the UK's largest 'with-profits' fund, which has grown to £50bn from less than £1bn in 2008.

M&G ➚ BUY
(MNG) 247.4p
Stop loss: 197p

Market value: £6.4bn

With-profits funds pool customers' money and smooth investment returns based on a long-term expected growth rate. When returns are better than expected, the surplus is put to one side and used as a buffer in times of market stress.

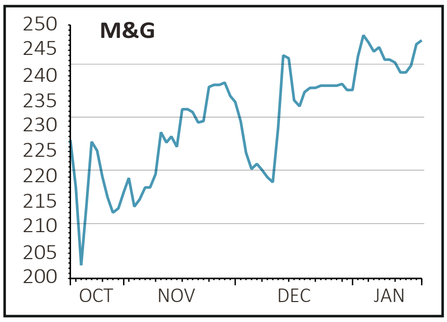
This has proven very popular with clients who want exposure to equity markets but with lower volatility. The ability to smooth returns is supported by the current surplus of £13.3bn which can be released in the event of market stress. This also gives the mangers more flexibility to take advantage of period market 'dislocations'.

Profits from this part of its business could provide a significant uplift to M&G's earnings in future years.

While fees have come under pressure in the asset management businesses, performance has improved in the last two years with 75% of funds in the top half of the peer group over rolling three years. This represents an opportunity to grow the international segment.

You may have heard about one of its property funds being suspended pending the sale of some buildings. This is negative from a reputation perspective but not disastrous for the business as a whole.

SHARES SAYS: ➚
Spin-offs can be a lucrative hunting ground and M&G has unique merits and growth opportunities not reflected in the valuation of the business.



Buy Go-Ahead as it gets back on track

The transport operator seems to be overcoming various problems and offers investors a nice dividend yield

Bus and rail group **Go-Ahead (GOG)** is something of a 'marmite' stock and won't appeal to everyone but we think it represents a cheap play on a recovering UK economy while offering a decent yield for income investors.

Go-Ahead is one of the UK's leading public transport providers. With the UK set to be the fastest-growing European economy in 2020 as confidence rebounds following the general election it should see a pick-up in demand.

Customer satisfaction is at high levels on regional buses, and passenger numbers are growing steadily. In the five months to the end of November organic revenues in the regional bus division were up 2.5%, while plans to raise margins were 'beginning to deliver improvements'.

Meanwhile the London and international bus division reported an 8% increase in organic revenues thanks to new contracts in the capital where it has a 23% share of the market.

The firm is also innovating with some success. Its on-demand minibus sharing service in Oxford, PickMeUp, has grown in popularity since launch in 2018 with 25,000 people now registered on the App and over 130,000 journeys completed.

GO-AHEAD BUY
(GOG) £20.88
Stop loss: £16.70
Market cap: £913m

The train business has a more patchy track record with Govia – a joint venture between Go-Ahead and Koelis – hitting the headlines in summer 2018 and spring 2019 due to fiascos with new timetables but on the whole the UK rail operations are running smoothly.

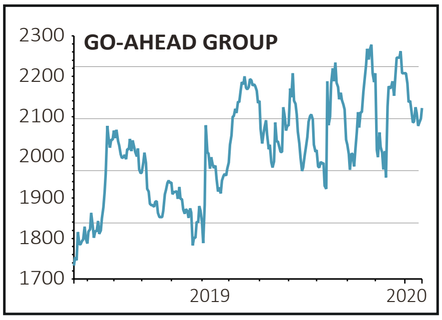
Govia is now the fourth-best UK train operator in terms of punctuality while Southeastern enjoys record levels of punctuality and hopes are high that the Government will issue a new contract from April this year.

The German rail operation has had teething problems but performance has stabilised and more contracts are in the pipeline. Also, the German government is investing €86bn in modernising its railways over the next decade. Shorter journey times should encourage commuters off planes, benefiting Go-Ahead while reducing carbon emissions.

As chief executive David Brown points out, efficient public transport networks 'can change the way people travel which in turn can slow the rate of climate change, improve air quality and ease congestion'.

Despite near-term uncertainty over the Southeastern rail contract, visibility of revenues is generally good and cash generation is high. The 4.7% yield is amply covered by earnings and the rating of 12.7 times this year's earnings doesn't seem excessive.

The shares are back below their post-election highs but the direction of travel is clearly upwards and we would get on board now.



IG DESIGN

(IGR:AIM) 742p

WINNING STOCKS FOR 2020

Gain to date: 6.5%

Original entry point:

Buy at 697p, 19 December 2019

OUR BULLISHNESS ON greetings card designer and supplier **IG Design (IGR:AIM)** gets some early vindication as it expands in the US.

It is set to buy CSS Industries for an enterprise value of £89.7m in a transaction which is expected to be earnings enhancing from the first full year of acquisition, doubling the size of its US business.

IG Design is paying five times earnings which looks cheap, and may reflect the material borrowings CSS had accrued.

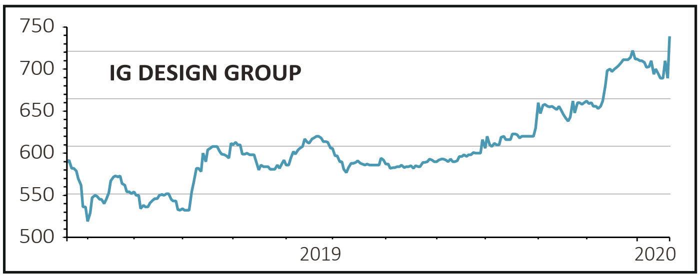
In a further update the company said it had raised £120m through a share placing, which will help pay down debt at CSS.

Shore Capital analyst Peter Ashworth says: 'The acquisition broadens the group's product portfolio and provides customers with a substantially enhanced "one-stop-shop", establishing a leading presence within the US craft market.

'The acquisition also reinforces the group's position as the global industry leader in gift packaging; rapidly scales its "everyday" product category as well as online revenues and presence within the floral decorative packaging industry.'

In addition Ashworth notes the deal provides a big boost to the company's manufacturing and distribution capabilities.

SHARES SAYS: ↗
This looks potentially a very positive purchase, so keep buying.



GVC

(GVC) 895.6p

Gain to date: 7.5%

Original entry point:

Buy at 833p, 17 October 2019

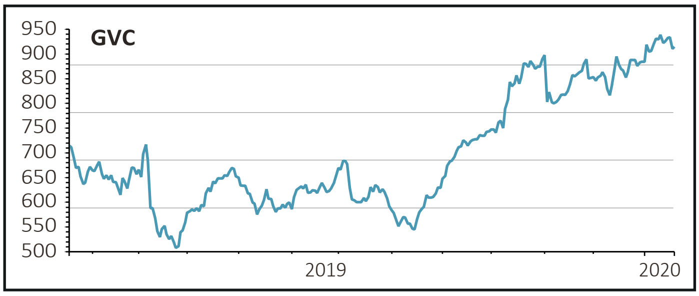
LADBROKES AND CORAL Sports owner **GVC (GVC)** released a post close trading update on 17 January, guiding for full-year earnings before interest, tax, depreciation and amortisation (EBITDA) to be towards the top of the already upgraded third-quarter range of £670m to £680m.

Strong online constant currency revenue growth of 14% and not as bad as feared like-for-like declines in its high street shops (-12%) are the key drivers behind the current buoyancy of the business.

The company also noted that it is seeing good progress in the US, with an exclusive multi-year deal with Yahoo Sports representing a 'significant step forward'.

Consensus earnings estimates have moved up around 10% since GVC initially upgraded its expectations back in the summer while the shares have risen 45% over the last six months.

However, an already frosty regulatory backdrop cooled further on 14 January when the gambling commission banned the use of credit cards for betting.



SHARES SAYS:

The direction of travel for regulation has been clear for some time, but so far GVC has made the necessary operational changes to successfully overcome all obstacles.

Weighing up the threats against significant US opportunities, we are minded to stick with our 'buy' rating.

BAE SYSTEMS

(BA.) 645p

Gain to date: 21.6%

Original entry point:

Buy at 503p, 17 January 2019

DEFENCE FIRM **BAE Systems' (BA.)** $1.9bn acquisition of a military GPS system (Military Global Position System or MGP for short) from US firm Collins Aerospace (20 Jan) should help it locate significant new business across the Atlantic.

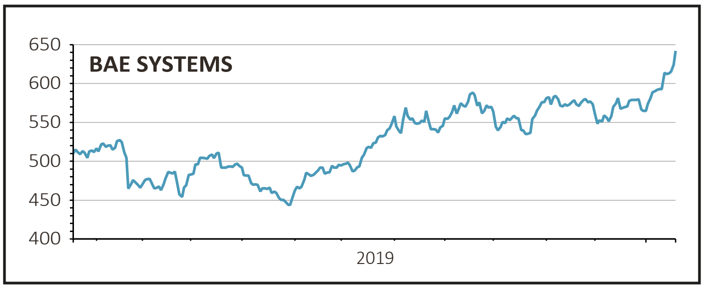
Coupled with the $275m purchase of Raytheon's Airborne Tactical Radios division, it has also provided a further catalyst to the shares which are now up more than 20% since we said to buy a year ago.

Analysts at investment bank Berenberg comment: 'This is clearly opportunistic M&A that is large but looks sensible from a strategic perspective as it would increase BAE's capability in high-growth areas such as weapon systems and defence electronics.

'MGP looks expensive but is high-margin – we guestimate c30% – and has compelling strong growth and high cash conversion. These deals will push BAE's higher growth US activities towards 50% of group sales.'

The growth potential in the US was one of the key attractions we flagged when highlighting the opportunity at BAE and this deal-making has helped advance that expansion.

Less positively, the fate of a £10bn order for 48 Typhoon jets from Saudi Arabia remains in question and is one of the issues likely to be raised when the firm reports its full year numbers on 20 February.



SHARES SAYS:

We remain positive on the stock.

The plan for the reborn Woodford Income Focus fund

New manager ASI gives the biggest hints at how it plans to revitalise the troubled income fund

Many people in the UK are eagerly waiting to discover what their investment in the **Woodford Income Focus (BD9X6V3)** fund will look like under the new management of Aberdeen Standard Investments (ASI).

The fund has been suspended since October 2019 and dealing is expected to recommence in the coming weeks under the new name of **LF ASI Income Focus**.

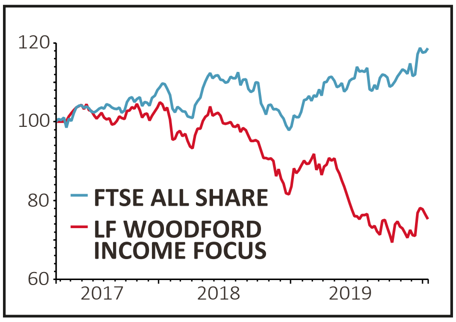
While the details of the restructured portfolio have yet to be released, the biggest clues we can get in terms of how it may look is by examining two other funds run by ASI, namely **Murray Income Trust (MUT)** and **ASI UK Income Equity (B0XWNB4)**.

Both of these funds are run by Charles Luke who will also co-manage the Income Focus fund alongside Thomas Moore, fund manager for **ASI UK Income Unconstrained Equity (B1LBSV5)**.

WHAT HAPPENED TO THE FUND?

Woodford ran the Income Focus fund as a concentrated portfolio with about 40 holdings, many of whom were mid to small-cap stocks.

It had suffered from a large number of investor redemptions due to poor performance and concerns about fund manager Neil Woodford's ability to make them money. Amid the decision to close down Woodford's asset management business, a new manager was sought for the Income Focus fund and ASI won the pitch.



Murray Income Trust and ASI UK Income Equity have 61 and 76 holdings respectively and their portfolios have a lot of cross-over. Murray differs in that it is an investment trust, borrows money to help widen its investment pool and supercharge returns (known as gearing), as well as having an independent board of directors.

HOW WILL THE WOODFORD FUND CHANGE?

The new version of the Woodford fund will be more concentrated with around 30 holdings, essentially continuing the concentrated approach used by the previous manager.

'The strategy for Murray and ASI UK Income Equity is to generate a high income, grow that income and deliver capital growth. They have relatively conservative portfolios with a focus on quality companies. We pay a lot of attention to downside protection, resilience and capital preservation,' says Luke.

'The Income Focus fund will have a highly concentrated portfolio of the ASI UK team's

best income ideas. We will still be seeking income and capital growth and an attractive dividend yield.

'We will harness the research insight from the 16-strong ASI UK team which we think is industry-leading. The number of holdings will be less that Murray and ASI UK Income Equity but we still feel 30 stocks provide significant diversification.'

HINTS ABOUT PORTFOLIO STRUCTURE

One of the key criticisms of Woodford's various funds was liquidity, namely that the manager was investing in too many stocks that would be hard to sell quickly. The Woodford Income Focus fund also came under fire for being too focused on certain sectors.

'We will run the Income Focus fund as a concentrated version of our strategy,' says Luke, adding that he and Moore are still in the process of selling some holdings from the inherited portfolio and making new investments, and so he refuses to disclose names until the portfolio has been fully reshaped to their liking.

It is likely to focus on the FTSE 350 index where stocks are more liquid.

'You can be concentrated and diversified at the same time. We are not being hostage to any one economic scenario, we won't have 20% of the portfolio in UK housebuilders; rather we'll have a range of ideas so there isn't one particular factor that we are depending on.'

Having fewer holdings in the revised Income Focus fund compared to Murray and ASI UK Income Equity effectively means the managers are taking bigger bets on a smaller pool of companies.

Theoretically if they pick the right stocks, individual share price gains will have a greater impact on the overall fund performance than a portfolio with significantly more holdings. The opposite applies where the manager and investors will feel a greater amount of pain if the wrong stocks are picked.

'Murray and the sister open-ended fund try to outperform with low volatility (up and down swings in price) and being risk-averse.

'The Income Focus fund will potentially have greater long-term outperformance but a little bit more volatility,' says Luke.

TEAM BENEFITS

ASI's 'significant resources' were highlighted by fund administrator Link Asset Services in a recent letter to Woodford investors announcing the new manager. Having a strong team to research the market is an advantage to all fund managers as it means they aren't overstretched trying to do everything themselves.

The 16 managers in the ASI UK team (including Luke and Moore) have live recommendations on every stock in the FTSE 350 index. As part of the research a lot of emphasis is put on ESG factors.

They then create something called a 'winners list' which is the top 20 ideas of the UK team. These are stocks where the managers see the highest potential for outperformance.

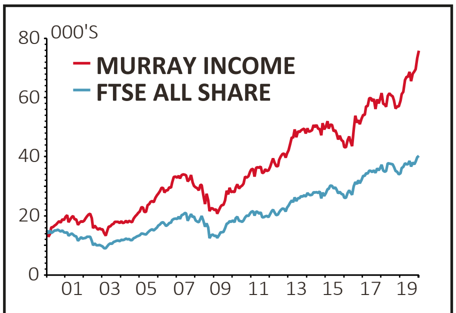
For Murray and ASI UK Income Equity, Luke then goes through the ideas and looks for quality companies and income opportunities. 'We have a scoring system which goes from Q1 to Q5, which runs respectively from best to worst. I will only invest in something with a Q1 to Q3 rating.'

WHAT'S IN MURRAY'S PORTFOLIO?

Murray's portfolio includes pharmaceutical group **GlaxoSmithKline (GSK)**, wealth manager **Close Brothers (CBG)**, life insurer **Prudential (PRU)** and miner **Rio Tinto (RIO)** and it currently yields 3.8%. The approach is long-term buy and hold.

New additions in the financial year to 30 June 2019 included building materials group **Marshalls (MSLH)**, Germany-focused **Sirius Real Estate (SRE)** and utility group **SSE (SSE)**.

Murray's performance has been good with a top quartile ranking over one, three and five years, according to FE Fundinfo.



One might have expected a quality tilt to have struggled since last summer when the value investment style started to come back into fashion, but Luke says that Murray still outperformed the market in October, November and December.

The fund manager says it can be hard to find lots of companies which are good quality and which pay a good yield so he writes some options to help provide additional income. However, he does point out that ASI's large research team means the asset manager is still capable of finding interesting ideas which many other people might have missed.

For example, car retailer **Inchcape (INCH)** is currently part of the portfolio despite the company operating in a struggling sector. 'We think the market doesn't appreciate its quality characteristics. The distribution division makes high margins and has long-term relationships. It is trading on 12 times earnings and has a generous dividend yield,' says Luke.

He also gives the example of wound care specialist **Convatec (CTEC)** which disappointed the market in the first few years after floating in 2016. Luke believes it suffered from poor management who over-promised. 'It has a very strong market position and now has a new management team.'

JURY STILL OUT

The investment trust hasn't been immune to bad decisions and it suffered from holding **Saga (SAGA)** which was removed from the portfolio after a bad profit warning.

'Unfortunately we had misjudged the strength of the company's brand and its resonance with its customer base and also the impact of the highly competitive and commoditised nature of the UK insurance market,' wrote the trust in its annual report.

Fund managers rarely get everything right; such is the way with investing. However, investors who were burned by holding the Woodford Income Focus fund – with a near-25% negative total return since launch in 2017 – will understandably be nervous, even with a new manager at the helm.

ASI's qualities would suggest investors are now in good hands, but the jury is still out until the fund has revealed the new-look portfolio and the co-managers can prove their approach works with positive performance data.

The accompanying table shows Murray's portfolio quality characteristics compared to the benchmark index, the FTSE All-Share. 'The price-to-earnings ratio is only marginally more expensive than the benchmark,' says Luke. 'We are getting really good quality companies but we aren't paying over the odds.'

MURRAY INCOME TRUST: QUALITY CHARACTERISTICS

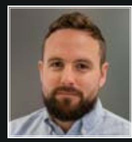
	Murray (%)	FTSE All Share (%)
Return on assets	7.0	4.7
Return on equity	15.5	11.8
Operating margin	18.4	17.4
Net debt ex-financials	65.6	83.6
EPS growth*	7.0	6.5
DPS growth*	5.7	4.5
Sales growth*	4.2	3.9
Cash flow growth*	5.4	5.4
PE**	15.6	13.1

Source: ASI, October 2019. *3 year forward estimate. **Calculated using forward year one estimates

By **Daniel Coatsworth**
Editor

TIME TO SELL OIL?

Climate change is putting pressure on the sector



By **Tom Sieber**
Deputy Editor

The oil and gas industry contributes to 42% of global emissions according to global consulting firm McKinsey.

It is little wonder that the sector has found itself in the crosshairs of environmental campaigners and a growing portion of the investment community is turning away from fossil fuel-based investments amid increasing focus on environmental, social and governance (ESG) issues.

At the beginning of this year the CEO of asset management giant BlackRock, Larry Fink, was vocal in committing his organisation to putting climate change considerations at the heart of its investment strategy. Others are likely to follow suit.

This raises the prospect of oil and gas fields becoming 'stranded assets' – resources that once had value but have since become a costly liability.

If capital shifts out of oil and gas shares it could create a vicious circle for the sector whereby their weighting in global indices decreases and they are therefore less widely held by tracker funds.

In this context, why would you continue to invest in oil stocks like **BP (BP.)** and **Royal Dutch Shell (RDSB)**? It's a big question that many investors are now asking.

We think there are several reasons why they still might appeal to someone comfortable with

any ethical considerations and the long-term challenges facing the space. Oil is under pressure but we still think it could be a good source of investment returns in the near-term.

HYPOCRITICAL STANCE?

Fink's comments drew fire from environmental campaigners who pointed to the inherent hypocrisy in BlackRock's new stance given its position as one of the largest global investors in the resources space.

And Fink himself admits: 'Despite recent rapid advances in technology, the science does not yet exist to replace many of today's essential uses of hydrocarbons. We need to be mindful of the economic, scientific, social and political realities of the energy transition.'

Charles Luke, fund manager of **Murray Income Trust (MUT)**, is one of the many institutional investors that still have exposure to the oil sector as a source of income. BP is under pressure from critics who say it should stop spending so much on dividends and redirect that money into renewable energy investments, thereby accelerating the transition away from a traditional oil and gas focus.

However, he comments: 'It is not clear to me that BP will have to cut the dividend to fund its growth in renewables.

'There is a middle way to do both things. It is conscious of the long term threat to oil but is also slowly transitioning the portfolio to a more renewables future. Typically it will need to invest in areas of the market where returns are lower and less guaranteed.

'It would be difficult to generate the yield for Murray Income Trust without having some oil and it would be difficult to have a diversified portfolio without having some oil.'

FOUR REASONS WHY OIL COULD STILL DELIVER

We see four reasons that oil could still deliver positive returns for investors for at least another few years.

1. DIVIDENDS

As Luke's comments allude to, the UK's oil majors pay very generous dividends. At the time of writing Royal Dutch Shell and BP yield

BACK TO $100 OIL?

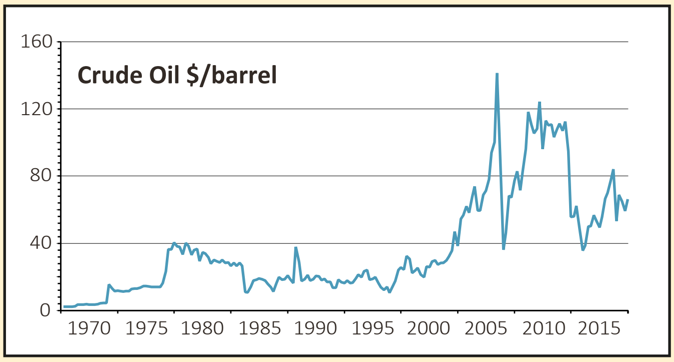
THE RECENT MIDDLE East crisis stirred by the US killing of top Iranian general Qasem Soleimani led to some speculation on oil reclaiming the $100 per barrel mantle.

If Iran were to shut the Strait of Hormuz – out of which a third of the world's traded oil flows – it might prove a sufficient catalyst to drive oil to that level. However, this seems an unlikely course of action as it would be almost sure to provoke ever more severe retaliation from the US.

The Middle East has been responsible for most of the big spikes in oil going back decades. In 1979 the Islamic revolution in Iran created a panic in the oil market and on an inflation-adjusted basis saw oil prices trade above $100. Oil hit a record $147 in June 2008 on Iranian missile launches. Six months later it was at $32 amid global recession.

The last time oil traded above $100 per barrel was June 2014 when the ISIS conflict in Iraq was at its height. This preceded a plunge in oil prices linked to the rapid growth in US shale production and global growth concerns which eventually saw prices bottom out around the $20 mark in January 2016.

OIL PRICE TRENDS



6.5% and 6.4% respectively.

Shell hasn't cut its dividend since the Second World War but BP's track record is less spotless – it temporarily suspended the payout in the wake of the Gulf of Mexico oil spill a decade ago.

Together they account for around 10% of the dividends paid by all UK companies. Shell is promising to pay out around $125bn between 2021 and 2025 based on its current cash flow projections.

We believe there is still strong demand from income funds in the short to medium-term to continue buying shares in the big oil companies despite concerns about the industry from an ESG perspective.

2. IMPROVING OIL PRICE OUTLOOK

Oil has retreated from the multi-month highs above $70 per barrel attained amid rising tensions between the US and Iran as both sides seemed to step back from the precipice of outright conflict.

However, some observers see reasons to be positive on the oil price in the short-term. Canaccord Genuity analyst Charlie Sharp says: 'We believe the increased supply-control commitment from OPEC, declining US shale output growth and Chinese economic stimulus look capable of offsetting some production expansion elsewhere.'

Sharp adds that the relative stability in the price in the second half of 2019 will have been supportive to firms' ability to make long-term investment decisions.

Investment bank Berenberg also has a positive view, saying: 'In our view, the risks to oil prices have started to be skewed more to the upside following the further OPEC cuts agreed in December, combined with downward revisions to the US shale production outlook.

'We still expect a surplus market in 2020 but that surplus is considerably smaller than our previous forecasts. It is also weighted to the first-half, shifting into a deficit by year-end.' For the investment bank this feeds into a $65 per barrel oil price assumption for 2020 – exactly in line with where the commodity price is trading at the time of writing.

3. CAPACITY TO ADAPT

Although ESG and oil and gas might seem entirely incongruous, there are things the resources industry can do to reduce its impact on the environment.

The indirect emissions from the use of fossil fuels is something which is out of companies' hands. However, there is scope to reduce the emissions generated in the course of their operations.

Management consultant McKinsey has pointed to several things oil and gas producers can do. This includes using renewable energy on-site, reducing methane emissions by improving leak detection and repair, limiting the burning or flaring of gas by increasing operational efficiencies, and using carbon capture technology.

4. THE DEATH OF THE OIL AND GAS INDUSTRY HAS BEEN EXAGGERATED

The growth of the electrical vehicle industry is seen as an existential threat to the oil and gas sector, with road transport accounting for upwards of 40% of all oil demand.

The transition from traditional combustion engines to electric vehicles is unlikely to be smooth or happen overnight. Oil consumption may be growing less quickly but it is still going up and there are lots of other uses for oil, such as petrochemicals production and fuel for the aviation or maritime sectors.

YOUR GUIDE TO FTSE 350 OIL STOCKS

ROYAL DUTCH SHELL (RDSB)

Market cap: £178bn
Forward PE: 11.5

Shell is an integrated energy business. This means it has operations in oil and gas exploration, production, marketing, refining, transportation and distribution. In a nutshell it is involved in everything from drilling and finding new sources of oil and gas to selling you petrol at the pump.

In recent years the company has been investing in natural gas projects – gas being cleaner than oil and other fossil fuels – as it attempts to respond to pressure over climate change and changing patterns in energy consumption.

BP (BP.)

Market cap: £100.8bn
Forward PE: 11.9

Like Shell this is an integrated operation, running the gamut from exploring for hydrocarbons to selling and marketing its own refined products. Under CEO Bob Dudley, who steps down in February 2020, the focus has been on becoming a more streamlined organisation, change driven in part by the impact on the company of the Gulf of Mexico oil spill in 2010. All told the company has sold around $60bn worth of assets in the interim making it a leaner and more cash generative business.

ENERGEAN OIL & GAS (ENOG)

Market cap: £1.55bn
Forward PE: 17.9

Among the better performing oil and gas shares in recent years, Energean listed on the London Stock Exchange in March 2018. The company is developing resources in the Mediterranean. The focus is on natural gas, which makes up 80% of the portfolio.

The company's flagship development assets are the Karish and Tanin fields located offshore Israel. The plan is to commence production from the Karish field in 2021 when total group production is expected to hit 140,000 barrels of oil equivalent per day.

CAIRN ENERGY (CNE)

Market cap: £1.15bn
Forward PE: 24.3

The company has been embroiled for several years in a tax dispute over its historic assets in India. After an unsuccessful and expensive exploration effort offshore Greenland the company has enjoyed renewed success in the waters off Senegal where it recently gave the green light to the Sangomar development.

The field is expected to produce around 100,000 barrels of oil daily. First oil is targeted in early 2023. Cairn also has producing assets in the North Sea, where its key assets are the Kraken and Catcher fields.

PREMIER OIL (PMO)

Market cap: £976m
Forward PE: 11.6

Since the oil price crash in 2014 Premier has been wrestling with heavy levels of debt. A recent court ruling means it can move ahead with a plan to extend the maturity of its borrowings and acquire North Sea gas fields from BP despite opposition from largest creditor Asia Research & Capital Management (ARCM). As well as buying up its debt the latter has been short selling Premier shares as a hedge.

Premier now needs to secure the approval of its other lenders to progress the plan. Selling its Zama discovery in Mexico could contribute to fixing the ongoing balance sheet problem.

TULLOW OIL (TLW)

Market cap: £751m
Forward PE: 7.2

The last decade was ultimately a miserable one for Tullow. In the noughties it had gone from small cap status to an established constituent of the FTSE 100 off the back of big discoveries in Ghana and Uganda.

A more patchy exploration record in the interim, and production problems as these African finds have been brought on stream, allied to volatile oil prices and too much debt have proved a toxic mix.

In December 2019 the shares lost more than half their value as Tullow suspended its dividend, slashed output guidance and saw chief executive Paul McDade and exploration boss Angus McCoss depart in ignominy.

OUR TOP OIL PICKS

ROCKROSE ENERGY (RRE) £22.08 BUY

The company's strategy has been built on buying assets in the North Sea at attractive prices and then investing to extend the life of these assets.

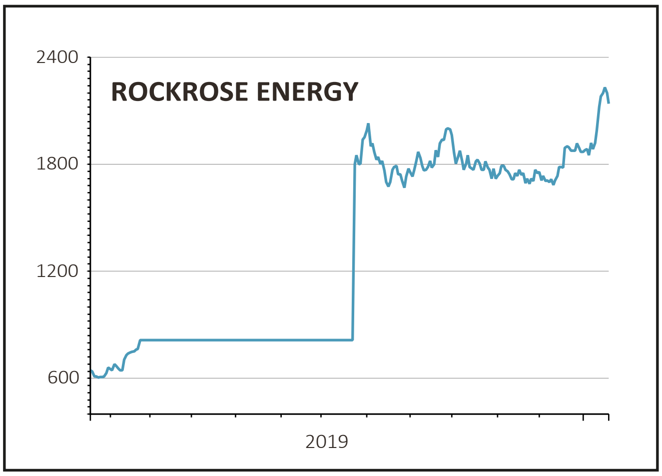
This has the advantage of boosting reserves and output as well as forestalling decommissioning liabilities. For example, the production life of the Ross and Blake fields has been extended from 2024 to 2029 under its ownership.

The success of this approach is reflected in the fact that the share price, in just a few short years, has gone from 51.5p to £22.08. We still think there could be more upside to come.

The company has built a large, cash-generative portfolio – the Marathon acquisition which completed in July 2019 has a particularly significant impact – and has returned a significant chunk of this cash to shareholders. Average production is expected to total 21,000 barrels of oil equivalent per day in 2020.

Growth opportunities through M&A activity could include buying into new fields as well as upping interests in existing fields, with the company sitting on cash of $370.7m at the last count.

RockRose is also drilling seven development wells in 2020 which could act as a catalyst for the shares. A commitment to pay out 85p per share in dividends for 2019 implies a yield of around 4%.



JADESTONE ENERGY (JSE:AIM) 83P BUY

The brains behind this Asia Pacific oil and gas play have an impressive track record. In particular chief executive Paul Blakeley who, at Canadian outfit Talisman Energy, built a business which became the UK North Sea's second largest operator with upwards of 160,000 barrels of oil equivalent per day production.

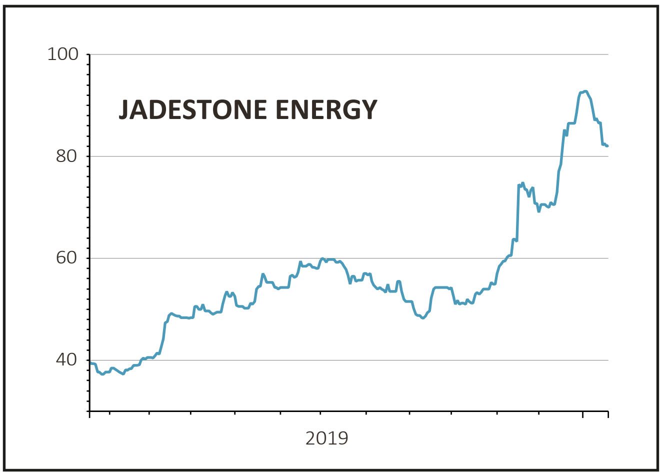
He then moved to Asia and delivered a business on a similar scale for Talisman before the group was bought by Spain's Repsol in an $8.3bn deal in 2015.

In both cases Blakeley's strategy involved hoovering up unwanted assets from major oil and gas companies. Jadestone is pursuing a similar approach.

Having already picked up assets in Indonesia, Australia and Vietnam its latest acquisition in November 2019 was the $50m purchase of the Maari field in New Zealand from Hungarian firm OMV.

Investment bank Stifel spells out the attractive metrics of this deal: 'We estimate $74m free cash flow net to Jadestone across 2019 and 2020 – having generated around $40m free cash flow in 2018 net to OMV – so the field is very likely to have paid for itself even before the transaction has completed.'

Blakeley tells *Shares* that the region is attractive as it is 'energy hungry and has a low cost profile'. The company plans to pay out up to $12.5m in dividends in 2020 which would add up to a prospective yield of 2.6%.



RUSS MOULD
AJ Bell Investment Director

Will China flourish in the Year of the Rat?

The Chinese stock market is looking for a stronger catalyst

The latest Chinese lunar year begins on 26 January as the Year of the Rat takes over from the Year of the Pig. In theory, China already has something to celebrate, in the form of the phase one trade deal signed with the US on 15 January.

In return for Beijing agreeing to substantially increase imports of agricultural and industrial goods from the US, America scrapped a third round of tariffs and cut the duties imposed on $120bn of Chinese wares from 15% to 7.5%.

This gives President Trump the perceived win that he wanted, 10 months before the US election. It gives President Xi the chance to avoid further economic damage and work on supporting economic growth as China prepares to mark the Communist Party's centenary in 2021.

However, this initial agreement is fairly limited in its scope.

- American tariffs on around $360bn of Chinese goods are still in place, or about 85% of the total, as are retaliatory Chinese duties. US imports from China fell by 22% in 2019, so they are hurting.
- The allegations of intellectual property misuse, or outright theft, by Chinese firms remain largely untackled.
- A phase two deal designed to address these and other issues may not be ready until after the US presidential election on 3 November.

This leaves China with much work to do if it is to placate its global economic rival on the one hand, yet maintain economic and therefore political stability at home on the other.

GOOD SAVERS

The Rat comes first in the cycle of the Chinese zodiac, which associate rats with wealth and surplus – rats are seen as good savers, even hoarders. Whether this means Chinese equities will have a good year or not is another matter entirely.

Fundamentals matter and questions are gathering over the quantity and quality of Chinese GDP growth.

Chinese GDP growth came in at 6.1% in 2019, the slowest growth rate since 1990. Some perspective may be needed – most countries in the West would be delighted with 6.1% growth. And that increase still equates to $815bn, which is a bit bigger than the entire output of Saudi Arabia, the world's largest economy.

Even so, the Chinese stock market seems far from impressed. The Shanghai Composite index is no higher than it was in March 2007.

SHANGHAI COMPOSITE IS UNCHANGED ON 2007 LEVELS

Source: Refinitiv

RUSS MOULD
AJ Bell Investment Director

QUALITY OF GROWTH

Economic growth is not the be-all and end-all, even when it comes to picking emerging markets, and doubts about the quality of Chinese GDP growth continue to linger.

The headline growth number of 6.1% does not sit easily alongside sliding imports and exports, a second straight drop in car sales or weakness in the Li Keqiang index, which is based on the (potentially more reliable) bottom-up indicators of electricity use, bank loan growth and railway cargo volumes.

LI KEQIANG INDEX REMAINS SUBDUED

Source: AJ Bell, Refinitiv

In addition, much of the recent increase in GDP has been funded by debt. According to the Institute of International Finance, government debt represents just 55% of GDP. But once borrowings at state-owned enterprises, private businesses and consumers are thrown in, and the so-called 'shadow finance' or non-bank credit industry taken into account, total debt-to-GDP is 310%.

DEBT CYCLE

China is doing its best to keep the plates spinning, cutting both interest rates and the amount of capital that banks have to hold (thus boosting their ability to lend) but some economists argue that the debt numbers mean China simply cannot grow at its current rate for much longer.

Some even argue that the country is facing its own Minsky Moment, as its economy reaches the third stage of the debt cycle outlined by economist Hyman Minsky in his 1993 paper *The Financial Instability Hypothesis*:

- Hedge finance, where a mix of cash flow and equity help borrowers to fund interest payments on debt and eventually pay off their liabilities
- Speculative finance, where debtors have enough money to cover interest but cannot repay the original loan, which must be rolled over
- Ponzi finance, where borrowers are unable to pay off the interest, let alone the principal debt and resort to asset sales to pay the bills

Investors may think this sounds a little apocalyptic, but it may help to explain why the Shanghai Composite index is going nowhere fast.

In 2018 and 2019 stock market index constructors such as MSCI and FTSE Russell began to include onshore Chinese A-class shares, and not just Hong Kong-traded H shares, in their benchmarks. This increased the weighting given to Chinese equities and raised the possibility that a wall of money from passive index trackers would be obliged to buy. That may have been the case but so far passive buyers appear to have been accommodated by plenty of willing sellers.

It seems highly likely that the Communist Party will ensure GDP growth looks (and feels) decent with the 2021 centenary in mind.

But how it manages to sustain growth without piling up too much debt, or cutting interest rates to the point that the stock market becomes bubbly (as per 2007 and 2015) or the renminbi weakens (as per 2015-17 and 2019, leading to trade troubles with America) will be fascinating to watch. In the end it feels as if something will have to give, especially if Minsky is right.

THE SNOWBALL EFFECT OF DIVIDENDS

If you're a regular reader, you'll know that we often talk about dividends. That's because they can make a big difference to your long-term investments. In this article we go back to basics and explore the role of dividends.

Making dividends work for you

If you're a shareholder in a company, you may receive a dividend from that company's profits – as a reward for entrusting it with your capital. As with all investment trusts, The Scottish's main source of income used to pay dividends to its investors are the dividends received from its portfolio of holdings. You may not be aware that we deliver one of the highest dividend yields in the AIC Global peer group. This is important because, in conjunction with share price movements, dividend income forms a substantial part of an investor's total return.

Compounding occurs as dividends are used to buy more shares which, in turn, earn dividends on their own. These reinvested dividends would then gain or lose in line with the movement of the share price. For example, over 25 years to 31 December 2019, the share price of The Scottish increased by 297%. The share price plus dividends taken as cash would raise this to 431% over the same period and, if those dividends had been reinvested, the total return would have been 612% (all before any dealing expenses). It's important to remember, of course, that markets can be volatile and shares (and the income from them) can go down as well as up.

Why a contrarian approach can pay dividends

As we've demonstrated, dividends can play an integral part in the return on your investments over the long-term. We're pleased to say that we've increased our regular dividend for the last 36 consecutive years which makes us a 'dividend hero' according to the AIC. Though remember that dividends are not guaranteed and they can fall as well as rise.

In this context, how does our contrarian style come into play? It guides us to look for what we call 'ugly ducklings' – unfashionable and unpopular investments. The share price of such investments typically reflects their 'unloved' status, often written off by other investors. By contrast, we research these companies to ascertain if they are ripe for improvement. Has there been a change in their business model, or to senior management? Are there nascent opportunities in the markets in which they operate? If we believe we can see a change, and the company presents a credible plan for recovery, we'll consider investing. However, we also take a 'belt and braces' approach to our investment – which brings us back to dividends.

One of the things we may consider before investing in an 'unloved' company is if it has sufficient cash to pay dividends throughout its turnaround. As our approach is based on long-termism and patience, a sustainable dividend may make it easier for us to hold the stock while the business is recovering. A good example of this is our investment in Dutch telecoms group KPN. Deemed unexciting by many, we view the steadiness of this business as a virtue. It fits our 'unloved' criteria, because shrinking revenues have set investors' expectations low. The company has a credible plan to improve its fortunes. As we wait for positive development, we can enjoy the dividend – the belt to the braces.

> “dividends can play an integral part in the return on your investments over the long-term”

What if the company doesn't pay a dividend?

If dividends are so useful, does that mean we'll shun companies that don't pay one? Not necessarily. When a company is putting its house in order, it might choose to stop paying a dividend, conserving its cash to allow it to improve the business (investing in new technology or changing its business model, for example). Indeed, this was the case with Tesco, which suspended its dividend before we invested. Tesco addressed areas of concern, made improvements to its business – then restarted its dividend. We see the reinstatement of a dividend as an important signal that a company's rehabilitation is underway. Another example is Royal Bank of Scotland, which was forced to cease dividends during the financial crisis. Similarly, the company restarted dividends when its financial position improved.

As you can see, dividends can tell us a lot about a company's health – and its future prospects. We always pay close attention to a company's dividends when we're considering investing – both its ability to pay them and its track record of doing so, because dividends can make a tangible difference to long-term investors. ■

6 January 2020

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M&S should choose revolution over evolution in order to grow

We undertake a deep dive of the food and clothing retailer to see why analysts are starting to like the stock

According to chief executive Steve Rowe, a 35-year veteran of **Marks & Spencer (MKS)**, the venerable retailer is roughly at the halfway point in its three to five-year journey of transformation to 'restore the basics' and create a 'profitable, growing family of businesses'.

However, true to his nickname of 'Nails', he pulls no punches in assessing the scale of the task. When he took over in 2016, the business suffered from 'a bureaucratic culture which had never been challenged', was 'behind the curve in digital and tech', was 'operationally weak and drifting upscale in Food' and had 'lost its style and value identity in Clothing & Home'. Moreover the store estate wasn't fit for the future and its supply chain was expensive and outdated.

In this year's first-half results, Rowe described M&S as having achieved 'far-reaching change – delivered at pace' and claimed that change was happening 'faster than at any time in my career'. Yet judging by the performance of the share price, it still isn't fast enough for investors.

We would argue that the food business, the biggest earner,

is back on track, and the joint venture with online delivery firm **Ocado (OCDO)** is a genuinely bold move. Management now needs to take a similarly bold line with the clothing and home business, and we have a couple of radical suggestions.

THIS IS MORE THAN JUST A MAKEOVER

To help break up the bureaucracy and reshape the organisation, Rowe brought in a raft of new leaders starting in September 2017 with chairman Archie Norman.

As well as an extensive retail and business career, Norman had overseen successful transformations at supermarket chain Asda and broadcaster **ITV (ITV)**. He was joined by Humphrey Singer, former chief finance officer of electrical retailer **Dixons Carphone (DC.)**, in July 2018, and Justin King, ex-chief executive of grocer **J Sainsbury (SBRY)** and a former head of the food division at M&S, who joined as a non-executive director in January 2019.

The job of making the property

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estate 'fit for the future' is a much tougher fix than changing the management culture as a third of M&S's full-line stores were built before 1939 and three quarters are over 25 years old.

To its credit M&S has been busy reshaping the estate. In addition to the 35 full-line stores closed in the 2018-19 financial year, in the six months to the end of September 2019 a further 17 full-line stores, two outlets and one food store were closed. Happily, nearby stores have seen an increase in sales with transfer rates approaching 20%, and more closures are planned for this calendar year.

Meanwhile spending on remodelling UK stores increased significantly in the six months to September 2019, hitting £22.8m against £6.8m in the same period the previous year. One of the regular complaints in customer surveys is that the stores are confusing and hard to navigate.

At the same time the firm is bearing down on operating costs with a programme to reduce outgoings by £350m ranging from central costs to warehousing and distribution to in-store costs including staffing.

"Key drivers of this improvement have been the move away from 'overly premium' ranges and confusing promotions"

UPGRADING THE SUPPLY CHAIN

As well as reducing and modernising its store estate, M&S has reduced the complexity of its supply chain network by closing four distribution centres and warehouses and opening a national centre at a former **Tesco (TSCO)** site in Welham Green in Hertfordshire, operated by DHL.

It has also beefed up capacity at its Donington warehouse facility and introduced a new warehouse management software system across the group with the aim of up speeding up replenishment to stores and reducing levels of stock holding by up to four weeks.

A part of the effort to reduce what it calls 'clog' in its stores, excess stock is removed from display and sent back to the warehouses making the stores less cluttered and easier for shoppers to navigate.

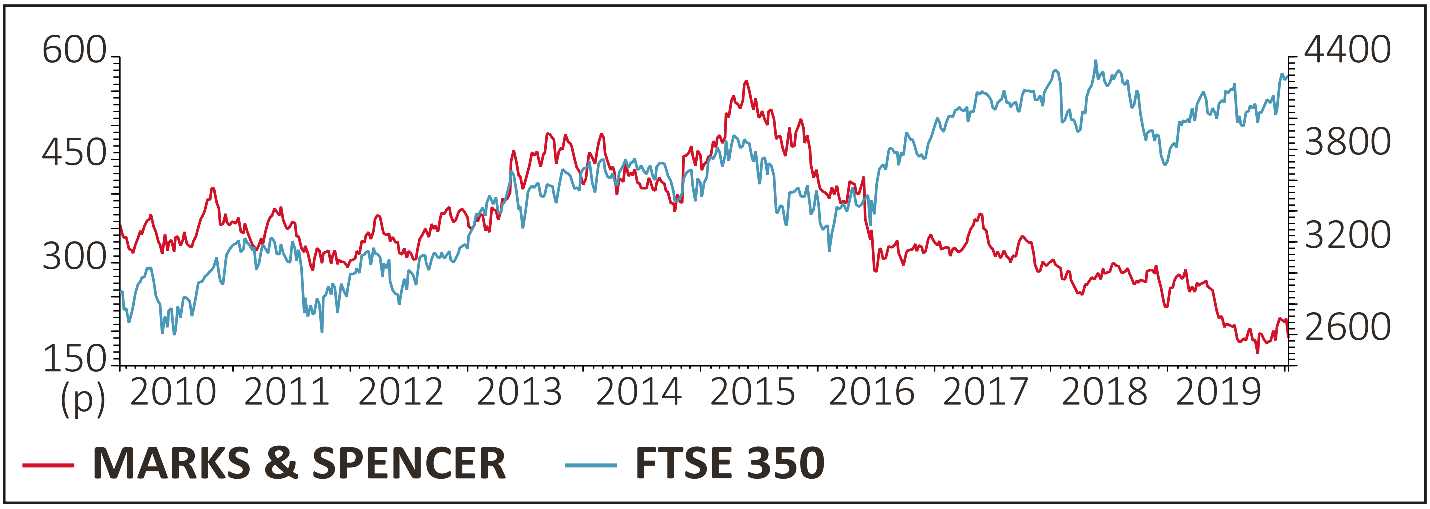
FOOD SALES GROWING AGAIN

We would argue that the changes made to the food business, especially the focus on everyday value and family appeal, are already bearing fruit. For the first time since 2015, like-for-like sales growth has been positive for three consecutive quarters.

Key drivers of this improvement have been the move away from 'overly premium' ranges and confusing promotions, better timing and scope of markdowns, and above all changing the in-store message to communicate value as well as quality.

There have also been changes behind the scenes, with effort going into shortening product development times, improving communication with suppliers, increasing collaboration and speeding up decision-making.

Meanwhile a reduction in space for 'ambient' (packaged)



foods is expected to generate cost savings of as much as £20m.

Unfortunately, food waste, which is amongst the highest in the industry and has historically been a problem at M&S, was again an issue last quarter with over-ordering of Christmas products. Better forecasting and communication with its logistics suppliers is needed.

This year also sees the operational start-up of the joint venture with Ocado to deliver online food orders. By combining the strength of its brand with Ocado's online offering, M&S hopes it can directly target the 12m M&S food customers who currently shop for food online with its competitors as well as picking up most of the existing Ocado customers who currently use the service to buy Waitrose products.

SIGNS OF IMPROVEMENT IN CLOTHING

While the food business has turned up, the clothing and home operations are still racking up negative like-for-like results and sales continue to dwindle despite numerous attempts to stem the tide.

The UK clothing market is worth an estimated £35bn per year and M&S is still the UK's number one clothing retailer with over 23m customers. When it comes to essentials like bras and children's school uniforms it dominates the market, and a renewed focus on 'must-haves' seems to be working with womenswear sales outperforming the market in the latest quarter.

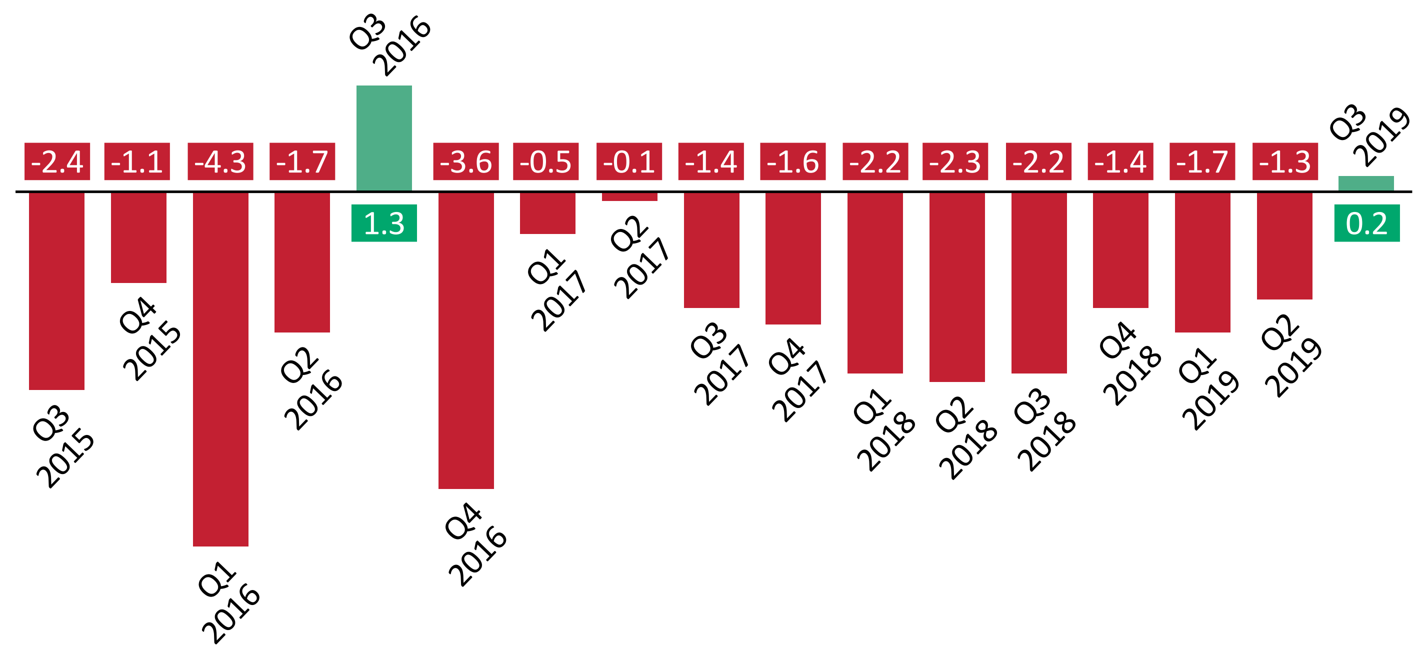
Historically, size ratios have been 'misaligned with the profile of the contemporary family-age customer we aim to appeal to' according to Rowe. Where management has reshaped its buying by introducing fewer options with slimmer fits and more mid-sizes, the customer response has been 'very strong'.

Many of the sub-brands such as Per Una and Blue Harbour are being 'edited' and relaunched, and a new pricing philosophy of 'first price, right price' aims to cut the amount of products sold at a discount.

There are also innovations, such as the new Goodmove 'athleisurewear' range targeted as customers who either work out regularly or like to wear athletic wear on a casual basis. The UK athleisure sector is estimated to be worth £3bn per year and GlobalData predicts it will grow by 20% per year to 2023, making it an attractive market.

The clothing business still suffers from slow stock replenishment and on occasion depth of buy, selling out of popular lines too quickly, and it still hasn't arrested the slide in menswear sales, but our sense is the like-for-like performance is improving. A reduction in the amount of stock held going

M&S LIKE-FOR-LIKE SALES GROWTH / DECLINE (%)



Source: M&S, Shares

FINANCIAL FIGURES AND FORECASTS

	2018	2019	2020	2021
Group sales	£10,698m	£10,377m	£10,242m	£10,201m
Food sales	£5,940m	£5,903m	n/a	n/a
Clothing and Home sales	£3,671m	£3,537m	n/a	n/a
Operating profit	£670m	£601m	£636m	£618m
Pre-tax profit	£581m	£523m	£445m	£452m

Source: M&S, Shares, Reuters Eikon. March year-end

into sales is also helping to lift margins.

RADICAL THINKING REQUIRED

The area we struggle with is the home products business. M&S refuses to break out sales figures or margins, and requests to leading analysts for their estimates of the business split were ignored suggesting that they don't know. Our best guess is that 'home' accounts for a good deal less than half of the broader home and clothing division's sales and earnings and like-for-likes are considerably worse than the clothing business.

Given the long list of heavyweight high street and retail park competitors for home products, such as Argos, **B&M European Value (BME)**, **Dunelm (DNLM)**, Ikea, Matalan, Wilkinson and even the supermarkets, and an endless list of online suppliers, we fail to see why M&S feels the need to operate in this market. Gross margins may be higher than food, but turnover is much lower and the amount of space given over seems disproportionate.

We would suggest scrapping home sales altogether and focusing on an area where the brand offering is weak and needs improvement – footwear. In fact we would go a step further and suggest that M&S acquires Clarks, which is in the process of restructuring its operations, shutting many of its 550 UK stores and turning its focus to the Far East.

Founded 195 years ago, Somerset-based Clarks was voted the UK's number one fashion brand in a summer 2019 poll of Britain's favourite brands by **YouGov (YOU:AIM)**, ahead of global giants Adidas and Nike. Those polled trusted its brand and praised the quality of its products.

Despite the family-owned firm's popularity, group turnover fell 5% to £1.46bn in its last financial year and it reported operating losses of close to £30m against profits of £75m the previous year due to 'onerous leases' on its high street operations.

Putting the trusted Clarks brand alongside Marks & Spencer's food and clothing offering would constitute a formidable proposition in our view. Adding footwear would not only give customers another reason to visit M&S stores, we believe it would increase margins in the clothing division.

Hopefully Richard Price, the current chief executive of F&F (owned by Tesco) who has been drafted in as the new managing director of the clothing and home division, is prepared to take bold decisions and steer the business in a new direction rather than simply tinker at the margins like his predecessors.

INTERNATIONAL BUSINESS UNINSPIRING

M&S has exported and sold food and clothing abroad for more than half a century, yet the business still only represents around 10% of group turnover.

Its track record in international markets is inconsistent. After a string of misjudged acquisitions and roll-outs it pulled out of the US and Europe in the early 2000s, only to expand again in 2011. Five years later, after another strategic review, it upped sticks in 10 overseas markets and now operates through franchise and joint venture partners who generate the bulk of sales and earnings.

Following a poor performance

in the 2018-19 financial year, international sales in the six months to September were down 1.7% and the slide continued in the third quarter with sales down 2.3%.

Despite optimism over India, where M&S has upgraded its existing stores, rolled out new ones and launched new beauty and lingerie ranges tailored to the local market, the international business seems unlikely to make a major contribution or 'move the needle' for the group in the next few years.

BUILDING A DIGITAL 'LAKE'

By its own admission, M&S is playing catch-up in terms of the digital market. There has been progress with the M&S.com website, which boasts 11m users, in the form of faster average page-load speeds, and the firm has explored social media 'piloting' with a shoppable feed on Instagram.

In the 2018-19 financial year, 22% of clothing and home sales were online and clothing sales are growing faster than the market. Next to come are later cut-off times for click and collect, trials of same-day delivery, faster payment speeds and a mobile M&S app targeting over 1m users. The aim is for a third of clothing and home sales to be made online.

However the Sparks loyalty card, which has 7m users, has been an undisputed flop and needs rethinking. Sparks customers tend to spend significantly more than other M&S customers and their click-through rate online is 50% higher yet the lack of a clear 'value exchange' has curbed its appeal.

In theory, across Sparks, its website, its bank and soon its Ocado joint venture, M&S has the potential to create a huge 'lake' of customer data which it can use to personalise the shopping experience and increase customer loyalty.

In practice, it has underinvested and the organisation isn't digitally joined up, meaning it has a long way to go. At least it has confronted the problem and knows what it needs to do.

EVOLUTION OR REVOLUTION?

M&S has the potential to become a bigger, better, more profitable business if it can tackle the issues over which it has control. With the election out of the way and 'Brexit uncertainty' no longer an excuse, consumer spending is likely to pick up in 2020 and retailers should be obvious beneficiaries.

The share price is close to decade-lows and discounting weak sales for the foreseeable future. If Steve Rowe and his team are up for making bold decisions, we think M&S could transform its proposition and its sales by realigning the clothing division, otherwise it looks like a slow grind back to growth.

Almost half of the brokers (nine out of 21) with a view on M&S have no view, ie. they have a 'hold' recommendation, with the rest split equally between 'buy' and 'sell'. Berenberg, which was slightly premature in moving from 'sell' to 'buy' ahead of the third quarter results, believes that easy like-for-like comparisons and Price's arrival will lift clothing and home like-for-likes this year.

On the other hand analysts at Liberum say 'sell' on the basis that pricing and margins in the food business could come under pressure and clothing and home still isn't fixed. 'We acknowledge the changes being implemented but are not yet convinced that these will materially improve the fundamentals.'

M&S could continue to plough on with its five-year plan to increase sales and earnings but as the share price suggests investors are losing heart. If it were to take bold action we suspect analysts and investors would back it but buying the shares today feels like a leap of faith given the dire commentary about the UK retail sector.

By **Ian Conway**
Senior Reporter

One-stop-shop funds are a great place to start investing

But don't put all your money in a single product as you still need to spread your risks

One-stop-shop funds are products designed to give investors everything they need under one roof, namely asset diversification.

They can be especially attractive to investors new to handling their own long-term savings, as well as first-time investors or retirees put off by poor annuity rates. They may also work well for those investors that do not wish to make asset allocation decisions themselves, but would rather leave the tough calls to an expert.

These types of funds tend to be multi-asset, which means that they will own shares and bonds, and can sometimes give you additional access to property, and commodities, while avoiding anything seen as too exotic that could suddenly blow a hole in performance.

STARTING OUT

All investors have to start somewhere with their investment journey and shares in an individual company are not really a suitable place for a first-timer. A multi-asset fund might be more appealing, or perhaps a tracker fund or ETF that tracks the FTSE 100 index in the UK or the S&P 500 index in the US, as these are much more diverse and the investor is spreading their risks.

The product decision comes down to individual needs and choices.

'What does an investor want to achieve?'

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'What is the individual's risk appetite?

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'What type of asset exposure do they want?'

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'What is their timeframe?'

The product decision comes down to individual needs and choices. 'What does an investor want to achieve?', says Paul Niven, who has run the **F&C Investment Trust (FCIT)** since 2014. 'What is the individual's risk appetite? What type of asset exposure do they want? And what is their timeframe?' These are all important questions for any investors to ponder, especially those new to financial markets who may never have considered their long-term savings goals before.

The scale of one-stop-shop funds available to investors can be mind-boggling. There are numerous multi-asset type funds on the AJ Bell Youinvest platform, for example, as well as many relevant investment trusts listed on the London stock market.

For example, the 152-year-old F&C Investment Trust – the UK's oldest – pitches itself as a one-stop shop fund largely to retail investors with the nuance of being 'exposed to growth assets' in stock market listed and private companies. 'We cover a lot of bases with one asset purchase', says Niven.

The four-star Trustnet rated **Brunner Investment Trust (BUT)** calls itself a 'one-stop-shop' investment solution for global growth opportunities and dividends that rise over time.

Run by manager Lucy Macdonald, Brunner is a 'Dividend Hero' trust, namely one that has increased its dividends every year for at least the past 20 years – in Brunner's case it is 47 years in a row. Investing exclusively in shares from around the world, its largest stake is currently Microsoft, but it also holds shares in pharmaceutical, semiconductor, payments and oil companies.

CAN STOCKS ALONE PROVIDE A SOLUTION?

Can funds that only contain equities (another word for stocks and shares) really be a one-stop-shop when gold, bonds and property bring their own advantages to a rounded investment portfolio, such as income that is fixed for a given time period and won't change, or reduce risk?

F&C's Paul Niven believes they can. 'Government bond returns have been as good as equities over the last decade, but that's historical, and returns may not be as generous going forward.' He believes equities provide flexibility that won't leave investors locked into income streams that may start to look unattractive when interest rates begin an up-cycle.

Access to gold can be obtained through select mining stocks, while commercial real estate firms or even housebuilders are equity ways to play property without

'But while a one-stop-shop fund may sound ideal for many investors, remember that you shouldn't put all your eggs in one basket'

the enormous cost of physical ownership or, importantly, the illiquidity that owning shopping centres of office blocks brings.

MULTI-MANAGER APPROACH

'Our multi-manager strategy is inherent in a one-stop-shop premise', says James Hart, investment director of the **Witan Investment Trust (WTAN)**.

Witan is not a multi-asset fund but deliberately describes itself as multi-manager. 'We run focused segregated mandates under Witan's control,' says Hart.

This means appointing the best specialist managers it can find

EXAMPLES OF MULTI-ASSET FUNDS
BlackRock Global Multi-Asset Income
Fidelity Multi-Asset Balanced Income
Janus Henderson Multi-Manager
JPM Multi-Asset Income
Kames Diversified Monthly Income
M&G Sustainable Multi-Asset
Threadneedle Global Multi-Asset Income
Vanguard LifeStrategy 40% Equity

Source: FEFundinfo

and letting them operate 15 to 60 stock concentrated portfolios covering different parts of the world and styles. It recently launched a climate change mandate, for example.

Combined, Witan has somewhere in the region of 350 to 400 stocks in the overall fund, giving it a broad spread. 'The message we get from financial advisers and wealth managers is that many investors see Witan as a cornerstone investment,' says Hart.

But while a one-stop-shop fund may sound ideal for many investors, remember that investing in a single fund contradicts an important tenet of investing – namely that you shouldn't put all your eggs in one basket, not even when that's a fund holding a wide selection of investments.

Financial advisers may have different views but the consensus opinion is that somewhere between 10 and 15 funds or investment trusts is probably ideal, depending on the size of an individual's savings pot. That's a sensible longer-term objective.

By **Steven Frazer**
News Editor

What are the options to fund care?

From renting or selling property to annuities and investments, we look at the different paths you can take

Funding care costs became a key topic in the recent general election, with different parties pledging money or proposing reviews into how to fix the problem of care funding. However, it's a problem that's been kicked down the road by continual governments, as the costs are high and there's no easy solution.

Until there are any major changes by the Government, you will typically have to fund your own care if you have savings or assets worth more than £23,250.

The average care cost is £39,000 a year, or £52,000 a year if you need nursing care, according to LaingBusson. This means if you're in care for 10 years the costs can reach more than £500,000 – or double if there are two of you.

The average stay in a care home is 2.5 years, making the average cost at current prices £97,500 for just care, or £130,000 for nursing care.

But how do you fund these costs, and what's the best use of your money?

"You will typically have to fund your own care if you have savings or assets worth more than £23,250"

RENT YOUR PROPERTY

Usually older people tend to have large property wealth that's mortgage free, even if they don't have lots of cash assets. You property won't be counted if you partner continues to live in it while you move into care. However, if that's not the case you could use the property to fund your care.

Some will want to try to hold onto the home for as long as possible, so they can pass it on to their children or other family members. However, you need to think about whether preserving wealth for your children is practical.

One way to keep the property untouched is to rent it out rather than sell it. It depends on the size of the property and where it is as to whether that will cover enough of your costs or not.

You also need to think about the condition of the property and any decorative or maintenance work that might need to be done to get it up to scratch to put on the rental market.

Also consider the costs of any tax that might be due on the rental income, of a managing agent running the property and how you will cover any vacant periods.

CARE ANNUITIES

Much like a pension annuity, you can get an annuity that pays for care fees. Assuming you're going into care imminently, you could use an 'Immediate Needs Annuity'. In exchange for a capital lump sum, an insurance company will cover the shortfall between income and the cost of care, paying a tax free regular amount directly to the care provider. It's tricky to work out exactly how much this costs, as the insurance company will base it on each person's circumstances, including life expectancy, current rates and GP reports.

The main advantage of these products is certainty and peace of mind – the shortfall could be covered for the rest your life and it will safeguard other family capital and pension income. The downside is that the capital sum needed up front might be too large, and access to that money is lost once the contract is set up.

You'll need to use a financial adviser to get this type of annuity, and the Society of Later Life Advisers has a directory of accredited advisers that you can contact and search based on your postcode.

USE YOUR INVESTMENTS OR PENSION MONEY

If you have a considerable sum in your ISA or SIPP you could use your investments to generate a sufficient income to fund your care costs. However, you'd need a considerable sum if you're going to try to meet the entire cost from this pot.

For example, you'd need a pot of almost £1m to be able to take the entire £39,000 annual cost of care from it, assuming a 4% income rate.

However, most people will have other sources of income, from the state pension to other company pensions, or perhaps rental income from buy-to-let properties, so the shortfall you need to meet might be smaller.

A rule of thumb of how much income you can generate often used is 4%, but you can decide whether you switch your investments to income-generating funds and stocks or you just invest the portfolio for growth and skim off any increase in value each year to fund your care. There's more information available here.

CAN I SELL MY HOME TO MY CHILDREN?

Often people hope they can keep their house in the family, and in return get their children to help pay the cost of care. These arrangements can get tricky, and you need financial and legal advice before doing it.

Some parents would like to sell their home for a low value to their children, in order to get it out of their estate for the purposes of working out whether they need to pay for their care. As well as many tax issues it's likely this would be considered 'deliberate deprivation of assets' and the sale would be disregarded by the local authority.

However, you could sell your home for full market value to your children in order to give you a lump sum to fund your care, if you wanted to keep the house in the family.

You need to think about whether your children want to take on the property and if they're able to pay the full value for it. If they already own a home they would be liable to the extra stamp duty surcharge too, which is an additional 3%.

EQUITY RELEASE OPTIONS

Equity release allows you to use some of the value you have in your home without having to sell the property. With some plans you effectively sell a percentage of your home, at less than market value, in return for a lump sum, which could in turn be used to fund care. You can sell additional portions of your home over time to release more money.

Another option is a lifetime mortgage, where you borrow money against the equity in your home and it's then repaid (plus interest) when the house is sold or you die.

Equity release often gets a bad name, as some of the interest charges can be eye-watering, but it can be a good option for some. Just make sure you get advice to ensure that you are getting the best value and are aware of the shortcomings of the product.

ASK THE LOCAL COUNCIL

One option if your house is the main source of your wealth is to ask the local authority for a 'deferred payment agreement'. It's offered under certain circumstances, but means that effectively the annual costs of care are paid by the local authority and accumulate and that money is taken when the house is sold after your death. It's effectively like equity release, but with much lower fees as it's offered by the council.

By **Laura Suter**
AJ Bell Personal Finance Analyst

‘How could inflation measurement changes affect my income?’

AJ Bell pensions expert Tom Selby looks at how investments like annuities might be hit

If the Government replaces RPI with CPIH, what will happen to existing contracts? I am currently in receipt of an annuity paying just over £15,000 that increases in line with RPI, while my wife has a small defined benefit pension which also enjoys RPI-linked rises. Will our incomes effectively be cut?
Gerard

Tom Selby
AJ Bell
Senior Analyst says:

The Retail Prices Index (RPI) has been widely lamented as an inflation measure by statisticians, politicians and others for flaws in the way it calculates the shifting cost of the things we buy.

In 2013, RPI was formally stripped of its status as a ‘national statistic’ by the UK Statistics Authority (UKSA), while both the Bank of England and the Government have argued for some time that it overstates inflation and therefore gives holders of products linked to it an uplift every year.

In recent years the Consumer Prices Index (CPI) and more latterly CPIH (a version of CPI that includes housing costs) have been the preferred measures of price changes.

Despite this, RPI continues to feature significantly in the lives of millions of savers and investors. In particular, index-linked gilts – which often feature in the investments of pension funds – rise in line with RPI, as do the incomes of many defined benefit (DB) scheme members, where RPI increases are written into the scheme rules.

In addition, a substantial number of annuities – which pay a guaranteed income for life in retirement – are also linked to RPI.

The Government has promised no change will be made in relation to RPI until 2025, with a more detailed update on future plans – which could see the measure scrapped altogether – expected at the Budget on 11 March.

We don’t know what will happen if and when RPI is replaced, in particular in relation to existing contracts such as those you have described. There will certainly be pressure on the Government to ensure people who have signed up to RPI are not materially disadvantaged.

The reason many savers and investors are concerned is that RPI, on average, tends to be about 0.8 percentage points higher than CPI (and CPIH, which has generally been similar to CPI since it was created in 2016).

To give you an idea of the impact this could have over time, someone with a £20,000 a year annuity rising by 2.8% a year would enjoy income of about £947,000 over a 30-year retirement. If the same £20,000 annuity increased by 2% a year then over the same time period they would receive about £120,000 less.

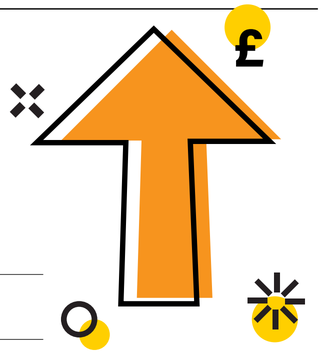
Unfortunately there is nothing you can do at this stage but wait and see what unfolds in the coming months. In the meantime, anyone buying a product linked to RPI should factor in the risk that over the long-term its value may drop.

DO YOU HAVE A QUESTION ON RETIREMENT ISSUES?

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

Please note, we only provide guidance 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.

What does a high share price mean?



They can reflect the past success of the underlying business

A lot of investors presume that a stock priced at £10 is much more expensive than something priced at 250p. Yes, you need more money to buy a single share, but you can't learn anything about how the equity is valued from its share price. Classic methods of valuing a company include comparing a share price to something else such as its earnings or dividends.

However, a high share price can potentially teach us something about a company's success as we explain in this article.

First we must address some basic issues. To the less experienced investor it can seem confusing as to why there is such a large price range for stocks. If you went into two different shops looking to buy a t-shirt you might see a range of £3 to £30. But the gap between the lower and upper end of stocks can be significantly greater.

While you may be able to instantly tell if a t-shirt priced at £3 is inferior quality to one priced at £30 just by touching it or examining the material, you can't do this with stocks.

Companies all have a different number of shares in issue. For example, Company X might have 1m shares in issue and trades at £10 a share, so its market value is £10m. Company Y might have 10m shares in issue and trades at 100p per share – its market value is also £10m.

HOW HIGH DO PRICES GET?

Excluding investment trusts, the UK stock market's highest price share is property company **Mountview Estates (MTVW)** at £116.50.

This might seem like a lot of money to purchase one share, but it pails into insignificance compared to Warren Buffet's Berkshire Hathaway in the US, where you would need to fork-out $343,000 for a paltry single share.

Buffet created a different class of shares for Berkshire (called the 'B' shares) in the 1990s in order to help small investors get in on the action. They trade at $125 a share, but only carry a tenth of the voting rights of the original 'A' shares.

When most companies come to the market they generally want as many investors as possible to be able to purchase shares, so they tend to price their shares at a level that smaller investors can afford, usually around the £1 level.

Over time if the business does well, the share price tends to rise in tandem with the underlying profits and perceived future value of the firm.

TO SPLIT OR NOT TO SPLIT

It became popular in the US and the UK for companies to 'split' their shares if the price got above £10 per share. This involves issuing more shares and reducing the price per share.

The thinking was that investors might erroneously associate a high share price with a highly valued business and be put-off buying. Some researchers even found evidence that companies that split their shares tended to outperform those that didn't.

Investors should be wary of companies that engage in reverse splits – increasing the share price and reducing the number of shares in issue.

These tend to be companies that have lost so much value that before the reverse split they had become penny shares. It's often an attempt to disguise the poor performance of the business.

HIGH PRICES TEND TO REFLECT PAST SUCCESS, WITH SOME CAVEATS

One thing that can be gleaned from a relatively high share price is that the underlying business has been successful, if we make two other assumptions.

We need to make sure that the company hasn't just been issuing new shares to grow in value and we also need to eliminate those businesses that started with a relatively high share price in the first place.

Once we do that, we can reasonably say that high share prices tend to reflect a fundamentally sound business, one that has grown its value over time and provided strong shareholder returns. It also

There is no sound reason why splitting shares creates any value. Let's see why. Pharmaceutical company **AstraZeneca (AZN)** trades around £77 per share, and there are currently 1.29m shares outstanding, giving a market value of £99.3bn.

The company could rebase its share price to 770p by issuing everyone 10 times more shares, so that there are now 12.9m shares priced at 770p. The action wouldn't change the value of the business.

implies that management are focused on the business and not distracted by the share price or liquidity of the shares.

We used Stockopedia to screen for high share prices, removing those that simply issued lots of shares or began life with an already high price. The 20-year price performance of these shares greatly outperformed the average share over the period.

That's very interesting data. However, as mentioned at the start of this article, you cannot tell from a share price if a company is a good value investment.

The high price might show a business has been successful in the past, but its shares may now be very expensive based on classic equity valuation metrics. Buying now would ultimately mean you could be overpaying for something, even if the business is very good.

By **Martin Gamble**
Senior Reporter

How stocks with the highest shares prices have performed

Company	Price (£)	20 year total return %
Spirax-Sarco Engineering	91.2	2,020
London Stock Exchange	76.4	2,330*
Next	68.5	1,630
Games Workshop	66.9	1,490
DCC	65.0	998
FTSE 100	**7,605**	**133**

Sources: Stockopedia and Sharepad.
*(since July 2001)

Splitting the London Stock Exchange universe into different price segments

Current share price	Number of companies	5-year total return (%)
Below £1	613	22.6
£1 to £2	145	91.4
£2 to £3	102	90.1
£3 to £4	59	97.5
£4 to £5	33	89.1
£5 to £6	**27**	**102.6**
£6 to £7	**29**	**139.7**
£7 to £8	**17**	**289.1**
£8 to £9	18	98.4
£9 to £10	16	77.7
£10 to £11	12	73.0
£11 to £20	**60**	**165.2**
£20 to £50	**62**	**165.1**
FTSE 100		42.3

Source: Sharepad

We put stocks into different segments based on their current share price. Stocks below 100p in value include struggling companies with falling share prices as well as ones unfamiliar to most investors. The big returns are seen in the 500p to 800p range where five-year total returns are very good. That suggests the 200p to 300p stocks of today could be interesting hunting ground.

KEY

- **Main Market**
- **AIM**
- **Investment Trust**
- **Fund**
- **Exchange-Traded Fund**

Anglo American (AAL) 7
ASI UK Income Equity (B0XWNB4) 18
ASI UK Income Unconstrained Equity (B1LBSV5) 18
AstraZeneca (AZN) 10, 44

B&M European Value (BME) 34
BAE Systems (BA.) 16
BP (BP.) 21, 24
Brunner Investment Trust (BUT) 38
Burberry (BRBY) 10
Cairn Energy (CNE) 25
Close Brothers (CBG) 19
Convatec (CTEC) 20
Dixons Carphone (DC.) 31

Dunelm (DNLM) 34
Energean Oil & Gas (ENOG) 24
F&C Investment Trust (FCIT) 37
Fevertree Drinks (FEVR:AIM) 6
Fundsmith Equity (B41YBW7) 2
GlaxoSmithKline (GSK) 19
Glencore (GLEN) 10
Go-Ahead (GOG) 14
GVC (GVC) 16
IG Design (IGR:AIM) 15
Inchcape (INCH) 20
InterContinental Hotels (IHG) 10
ITV (ITV) 10, 31
J Sainsbury (SBRY) 31
Jadestone Energy (JSE:AIM) 26
Lloyds (LLOY) 10
M&G (MNG) 12
Marks & Spencer (MKS) 31
Marshalls (MSLH) 20
Melrose Industries (MRO) 9
Mondi (MNDI) 10
Mountview Estates (MTVW) 44
Murray Income Trust (MUT) 18, 22
Ocado (OCDO) 31
Premier Foods (PFD) 8
Premier Oil (PMO) 25
Prudential (PRU) 12, 20
Rio Tinto (RIO) 20
RockRose Energy (RRE) 26
Royal Dutch Shell (RDSB) 10, 21, 24
Saga (SAGA) 20

Sage (SGE) 9
Scottish Mortgage Investment Trust (SMT) 9
Sirius Minerals (SXX) 7
Sirius Real Estate (SRE) 20
SSE (SSE) 20
St. James's Place (STJ) 10
Sylvania Platinum (SLP:AIM) 7
Tesco (TSCO) 10, 32
Tullow Oil (TLW) 25
Unilever (ULVR) 9
WisdomTree Physical Palladium (PHPD) 7
Witan Investment Trust (WTAN) 38
Woodford Income Focus (BD9X6V3) 18
YouGov (YOU:AIM) 34

KEY ANNOUNCEMENTS OVER THE NEXT WEEK

Full year results

27 January: Global Invacom, SThree. **28 January:** Crest Nicholson, McCarthy & Stone. **30 January:** Unilever.

Half year results

24 January: Hansard Global. **27 January:** ITM Power. **28 January:** NWF, PZ Cussons. **29 January:** Hargreaves Services. **30 January:** Best of the Best, Haynes Publishing, Rank, Renishaw.

Trading statements

27 January: Petra Diamonds. **28 January:** AG Barr, DP Eurasia, UDG Healthcare. **30 January:** Evraz, Fuller's, Royal Dutch Shell.

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