TRUSTNET magazine

Issue 37 / February 2018

FOLLOWING AMAZON
Tapping the e-commerce boom

PRICE AND PREJUDICE
Is value making a comeback?

KEEP IT GROWING
The case for taking risk in retirement

ISSUE 37

CREDITS

TRUSTNET MAGAZINE (FORMERLY INVESTAZINE) IS PUBLISHED BY THE TEAM BEHIND FE TRUSTNET IN SOHO, LONDON.

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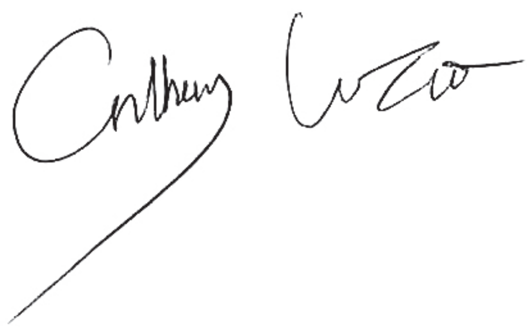
EDITOR'S LETTER

THE BEST-PERFORMING STOCK ON THE FTSE ALL SHARE LAST YEAR wasn't the UK's answer to Facebook or Google, nor was it a miner riding a price rebound in its underlying commodity. Amid all the talk of a sector in long-term decline, the index's top-performer in 2017 was actually high-street stalwart Games Workshop, with gains of more than 300 per cent. While the manufacturer of fantasy board games is by no means a typical store and it makes approximately 70 per cent of sales from overseas, it still demonstrates what investors could be missing out on if they tarnish an entire sector with the same brush, as Rebecca Jones finds out in this issue's cover feature.

If you like the idea of finding value in out-of-favour stocks, the good news – according to an article from Cherry Reynard – is that the conditions look extremely favourable for this type of investing. However, Adam Lewis says the bad news is that all the easy gains in UK small caps, which have a higher exposure to the UK consumer, may have already been made. I look at the other side of the coin as I search for the best way to tap into the unstoppable rise of internet shopping.

In our regular columns, John Blowers floats the idea of maintaining the same level of risk throughout your retirement, MitonOptimal's Paul Warner reveals why he is adding Montanaro UK Income to his SRI Balanced Growth portfolio and Gervais Williams names three stocks he is backing in another out-of-favour sector – oil.

Enjoy reading,



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DEATH OF T
HIGH STR

Should it be off-limits for investors?

Even more worrying for investors, though, is the most recent trend to emerge among consumers: that of not – in-fact – consuming. This is most evident in the supermarket sector, where back-to-basics German discounters Aldi and Lidl have stolen a march on British stalwarts such as Tesco and Sainsbury's. Williams retailers [where] you don't need to choose from 15 types of pepper."

While this has not yet extended much beyond groceries, Williams says this could be a trend to watch: "There's a kind of pattern where people are getting a bit tired of having too many things. I think there is a sort of weariness and people are changing their behaviour a bit."

Survivors and thrivers

The retail sector as we know it is changing beyond all recognition, but this doesn't make it a no-go area for investors, writes **Rebecca Jones**

UK RETAILERS AREN'T HAVING A GREAT TIME OF IT. Over the past decade, brands once synonymous with everyday British shopping habits – from Marks & Spencer to Tesco to department store goliath Debenhams – have reported sales figures that have become weaker and weaker. Despite a difficult backdrop, however, some unexpected winners are beginning to emerge in this new retail landscape – if you know where to look.

ONLINE OR BUST

The arch nemesis of the high street is, undoubtedly, the internet. Online retailers have made sourcing and purchasing even the most obscure items effortless, leaving little reason for consumers to tackle high street crowds. Areas that have been hit particularly hard by this trend include books, media and electronics – products that arguably only the most eccentric consumers refuse to source from Amazon or iTunes. The demise of entertainment retailers including Virgin Megastores (later Zavvi) and HMV between 2009 and 2014 is testament to this, while Dixons is clinging on by its fingernails after the collapse of Comet in 2012.

Fashion retailing is one of the more recent victims. An area once thought to be safe from the online juggernaut due to the vagaries of size and fit that were most efficiently navigated onsite has been transformed by companies making it easier than ever to find the perfect outfit. Keith Ashworth-Lord, manager of the Sanford DeLand UK Buffettology fund, explains: "In fashion, the trend is absolutely away from bricks and mortar, towards online. I only have to look at my daughter who orders three sizes of something then sends two back the next day to see that. When the market cap of ASOS overtakes Marks & Spencer, that tells you something."

While fending off the internet giants, high street retailers have also had to contend with rising rents. Ashworth-Lord says that property values in many prime central retail locations have rocketed, hurting larger firms with big stores such as M&S, Debenhams and House of Fraser (the latter two recently issued crippling profit warnings). According to Gervais Williams, manager of the Miton UK MicroCap trust, this has compounded other cost concerns: "We've been very cautious on this sector for a long time – there are a lot of headwinds. In the UK we've got the minimum wage rising quite fast at the moment, which affects a lot of counter staff at retailers, adding more pressure."

POUND SALE

In addition to these longer-term challenges, the UK's vote to leave the EU in June 2016 – and the subsequent sharp devaluation of the pound – has hurt businesses across the board, although once again, it's retailers that are taking the heat: "I think sterling was overdue a correction, but for businesses that import a lot of what they sell – and that is predominately retailers – that has been a problem, without doubt," says Ashworth-Lord. Williams concurs, adding the currency hedges that savvy importers may have purchased pre-Brexit will now likely be expiring, adding further cost-woe for some retailers.

Perhaps more important, however, is the effect that shrinking sterling has had on the UK consumer. Inflation has been glued to the floor since the Bank of England embarked on its titanic monetary stimulus programme in 2009, however Brexit has pushed it back up to pre-crisis levels of more than 3 per cent. While this in itself is not bad news, wage stagnation has provided a double whammy: "Simply put, wages are not rising as fast as prices and that squeeze is onerous. Sterling has strengthened of late, but despite this – and rising employment – the consumer is struggling," says James Henderson, manager of the Henderson Opportunities Trust.

Even more worrying for investors, though, is the most recent trend to emerge among consumers: that of not – in-fact – consuming. This is most evident in the supermarket sector, where back-to-basics German discounters Aldi and Lidl have stolen a march on British stalwarts such as Tesco and Sainsbury's. Williams explains: "It used to be that people looked for the widest range. Now many are happy with smaller local retailers [where] you don't need to choose from 15 types of pepper."

While this has not yet extended far beyond groceries, Williams says this could be a trend to watch: "There's a pattern where people are getting tired of having too many things. I think they are changing their behaviour a bit."

> "Games Workshop is totally fan-based. The people that buy this product would find this store if it was 100ft underground"

SURVIVORS AND THRIVERS

Despite all this doom and gloom, managers insist there is hope for Britain's high street retailers. Perhaps unsurprisingly, one of the most important survival factors is an online offering. Ashworth points to Next – one of the few fashion retailers that is holding up in the current environment – as a case in point: "The trend is very clearly towards online and what we have to look for as investors are the businesses that are best placed to withdraw from the high street. For me, Next fits this bill. The average

rental lease on its stores is around seven years, so it can get out pretty quickly, while it is growing purely through online sales."

Shutting up shop isn't the only option. As Henderson observes, there are plenty of bricks and mortar retailers that are growing – and playing to the consumer squeeze is key. His holdings in Shoezone, convenience store chain McColl's and Bargain Booze-owner Conviviality have performed well thanks to a combination of renting units in cheaper areas, discounting and an astute awareness of customers' needs. Matt Hudson, co-manager of the Schroder UK Opportunities fund, points to B&M – an everyday essentials retailer that is expanding fast: "B&M is putting down more space, but it buys in bulk and sources well from Asia. It's a price-competitive model set up to ensure that low price is passed on to consumers, and they seem to like that."

SPECIAL SAUCE

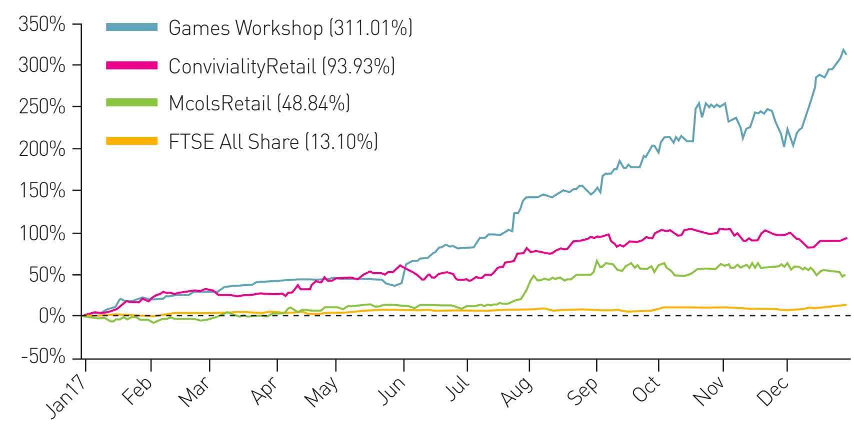
Businesses that provide specialist products and services are also more likely to thrive and Henderson and Hudson point to Halfords as an example: "Halfords is a destination if you want to motor or bicycle, so it has a role as a high street retailer as it is not something that's easy to do online. Specialists can buck trends more easily than generalists," Henderson argues.

In no company is the specialist dynamic more evident than fantasy board game manufacturer Games Workshop – the best performing stock on the FTSE All Share last year – and a standout performer for Ashworth-Lord: "That is really specialist and totally fanbased. The people that buy this product would find this store if it was 100ft underground."

As Games Workshop shows, a strong brand encouraging a loyal customer base still has a role to play in retailing – despite price becoming ever more important. For Hudson, urban streetwear label Superdry is another good example. Launched in 2004, the brand has grown through the label-love of the mid 2000s to emerge as a staple for mid-level consumers, while its expansion into Asia and the US is providing support. "In the UK, [Superdry] only has 100 stores, but the real strength has been the way it has distributed the brand globally. It's on trend with the growth of athletic leisurewear and we've seen lots of stocks in that area do really well," Hudson says.

The future of UK retailers is perhaps more uncertain than it has ever been. The pace of growth in online retail has caught many investors by surprise and if Moore's Law is anything to go by, it's not going to slow down. The more short-term headwinds buffeting the sector – namely the post-Brexit consumer squeeze – will die down. However, retailing is going through a fundamental shift and investors must ensure they pick the winners. Hudson summarises: "The most important thing is that retailers acknowledge these changes in consumer behaviour, how they impact their businesses and have the flexibility to take on that challenge. Those that can embrace the change will survive." ●

PERFORMANCE OF STOCKS VS INDEX IN 2017



Source: FE Analytics

For promotional purposes

AIM FOR THE STARS

James Henderson of the Henderson Opportunities Trust says the AIM index contains the next generation of UK companies that could drive the economy for years to come

THERE ARE ALWAYS MONEY-MAKING INVESTMENT OPPORTUNITIES waiting out in the market and it is only lack of imagination and idleness that stop us professional investment managers from taking them. This is a fact I have needed to remind myself about in recent months. The UK can appear depressing with the Brexit debate ratcheting up to the point of angry disagreement in which everyone will be a loser and where real wages are falling. The large consumer stocks, property companies and utilities are facing strong headwinds, with a slowdown in economic activity predicted. There is also the structural challenge caused by yesterday's strong franchises rapidly being reduced to today's tired business models.

Think how Ladbrokes dominated the betting market only for its market share to be eaten away by the online platforms or the way internet clothes retail business ASOS went from a start-up to having a market capitalisation nearly the same as Marks and Spencer.

It is the rapid speed of change that is making some AIM-listed companies such a good hunting ground for opportunities, despite the economic backdrop. ASOS had a value of a few million pounds in 2005 and it now has a market value of £5bn (Source: Bloomberg, February 2018). It is still listed on AIM.

Many of the new, young companies on AIM will fail but this will primarily not be the fault of the economy – rather their inadequacies as a business. In the same way the winners will succeed because of their own efforts and excellence of product. It is refreshing every time to meet and talk to a new young company on AIM.

For a start, Brexit is unlikely to be mentioned. The successes come in many different areas of activity. Tonic water producer Fevertree and robotics company Blue Prism were two of the stars last year, while Scapa, an industrial tape company, and Johnson Services, a laundry business, have given very strong returns recently. Success, like failure, comes in many different areas. An interesting characteristic of Scapa and Johnson Group is that they were both once quoted on the main market. They had become problem-riddled old companies, but the move to AIM and new management teams meant they rediscovered their purpose and drive. This shows it is not only young companies that succeed on AIM, old companies can reinvent themselves. It is the lighter regulations and lower costs that mean some companies leave the main market to join AIM and these can be important factors in their recovery plans.

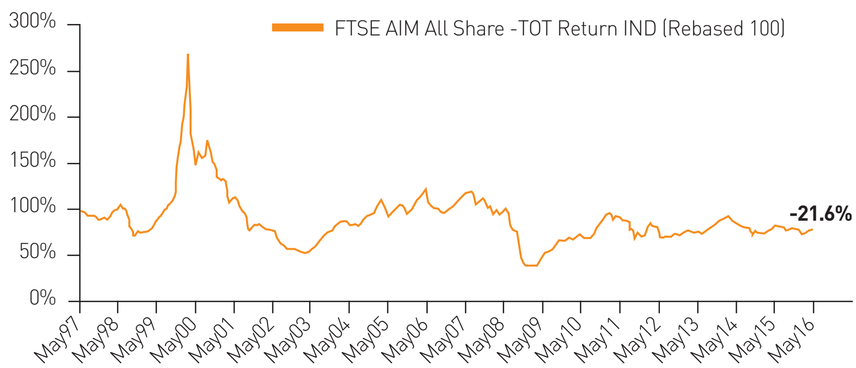
What, therefore, is the process for finding a successful investment on AIM? Given there is no blueprint for success, there is no process for finding a successful investment other than doing the research. If you stay open to new ideas and then see a lot of companies already quoted on AIM or coming to AIM every so often, through elements of luck and hard observation, the successful investment will be found.

AIM has had a good year but this has not always been the case: in fact the AIM index was down from its launch in 1997 to May 2016 (see chart top-right).

The reasons for this were that investors had chased fashion. There were too many tech companies in the early days with absurd valuations that proved to be businesses of no value, followed by a mining boom when the hype did not match the reality, resulting in heavy losses for investors. These two events dragged down the AIM returns. The returns since the 19th year anniversary have seen substantial growth driven by a diverse range of stocks (see bottom chart).

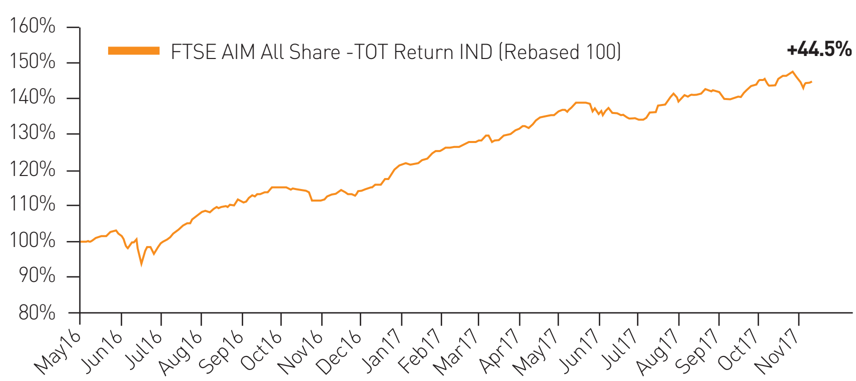
There will be many disappointments, but the next generation of dynamic UK companies that will play their part in driving the UK economy forward, regardless of Brexit and politicians, can be found on the over one thousand companies that are on AIM. AIM can therefore play an important part in a well-balanced portfolio.●

PERFORMANCE OF INDEX MAY 1997 TO MAY 2016



Source: Datastream, as at 12 May 2016. Rebased to 100, as at 12 May 1997

PERFORMANCE OF INDEX MAY 2016 TO NOV 2017



Source: Datastream, as at 21 November 2017. Rebased to 100, as at 12 May 2016

PRICE AND PREJUDICE

Cherry Reynard says there are signs the out-of-favour value strategy could be coming back into fashion

It has been an uncomfortable time to be a value manager and even the most ardent followers of the discipline may be wondering whether it has had its day. After almost a decade when the value style has lagged its peers, is it time to admit defeat? Or could it be that the underperformance is simply down to monetary policy and the scales will start to tip back now that interest rates are rising?

Over the last 10 years, the MSCI World Value index has delivered a total return 125.26 per cent, compared with 183.56 per cent from the equivalent growth index. Against an uncertain economic backdrop, investors have favoured reliable growth with little concern for how much they paid for it. Few were willing to take a risk on unloved "value" names, such as banks or mining companies.

PROXIES

Certainly, the monetary policy environment has been contributory. Falling interest rates and the resulting low bond yields have made bond proxy sectors attractive. This has driven the performance of companies that delivered dependable earnings growth when it was hard to come by in most other areas of the market. At the same time, banks and mining companies have appeared too precarious for most investors' tastes.

The question then, with many of the factors that have driven the outperformance of growth styles reversing, is whether this will change as the environment does? The US 10-year treasury yield, for example, is now edging towards 3 per cent, having been as low as 2 per cent in September 2017. This means risk-averse investors no longer have to look to the equity market for income.

FAVOURABLE CONDITIONS

At the same time, economic growth is no longer scarce. The IMF recently upgraded its global growth forecast to 3.9 per cent, aided by US tax cuts and a buoyant Chinese economy. Companies are generally operating in a favourable environment, meaning investors should no longer have to pay higher prices for growth stocks when "weaker" companies are also delivering the goods.

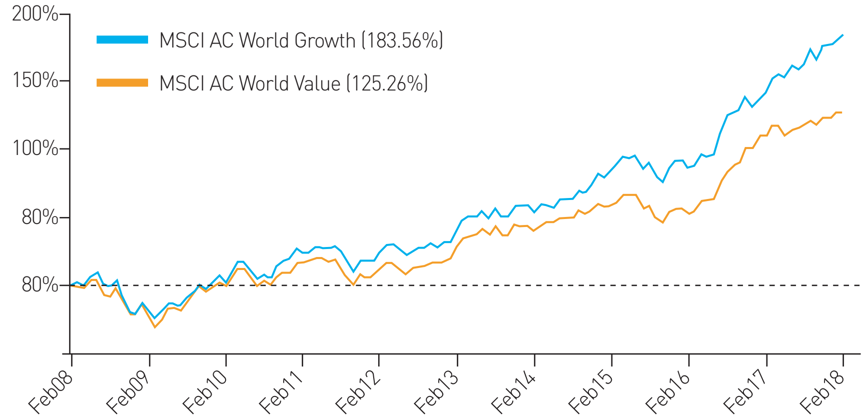
This can be seen in the valuation differential between sectors such as consumer discretionary companies and industrials. Estimates suggest that the consumer discretionary sector is now trading at a discount of around 25 per cent relative to industrials, yet there is no meaningful difference in earnings growth or future prospects.

Value has started to fare better since the start of 2018, but Stephen Peters, portfolio manager at Barclays Wealth and Investment Management, points out that January 2017 saw a similar trend before growth reasserted itself. At the same time, markets have shown that they can be insensitive to valuations for extended periods.

TURNING THE CORNER

Nevertheless, asset allocators are starting to adjust their portfolios and there is a recognition the environment may have finally turned. James Klempster, head of portfolio management at Momentum Global Investment Management, says he normally maintains a balance between equity and growth styles in his portfolios, but is starting to tilt them towards value: "Growth has been at the fore for a number of years and has had a phenomenal time, but is now quite concentrated and value has been left behind – it is bifurcated." •••

PERFORMANCE OF INDICES OVER 10YRS



Source: FE Analytics

> **Fund managers would need to be willing to rotate portfolios towards the sectors that have struggled since the financial crisis if they start to outperform and may end up looking more passive**

He believes the gap is wider in some countries than others, adding: "We need to be careful about regional allocation. Growth in the US has done well and there are more question marks over valuations than in the UK or Europe. That said, we believe there are good opportunities in value-driven strategies everywhere."

Which value managers are likely to benefit most from this environment? Proponents of this style tend to fall into "extreme" and "value-lite" approaches. Peters says managers such as Old Mutual's Richard Buxton and Jupiter's Ben Whitmore – who have long term contrarian styles with a value tilt – stand to perform well in this type of value-driven market. However, their approach is not so assiduous as to only function in a "value" environment.

At the same time, there are managers who will find it more difficult. Peters says: "It will be interesting to see how some of the top-performing managers of the last few years and small- and mid-cap focused managers do."

There is a more nuanced point about active versus passive if the environment is moving to favour value, says Peters. Many of the value names are to be found among the largest companies such as those in banking, mining and the oil & gas sectors. Active managers tend to hunt around small and mid cap names and don't see as many opportunities to add value among their larger counterparts. Fund managers would need to be willing to rotate towards the sectors that have struggled since the financial crisis if they start to outperform and may end up looking more passive.

Value has had "dead cat bounces" before, but this time feels different. Monetary policy is shifting and this is finally being felt in bond markets. All this influences sector preferences among equity investors and may tip the balance towards value.●

REGARDS *from* SHANGHAI

I've seen the future and it probably works.

I'M WRITING AN HOUR AFTER THE PRIVILEGE OF A MEETING WITH JACK MA. The founder of Chinese internet giant Alibaba was in especially ebullient mood as he was preparing for the start of Singles Day – a company invented occasion that now attracts a TV audience twice the size of the US Super Bowl and dwarfs any other shopping day anywhere in the world be it online or traditional. Alibaba expects to process 360,000 transactions a second in the coming 24 hours. No other company in the world comes close to this scale.

Singles Day and Alibaba symbolise developments that are transforming our economic and social lives. The forces set in motion are highly likely to dominate our lives and financial markets. Alibaba's rise encapsulates the ascent and challenges of the power of technology, its scale signals the awesome power of a small number of giant corporations and its example is a harbinger of an age of Chinese progress and global leadership that is barely grasped in even the most ambitious forecasts.

Why does Alibaba promote Singles Day? It's great publicity for sure and probably helps boost the business overall. But that's not the point. As Mr Ma explained it's a stress test for the future. In about eight years' time Alibaba thinks it will be dealing with such volumes every normal day – around 10-12 times current average levels. The logistics systems need to learn how to cope. Alibaba's human and machine scientists need to see how such unparalleled data sets can be sorted and interpreted to further strengthen links to individual customers.

At present the US and China compete for global leadership in machine learning and artificial intelligence. But it's likely that in the next decade Chinese leadership will become firmly established. As Martin Lau of Tencent (the other Chinese technology giant to have added a mere $200 billion of market value in 2017) puts it, scale is more of an advantage to China in a data age than it was in the manufacturing era. And in turn data is the most important factor of production in our new economy. From the delivery of food through to autonomous driving, this gives brilliant and blindingly ambitious Chinese entrepreneurs a giant canvas to work on.

There follow wider and beneficial consequences. It's already clear that Alibaba, Tencent, Baidu and a host of their smaller and usually affiliated brethren are expanding progress in data into early explorations of the potential to improve healthcare and education after the paralysis of recent decades. In these contexts parallel efforts in China and America are more likely to be helpfully symbiotic than damagingly exclusive. That's great for us all. In healthcare the combination of data empowering personalised medicine, and the collapse in the price and rise in performance of genomic sequencing, will permit far earlier and better diagnosis of health problems. Advances in gene therapy and synthetic biology ought to match cures with diagnosis for all their societal challenges.

JAMES ANDERSON
Investment Manager
James graduated BA in History from Oxford University and after postgraduate study in Italy and Canada he gained an MA in International Affairs in 1982. He is a Trustee of the Johns Hopkins University. He joined Baillie Gifford in 1983 and became a Partner in 1987. He headed our European Equity team until 2003 when he co-founded our Long Term Global Growth strategy and has been the Manager and then Joint Manager of Scottish Mortgage Investment Trust since 2000.

But let's refocus on the specifics of Alibaba and the Chinese economy. Alibaba recently celebrated its 18th birthday. Revenue growth was 61% in the quarter to September 2017. As the company points out, China's per capita GDP has compounded at an annual rate of 14% over the last 18 years. This means that the average citizen is almost 10 times better off than when Alibaba was born. With its help, China now possesses the most advanced mobile internet technology in the world. China's physical infrastructure is also modern and often superb. Education levels are generally high. Social solidarity is strong.

So why would China stop growing? As I discussed with Jack Ma, shouldn't we instead be thinking that China has every chance of being as rich as America on a per capita basis? Although this will take time to come to fruition, if 7% annual growth continues for another decade then even Anglo-American commentators might have to acknowledge a shifting world order. In any case pessimism about world growth would have proven rather exaggerated.

For markets it's only companies of the significance and scale of Alibaba, and tectonic shifts in perception such as China potentially becoming as rich as America on a per capita basis, that are worthy of attention. There's a persistent illusion that the normal is of relevance. It isn't. It matters not one iota to long-run market returns that British GDP turns out to be a decimal point or two higher or lower than expected. It's only of interest to traders, speculators and investment banks if quarterly earnings reports exceed or disappoint expectations. As recent academic research has confirmed, most stocks don't even outperform bonds over their lifetime. Just ignore the daily nonsense. Throw market forecasts in the nearest bin. Investment life is best lived in the exponential extremes. We're lucky to live in an era where companies and economies can grow to the sky.●

FOLLOWING AMAZON

Anthony Luzio seeks out the most effective way to tap into the e-commerce boom

WITH TRADITIONAL HIGH STREET STORES IN LONG-TERM DECLINE, the natural place for investors to turn to is online retail. But just because e-commerce has dealt a fatal blow to many of the shops we grew up with, does this automatically make it a good investment?

When it comes to internet shopping, one name stands head and shoulders above all others – Amazon. And the figures speak for themselves: for every dollar spent online in the US last year, Amazon captured 53 cents. It accounted for 4 per cent of total retail sales and is expected to bring in $200bn in 2018.

As Janus Henderson's John Pattullo put it: "We were at an Amazon Disruption Day run by Morgan Stanley recently – we went with trepidation and we came back pretty scared. Even the thought that Amazon is going to move into something like the pharmaceutical sector causes that sector to sell off and companies to start consolidating on the back of it."

One number that isn't so impressive is the bottom line. While Amazon has recently begun to turn a profit, this is mainly down to Amazon Web Services, the company's cloud-computing unit. It still loses money from its retail operations and it is this, combined with a $650bn market cap and P/E of above 200, that has led some investors to call it overvalued.

However Tom Slater of the Scottish Mortgage Investment Trust says investors need to look at the bigger picture and that with companies such as Amazon, it is about where they will be in five years' time at the very least.

"I think there's this idea that Amazon isn't interested in making money because it has persistently low margins," he explains. "I see it slightly differently, which is that it takes the profits from things that are working and invests them extremely aggressively in new areas. I would be astonished if its books business, for example, didn't have extremely attractive margins given its global market share. It's just that you never see that, and that's why looking at short-term earnings multiples can be quite dangerous."

He adds that you do not need to delve too deeply into the numbers to see the benefits of this strategy – Amazon's revenue growth hasn't fallen below 20 per cent in the past 10 years, and the figure for 2017 stands at 31 per cent compared with about 6 per cent for the wider market.

OPEN SESAME

To consider just how far Amazon can go, we need to address the falsehood at the beginning of this article – that the company stands head and shoulders above the competition when it comes to online retail. The truth is its scale is dwarfed by its Chinese counterpart, Alibaba.

> **"We were at an Amazon Disruption Day run by Morgan Stanley recently – we went with trepidation and we came back pretty scared"**

"If you go to the biggest day of Chinese retail, Singles Day, there are $25bn of sales on Alibaba's website," says Slater. "If you got every website in the US on Cyber Monday, they took $6bn."

While these figures are impressive on their own, what is truly staggering is that within the next decade Alibaba expects to see sales on this scale every day and is currently using the levels seen on Singles Day to stress-test its service.

Aside from the growth of online shopping, Alibaba is also benefiting from the growth of the Chinese middle class. As Scottish Mortgage's James Anderson notes on page 12, China's per capita GDP has compounded at an annual rate of 14 per cent over the past 18 years, helping Alibaba to drive revenue growth of 61 per cent in the quarter to September 2017.

It is currently on a P/E of just over 40 with a market cap of $450bn and Gary Greenberg, head of emerging markets at Hermes, believes it has scope to create further value. Like Amazon, he notes it continues to reinvest its increasing free cash-flow into new markets.

"Alibaba is still in the early phase of monetising its customer base and increasing engagement as it continues to increase its data management capability and network reach," he says.

"The diversification of revenue streams is creating strong captive eco-systems, which will continue to engage and grow its customer base further. The high investment will pay dividends in the medium to long term as net profits continue to see steady and healthy absolute growth, which we believe the market is underappreciating." •••

LATE TO THE PARTY

After looking at how far the likes of Alibaba and Amazon have come already – both have gone up more than 10-fold since Slater first added them to Scottish Mortgage, for example – some investors who are wistful of missing out on the easy money may be tempted to look for the next big thing instead.

However Catherine Yeung, Fidelity's investment director in Hong Kong, says this is an extremely risky strategy as the scale of the forerunners means they are effectively running an "e-commerce monopoly".

She pointed to what happened with Chinese online retailer JD.com – which has a market cap of $60bn – when it tried to expand.

"One of its spin-offs is called VIP Shop whose market share is in the low teens," she explains. "In June it has its equivalent to Alibaba's Singles Day and this quarter is where it had its highest sales. But Alibaba just came in over the top and there was nothing it could do."

> **"It is not just about having lorries. Clothing retailers need the returns sorted, dispatched to a dedicated steam room, re-hung, bagged and returned"**

BACK HOME

ASOS and Boohoo are the e-commerce leaders in the UK, but neither has the scale of Amazon or Alibaba, although both have similarly weighty P/E ratios.

Many fund managers believe a better way to play the theme of online retail is through investing in its "picks and shovels" instead.

Nigel Thomas, manager of AXA Framlington Select Opportunities, notes 40 per cent of the products delivered by ASOS are returned, which has led to the growth of reverse logistics companies.

"It is not just about having lorries, vans and distribution centres. Clothing retailers need the returns sorted, dispatched to a dedicated steam room, re-hung and bagged, and returned to the retailer," he says. "We invested in Eddie Stobart Logistics, which has expanded into this area, leveraging its expertise in distribution centres and 'middle mile' haulage."

Thomas says payment is another crucial area of e-commerce.

"We have witnessed significant improvements in online transaction security and growth in credit payment options, with firms such as Worldpay and Experian benefiting from the growth of payments online," he adds.

There is no doubt the internet's stranglehold on retail will tighten over the long term, nor is there much doubt about who the major players will be. The question is whether you think they are worth the sky-high multiples they command. You can opt for one of the satellite industries that supports the e-commerce boom, but with a smaller company there is the risk its business model will be disrupted by the next big thing – much like the high street itself. ●

Fund

POLAR CAPITAL UK ABSOLUTE EQUITY

Guy Rushton's fund is the best-performer in its sector since launch, but it may not be suitable for every absolute return investor

THE POLAR CAPITAL UK ABSOLUTE EQUITY FUND was launched little over three years ago but has generated what is by far the highest total return of the IA Targeted Absolute Return sector over this time.

Between launch on 29 September 2014 and the end of January 2018, Guy Rushton's £502.8m fund made 115.2 per cent, compared with just 8.83 per cent from the sector average and 39.10 per cent from the fund in second place, JPM Global Macro Opportunities.

Polar Capital UK Absolute Equity aims to deliver positive absolute returns over 12-month periods by investing on a long/short basis, mainly in UK equities, although it can take a small exposure to European and global equities as well.

Data from FE Analytics shows the fund has succeeded in its 12-month positive absolute return target on a rolling basis in every one of the 29 months of relevant track record. Its highest 12-month return stands at 47.51 per cent, which it achieved in 2017; the lowest was 7.49 per cent, its performance in 2016.

Of course, the IA Targeted Absolute Return sector is a mixed bag of funds with aims ranging from extreme capital preservation through to aggressive bets against equities. The Polar Capital fund has surged to the top of the performance table because of its focus on equities, which offer the potential for high returns but with correspondingly high levels of risk.

For example, the fund's annualised volatility since launch is 10.75 per cent, the fifth-highest score in the sector, where the average stands at just 1.75 per cent. Likewise, its maximum drawdown – the amount investors would have lost if they bought and sold at the worst possible moments – of 5.73 per cent is higher than the 1.12 per cent average. However, many absolute return funds have posted a higher maximum drawdown in the past three years, with several hit by double-digit losses.

Rushton has put this risk to good use and the fund's Sharpe ratio – a measure of risk-adjusted returns – of 2.08 is by far the highest in the peer group. JPM Global Macro Opportunities in second place has a score of 0.86.

The fund was awarded the highest score of five FE Crowns when it first became eligible for the award in January, as a result of its superior performance in terms of stockpicking, consistency and risk control.

Charles Younes, research manager at FE, said: "The long/short equity Polar Capital fund returned a positive performance of 47.51 per cent last year with its stockpicking and long exposure to materials, IT and financials paying off. But this is a highly volatile strategy, which does not suit every investor profile." ●

FILE

MANAGER: **Guy Rushton**

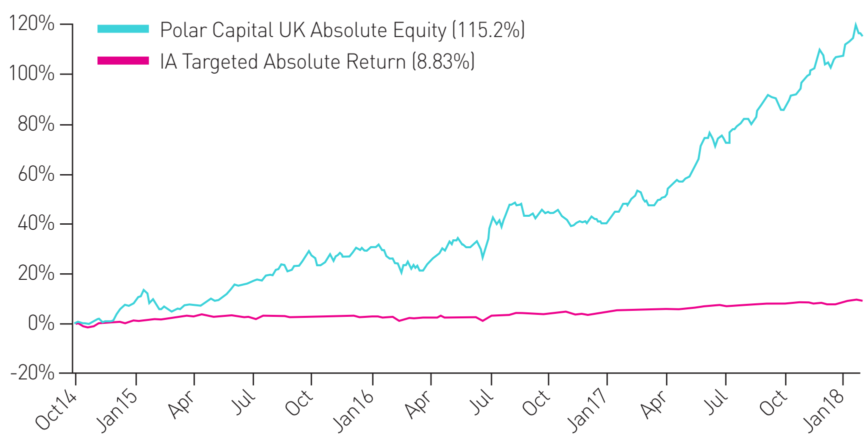
LAUNCHED: **29/09/2014**

FUND SIZE: **£502.8m**

OCF: **1.15% (plus 20% performance fee)**

FE CROWN RATING:

PERFORMANCE OF FUND VS SECTOR SINCE LAUNCH



Source: FE Analytics

Pension

F&C RESPONSIBLE INCOME

Despite being limited in the type of stocks this fund can hold, it has still outperformed its sector in the short term

ETHICAL FUNDS HAVE A REPUTATION FOR UNDERPERFORMING THEIR MORE CONVENTIONAL PEERS as they have a smaller universe of screened stocks to choose from. As such, ethical funds account for just £15bn of the total £1.2trn of industry funds under management, or around 1.3 per cent.

However, there are a number of UK-focused strategies that have been able to outperform their peers and the FTSE All Share index despite these restraints.

One such fund is F&C Responsible Income, formerly known as F&C Stewardship Income, which offers exposure to UK equity income with a more ethical focus.

BMO Global Asset Management's ethical investing specialist Catherine Stanley has headed up the £330m fund since 2009. She also runs its £418.4m sister fund, F&C Responsible UK Equity Growth.

F&C Responsible Income has made 25.21 per cent over the past three years, slightly below the FTSE All Share index's gain of 25.85 per cent, but ahead of the 21.59 per cent from the average IA UK Equity Income fund and enough to put it in the top-quartile of its sector.

The fund opened for business in 1987. It invests in UK companies whose products and operations "are considered to be of long-term benefit to the community at home and abroad".

The asset manager noted that such companies will generally exclude those "considered to be involved with harmful products and practices or trading extensively with oppressive regimes".

While this limits the type of stocks it can hold, avoiding companies that focus on short-term gains at all costs helps to keep risk under control and the fund is a top-quartile performer over three years in terms of suppressing maximum drawdown and volatility.

More recently, given the ongoing uncertainty surrounding Brexit and the impact of weaker sterling on domestic consumer spending, Stanley has favoured UK stocks with strong balance sheets and attractive dividends.

Despite the fund's ethical focus, a number of well-known income generators can be found among its top holdings, such as banks HSBC and Lloyds, insurers Legal & General and Prudential, pharmaceutical GlaxoSmithKline, consumer goods company Unilever, mobile phone operator Vodafone and miner BHP Billiton.

F&C Responsible Income's largest sector weighting is to financials, which represent 29.4 per cent of the portfolio; followed by industrials (11.9 per cent); telecommunications, media & technology (10.7 per cent); and, services (10.5 per cent).

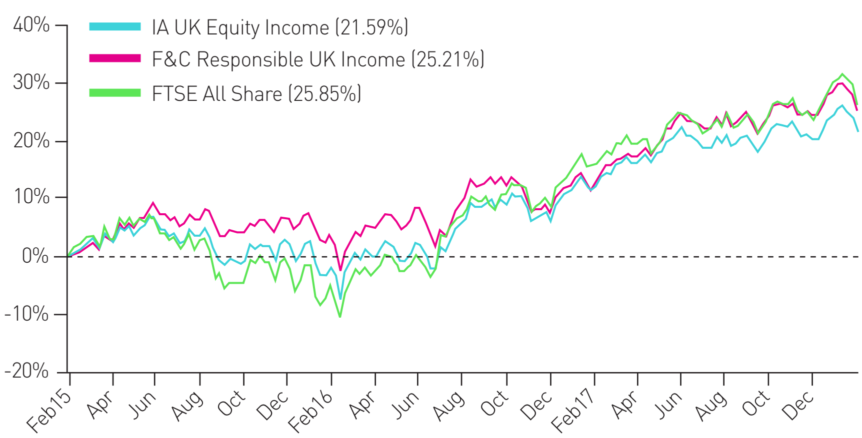
The fund can also hold ethically screened corporate bonds to help it meet its income target.

It is currently yielding 3.9 per cent, which is lower than the 4.12 per cent of the sector average. ●

FILE

MANAGER: **Catherine Stanley**
LAUNCHED: **13/10/1987**
FUND SIZE: **£330m**
OCF: **0.81%**
FE CROWN RATING:

PERFORMANCE OF FUND VS SECTOR AND INDEX OVER 3YRS



Source: FE Analytics

Trust

CAPITAL GEARING TRUST

Peter Spiller's trust would add some stability to a portfolio with a high equity exposure

WITH CENTRAL BANKS AROUND THE WORLD expected to ratchet up the speed of interest-rate hikes this year, the bond market looks like a poor choice for anyone looking to shelter their cash from market volatility. However, Peter Spiller of the Capital Gearing Trust is turning to index-linked government bonds – which currently account for 37 per cent of the portfolio's assets – in a bid to maintain his solid track record of preserving investors' capital.

Index-linked government bonds will protect against a rise in inflation, something Spiller – along with co-managers Alastair Laing and Chris Clothier – believes is likely to persist with global debt levels "unsustainably high".

"Their view is that this can only be remedied by a sustained period of inflation and he points to signs of rising wage growth in the US as evidence that inflationary pressures are building," said Kieran Drake, analyst at Winterflood Investment Trusts.

"While the significant allocation to bonds will mean that the fund is likely to lag strong equity market rallies, we believe it is an attractive vehicle for investors looking for low-volatility long-term capital growth."

The trust's main aim is to preserve capital over the short-term and generate strong risk-adjusted returns over the long-term. As well as index-linked bonds, it is 40 per cent weighted to funds/equities, further diversified through underlying exposure to property, equities, private equity/hedge funds, loans and infrastructure.

It has an impressive record of delivering solid absolute returns with considerably lower volatility than that of the equity market.

For example, it has returned 105.94 per cent over the past 10 years, with an annualised volatility of 8.92 per cent, compared with a gain of 98.08 per cent from the FTSE All Share and a volatility score of 13.75 per cent.

It performed particularly well in 2008 and 2011 when markets fell, making top-quartile returns.

However, it is a bottom-quartile performer over one, three and five years, failing to participate in as much of the equity market upside, and was hit particularly hard in 2013 around the time of the taper tantrum.

It may be worth pairing the investment company with other, more out-and-out growth-orientated equity strategies – though weightings will vary depending on investor risk tolerance.

The trust's shares are at a 2 per cent premium, according to data from the Association of Investment Companies (AIC). It has ongoing charges of 0.86 per cent.●

FILE

MANAGERS: **Peter Spiller, Alastair Laing & Chris Clothier**

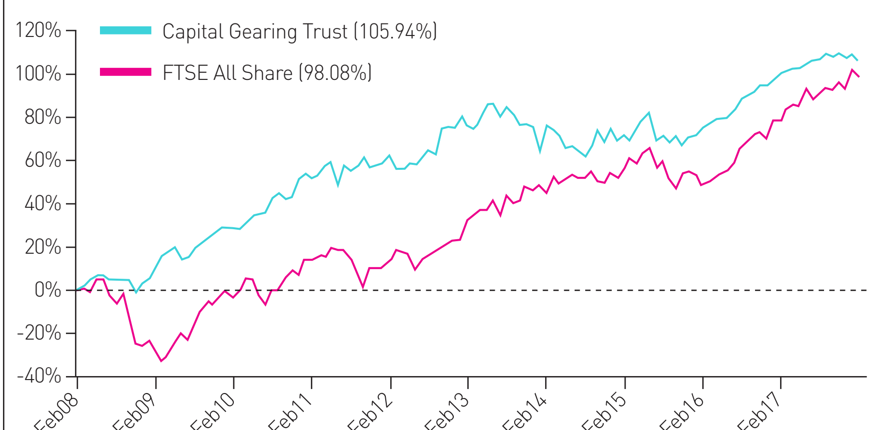
LAUNCHED: **1963**

PREMIUM/DISCOUNT: **+2%**

OCF: **0.86%**

FE CROWN RATING:

PERFORMANCE OF TRUST VS INDEX OVER 10YRS



Source: FE Analytics

THE SCOTTISH
Investment Trust

Shopping around – opportunities in retail

If you look at the share prices of conventional retailers today, you'd be forgiven for thinking that the high street is on its last legs. Meanwhile, the eye-watering valuation of Amazon's stock already reflects a very optimistic future, leaving little room for any disappointment. Amazon now trades on over 170 times 2018 earnings. In contrast, Marks & Spencer is on just 11 times and Gap 16 times.*

Does this gulf in valuations point to the extinction of the high street? We believe it's misguided to assume that online will be the only way to shop. Online transactions are here to stay, but investors shouldn't underestimate the staying power of shops.

Instead, the market's disdain for conventional retailers should be a buying signal for contrarian investors. Shopping is a major leisure activity for a great number of people – not just a necessity, but a social activity, even a hobby. The convenience of clicks can't compete with that.

Meanwhile, many bricks-and-mortar retailers are meeting the e-commerce challenge head on, by creating multi-channel offerings with mobile apps and 'click and collect'. Some are also adding other leisure services to their sites, increasing footfall and encouraging spending. And many have powerful brands that e-commerce has yet to rival. Gap and Marks & Spencer provide two good examples.

Although Gap has fallen from favour since its peak of popularity in the 1990s, a turnaround is underway. The company is refocusing on its popular Old Navy and Athleta brands, while reducing Gap branded stores and bringing products more quickly to market to capitalise on current trends. All of this should boost earnings and improve margins. So too should its drive to move away from a reliance on promotions – which has encouraged consumers only to buy when there's a sale on.

Marks & Spencer is also reducing promotions as part of its own turnaround plan. Revivals in its fortunes have been heralded before, but we believe that this time really is different. Led by veteran retailer Steve Rowe and turnaround specialist Archie Norman, the company is shedding excess stores, revitalising product lines and improving its pricing strategy. Its food division is still market-leading, and its investments in IT and infrastructure are creating a robust multi-channel offering.

We see these and many other retailers as 'ugly ducklings' – unloved shares that most investors shun. Although they have been under pressure from online competitors, they have considerable potential to defy the market's pessimistic expectations and turn their circumstances around. And while we wait for our ugly ducklings to become swans, most – like Gap and M&S – offer higher-than-average dividend yields. We believe that the depressed shares of high-street operators conceal compelling opportunities. Smart investors should look out for high street bargains.

* As at 2 February 2018.

MISSED THE BOAT?

Anyone who thinks Brexit worries have created a value opportunity in UK small caps may be a year too late, warns **Adam Lewis**

INVESTORS IN UK SMALLER COMPANY INVESTMENT TRUSTS enjoyed a bumper 12 months last year, as the sector continued its recovery from the shock of Brexit in 2016.

Having made a meagre return of 3.98 per cent in 2016, the average IT Smaller Companies trust posted gains of 27.62 per cent last year as UK domestic stocks rallied.

As a result, the sector re-rated heavily, with the average discount narrowing from 14 per cent at the start of 2017 to its current figure of 9 per cent. Alex Paget, a research analyst at Kepler Partners, says that with the benefit of hindsight, early last year was the time to buy UK small caps and that the sector could be due a bout of volatility in the short-term.

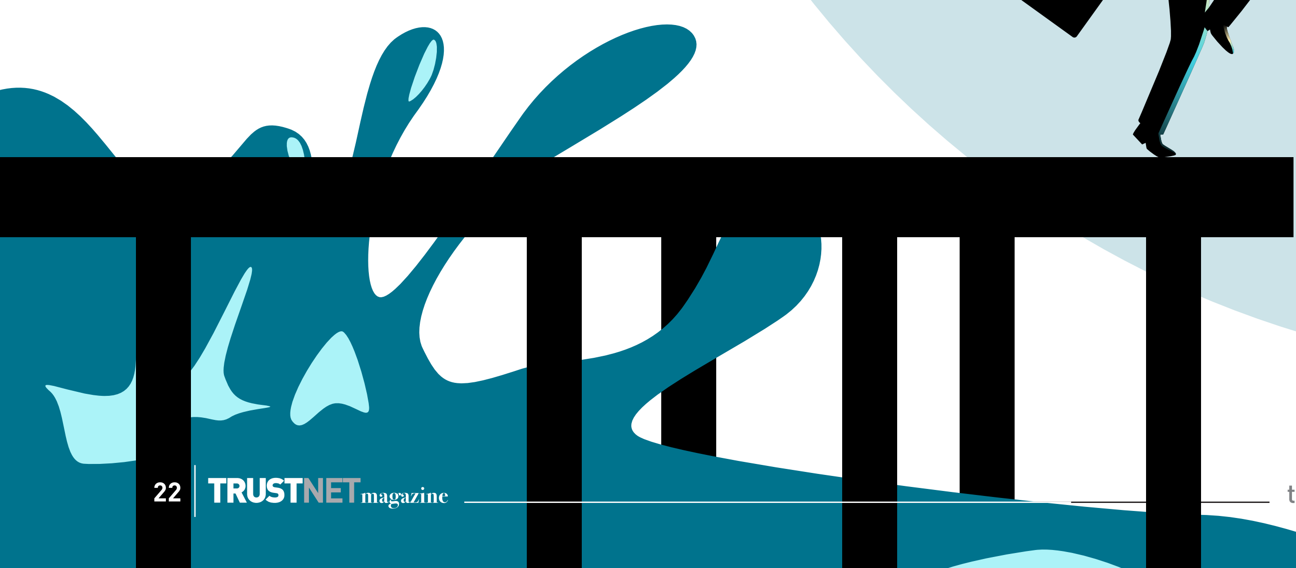
"Mid and small caps, more generally, witnessed a degree of mean reversion following painful, Brexit-induced declines in 2016 while many active managers in the space boosted returns by shifting their portfolios towards more internationally exposed stocks," says Paget.

A MISSED OPPORTUNITY

He points to the narrowing of discounts over the last 12 months as evidence of what may have been a missed opportunity, with the current figure standing below the five-year average of about 11 per cent.

"Before we go any further, it is clear an allocation to UK small caps makes sense for any long-term investor," Paget continues. "In fact, we would argue they should form a core allocation within a long-term portfolio."

"However, over the shorter term, we see a variety of risks, which in the context of narrower than average discounts, could dampen appetite for small caps. For example, rightly or wrongly, mid



and small caps are likely to be the worst hit if there are any hiccups in the ongoing Brexit negotiations."

GROWING COMPLACENT

More generally, however, Paget says there is clearly a growing sense of complacency among investors and this, combined with high multiples across the market, leaves equities open to a correction if there is any change to the status quo.

"Smaller companies, with their higher-beta characteristics, would likely be hit hard in such an event," he says.

Despite a significant re-rating in 2017, the average IT UK Smaller Companies discount remains wider than the average for the investment trust universe – 3.3 per cent at the end of 2017, compared with 5.1 per cent 12 months earlier.

To put 2017's figure in historical context, the long-run average discount for the investment trust universe since the end of 1989 stands at 9.4 per cent. As such, Winterflood also warns that with 2018 marking the 10th anniversary of the global financial crisis, and with the bull market now entering its ninth year, there is reason to believe discounts could widen again in the not-too-distant future.

PERFORMANCE OF IA AND IT SECTORS

	1yr (%)	3yr (%)	5yr (%)	10yr (%)
IA UK Smaller Companies	24.79	58.92	104.23	205.43
IT UK Smaller Companies	24.6	67.05	117.7	244.57

Source: FE Analytics

Innes Urquhart, a research analyst at Winterflood, says another reason why UK Smaller Companies trusts trade on wider discounts is because of the element of illiquidity in their assets. In this sense he says the investment trust structure, which doesn't force managers to buy and sell shares based on inflows and outflows, works particularly well for UK smaller companies, in particular at the micro cap level.

This contention is backed up by the figures. The average fund in the IA UK Smaller Companies sector made 24.79 per cent last year, marginally ahead of its

•••

••• IT counterpart. Over longer time periods, however, this performance gap reverses, and does so significantly. The average open-ended small cap fund has made 58.92 per cent, 104.23 per cent and 205.43 per cent over three, five and 10 years, compared with 67.05 per cent, 117.7 per cent and 244.57 per cent from its closed-ended counterpart.

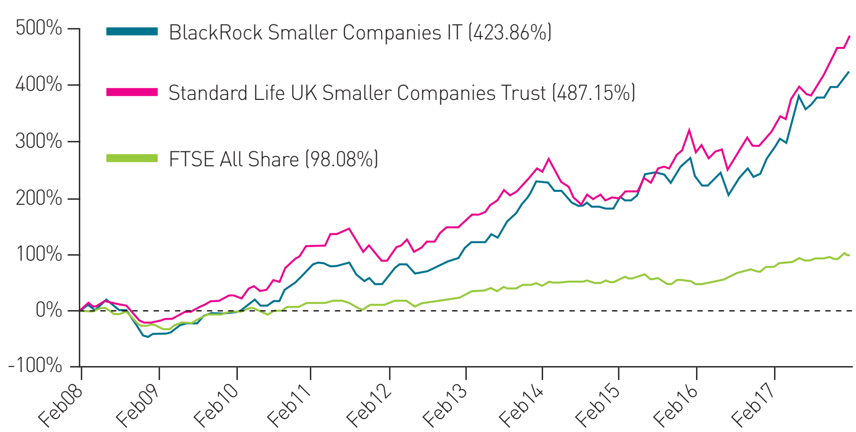
THE STOMACH FOR IT

"For those who can stomach volatility and are willing to focus on the long-term, we think Aberforth Smaller Companies is an interesting proposition at this stage," says Paget. "It is the most value-orientated member of either the open- or closed-ended sectors and is managed by a highly experienced and well-resourced team with a strong track record."

"However, thanks to this value style (and though it has outperformed its benchmark), it has struggled to keep pace with many of its peers over the past five years (and in 2017 in particular). We think value investing is due a long-term return to form (whether that be from an absolute or relative perspective) following a long period in the doldrums and, in such an environment, Aberforth should be a prime beneficiary."

Winterflood added The Mercantile Investment Trust to its mid and small cap exposure in the 2018 rebalancing of its model portfolio, replacing the River & Mercantile UK Micro Cap trust. •••

PERFORMANCE OF TRUSTS VS INDEX OVER 10YRS



> **There is clearly a growing sense of complacency among investors and this leaves equities open to a correction**

"We have switched to Mercantile Investment Trust, which we believe offers a better value opportunity on its current discount of 9 per cent," says Urquhart. While this discount has narrowed considerably over the last year, he adds that it has an active buyback policy which has seen 6.3 million shares, or 7 per cent of its share capital worth £117m, bought back since the start of 2017.

"Consequently we believe that downside discount volatility is relatively limited, which in our opinion, is important at a time of historically tight discounts across the sector."

Winterflood also holds Mike Prentis's BlackRock Smaller Companies trust, the discount of which has also narrowed. However, at 14.8 per cent, he says it remains wider than its five-year average, and wider than the average figure for the sector.

"There are a number of strong trusts to choose from in the sector," Urquhart says. "We rate Henderson Smaller Companies, which has a great long-term track record and trades at a double-digit discount. We also like the Standard Life UK Smaller Companies Trust, although it has moved out to a small premium." ●

The best performer
RIVER & MERCANTILE UK MICRO CAP

River & Mercantile UK Micro Cap is the best performer in the IT UK Smaller Companies sector over the last 12 months with a share price return of 63.83 per cent. It is also the second best performer in the sector over three years with gains of 115.9 per cent, which helps to explain why it moved from a 9 per cent discount to a 16.2 per cent premium in the 12 months to the start of February. The trust invests in UK companies with market capitalisations of less than £100m, which according to Winterflood makes it ideally suited to the investment trust structure. At the time of going to press, River & Mercantile has just announced George Ensor will be taking over from manager Philip Rodrigs after the latter left the business following a professional conduct issue.

The discount play
THE MERCANTILE INVESTMENT TRUST

Unlike its ultra small-cap cousin, The Mercantile Investment Trust, run by JP Morgan Asset Management, targets UK mid and small caps. Its assets of £2.2bn mean it is currently the largest of those trusts investing predominately in the UK market. Although it sits in the IT All Companies sector, Winterflood added it to the small cap part of its model portfolio at the start of the year. The trust struggled during the second half of 2016 due to an overweight position in UK consumers and underweight position in energy and resources at the time of Brexit, but it is still ranked first quartile over one and three years.

The long-termer
STANDARD LIFE UK SMALLER COMPANIES

While much attention has been focused on the short-term performance of UK small caps, the product with the best 10-year track record is Harry Nimmo's Standard Life UK Smaller Companies Trust. The trust is up 487.15 per cent over this time, compared with 423.86 per cent from the second-best performer – BlackRock UK Smaller Companies. Nimmo uses Standard Life's Matrix as part of his investment process: a quant-based screening system that highlights high-quality businesses with a competitive advantage which should lead to consistent and sustainable earnings growth. He is also known for running his winners: holding companies through their maturation for as long as he sees value.

KEEP IT GROWING

Longer lifespans and recent pension freedoms may have removed the need to de-risk your portfolio as you approach retirement, writes **John Blowers**

RECENTLY, I ATTENDED A CONFERENCE DEDICATED TO THE SUBJECT of retirement planning, where the great and the good of the financial services industry could listen to both conventional wisdom and some provocative new ideas.

By the end of the conference, people were arguing and shouting at each other – all, it has to be said, on your behalf. Proper handbags.

The cause of all the debate was, what was the best strategy for people to adopt with their savings as they approached and then entered retirement?

Popular wisdom dictates that there are three phases to planning for retirement: growth, consolidation and then income.

In your 30s and 40s, when you have time on your side and a long time-horizon, you should be encouraged to go for growth and take more risk in your investment choices. There's plenty of time for an investor to ride the peaks and troughs of the market on the basis that it has historically risen over long periods.

When you approach retirement, maybe from your mid-50s, you should then embark on phase two of the strategy: that of consolidating your accrued wealth. At this point, it is assumed, you certainly don't want to lose the untold fortune that you have accrued from the growth phase of your investments, so undue risks are taken off the table with a view to protecting your money.

Phase three is income. When you retire, you will have amassed such a huge amount of money that you'll be able to flip all your investments into income-paying holdings and live off these until your dying day, leaving the kids with a house and a wad of cash. Job done.

Of course, if you were lucky enough to have a final salary pension scheme – even better. Same results, but you wouldn't even have to worry about the strategy as it would pay a large percentage of your final salary each year until you die.

THE REALITY

This growth, consolidation and income strategy makes perfect sense – if that's exactly what happens. But now it rarely does as the reality has changed significantly.

Let me paint a different picture and see which scenario more closely reflects where you are in the journey.

Most people in the UK haven't amassed a vast pension by the time they approach retirement. They don't have the massive security blanket of a final salary pension either. In fact, the average pension pot at retirement in the UK is less than £100,000.

That doesn't buy much of an annuity and won't pay out much in drawdown either, particularly if you've tipped your pension into low-risk investments or even cash. Charges and inflation will ravage your safe little income strategy.

Add to this the fact that we are living significantly longer than when conventional wisdom was invented and we have a conundrum.

LOWER FOR LONGER

Our retirement pots are smaller, but we need to make them last longer.

Yet, conventional wisdom says we still have to put up with following the three phases of retirement and de-risk our portfolios as we get older.

What would happen, given we are all living much longer, if we stayed in the growth phase of investing and didn't bother with the consolidation and income phases?

Now we are not obliged to buy an annuity at retirement, or cash in our investments on any future date. Yes, we'll need to access some of our investments as and when, to pay the bills and to carry on living in lieu of a salary. And we'll also have (all things being equal) a further £155 per week in the bank from our state pension.

Could we – dare we – keep our retirement pot in higher risk investments so that the money can keep on growing?

> **This growth, consolidation and income strategy makes perfect sense – if that's exactly what happens. But now it rarely does**

This was where the conference erupted into uproar. Some thought these new aspects of retirement such as longer life expectancy, smaller defined contribution pension pots, pension freedoms, drawdown, the death of annuities and so on were mere irritants to conventional retirement wisdom.

Others believed that this new set of circumstances necessitated a fresh look at how we plan for retirement.

Financial advisers in particular felt they had a responsibility to their clients to protect them from the vagaries of the stock market (and themselves) and couldn't possibly recommend taking more risk into retirement, whereas asset managers thought the opposite (although I suspect they may have had a vested interest).

So, let's argue the case for taking more risk in retirement, if you're trying to stretch a retirement pot over a longer period of time.

YOU HAVE A LONGER TIME HORIZON

GIVEN THE ADVANCES IN HEALTHCARE, we are undoubtedly living for longer. It wasn't that long ago that people were glad to get to 75 years old, whereas people retiring over the next 10 years can reasonably expect to live until the age of 90. Consequently, the actuarial calculations used in annuity rates take these increased life expectancies into account, which is why monthly incomes seem so low. Annuities were principally invented to fund a much shorter life post-retirement.

The problem of longer life expectancy and funding of a potential 15 to 20 years can also be a solution. Investing has always been a longer-term process, as the market is prone to ups and downs, so deemed unsuitable post-retirement. But if you retire at 65 and live until the age of 90, that's now a genuine long-term time horizon, so you can ride the ups and downs of the market. Modern theory suggests that you can take risk well into your 80s and annuitise at that point to guarantee an income in your final years.

YOU MAY NOT HAVE SAVED ENOUGH

AS FINAL SALARY PENSION SCHEMES DISAPPEAR FROM THE MARKET, most of us will come to rely on our defined contribution schemes. There is nothing stopping people hoarding a fortune in these schemes, although tax relief is capped at £1m lifetime value. The reality is that most people fall well short of this maximum figure, particularly if you start to de-risk your portfolio in your 50s. Future generations could possibly struggle further, with student loans to pay off and getting a foot on the property ladder taking priority over long-term savings.

Auto-enrolment pensions may help people to get into the habit of saving, but the amounts currently mandated are too small to build a retirement pot of sufficient value.

With smaller pension pots (I'm afraid I'm talking about less than £400,000), putting money into low-risk investments before and during retirement can have a similar effect to cashing in your investments and sticking the money in the bank.

Putting your pension to work in higher risk investments can stretch your income for another 10 years over a 20-year-plus time horizon.

THERE IS NO LONGER ANY REASON TO ENCASH YOUR PENSION

AT RETIREMENT, THE FORMER DEFAULT PROCESS WAS TO ENCASH YOUR PENSION and purchase an annuity. Now there isn't a set date when you have to stop or start doing anything, barring "switching the points" on your pension so you can start withdrawing money as opposed to putting it in.

There are many changes in lifestyle that come into play when you retire. You should find that you have no debt, the cost of getting to work and clothing yourself accordingly falls away and you're faced with more modest outgoings. Downsizing, as many people do, may realise further capital to deploy in your retirement. It's worth seeing how life and living costs pan out before you start to get a feel for the income you need to draw down from your investments. It may be less than you think.

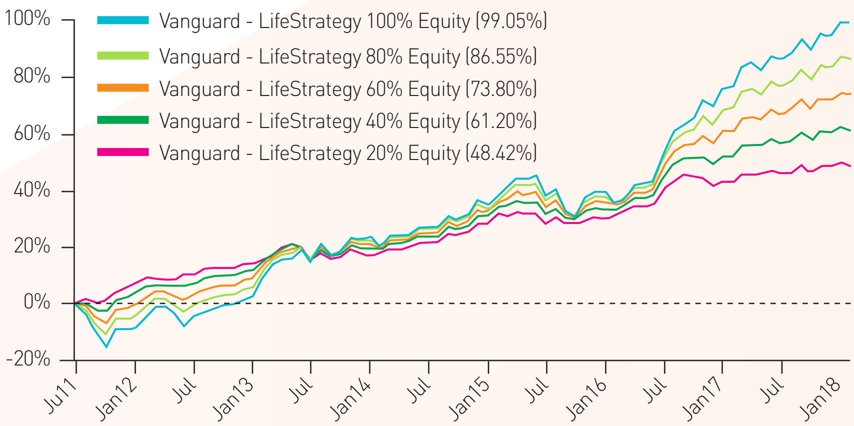
Leaving your investments in a higher growth portfolio for as long as possible gives your money the best chance to grow. If you want, you can take up to 25 per cent of your pension pot out tax-free, then reinvest it, rather than spend it, unless you are desperate for the cash.

If the markets are down, try to spend less or avoid cashing in investments that have lost value. They should climb back from any low points and regain their value and continue to grow in the longer-term.

In conclusion, taking a higher risk stance before and during retirement gives your pot the chance for upside growth over the longer term, rather than surrendering that potential upside to limit any downside losses. Historically, these losses can be dramatic, but they have recovered over time.

The principle is sound, but it all depends on how easily you'll sleep at night if the stock market hits a rocky patch.

PERFORMANCE OF FUNDS SINCE LAUNCH



Source: FE Analytics

Above is a graph of a five-fund family denoted by risk level. As you can see, in down markets the highest risk fund (100% Equity) falls the fastest, but in the good times it grows the fastest too. The 20% Equity fund falls the least in down markets but grows very slowly in the good times.

WELL-OILED

Miton's **Gervais Williams** names three oil producers set to benefit from the commodity's price recovery

THE SYNCHRONOUS PICK-UP IN WORLD GROWTH has boosted demand for energy. Stockpiles of US crude oil and oil products have therefore greatly reduced over the last six months, stimulating a strong recovery in the oil price.

The more famous energy stocks have performed well over this period. However, we believe many of the smallest companies remain overlooked, even though some are in significant production or very close to this stage, and thus beneficiaries of the oil price recovery. Here are three we consider to be the most overlooked.

GULF KEYSTONE PETROLEUM

GULF KEYSTONE PETROLEUM HAS BEEN A MAJOR OIL PRODUCER in Kurdistan, Iraq for many years. However, geopolitical risks and arrears in receiving payment have frustrated investors. The regional government allowed it to restart investing in oil fields in January, which could boost daily production from circa 30,000 barrels of oil to 55,000 barrels. The stock is overlooked in our view, given it has a surplus of net cash, and its tangible asset value is 23 per cent above the current share price.

SAVANNAH PETROLEUM
Proud to partner Niger

SAVANNAH PETROLEUM RECENTLY ANNOUNCED A DEAL WITH Seven Energy giving it a 40 per cent interest in the Uquo oil & gas field. This is based onshore in Nigeria, where there has been disruption for oil producers in the delta. However, the Uquo assets are far from the disputed areas and could produce the equivalent of 20,000 barrels of oil a day as a midstream gas business. This should quickly generate profits and the firm intends to pay a maiden dividend later in 2018.

ZENITH ENERGY

ZENITH ENERGY IS SMALLER THAN EITHER GULF KEYSTONE OR SAVANNAH, with a market cap of just £12m. It has been investing in recompleting wells in the Zardab fields in Azerbaijan, a well-established oil district. The company recently stepped up investment through leasing two rigs, which will increase the profitability of its operations. Zenith appears overlooked by the market, with its brokers suggesting it is on a P/E ratio of just 1.5x to March 2019 and debt-free to boot.

MONTANARO UK INCOME

MitonOptimal's **Paul Warner** says this fund is suitable for the group's SRI portfolios, even though it isn't marketed for this purpose

A FUND WITH "INCOME" IN ITS NAME shouldn't automatically preclude it from a portfolio whose aim is capital growth.

We are always looking for new funds that meet the criteria for inclusion in our SRI (socially responsible investing) portfolios and towards the end of 2015, we were looking for equity funds to add to our SRI Balanced Income product. One fund that caught our interest was Montanaro UK Income – not just because it had an excellent track record, but also because it fulfilled all our criteria yet wasn't being marketed as an SRI or ethical fund. More recently, we have added it to our SRI Balanced Growth portfolio.

Charles Montanaro set up Montanaro in 1991, specialising in UK – and then European – small and mid caps, with ESG (environmental, social and governance) at the core of its investment process.

One of the Montanaro investment philosophies is "do the work yourself". To this end the company has a team of internal investment analysts, which currently number 11.

So why have we added the Montanaro UK Income fund to our SRI Balanced Growth portfolio? Firstly, following the vote to leave the European Union, the UK market has fallen out of favour with international investors. At the same time the huge increase in passive investing has made the UK mid and small cap area even more unpopular. Even passives that invest in the FTSE All Share index will have little exposure to this area, due to the huge weightings of the top dozen or so companies.

Secondly, this income fund is run on a total return basis and this is one of the reasons why it is in the IA UK All Companies sector, rather than IA UK Equity Income. Our ratings, which measure five-year consistency of performance, place the fund 14th in this sector.

From an income investor's point of view, funds that fish in the mid and small cap space have several advantages over those that focus on large caps. To start with, mid and small caps have better dividend cover than their larger counterparts. A quick glance at the FT will show you that the FTSE 100's dividend cover is 1.17, the FTSE 250's is 2.07 and the FTSE Small Cap's is 2.47. According to Bloomberg, some of the best-known companies have cover of less than 1: HSBC has cover of just 0.13, GlaxoSmithKline 0.23, Royal Dutch Shell 0.30 and Lloyds Bank 0.79; meanwhile Vodafone, Tesco, RBS and Rolls Royce have none at all. There is also a greater diversity of sectors once you move away from the large caps.

A total return income fund therefore has a place in our SRI Balanced Growth portfolio. After last year's market gains, a pickup in volatility can't be ruled out. A fund with a yield will offer some protection in this sort of scenario. ●

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TRUSTNET

MARCH PREVIEW

Un-SIPPed

The next issue of Trustnet Magazine will investigate the growing number of complaints about SIPPs. Hailed for so long as the passport to pension freedom, these products are of course only as good as the investment advice used to guide them – which has frequently proved to be below par.

Our sector focus will fall on IA Emerging Markets as we find out whether all the predictions of outperformance this year can withstand an accelerated rate-hiking cycle in the US.