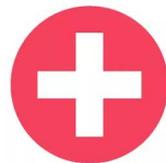


STOCKS | FUNDS | INVESTMENT TRUSTS | PENSIONS AND SAVINGS

VOL 26 / ISSUE 31 / 08 AUGUST 2024 / £4.49

# SHARES

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## TIME TO TAP INTO RECOVERY STOCKS

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candidates on the UK market**



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## Why now is the time for adventurous investors to seek out recovery funds

Cheap valuations, an economy which is gaining momentum and a tailwind from falling interest rates are the ideal combination for managers looking at 'special situations'.



2

## What does the Indian budget mean for investors?

We discuss the prospects for the 'sleeping giant' of emerging markets with leading fund managers and get their take on the government's new spending plans.



3

## Why did Pershing Square's US offering fail to launch?

Despite his market nous, Bill Ackman's plan to raise as much as \$25 billion has run aground after US investors questioned the merits of the deal.

## Visit our website for more articles

Did you know that we publish daily news stories on our website as bonus content? These articles do not appear in the magazine so make sure you keep abreast of market activities by visiting our website on a regular basis.

Over the past week we've written a variety of news stories online that do not appear in this magazine, including:



Domino's Pizza plunges to fresh one-year low after downgrading guidance



JD Wetherspoon chair offloads 1% stake while hVIVO chair exits the register | Directors Deals



YouGov shares jump 16% after polling outfit lifts guidance and makes AI acquisition



Wood Group tanks after Sidara terminates takeover talks

# Why the strong yen is behind the 'tech wreck' and the broader market meltdown

Different approaches to monetary policy in Japan and the US are to blame

Investors looking to pin the blame for the sudden panic in markets might wonder whether US chip firm **Intel's (INTC:NASDAQ)** decision to lay off staff and cut spending, triggering a 26% fall in the share price on 2 August, was the trigger for the broad sell-off.

While Intel may have played a part, the root cause of the market's current malaise is the unwinding of the 'carry trade' involving the Japanese yen.

Since the start of 2021, global investors have been borrowing money in yen at rock-bottom interest rates and reinvesting that money in riskier, higher-yielding assets including technology and AI (artificial intelligence) stocks.

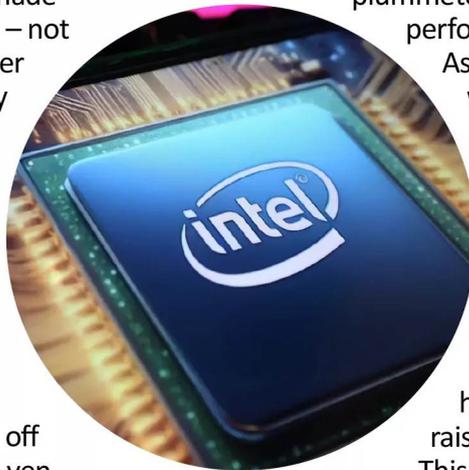
Over the last three and a half years the yen has steadily weakened from around Y100 to the dollar to Y160 meaning investors have made money on both sides of the trade – not only have tech stocks, among other riskier assets, done phenomenally well for them, but their cost of funding has got cheaper.

However, with little advance warning this trade hit the buffers last month and in the last three weeks the yen has appreciated by more than 10% to less than Y143 to the dollar.

A combination of the Bank of Japan raising interest rates to fight off inflation, which has supported the yen, and the US Federal Reserve's refusal to ease monetary policy despite the growing evidence of a slowdown in the labour market, has stoked fears a global recession could be in the making.

The net result is traders have reversed their 'carry' trade, closing their short yen positions and taking off their riskier bets.

That has had the effect of undermining the most



## Japanese yen to US dollar

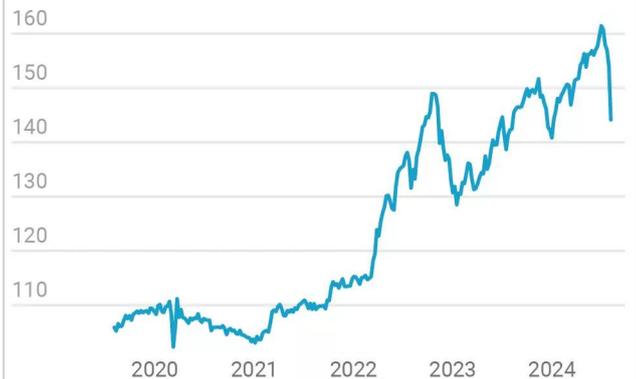


Chart: Shares magazine • Source: LSEG

consensus trades, which as well as US tech stocks include the Japanese market and the highest-risk assets of all, cryptocurrencies.

On 5 August, the Japanese Nikkei 225 index plummeted 13% marking its worst one-day performance in 37 years, while other Asian markets such as Taiwan – which is heavily-weighted towards tech stocks – also fell heavily.

These sharp downward movements in prices are contributing to what is known as 'forced selling', where some investors – especially those who trade 'on margin' or use futures and options – suddenly have to ditch their holdings and raise cash to cover their losses.

This leads in turn to more selling pressure in an already-weak market, which can give rise to 'panic-selling', where investors just want to get out to the market altogether to avoid losses.

This kind of volatility is perfectly normal, and in time markets will settle down, so while the temptation to hit the sell button is strong the smart thing to do may actually be to do nothing. [IC]

# Buffett's Berkshire Hathaway slashes Apple stake in half amid valuation concerns

iPhone maker's earnings growth has not kept pace with its enormous share price appreciation

**W**arren Buffett's **Berkshire Hathaway (BRK.B:NYSE)** dumped roughly half its enormous stake in **Apple (AAPL:NASDAQ)** in a shock shift for the famously long-term-focused investor.

The Omaha-based conglomerate disclosed in its earnings filing that it slashed its holding from 789 million shares to approximately 400 million shares, suggesting that the Oracle of Omaha offloaded a little more than 49% of the tech company stake.

At the end of the second quarter (30 Jun) Berkshire's stake in the iPhone maker was valued at \$84.2 billion or about 2.6% of Apple. Based on a 5 August close of \$209.27, the stake's valuation had fallen to \$83.7 billion after a wild sell-off in equity markets during which Apple stock declined by nearly 5%.

Even after selling a huge chunk of Apple, the Cupertino-based tech firm remains the largest stock holding by far for Berkshire.

The move, while surprising in its magnitude, is aligned with Buffett's long-held investment philosophy. Contrary to the common perception of Buffett as a staunch buy-and-hold investor, he has historically made adjustments when he perceives asset valuations to be excessively high.

Apple's substantial price appreciation since 2016, when the stock traded below \$25, coupled with its rising price-to-earnings ratio, from roughly 12 times at the time of Buffett's acquisition to 33 times more recently, likely contributed to this decision.

Buffett's investment in Apple back in 2016 has been extraordinarily lucrative, with the stock appreciating more than eight-fold since then. However, despite the impressive returns, Buffett's decision to sell may have been influenced by concerns about Apple's core business fundamentals. Although the company has benefited from an expanding valuation, its earnings growth has not been proportionally strong.



Berkshire Hathaway's main source of capital today is insurance, from which it invests in a broad portfolio of subsidiaries and equity positions. It is one of the largest companies in the US employing several hundred thousand people through its railroad, manufacturing, retailing, energy, confectionery and insurance businesses.

In late 2023 Buffett and Berkshire lost Charlie Munger, Buffett's right-hand man for six decades, during which they forged their reputation as the world's supreme investors. It was Munger who steered Buffett away from what he had learned from Ben Graham, buying dirt-cheap 'cigar butt' shares with a view to selling at a fair value, and towards buying quality businesses at fair prices and then holding them for the very long term. [SF]

# Rolls-Royce shares roar to new life-high on raised guidance

The company has even reinstated dividends for 2024

Shares in aero engine-maker **Rolls-Royce (RR.)** bolted 11% to 500p on 1 August, the first time in their history they have touched that milestone, after the firm posted forecast-beating first-half results and raised its full-year outlook.

A 14% operating margin and 13.8% return on capital employed are testament to chief executive Tufan



Erginbilgic's 'tough love' approach to optimising the firm's commercial operations and grinding out cost efficiencies.

From £1.1 billion in the first half, an increase of 74% on the first half of 2023, full-year underlying operating profit is now seen between £2.1 billion and £2.3 billion against a previous forecast of £2 billion.

The firm is also reinstating dividend payments, with a 30% payout ratio this year rising to 40% over time.

Erginbilgic said the company was 'expanding the earnings and cash potential of the business in a challenging supply chain environment, which we are

## Rolls-Royce



Chart: Shares magazine • Source: LSEG

proactively managing'.

Free cash-flow guidance for the year of up to £2 billion includes a £200 million 'hit' from supply-chain issues which the chief executive suggested could last until 2026.

Having trebled last year, Rolls-Royce shares are up more than two thirds this year making them the second-best FTSE 100 performer after cyber-security takeover target **Darktrace (DARK)**. [IC]

# Wizz Air spirals to six-month low on first-quarter loss

Shares hit a major air pocket as aircraft are grounded for technical reasons

Budapest-based low-cost airline **Wizz Air (WIZZ)** posted (1 August) a slight increase in revenue to €1.26 billion for the quarter to the end of June, but higher operating and finance costs plus a foreign exchange loss sent it into deficit for the period.

The shares slumped as much as 380p or 20%, the most since the early days of the pandemic, as investors headed for the exits.

The airline cut its full-year net profit outlook from a range of €500 million to €600 million to a range of €350

million to €450 million after aircraft were grounded during the busy summer season due to supply-chain issues, mainly with engines.

Wizz is among the carriers which have been hardest-hit by an engine issue on A321 aircraft manufactured by Toulouse-based **Airbus (AIR:EPA)**.

At the end of June, the airline had 46 aircraft grounded due to engine problems and the company said the situation was unlikely to improve between now and September 2025.



## Wizz Air

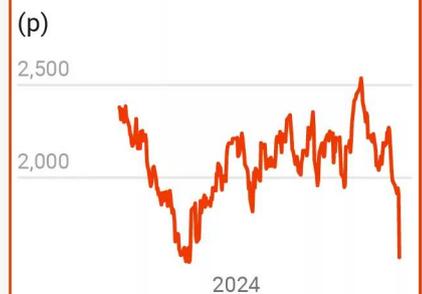


Chart: Shares magazine • Source: LSEG

Interviewed by *Bloomberg*, executive Jozsef Varadi admitted there was 'no overnight fix, this is going to take years'.

In addition, delays to deliveries of Airbus aircraft could have an impact on Wizz Air's future plans to expand its fleet, conceded the chief executive. [IC]

**UK  
UPDATES  
OVER THE  
NEXT 7  
DAYS**



**INTERIM RESULTS & TRADING UPDATES**

- 9 Aug:** Bellway
- 12 Aug:** Alliance Witan, Marshalls, Plus500
- 13 Aug:** Dowlais, Genuit, Just Group, Network International, Telecom Plus
- 14 Aug:** Aviva, Balfour Beatty

# Balfour Beatty half-year earnings unlikely to produce a major shock

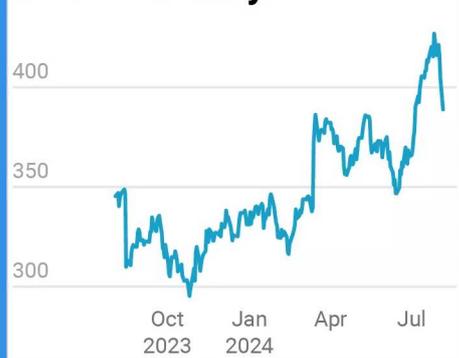
Infrastructure group is expected to confirm full-year targets

Although shares in leading infrastructure group **Balfour Beatty (BBY)** haven't been immune to the recent pull-back in markets, they were recently sitting at their best level in more than a decade so investors will be keen to hear how the business has been performing when it reports half-year earnings on 14 August.

In its last trading update in May, the firm said trading was in line with its full-year expectations and it 'continues to expect an increase in profit from its earnings-based businesses and an increase in group earnings'.

Since the start of 2024, Balfour Beatty has made progress on several

## Balfour Beatty



major projects 'for which material orders are expected to follow', including electricity transmission works in the north of Scotland for SSEN, a power project in Teesside for oil firms **BP (BP.)** and **Equinor (EQNR:CPH)** and expansion work at **Rolls-Royce's (RR.)** Raynesway site in Derbyshire.

After purchasing £150 million of shares last year, the firm committed to a further £100 million buyback this year, of which half had been completed by May, so investors may get a pleasant surprise with an uplift to the full-year target if the board is feeling generous. [IC]

## What the market expects of Balfour Beatty

	2024E	2025E
Revenue (£m)	9,280	9,570
Net Profit (£m)	208	223
Earnings per share (p)	38.3	41.8

Table: Shares magazine • Source: Stockopedia, all data correct as of 5 August 2024



# Hard yards ahead for the world's largest home improvement retailer

**Home Depot will hope interest rate cuts unfreeze the US housing market and drive a sales growth return**

A subdued US housing market and a consumer who remains hard-pressed across the pond mean expectations are subdued ahead of second quarter earnings (13 August) from the world's largest home improvement retailer, **Home Depot (HD:NYSE)**.

Of late, a raft of companies have reported weaker US consumer trends, notably in lower income groups, with high interest rates crimping spending.

Guided by chief executive Ted Decker, Home Depot will be hoping the Federal Reserve duly delivers an interest rate cut in September as this should help to unfreeze the US housing market and boost spending on big discretionary DIY projects.

The group's first-quarter results (14 May) were downbeat, revealing

a 2.3% year-on-year decline in overall sales to \$36.4 billion including comparable sales down 2.8%, pulled lower by a 3.2% dip in US comparable sales. Home Depot also reaffirmed full year 2024 guidance for a 1% fall in comparable sales.

In a sign management expects the housing market may remain sluggish, the firm recently made a foray into the professional market through the acquisition of building products supplier SRS Distribution for an enterprise value of \$18.25 billion.

This deal expands Home Depot's reach among contractors and builders and increases its total addressable market by roughly \$50 billion to approximately \$1 trillion. [JC]

## US UPDATES OVER THE NEXT 7 DAYS

### QUARTERLY RESULTS

- 9 Aug:** Constellation Software
- 12 Aug:** Barrick Gold
- 13 Aug:** Home Depot
- 14 Aug:** Cisco
- 15 Aug:** Walmart, Deere & Co



### What the market expects of Home Depot

	2025	2026
Sales (\$bn)	158.9	165.2
Net profit (\$bn)	14.9	16.1
Earnings per share (\$)	15.1	16.4

Table: Shares magazine • Source: Stockopedia, all data correct as of 5 August 2024. Year end January

### Home Depot

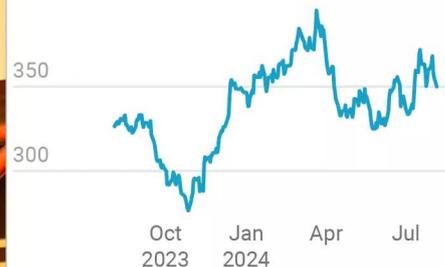


Chart: Shares magazine • Source: LSEG

# Markets skid as US jobs data prompts ‘growth scare’ among investors

The Fed may rue its decision not to cut rates with the Bank of England

All along, the US Federal Reserve has maintained the economic data hasn't justified cutting rates early and risking letting the inflation genie back out of the bottle.

Even though inflation is close to – and by some measures already below – its 2% medium-term target, and by keeping rates at 5.5% it is risking breaking something in the economy or the financial system, the Fed has been fixated on the employment statistics which so far have proved robust.

That policy now increasingly looks to have been

a mistake, as last week's jobless claims, ISM hiring intentions and last but by no means least non-farm payrolls data all showed a sharply-slowing labour market.

Payrolls rose by just 114,000 instead of 175,000 as predicted, while the unemployment rate rose to 4.3% instead of sticking at 4.1% raising concerns over the robustness of consumer spending which has been the driving force behind the US's 'exceptionalism'.

'A September rate cut is in the bag and the Fed will be hoping that they haven't, once again, been too slow to act,' commented Seema Shah, global strategist at Principal Asset Management.

Here in the UK, the Bank of England succumbed to pressure and lowered its benchmark interest rate by one quarter of a percentage point from 5.25% to 5% last week, although the decision was finely balanced with the smallest possible majority voting in favour.

Given the US experience, we suspect while the Monetary Policy Committee might have wanted to hold off until December to cut again, it is likely to bring that decision forward to its next meeting in September, especially if this week's retail sales figures and PMI survey and next week's unemployment, inflation and GDP (gross domestic product) reports point to a weakening backdrop. [IC]



## Macro diary 13 August to 15 August

Date	Economic Event	Previous
13-Aug	UK June employment change	19k
	Eurozone Aug ZEW economic sentiment	43.7
	US July core producer price index	3.0%
14-Aug	UK July core producer price index	1.4%
	UK July core consumer price index	3.5%
	UK July headline consumer price index	2.0%
	US July core consumer price index	3.3%
	US July headline consumer price index	3.0%
15-Aug	UK Q2 GDP	0.3%
	US July retail sales	2.3%
	US July industrial production	1.6%

Table: Shares magazine • Source: Morningstar, Central Bank websites

## Next Central Bank Meetings & Current Interest Rates

Date	Event	Previous
12-Sep	European Central Bank	4.25%
17-Sep	US Federal Reserve	5.5%
19-Sep	UK Bank of England	5%

Table: Shares magazine • Source: Morningstar, central bank

# Why this reliable income payer is a screaming buy right now



Insurer Aviva has hinted at ramping shareholders returns

**Aviva** (AV.) 464p

Market cap: £12.9 billion

**T**here's a gambit insurance salespeople use which goes something like: if you had a machine in the shed which printed £70,000 a year of genuine £20 notes, how much would you insure it for? The customer usually gives a high figure, say in the region of £500,000.

The salesperson then counters, so shouldn't you insure your homes' chief breadwinner for the same, assuming they earn £70,000 a year of course? You may have heard a variation of this line yourself.

Insurance companies are like that machine in the shed in as much as they have the ability to churn out cash like few others, and when the muck looks like hitting the fan there is precious security for investors in that.

After the recent worldwide sell-off in equities, we believe **Aviva (AV.)** can act as one of those relatively safe, secure cash machines for your portfolio.

This is a stock which has returned more than £9 billion to shareholders over the past three years, equivalent to 70% of its current market cap.

With £750 million cost savings being achieved a year earlier than planned, management are now asserting their confidence in surplus capital generation, raising dividend guidance, and embarking on a £300 million buyback programme.

The consensus is forecasting a dividend of 35.4p per share for the year to 31 December, according to Stockopedia, rising to 38.1p in 2025, implying an income yield of 7.6% and 8.2%, with the payout 1.3 times covered by earnings.

Experienced investors know that, normally, yields this high reflect a particularly cyclical or unreliable business, and it is true that insurance companies

## Aviva

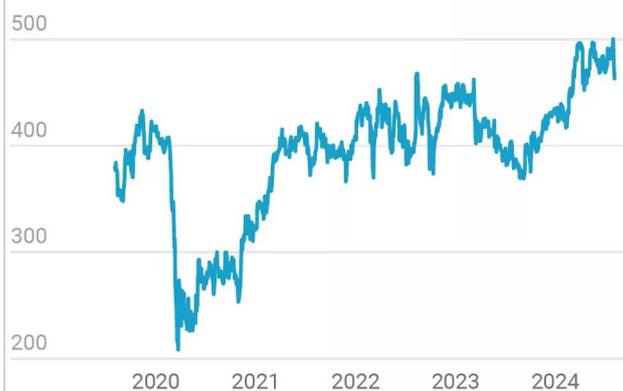


Chart: Shares magazine • Source: LSEG

can be impacted by one-off catastrophes – storms, floods, earthquakes and so on – which explains why industry stock often trade at discounted multiples.

That said, Aviva is not big in these areas as most of its income stems from life, health, home and motor cover, with annuity sales and wealth management other growth lines.

'Aviva has continued to accelerate growth and shift its earnings mix towards capital-light lines, which should be well-received by investors in our view,' said analysts at Jefferies following the firm's first-quarter results.

In the past, there were worries Aviva had spread itself too thinly internationally, but new chief executive Amanda Blanc, appointed in 2020, has sold many overseas operations at better valuations than the wider group.

This has resulted in the company handing back £4 billion of capital since 2021, and further non-core sales could result in similar shareholder returns in future.

Berenberg analysts see the stock going to 584p over the coming months, and we agree the upside is considerable, priming investors for substantial total returns. [SF]



# Future has a credible growth plan and the shares look cheap

The media group looks attractive despite economic jitters

**Future (FUTR)** £10.42

Market cap: £1.17 billion



**D**espite some recent economic jitters, we think the current valuation at media group **Future (FUTR)** undervalues the company's strengths as it gets stuck into its GAS (growth acceleration strategy).

Based on consensus forecasts for 2025 the company trades on a price to earnings ratio of just 7.7 times. The current strategy hopes to deliver mid-single digit revenue CAGR (compound annualised growth rate) over the next three years and the media group has a new hire to help it achieve this.

Future's new chief financial officer, Sharjeel Suleman will start on 16 September replacing Penny Ladkin-Brand who stepped down on 28 July after nine years with the company.

Ladkin-Brand's tenure, which included the top finance job as well as a strategy role, coincided with a big increase in earnings and the share price – culminating in a valuation more than three times the current level during the pandemic.

The approach, pursued in concert with former chief executive Zillah Byng-Thorne, was to focus on brands, covering topics from films to computer games and photography, which were and are a conduit between fans and their enthusiasm or hobby. This helped drive a loyal and engaged audience which Future could monetise, employing a centralised platform to derive e-commerce, licensing and digital advertising revenue.

However, of late the shares have come under pressure thanks to a weak global outlook for advertising spending.

Suleman, who joins from **ITV (ITV)**, is certain to

## Future

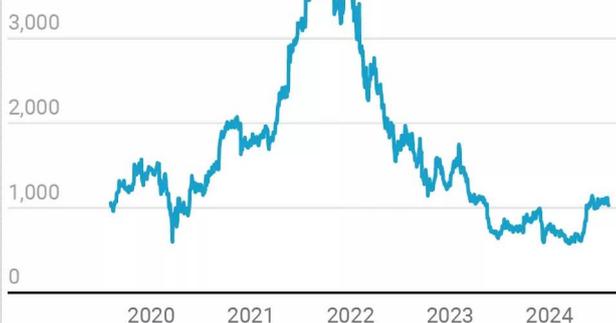


Chart: Shares magazine • Source: LSEG

use her strong background in content and digital transformation in the role alongside CEO Jon Steinberg, who was appointed in April 2023.

The media group will continue with its 'content-centric approach,' the company, said and build on its reputation as a long-standing specialist.

Future has 300 titles including *Ideal Home*, *games radar*, *TechRadar*, and the price comparison site *Go.Compare* which made up 25% of the company's first-half revenue.

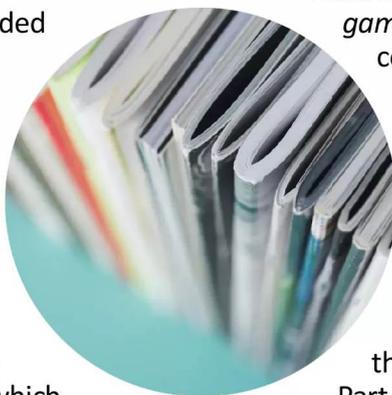
These titles gave Future an impressive online reach of 481 million digital users in 2023.

The group has guided toward aggregate investment associated with GAS of £25-30 million during the full year 2024 and full year 2025.

Part of the strategy will involve focusing investment on its so-called 'Hero' brands – 12 titles which generate 50% of its revenue. The company is also targeting growth in US digital advertising. Digital revenue from across the pond is only twice the size of that from the UK, despite the addressable market being seven times larger.

A risk for the business if it pushes the commercial aspect too strongly is it alienates readers and followers so it does need to strike a balance here.

[SG]





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Capital at risk



# Why small- and mid-cap specialist Smithson remains a smart idea

The Fundsmith-managed trust should outperform once the small-cap sector swings back into fashion

## Smithson Investment Trust

(SSON) £13.58

Loss to date: **2.5%**

**W**e urged readers to buy investment trust **Smithson (SSON)** at £13.93 on 25 January in the belief a share price rebound then underway had further to run as sentiment towards quality global small- and mid-cap companies improved.

We reckoned potential interest rate cuts would provide a tailwind and highlighted the Fundsmith-managed trust's re-rating potential given the wide 11.5% discount to NAV (net asset value) at the time.

### WHAT HAS HAPPENED SINCE WE SAID TO BUY?

Smithson's shares hit a 52-week high of £14.78 on 31 July before the recent global market rout pulled the shares lower, leaving our 'buy' call 2.5% in the red. Our bullish thesis has yet to play out, with interim results (29 July) to 30 June 2024 highlighting a period of underperformance in a challenging six months for small- and mid-cap stocks.

The trust delivered a negative NAV total return of 1.8% versus a rise of 3.4% for the MSCI World SMID Index in the half. Higher interest rates have proven a headwind, while manager Simon Barnard commented that 'the level of asset flows currently being attracted to certain US large cap stocks is potentially sucking the air out of entire asset classes.'

### WHAT SHOULD INVESTORS DO NOW?

Keep buying Smithson, as the headwind from rising rates won't last forever and its concentrated portfolio of 34 quality small- and mid-cap holdings

## Smithson Investment

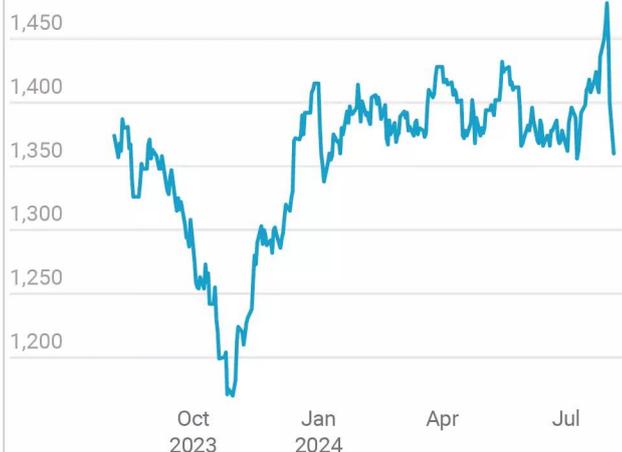


Chart: Shares magazine • Source: LSEG

is well-placed to outperform over the long run.

*Shares* likes the focus on companies with strong competitive positions, robust balance sheets and sustainably high margins, with holdings ranging from US insurance data company **Verisk (VRSK:NASDAQ)** and luxury fashion brand **Moncler (MONC:BIT)** to industrial products distributor **Diploma (DPLM)** and Danish medical device maker **Ambu (AMBU-B:CPH)**.

Barnard's new buys include leak detection and vacuum control instruments play **Inficon (IFCN:SWX)** and hotel franchisor **Choice Hotels (CHH:NYSE)**.

A double-digit NAV discount offers great value, supported by share buybacks. As Deutsche Numis explains: 'After a slight own goal in the current year of deciding not to offer a continuation vote, which was subsequently reversed, investors may be reassured by the board's commitment to continue to offer continuation votes should the discount average greater than 10% over the year.' [JC]





# TIME TO TAP INTO RECOVERY STOCKS

The best bounceback  
candidates on the UK market



By Ian Conway Deputy Editor

**W**ith the UK economy seemingly headed for a 'soft landing' and interest rates set to fall at some point this year, more adventurous investors will be looking to add a little more risk to their portfolios.

Given the UK market, and the mid-cap space in particular, is widely acknowledged to be cheap, the passive option would be to buy a mid-cap ETF (exchange-traded fund) such as the **iShares FTSE 250 (MIDD)** or the **Vanguard FTSE 250 (VMIG)**.

However, for those wanting to take a more active approach or those looking for stocks which are cheaper still than the market, picking a manager with experience in the field is probably a better option.

There are a handful of 'recovery' or 'special situations' funds which focus on investing in companies whose shares have been beaten down, usually due to temporary difficulties, but which have the capability to bounce back generating large returns in the process.

## THREE OF THE BEST

Probably the best-known funds in this sector are the **Fidelity Special Situations Fund (B88V3X4)** and the **Jupiter UK Special Situations Fund (B4KL9F8)**.

Both are run by highly-experienced managers, Alex Wright at Fidelity and Ben Whitmore at Jupiter.

## Fidelity Special Situations



## Jupiter Special Situations



Both are rated four-star by *Morningstar* and sit at the higher end of the risk spectrum, and both have beaten the FTSE All-Share total return index and the IA (Investment Association) All Companies index over one, three and five years.

The Jupiter fund has been around longer, having been launched in 2006, but the Fidelity fund is larger at roughly £3 billion against £1.5 billion.

The make-up of the two is also quite distinct with very little cross-over, despite both having more or less the same brief, which is interesting.

Slightly smaller and therefore possibly less familiar to readers, but considerably older than both of these, is the £900 million **Schroder Recovery Fund (B3VVG60)**, which was launched way back in 1970 and is currently managed by Andrew Lyddon and Nick Kirrage.

With a brief to invest in UK stocks which have suffered 'a severe setback in either share price or profitability', the fund has comfortably beaten the FTSE All-Share and the IA benchmark over one, three and five years.

## OPPORTUNITY KNOCKS

Alex Wright explained to *Shares* how he manages both the open-ended Fidelity Special Situations and the closed-end sister fund **Fidelity Special Values (FSV)**.

'Our portfolios aren't buy-and-hold strategies, a key part of our investment process is to be constantly on the lookout for new opportunities as well as remaining disciplined and taking profits in stocks which have performed well and where the risk/reward is no longer as attractive.'

Financials are strongly-represented in the Special Situations fund – as well as their attractive

valuations, UK banks have seen a positive impact on their profitability from higher interest rates, while life insurers have benefited from an acceleration in the pace of pension de-risking and non-life insurers are enjoying better pricing and a moderation in the cost of claims.

'Another area where we continue to find opportunities is defensives, where we have added to the likes of **Reckitt Benckiser (RKT)**, **BAT (BATS)** and **National Grid (NG.)** on weakness,' says Wright.

He cites last month's Labour general election victory as a further catalyst for adding to National Grid: 'The stock would be a key beneficiary if the newly-elected Labour government increased the speed of the build-out of renewables as they hope to do. The company is very much part of the solution in terms of the need for more investment, and thus far less likely to be targeted as source of tax revenues.'

On the flip side, Wright and co-manager

## Schroder Recovery Fund





Jonathan Winton reduced their North Sea oil and gas exposure in response to the fact Labour doubled down on their removal of the North Sea investment allowance which clearly hurts that sector.

## ‘CONTRARIAN’ INVESTING

Jupiter’s Ben Whitmore describes his ‘contrarian’ approach to investing as hunting in unpopular areas of the market, looking for companies where the valuation of their assets, cashflows or profits is low, as consistently applying that same discipline to generate above-average returns over the long term.

‘In the short term, the market is driven by human emotion so we’re always looking in areas which people have shunned and are out of favour for temporary reasons.’

Whitmore admits his strategy doesn’t work every year, and there can be difficult periods, but as long as the price paid reflects the quality of the business then over time valuations will recover.

‘We don’t think it’s possible to think of quality or valuation on their own. For us, good value can be either an above-average quality company trading at an average valuation, or a below-average quality company at an absolute bargain price. We’re always thinking about that trade-off.’

In the year to March 2024, the fund added to new positions in **Anglo American (AAL)**, **Burberry (BRBY)**, **Johnson Matthey (JMAT)** and Reckitt Benckiser among others.

‘In each case, the stock market has a very cautious valuation either due to worries over the economy or a particular concern about the individual company. We think these low valuations offer a compelling risk/reward,’ says Whitmore.

The purchases were funded by the complete sale of positions in **BAe Systems (BA.)**, **BT (BT.A)**,

**Intel (INTC:NASDAQ)**, **Kyndrel (KD:NYSE)**, **Moneysupermarket (MONY)** and **South32 (S32)**.

## ‘MEANINGFULLY UNDERVALUED’

Schroders managers Lyddon and Kirrage believe the ‘material’ outperformance of growth companies, and those associated with AI (artificial intelligence) in particular, is unsustainable and ‘the next decade is likely to see a reversal of these trends with the cheapest parts of the market meaningfully undervalued versus their long-term histories’.

‘In the past few years, when fear has taken hold, we have witnessed some rapid sector and market cap rotations,’ adds investment director Andy Williams.

‘Sometimes, we are compensated for running into a burning building,’ says Williams, using the example of insurer **Direct Line (DLG)** which was caught out by a combination of higher-than-expected claims inflation and regulatory change which put pressure on its capital position.

The firm let go of its chief executive and cut its dividend to save cash, sending the shares skidding, but by subsequently selling its Commercial Insurance business for an impressive multiple of profits, alongside several smaller capital generation measures, its capital strength improved significantly.

As profits recovered and dividends restarted, the shares recovered strongly helped by a bid approach from an overseas competitor who understood the long-term attractions of the company.

‘Making uncomfortable decisions today sows the seeds of outperformance tomorrow,’ maintains Williams.

During the second quarter of 2024, the Recovery Fund continued to outperform the IA sector and its benchmark thanks to contributions from energy services businesses **Hunting (HTG)** and **Wood Group (WG.)**, the former on a record contract win and the latter on a bid approach.

Royal Mail-owner **International Distribution Services (IDS)** was another winner thanks to bid interest, while BT, **Barclays (BARC)** and **NatWest Group (NWG)** performed well on their results.

Interestingly, the managers established new positions in Burberry and Johnson Matthey, in line with Jupiter’s Whitmore, as well as adding low-cost airline **easyJet (EZJ)** to the portfolio.

Iron ore pellet producer **Ferrexpo (FXPO)** was sold to make way for the new arrivals, along with facilities management company **Mitie Group (MTO)**.

# What does **Schroder Japan Trust's** new dividend policy mean for investors?



## *Improving the trust's appeal to a broader range of investors*

The Board of [Schroder Japan Trust plc \(SJC\)](#) has recently announced a package of measures, including an enhanced dividend policy and a “conditional tender offer” mechanism. These steps are designed to enhance the trust's investment proposition, particularly for investors seeking both income and growth from the long-term value of Japanese equities. This article addresses investors' likely questions about these changes and explains their implications for shareholders.

### **WHAT IS THE ENHANCED DIVIDEND POLICY AND HOW DOES IT DIFFER FROM THE PREVIOUS POLICY?**

The new enhanced dividend policy introduced by SJC involves paying out 4% of the average net asset value (NAV) each financial year. Previously, the Company was focused on growing dividends organically. This resulted in average yearly dividend growth of 12.7% over the last ten years, but the level of dividend yield was lower, at 2.1% (as at 31 May 2024). The new policy will therefore result in a much higher and predictable level of income for shareholders.

### **WHY HAS THE BOARD MADE THIS CHANGE?**

The Board believes that, when investing in Japan, dividends will play an increasingly important role in overall shareholder returns. In recent years, Japanese companies have been focusing more on improving shareholder value and good corporate governance practice. This progress was given additional impetus last year by the Tokyo Stock Exchange's efforts to make Japanese businesses focus on achieving sustainable growth and on raising corporate value.

Companies can improve shareholder value through investments, restructuring, or increasing returns via dividends and buybacks (repurchasing shares). Higher payouts make companies more attractive to income-focused investors.

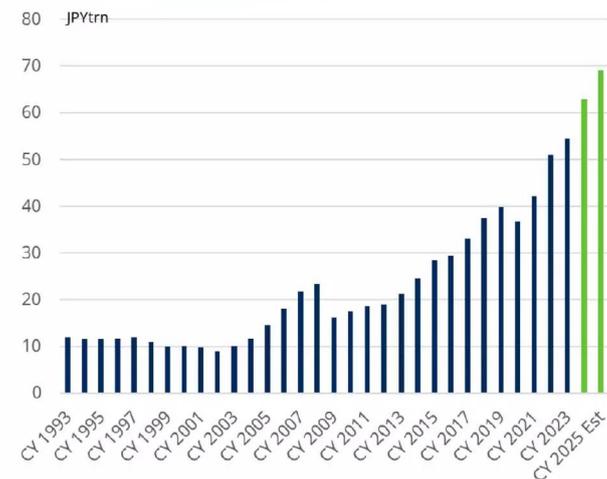
Japanese companies are well-placed to take some or all of these steps. The percentage of companies that are “net cash” (i.e. whose cash on the balance sheet is greater than their liabilities) is 44%, which is much higher than in North America and Europe. That gives those companies scope to invest in their business, or increase returns to shareholders, or both.

This should make Japanese companies an increasingly appealing proposition for investors who are seeking income, while also obtaining growth from their investments.

# Strong trend for shareholder returns

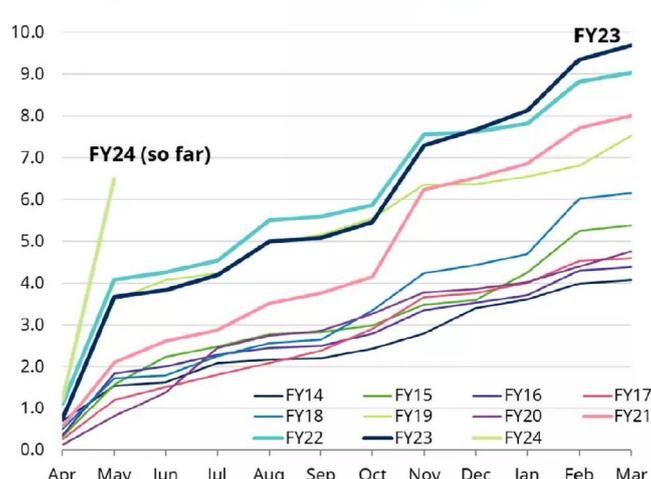
## Significant scope for dividend increase and share buyback

### Dividend Per Shares (TOPIX)



Sources: Schroders, Bloomberg, as at 31 May 2024.

### Share buyback plan announcements by FY



Sources: QUICK, SMBC NIKKO, as at 31 May 2024. Note: Universe is TOPIX constituents.

*Disclaimer: Past performance is not a guide to future performance and may not be repeated. The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. Forecasts and assumptions may be affected by external economic or other factors. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and/or current market conditions and are not an exact indicator.*

### HOW WILL THE ENHANCED DIVIDEND POLICY IMPACT THE COMPANY'S INVESTMENT STRATEGY?

The new dividend policy will **not** alter the Company's investment approach or strategy. SJG will continue to focus on well-managed, high-quality Japanese companies where current share prices do not yet fully reflect their potential. This ensures that the trust remains committed to identifying undervalued businesses with strong growth prospects across the complete spectrum of Japanese companies.

### WHAT ARE THE BENEFITS OF PAYING OUT 4% OF THE AVERAGE NET ASSET VALUE AS DIVIDENDS?

Paying out 4% of the average NAV as dividends offers several benefits, including:

- **Predictable income:** Provides a reliable dividend stream, appealing to income-focused investors
- **Attractiveness:** Enhances the trust's investment proposition, potentially increasing demand
- **Investor confidence:** Demonstrates confidence in generating sufficient returns to support the payout level

### WHAT IS A CONDITIONAL TENDER OFFER?

A conditional tender offer allows shareholders to sell a portion of their shares back to the company in the future under specific conditions. This can serve as a performance accountability measure and a tool for managing the discount at which the company's shares trade relative to NAV.

### HOW IS THE NEW CONDITIONAL TENDER OFFER MECHANISM STRUCTURED AND WHAT ARE ITS TRIGGERS?

If the portfolio manager fails to deliver performance at least in line with the Tokyo Stock Price Index Total Return in sterling terms over the five-year period from 31 July 2024 to 31 July 2029, the board will propose a tender offer. This offer would allow shareholders to tender 25% of SJG's issued share capital at a price equal to the prevailing NAV less costs. This mechanism aligns the interests of the portfolio manager with those of the shareholders, ensuring a focus on sustained outperformance.

This mechanism follows the previous conditional tender offer mechanism that was introduced in August 2020. Since that time, the portfolio

manager has met the requirements by delivering sustained outperformance of the benchmark, such outperformance compounding at 4.67% per annum to 31st May 2024, so it is not expected that the tender offer will be triggered on 31 July 2024.

### **WHAT DOES THE BOARD HOPE TO ACHIEVE WITH THESE CHANGES IN TERMS OF SHAREHOLDER VALUE?**

The board aims to enhance overall shareholder value by making the trust more attractive to a broader range of investors. The enhanced dividend policy is designed to provide consistent and predictable returns, while the conditional tender offer mechanism ensures that the portfolio manager remains aligned with shareholders and focused on achieving strong performance. Together, these measures should improve the trust's appeal, support share price performance and ultimately deliver greater value to shareholders.

### **CONCLUSION**

The new measures introduced by SJG aim to enhance shareholder value by making the trust more attractive to income-focused and growth-seeking investors. Meanwhile, the conditional tender offer mechanism provides an effective tool for managing the trust's market rating. The board is confident these measures will benefit shareholders and support the trust's ongoing success.

[Click here to find out more about the Schroder Japan Trust plc >](#)



### **Risk considerations: Schroder Japan Trust plc**

- **Capital erosion:** Where fees are charged to capital instead of income, or a fixed distribution amount is paid regardless of the Company's performance, there is the potential that performance or capital value may be eroded.
- **Concentration risk:** The Company may be concentrated in a limited number of geographical regions, industry sectors, markets and/or individual positions. This may result in large changes in the value of the company, both up or down.
- **Counterparty risk:** The Company may have contractual agreements with counterparties. If a counterparty is unable to fulfil their obligations, the sum that they owe to the Company may be lost in part or in whole.
- **Currency risk:** If the Company's investments are denominated in currencies different to the currency of the Company's shares, the Company may lose value as a result of movements in foreign exchange rates, otherwise known as currency rates.
- **Derivatives risk:** Derivatives, which are financial instruments deriving their value from an underlying asset, may be used to manage the portfolio efficiently. A derivative may not perform as expected, may create losses greater than the cost of the derivative and may result in losses to the Company.
- **Gearing risk:** The Company may borrow money to make further investments, this is known as gearing. Gearing will increase returns if the value of the investments purchased increase by more than

the cost of borrowing, or reduce returns if they fail to do so. In falling markets, the whole of the value in such investments could be lost, which would result in losses to the Company.

- **Liquidity Risk:** The price of shares in the Company is determined by market supply and demand, and this may be different to the net asset value of the Company. In difficult market conditions, investors may not be able to find a buyer for their shares or may not get back the amount that they originally invested. Certain investments of the Company, in particular the unquoted investments, may be less liquid and more difficult to value. In difficult market conditions, the Company may not be able to sell an investment for full value or at all and this could affect performance of the Company.
- **Market Risk:** The value of investments can go up and down and an investor may not get back the amount initially invested.
- **Operational risk:** Operational processes, including those related to the safekeeping of assets, may fail. This may result in losses to the Company.
- **Performance risk:** Investment objectives express an intended result but there is no guarantee that such a result will be achieved. Depending on market conditions and the macro economic environment, investment objectives may become more difficult to achieve.

- **Share price risk:** The price of shares in the Company is determined by market supply and demand, and this may be different to the net asset value of the Company. This means the price may be volatile, meaning the price may go up and down to a greater extent in response to changes in demand.
- **Smaller companies risk:** Smaller companies generally carry greater liquidity risk than larger companies, meaning they are harder to buy and sell, and they may also fluctuate in value to a greater extent.

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## What comes next for investors after India's budget?

Government gave the green light to spending on renewable energy, digital infrastructure sectors

**O**n 23 July, India announced its first budget under a new coalition government led by Narendra Modi, who became prime minister for the third time albeit with a reduced majority of 293 MPs for his BJP (Bharatiya Janata Party).

In the Indian general election held between 19 April to 1 June, 642 million people voted out of a total population of 1.4 billion.

### WHAT WERE THE KEY POINTS?

India's finance minister Nirmala Sitharaman unveiled several key proposals in her coalition government's first budget, including an increase in short-term capital gains tax from 15% to 20% and an increase from 10% to 12.5% in long-term capital gains tax on all financial and non-financial assets.

Both these moves were poorly-received by investors, with India's benchmark Nifty 50 index

falling more than 1% on the day, although up to that point the index was up around 25% on the year so some profit-taking was inevitable.

There were, however, positive announcements including a \$24 billion jobs plan with one scheme targeting first-time job entrants and two more aimed at boosting manufacturing jobs.

There was also good news for India's burgeoning middle class, foreign corporates and start-ups, with the angel tax levied on capital raised by private companies abolished and corporation tax on foreign companies reduced from 40% to 35% to promote investment.

The finance minister announced a 260-billion-rupee (roughly £2.5 billion) industrial corridor through the state of Bihar, and 150 billion rupees (roughly £1.4 billion) for a new high-tech capital in the state of Andhra Pradesh called Amaravati.

### ACTION TO REDUCE THE BUDGET DEFICIT

The target for India's fiscal deficit was lowered to 4.9% of GDP (gross domestic product) for full-year 2025, down from the previous forecast

of 5.1% of GDP.

Rita Tahilramani, assistant investment manager of the **Abrdn New India Investment Trust (ANII)**, told *Shares* said the new target could prove beneficial for India's ratings outlook.

'This narrower deficit target could prove beneficial for India's ratings outlook. The additional dividend of 1.1 trillion rupees from the Reserve Bank of India might have allowed the government to increase the allocation towards rural and social welfare schemes without cutting government capex, which has been in line with our expectation.

'Overall, central capex support was maintained at around 3.4% of GDP for the current fiscal year, and allocation to core ministries such as roads, railway, and defence were broadly unchanged compared to the interim budget, while there was an increase in allocation to housing and rural road schemes. Special assistance to states was also raised.'

India's finance ministry expects the economy to grow between 6.5% and 7% in the financial year ending March 2025, lower than last year's 8.2% and below forecasts from the IMF (International Monetary Fund) and ADB (Asian Development Bank) but significantly faster than say China where forecasts are below 5% with



**The budget includes plenty of opportunities for investors but also some risks so it is important to 'stay informed.'**



Citibank the latest to downgrade its outlook.

**WHAT DOES THE BUDGET MEAN FOR INVESTORS?**

M&G portfolio manager Vikas Pershad, who covers Asian equities including the Indian market, says the budget includes plenty of opportunities for investors but also some risks so it is important to 'stay informed'.

Pershad sees opportunities in the infrastructure and renewable energy sector, where the government has prioritised large-scale development projects including 5.54 trillion rupees (roughly £52 billion) allocated to the ministry of road transport and highways and the expansion of the national infrastructure pipeline to 9,000 projects.

The government has promised significant incentives for renewable energy projects with companies involved in solar, wind and other green technologies standing to benefit from favourable policy support, says Pershad.

**ACTIVE OR PASSIVE**

For investors who just want exposure to the market and aren't interested in stock-picking, the easiest and cheapest way to gain access to India is through ETFs (exchange traded funds), better known as

**Top-performing country-specific ETFs over one and three years**

Fund name	1-year %	3-years %
Xtrackers MSCI India Swap UCITS ETF 1C	34.59%	56.48%
Franklin FTSE India UCITS ETF	34.49%	59.38%
iShares MSCI India UCITS ETF USD (Acc)	34.00%	57.79%
Amundi MSCI India II UCITS ETF USD Acc	31.59%	52.24%
Amundi MSCI India UCITS ETF USD	31.58%	52.70%

Table: Shares magazine • Source: Just ETF 30/07/2024

## Most Indian trusts are trading at a discount to NAV

Trust name	Market cap (£m)	Discount/Premium (%)	1Y Total Return (%)	3Y Annualised TR (%)	5Y Annualised TR (%)	10Y Annualised TR (%)	Manager tenure (years)
abrdrn New India	414	-17.8	46	13	10	12	20
Ashoka India Equity	460	0.9	36	20	20	NA	6
India Capital Growth	162	-9.0	31	19	19	14	13
JPMorgan Indian	719	-18.5	23	11	7	9	2

Table: Shares magazine • Source: Association of Investment Companies (AIC)/Morningstar 31/07/2024

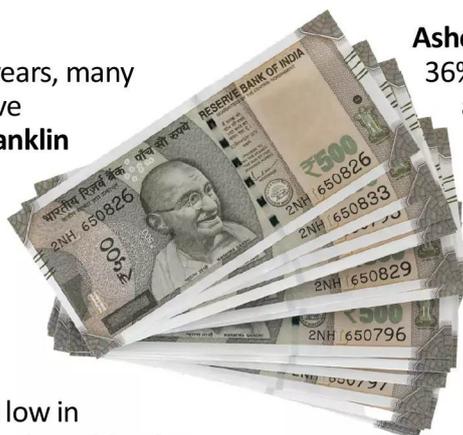
tracker funds.

Over the past one and three years, many Indian-focused tracker funds have performed well including the **Franklin FTSE India UCITS ETF (FLXI)**, which has returned 35% and 59% respectively, and the **iShares MSCI India UCITS ETF (IIND)**, which has returned 34% and 58% respectively.

Ongoing charges for these India-focused ETFs are generally low in comparison to India-focused investment trusts: the charge for Franklin FTSE India ETF is just 0.19%, but the charge for the MSCI India ETF is a fairly hefty 0.65% which is not much less than some funds and trusts.

There are a number of investment trusts solely focused on India and there are broader Asian or emerging market funds with some exposure to India, which helps spread the risk across a portfolio and keep it diversified.

Among the country-specific trusts, **Abrdrn New India (ANII)** has returned 46% over one year and 13% per year on an annualised basis over three years while its slightly larger rival



**Ashoka India Equity (AIE)** has returned 36% over one year and 20% per year annualised over three years.

James Thom, co-lead manager of abrdrn New India, attributes the strong annual performance to the trust's bottom-up stock picking process, the consistency of earnings growth across the portfolio and the fundamentals of their holdings.

The top three equity holdings as of 30 June 2024 were **ICICI Bank (ICICIBANK:NSE)** at 7.1%, **Aegis Logistics (AEGISLOG:NSE)** at 5.4% and **HDFC Bank (HDFCBANK:NSE)** at 5.3%.

Thom concedes investing in India is never without risk as it expensive compared to other emerging markets.

'While high valuations reflect the long-run potential of the country, they leave less margin for error. Hence, it is important to be selective in finding good companies which can consistently deliver on earnings.'

'There are some other external risks too: potentially higher energy prices when India is a net oil importer; a global economic slowdown which

“**While high valuations reflect the long-run potential of the country, they leave less margin for error.**”

can affect exports; and geopolitical tensions with neighbours China and Pakistan, which could also have an impact on political stability.'

Another India-focused investment trust which has generated strong returns in the long term is **India Capital Growth (IGC)**, although the ongoing charge of 1.57% is the highest in the AIC India sector.

The fund has returned a solid 31% over one-year and 19% annualised over three-years, and it is currently trading at a 9% discount to NAV (net asset value).

For investors looking to include India in a diversified trust, **JPMorgan Emerging Markets (JMG)** gives investors that exposure alongside markets like Taiwan and South Korea. Over 10 years the trust has returned 120% and the ongoing charge of 0.85% is relatively low for an emerging markets product.

#### NEW WORLD ORDER

According to Morgan Stanley, India is on track to become the world's largest economy by 2027, and

have the largest stock market by 2030, so investors should definitely consider having some exposure when embarking on their investment journey.

The budget, while generally well-received, did highlight some of the challenges facing the country says M&G's Vikas Pershad.

For instance, while the budget has increased spending on healthcare, 'the sector faces challenges related to pricing pressures and regulatory changes', while the energy sector also has problems due to global oil and gas price volatility and environmental concerns.

'The transition towards cleaner energy sources may pose long-term challenges. The ongoing global push for carbon neutrality and potential policy shifts towards reducing fossil fuel dependency add layers of uncertainty for this sector,' observes the manager.



By Sabuhi Gard Investment Writer



# Money & Markets podcast

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# How Pershing Square's \$25 billion IPO vanished into thin air

Bill Ackman's net worth was \$8bn after he sold 10% of Pershing Square for over \$1 billion in June

**B**illionaire hedge fund manager Bill Ackman is not the shy, retiring type who shuns publicity, so when he announced plans to launch an IPO (initial public offering) of a new closed-end fund on the New York Stock Exchange touting a \$25 billion valuation it seemed natural to believe he could execute his bold plan without any hiccups.

After all, the proposed vehicle would mirror an existing closed-end fund, **Pershing Square Holdings (PSH)**, which trades on the London and Amsterdam stocks exchanges, and Ackman could use his million-plus followers on social media to drum up support.

US closed-end funds are similar to UK investment trusts in that they have a fixed number of shares, so they are not subject to inflows and redemptions, giving the managers what is referred to as 'permanent capital'.

Uncharacteristically, Ackman seems to have miscalculated the potential demand for the vehicle as well as the regulatory hurdles. On 31 July, Pershing Square abruptly withdrew the IPO just days before its debut.

How did the IPO unravel so quickly? *Bloomberg* reported that Ackman sent a letter to strategic partners of Pershing Square in which he said he had 'reshaped' his thinking having considered investor feedback after several weeks of marketing.

Ackman said the perceived size of the deal initially 'anchored' investors in thinking the deal was too large, although he believed this would ultimately be helpful.

The manager wrote he expected to file a prospectus the next day with a \$2.5 billion to \$4 billion deal size, a significant reduction on the original plan.

The thorniest problem for Ackman was the closed-end structure of the IPO. Investors could not get past the idea that such funds often trade at a discount to the underlying value of the assets in the portfolio.



In other words, why buy at the IPO price when there is a fair chance of getting cheaper stock in the secondary market?

The US market is a different beast to the UK and European markets, but even so it didn't help the argument that Pershing Square Holdings currently trades at a 30% discount to NAV.

To appease investors' fears, Ackman said he had committed to limiting supply versus potential demand so the stock would trade 'well' in the aftermarket. 'In all previous closed-end fund IPOs the issuers have met 100% of the demand stock,' wrote Ackman.

The manager also touted the global appeal of the Pershing Square brand and suggested people who weren't eligible to buy stock in the IPO could provide good demand in the aftermarket alongside US retail investors.



By **Martin Gamble** Education Editor

# BECOME A BETTER INVESTOR WITH SHARES



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## Understanding EBITDA and its pros and cons

This measure of earnings has its detractors but can be useful if not relied on in isolation

It's fair to say earnings before interest, tax, depreciation and amortisation (EBITDA for short) is not universally popular as a measure of earnings.

It has some notably high-profile detractors in the form of Warren Buffett and his late business partner Charlie Munger. Munger even crudely observed EBITDA earnings should be characterised as cow-pat earnings, although he didn't use the words cow or pat.

In this article we will take a closer look at EBITDA, discussing its limitations but also how it can be useful to investors if employed sensibly.

### WHAT IS EBITDA?

EBITDA is sometimes characterised as being a proxy for the cash generated by a business. This is because it removes the effect of non-cash expenses such as depreciation and amortisation. In theory these non-cash items are of less significance to an



investor because they are ultimately interested in the cash flows of a business.

EBITDA is often used when looking at businesses with lots of plants and machinery which have significant associated non-cash depreciation costs, which might obscure the underlying performance, as well as technology firms which amortise the cost of software development and other intellectual property.

However, it fails to take account of the fact depreciation, in particular – which measures the decrease in loss or value of an asset over time

due to age, wear or market conditions – is a very real cost of doing business in a lot of sectors and should therefore be taken into account when analysing them.

### WHY DOES BUFFETT HATE IT?

Crystallising this point, a key charge levelled at EBITDA, including by Buffett and Munger, is it does not encompass

two major cash outflows, capital expenditure and changes in working capital: in other words the money needed to invest for future growth and to fund day-to-day operations, which are essential to the running of any business.

In the words of Buffett: ‘When Charlie and I read reports, we have no interest in pictures of personnel, plants or products. References to EBITDA make us shudder – does management think the tooth fairy pays for capital expenditures? We’re very suspicious of accounting methodology that is vague or unclear, since too often that means management wishes to hide something.’

This is the key consideration. If management wish to abuse the flexibility in how EBITDA is calculated, particularly if using adjusted EBITDA, it creates scope to present performance in a misleadingly positive light.

With these drawbacks in mind, why would an investor look at EBITDA? First of all, because it is calculated before interest and tax payments, it can be used to compare companies in the same sector which have different financial structures and tax domiciles.

### WHAT ABOUT EV/EBITDA?

The EV/EBITDA ratio is a comparison of enterprise value with EBITDA. The enterprise value measures the total cost of buying a business. It is calculated by adding a company’s liabilities (borrowings and pensions) to the market cap and subtracting any cash. This explains why financially-distressed companies are sometimes acquired for a nominal sum of say £1, as the acquirer has to absorb all the associated debt.

As an investor it is important to look at your shares not as flashing prices on a computer screen but as part-ownership of a business. In order to know the true market value of a business you must use the EV.

An advantage the EV/EBITDA multiple has over the price to earnings multiple is that it can be used to directly compare companies with different levels of debt or cash. Also, for example, if a company issues shares to pay off its debt. This would lead to a reduction in EPS – more shares mean the earnings attributable to each individual share drops - and would lead the PE to increase in turn making the stock look superficially more expensive. However, the EV/EBITDA would be unchanged

## Calculating EBITDA

### Calculating EBITDA for Company X

Post-tax profit	£200 million
Depreciation & Amortisation	£100 million
Interest expenses	£50 million
Taxes	£50 million
<b>EBITDA</b>	<b>£400 million</b>

Table: Shares magazine • Source: Shares magazine

Widget maker Company X generates £1 billion in annual revenue from which £400 million of production costs are subtracted along with another £200 million in overheads like energy bills and paying staff. Depreciation and amortisation expenses total £100 million, which adds up to an operating profit of £300 million. The company pays out £50 million in interest on its borrowings, leaving pre-tax profit of £250 million. With a 20% tax rate, post-tax profit equals £200 million after £50 million in taxes are factored in. With depreciation, amortization, interest and taxes are added back to net income, EBITDA equals £400 million.

despite the new capital structure.

Ultimately, EBITDA is a useful part of the toolkit when analysing companies and can be instructive as long as it isn’t used in isolation. A useful check would be to see how much difference there is between the cash flow figure and EBITDA: if they are miles apart then serious questions would have to be asked of how transparent management are being about performance.



By Tom Sieber Editor

# Will Broadcom be the next member of the exclusive trillion-dollar club?

US tech firm's hardware and software touch every part of 21st Century digital life

It seems fair to say **Broadcom (AVGO:NASDAQ)** is one of the unsung heroes of the modern technological revolution.

A couple of years back, the Silicon Valley semiconductor and infrastructure software business had a market valuation of about \$220 billion based on a share price of around \$44.

As the AI (artificial intelligence) investment story emerged, talk in investment circles was all about OpenAI, lifting **Nvidia (NVDA:NASDAQ)**, **Advanced Micro Devices (AMD:NASDAQ)**, **Microsoft (MSFT:NASDAQ)** and a handful of others.

Broadcom barely got mention, which was odd considering how crucial the firm's kit is to the modern world: an estimated 99% of all internet traffic passes across its chips, which means the company touches pretty much every major tech

theme from AI to automation, cloud computing to cybersecurity and much else besides.

*Shares* has written about Broadcom's emerging revenues and earnings story as far back as [May 2022](#) in the wake of its shock \$69 billion acquisition of VMware, yet the wider investment community largely ignored the promising signs and its stock only really started motoring over the past year, up 60%.

That means Broadcom shares will now cost you around \$140 (after July's 10-for-one stock split) and its market cap of \$732 billion puts in with a reasonable chance of becoming the next member of the exclusive trillion-dollar club. It currently sits as the S&P 500's ninth biggest company, if we combine **Alphabet's (GOOG:NASDAQ)** Class A and C shares.

## Top 10 stocks that have driven S&P 500 this year

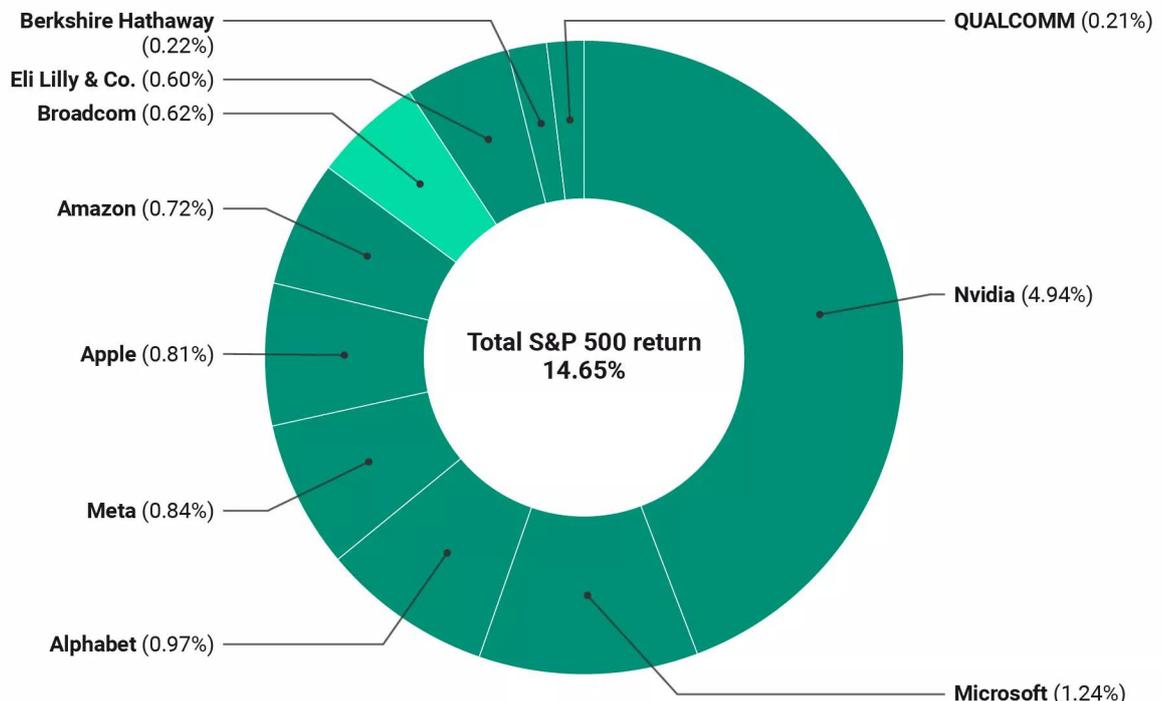


Chart: Shares magazine • Source: Goldman Sachs, Visual Capitalist, to 13 June

## How Broadcom is making money

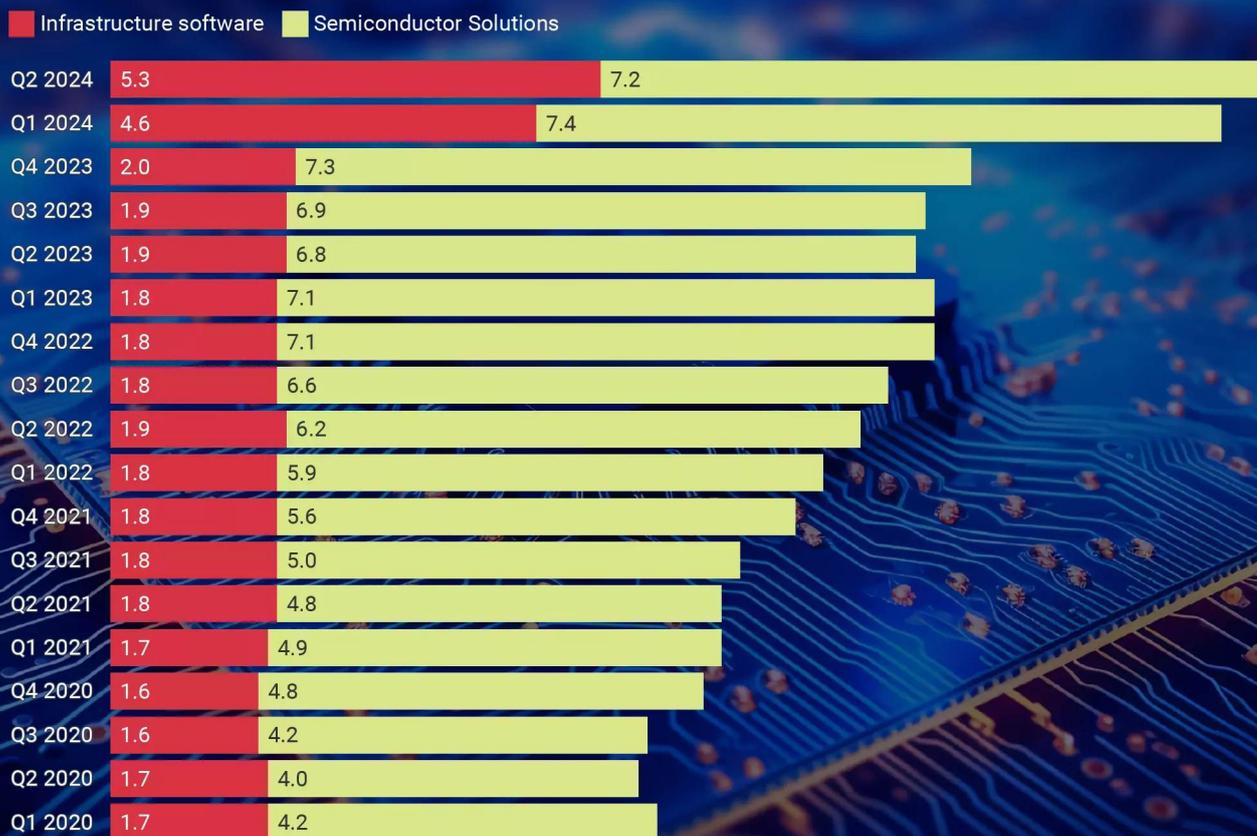


Chart: Shares magazine • Source: Broadcom

### UNDERSTANDING BROADCOM

San Jose, California-based Broadcom today operates across two primary segments - Semiconductor Solutions and Infrastructure Software. The former designs chips for networking, server storage, broadband, wireless communication and industrial applications, the traditional knitting of the business.

This part of the business is also one of the world's leading custom silicon developers, working closely with customers like Alphabet, for example, to create application-specific chips or ASICs (application-specific integrated circuits), which deliver superior performance and energy efficiency at lower cost for targeted workloads.

Infrastructure Software was traditionally the smaller part of the business, although not so much following the acquisition of VMware which completed in November 2023. A leader in cloud computing and virtualisation, VMware brought its software solutions into Broadcom's

portfolio, substantially diversifying its revenue and propelling the segment's contribution massively, as the bar chart shows.

Broadcom shuns the growth-at-any-cost approach and, according to **Blue Whale Growth's (BD6PG78)** Stephen Yiu, chooses to work with its largest 600 to 700 customers to expand their use of its software, resulting in a highly attractive margin profile.

Gross margins ran above 62% in the most recent second quarter earnings to 5 May (announced 12 Jun), with operating and net profit margins coming in at 24% and 17% respectively.

One-time items hurt margins year-on-year, primarily due to expenses related to the VMware integration including the amortisation of intangible assets, but analysts see margins stabilising towards past levels of close to 70% (gross) in future, with operating margins returning towards 40% as structural tailwinds behind the sector combine with the firm's pragmatic business approach which has

led to years of superior investment returns.

AI has been a significant growth driver, with \$3.1 billion in Q2 revenue coming from AI products or roughly 26% of overall income. Based on the 280% growth discussed by management during the earnings call, AI alone contributed to a \$2.2 billion revenue increase year-on-year offsetting cyclical weakness in semiconductor revenue from enterprises and telcos.

### WHAT TO WATCH

The equity market's sharp shock is creating increased volatility at the moment, which may continue in the short-term, but beyond that Broadcom's AI kit is driving significant growth. Maintaining momentum here will be crucial to keeping the share price rising.

Investors also need to watch for next-generation product releases from its large R&D investment, which reached \$2.4 billion in Q2. The recent launches of its Tomahawk and Jericho switching products will be vital to maintaining its leadership in networking, for example.

The return of the inflation monster and any supply chain trips could undermine the stock, while there will always be regulatory scrutiny, and the European Commission is investigating the VMware acquisition, which could lead to fines or other penalties.

A final fact to consider is Broadcom's balance sheet. With its history of jumbo acquisitions,

Broadcom doesn't look like the rest of the big tech universe which typically enjoys large cash piles.

By contrast, Broadcom needs to service gigantic net debt of around \$62 billion, yet equally it throws off enormous amounts of cash every year, \$18 billion over the past 12 months alone, demonstrating its ability to handle its financial obligations and invest in future growth.

In short, Broadcom provides crucial kit right across the tech sphere, presenting decent defensive moats to its revenues. It is also enjoying strong AI momentum but from a diversified portfolio.

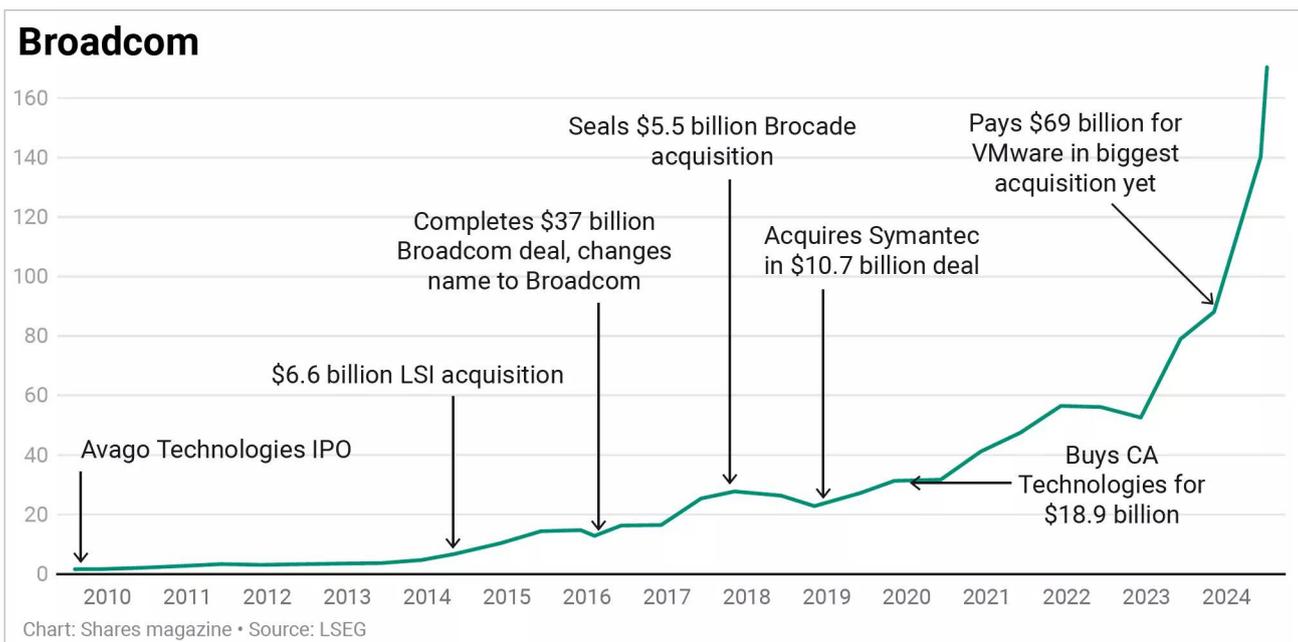
Analysts see fiscal 2023 revenues of around \$35 billion close to doubling to more than \$67 billion by 2026 based on Koyfin consensus, implying EPS (earnings per share) of about \$7 versus \$4.22 last year.

This makes its three-year average forward PE (price to earnings) multiple of less than 25 times look attractive in our view, while it needs its share price to reach roughly \$196 to hit the trillion-dollar market cap mark.

**DISCLAIMER: Steven Frazer owns a personal stake in Blue Whale Growth.**



By Steven Frazer News Editor





# Why the yen holds the key to markets and what may lie ahead

Investors should keep an eye on three key indicators from here

**A** market storm is emerging from a seemingly cloudless summer sky. The question now is whether this is just a tempest in a teapot, and the result of thin trading volumes as the big hitters head to the beach and leave deputies and juniors in charge, or whether it is the harbinger of a more serious – and bearish – shift in market sentiment.

The first step to working this out is to understand what may be upsetting markets right now. The second is to see what might influence those trends and issues, for better or worse.

## TRICKY TRIO

In sum, three issues seem to be at work:

First, equity (and to some degree bond) markets have priced in the ‘perfect’ scenario of cooling inflation, a soft landing in Western economies (and thus corporate earnings) and rate cuts from the US Federal Reserve, the Bank of England and others.

Any deviation from that path could therefore lead to trouble – either stickier inflation, economic and earnings disappointment or slower-than-expected rate cuts.

Deviations from that path can be found, however. Rate cuts have come more slowly than hoped, and the Fed has yet to deliver, after the market started 2024 looking for six, one-quarter point cuts from the US central bank.

Inflation has proved stickier, and there are signs the US economy is slowing – unemployment is up, the housing market is a mess

and the latest purchasing managers’ index for manufacturing showed weak orders and sticky prices.

A US slowdown is not priced in at all – if anything markets were more concerned about it overheating earlier this year – and those with long memories will remember how frantic rate cuts in 2000-02 and 2007-08 failed to stave off a bear market in stocks, because the economy tipped over and corporate earnings fell far faster than the headline cost of money.

Second, the yen is rallying. As this column hinted back in February of this year, the Japanese currency has been a major source of global liquidity as major market players have shorted it, borrowed against it and used that money to go long risk assets around the globe.

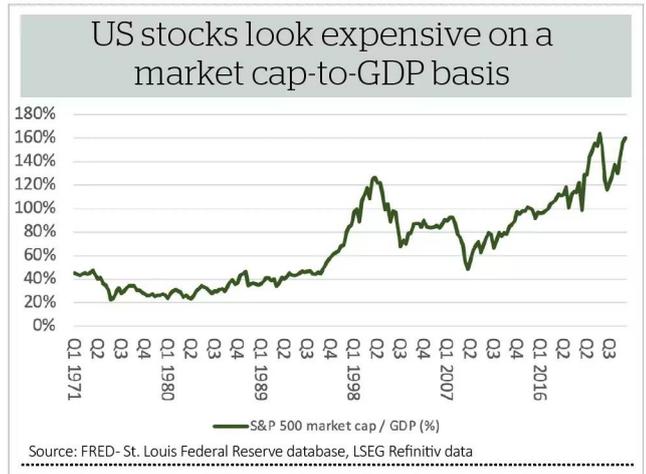
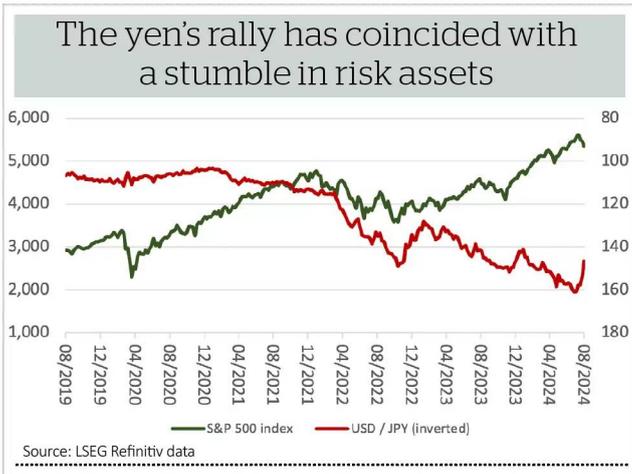
The Bank of Japan’s belated efforts to raise rates and defend the yen may be turning off the tap, even if Western central banks are slowly cutting rates to keep liquidity flowing.

The yen is rallying, as massive short positions against it are closed out, to drive the currency higher still and force yet more liquidation by the shorts, to create a circle every bit as vicious as it had previously been virtuous.

Finally, US equities in particular have gone up in a straight line and done so much faster than GDP

growth, corporate earnings or cash flows. The result is that US equities look expensive: according to FactSet, the S&P 500 trades on 20.6 times forward earnings against a 10-year average of 17.9. As a result, the US S&P 500’s market’s capitalisation represents 160% of GDP, an all-time high. According to Professor Robert

**“The yen is rallying, as massive short positions against it are closed out, to drive the currency higher still and force yet more liquidation”**



Shiller, the US stock market trades on a cyclically adjusted P/E (price-to-earnings) ratio of 35, a figure only exceeded in 2000 (and that did not end well).

LEAD INDICATORS

As the old saying goes, valuation never tells you when there may be trouble (or an opportunity) but it will tell you how far things can go (up or down) before something snaps back the other way.

Those numbers suggest either prices must fall (some way), or earnings must surge quickly for stock markets to regain their equilibrium – although UK equity prices are nowhere near as stretched as they are in the USA.

To test market sentiment, rather than fundamentals, investors can watch three indicators:

The first is the VIX index, or so-called fear index, which measures expectations of US stock market volatility in the month ahead. The long-run average reading since 1994 is 19. It is usually a good counter-cyclical indicator.

Sustained periods of low readings, down towards 12 or lower, speak of investor complacency and likely trouble ahead (because it won't take much to frighten everyone).

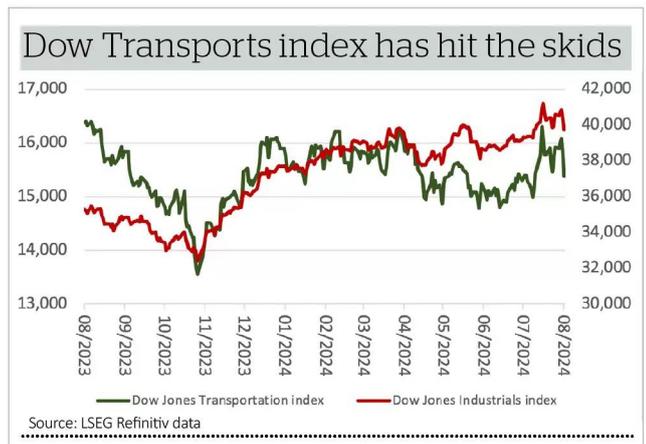
A sustained run above say 30 suggests there is panic around and there may be bargains appearing, but the shake-out in this case could be violent. (This simply distils Buffett's maxim about being fearful when others are greedy and greedy when others are fearful).

The second is again the yen, given its pivotal role in global market liquidity. If the Bank of Japan backtracks on its promise of more rate hikes that might help, although whether that stokes global

inflation expectations is another challenge, and rapid cuts from the Fed and other central banks might stoke money supply and liquidity in the West, but they might fuel inflation fears too – which may be why gold is holding firm.

For those looking for an indicator that looks at both US markets and the US economy (and we are focusing on those are they are the biggest in the world on both counts) then nothing is usually more helpful than this column's old friend, the Dow Jones Transportation index.

It has lagged the Dow Jones Industrials and lost momentum. That is usually a bad sign as it speaks of economic weakness. That indicator needs to start trucking again, or a summer squall could turn more serious.




By Russ Mould  
AJ Bell Investment Director



## The odds are stacked against most Premium Bond holders winning

Two-thirds of investors have never won despite the average holding topping £5,000

**P**remium bonds are the most popular product from NS&I (National Savings & Investments) with around 22.5 million people holding the accounts, but new figures show most of these holders have never won a single prize.

A Freedom of Information request\* obtained by AJ Bell reveals two-thirds of Premium Bond holders, equivalent to just under 14.4 million people, have never won anything.

It paints a disappointing picture for hopeful bondholders who could have otherwise have stuck their money elsewhere for a more reliable and sometimes guaranteed return.

The figures also show that 5.3 million Premium Bond holders won a prize between June 2023 and May 2024, with 80% of those winners winning more than once during that period. However,

the clincher is in order to have a better chance of winning you have to have much bigger-than-average holding.

There is a whopping £126 billion sat in Premium Bonds, with the average overall holding coming in at £5,185. However, if we drill down into the 5.3 million Premium Bond holders who won in the past year their average holding sits at £23,047.

Over the past 12 months the average holding of someone not winning is £175, showing that those with very small balances are unlikely to strike it lucky.

Moreover, while the average overall holding of Premium Bond holders sits at a modest £5,185, given there's a pretty decent chance that amount will *not* win a prize, savers might be better off considering other options with their cash.

For example, if they had taken more risk and

invested the money instead, putting £5,185 in the Fidelity Index World global tracker fund 10 years ago, they'd be sitting on a pot worth £16,689 today\*\*.

Of course, the lure of Premium Bonds is you might win the big £1 million prize but these figures show it's very unlikely if you only have a small amount saved in the bonds.

That said, there are a few groups for whom Premium Bonds may be an attractive option. The first is those with large savings who are higher-or additional-rate taxpayers.

Premium Bond prizes are tax-free, but since the introduction of the Personal Savings Allowance most people didn't pay tax on their savings income anyway.

The allowance means basic-rate taxpayers can earn £1,000 in interest on their savings before they pay tax, while higher-rate taxpayers can earn £500. As interest rates have risen, more people are starting to start to hit this allowance.

On top of that, anyone who is an additional-rate taxpayer gets no savings allowance so will pay 45% tax on any of their savings income. For these highest earners, or those who have already breached their allowance, the tax-free nature of Premium Bond becomes far more attractive.

An alternative for these savers is a cash ISA account where your money will be protected from tax and your interest rate return is guaranteed, but if someone has already maxed out their £20,000 ISA allowance then Premium Bonds are a good second option.

The next group Premium Bonds will appeal to is gamblers who want the chance to win the big prize. If the savings rates on standard accounts don't excite you, you can gamble on winning one of the top Premium Bond prizes – after all, someone has to win. However, anyone in this camp needs to be aware they could win nothing and therefore get zero return on their money.

The final group is savers who are very risk-averse. A big part of the appeal of Premium Bonds is they are backed by the government, so they are seen as the safest-of-safe places to keep your money.

However, we're all protected by the Financial Services Compensation Scheme, which covers



up to £85,000 of money per person per financial institution. This means your money is theoretically as safe in any other bank with FSCS protection as it is with Premium Bonds.

Still, because NS&I is government-run, technically it can't go bust, whereas a bank could go bust and then you would have to reclaim your money through the compensation scheme. It's a marginal difference but some people just feel safer with their savings being with the Government.

\*Based on data obtained by AJ Bell from the NS&I via a Freedom of Information request, accurate as at 23 May 2023. The number of current holders who have not won a prize is based on data from February 1994 onwards and includes new holders who were not eligible as their Bonds were not beyond one month purchased.

\*\*Based on FE data. Doesn't take into account platform fees.

**Disclaimer: Financial services company AJ Bell referenced in the article owns Shares magazine. The author of the article (Laura Suter) and the editor (Ian Conway) own shares in AJ Bell.**

“Of course, the lure of Premium Bonds is you might win the big £1 million prize but these figures show it's very unlikely”



By Laura Suter  
AJ Bell Head of Personal Finance



# How stocks perform after the first rate cut in the cycle

UK shares have outperformed on average after the Bank of England makes its initial move

It may have been overshadowed since by significant market volatility but, widely expected as it was, the Bank of England's decision to cut interest rates for the first time since 2020 represents a significant inflection point.

And with the usual caveat that the past is not a guide to the future, investment bank Berenberg has done some useful work on the average performance of the UK market in the wake of the first cut in each interest rate cycle over the last five decades.

The results make for pretty positive reading if you are invested in UK shares. Averaged out, the performance after the first rate cut has been appreciably better than the all-time average on a one-, three-, six- and 12-month view.

There is considerable variation within that average, reflecting the fact rates can be cut for a variety of reasons including in the wake of significant market shocks like the Covid pandemic or 2007/8 financial crisis.

Berenberg analyst Jonathan Stubbs notes the latter represents the lowest extreme on the rate cut continuum, with a 37% fall for UK equities following the first cut in 2007, while at the top end in 1976 the first cut heralded a 56% gain.

Stubbs adds: 'We think rate cuts, alongside reduced political uncertainty, net inflows into UK equities, cheap valuations and modest earnings growth should support UK equity returns over the coming 12 months.'

His economist counterparts at the bank believe there will be a further 150 basis points worth of cuts through to the end of 2025 bringing rates down to a terminal rate of 3.5%.

It is worth flagging a few points of caution here. There is a chance, albeit modest, that the largely positive market reaction to Labour's decisive victory in last month's election could be diluted by the recent far-right violence in the UK. Second, the trajectory of rates may not prove as smooth as expected if, for example, there were to be a renewed uptick in inflation.

## Average UK equity market performance following the first rate cut (last 50 years)

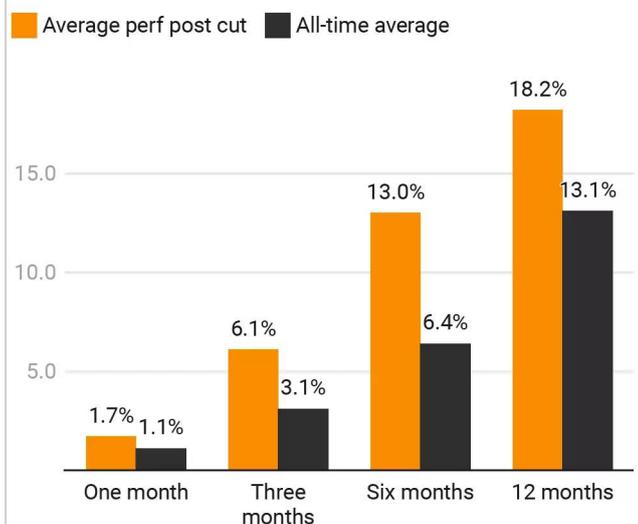


Chart: Shares magazine • Source: Berenberg research, Eikon. Note: based on the first rate cut from the Bank of England in each cycle over the last 50 years

Finally, as my colleague Ian Conway pointed out in this column [last week](#), corporate results are likely to be a more reliable delineator of market returns than what happens with rates.

While we're on the subject of interest rates, calls for the Federal Reserve to introduce an emergency cut in response to the recent market weakness seem massively overblown and could well prove counterproductive.

Events could conspire to force the Fed's hand but, for now, such a move would probably do more harm than good as it would only add to a sense of panic. While the factors behind the correction in stocks should not be dismissed, it is also true to say summer sell-offs are not unusual amid thinner trading as a large number of market participants are on the beach.



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

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