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FE Trustnet

magazine

BLOWN OUT OF THE WATER

DEBUNKING THE BIGGEST MYTHS ABOUT PASSIVES

WEIRD AND WONDERFUL
Obscure markets you can access with ETFs

ADMITTING DEFEAT
When active fans go passive

GET WITH THE PROGRAM
Are trackers at risk from algorithms?

+ Fund, Pension, Trust / Sector Profile / Stockpicker / What I Bought Last

ISSUE 44

CREDITS

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FE BE BETTER INFORMED

Editor's letter

The asset management industry doesn't do itself many favours when it comes to transparency. One interview I attended consisted almost entirely of a bond manager attributing his stellar returns to the small size of his fund – yet when I asked if he was going to close it once it reached a certain level of assets, the PR assistant demanded a quote-check before banning me from using 90 per cent of the 2,000-word transcription I submitted. And, at a recent press conference which aimed to highlight how a third of funds in one area of the market had cut their fees since RDR, the mood quickly soured when one journalist asked: "So... why wasn't anyone cutting their fees before RDR?"

A lack of trust in the industry may be responsible for the recent growth of passive investing. Investors have begun to take the utterances of active managers with a pinch of salt, focusing less on claims of beating the market and more on the one variable they know they can control – cost. This is why we are devoting this issue to the merits of index tracking, with a cover feature by Robin Powell – a man who thinks that, rather than not doing itself many favours over the years, the asset management industry might just have been doing itself one too many favours.

Enjoy reading,

Anthony Luzio
Editor

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Robin Powell of The Evidence-Based Investor debunks some of the biggest myths about passive investing

Blown out of the water

It is difficult to get a man to understand something," the American author Upton Sinclair once remarked, "when his salary depends upon his not understanding it". That quotation often comes to mind when I read the stories the industry PR machine keeps churning out about the "dangers" of passive investing.

Let's start with a disclosure. I'm not a fan of active management. I'm a journalist and five years ago I was asked to make a documentary about the merits of passive investing. What I discovered from the weeks of research I carried out and the interviews I conducted with academics, including Nobel Prize winners, astounded me.

There's more than 50 years of peer-reviewed academic research to support eschewing actively managed funds in favour of low-cost index funds, and yet the vast majority of investors around the world either continue to ignore it or, more likely, are blissfully unaware of it.

Can you pick the 1%?

As research by David Blake at Cass Business School and others has shown, only around 1 per cent of active managers beat the market over the long term on a risk- and cost-adjusted basis, which is about what you'd expect purely from random chance.

If I knew who tomorrow's winners were going to be, I would be first in the queue. But anyone who has studied fund performance will tell you that distinguishing luck from skill is extremely difficult, and picking a

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Only around 1 per cent of active managers beat the market over the long term on a risk- and cost-adjusted basis

The myths continue

Here are some of the more common myths about the growth of indexing that keep doing the rounds

- **It's out of control.** Nonsense. Only around 20 per cent of global stock is owned by index investors. Even in the US, where passives are most popular, active management is the default investment style. In large swathes of Europe, Asia and South America, indexing has barely made inroads at all.

- **It's inflating the prices of the biggest stocks.** This is not how indexing works. If the price of a stock rises, its weighting in the fund increases automatically. The fund doesn't need to buy more shares or sell them in companies whose stock is falling. The bulk of trading — around 95 per cent — is carried out by active managers.

- **It's making markets less efficient.** There is more price-setting going on now than ever, with more than 80 million trades placed every day. And, by forcing the worst-performing fund managers out of business, isn't indexing making markets more efficient?

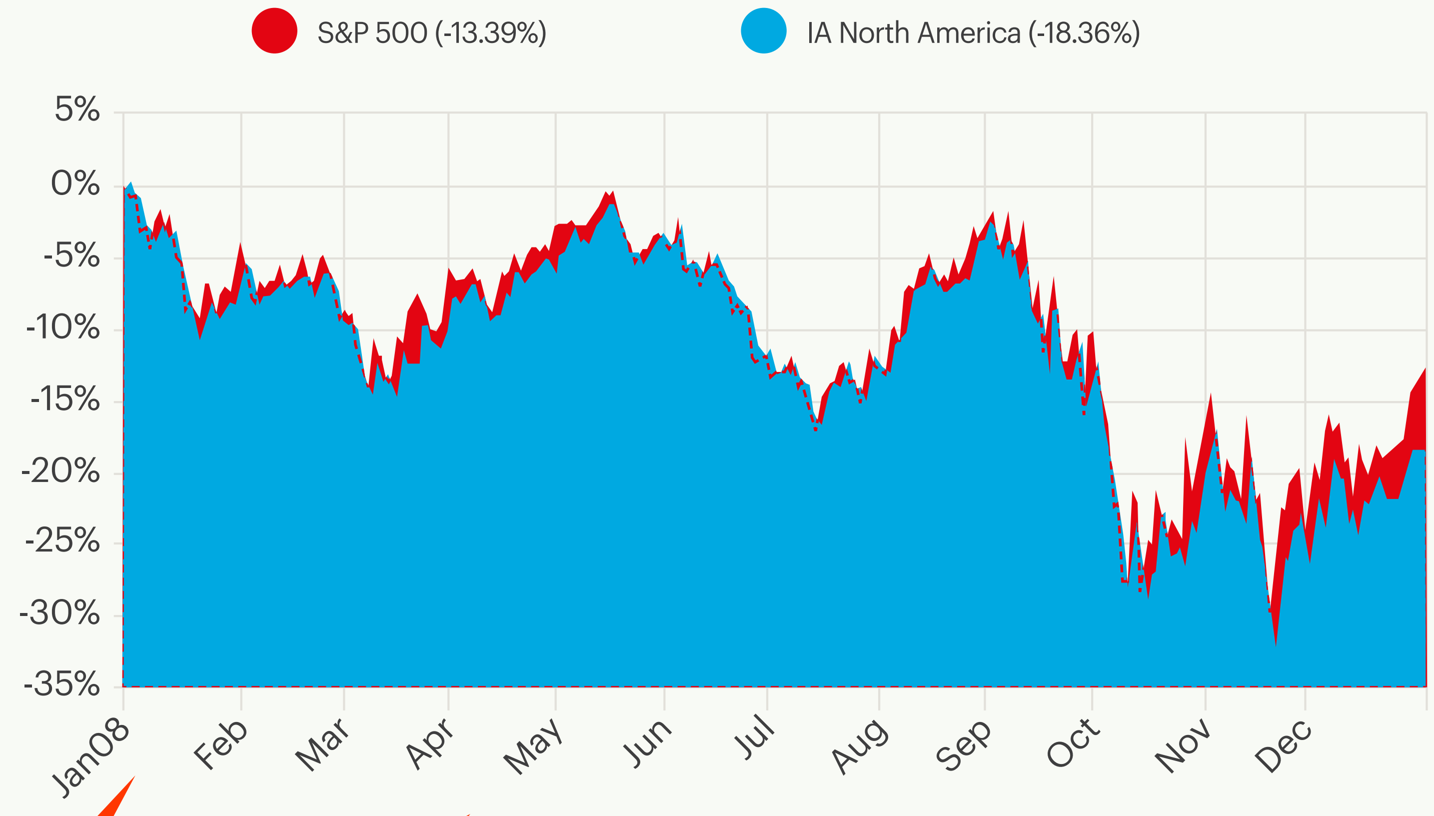
- **It's causing the misallocation of capital.** It's true that allocating capital to the most deserving enterprises is an important function of active management. But new public offerings account for a tiny amount of trading. The vast majority of the time, active managers are simply trading with each other.

- **It's undermining corporate governance.** Active managers' record on corporate governance isn't exactly impressive; just look at their failure to control boardroom pay. Passive managers, who have no choice but to carry on holding stocks and work with company management, are better placed to make a positive difference. The evidence shows they are bringing their influence to bear.

- **It's going to go badly wrong in a correction.** One of the most common myths about active managers is they outperform passive managers when markets fall; the data clearly shows they don't. It's also suggested indexers will take fright and bail out when the bull run ends, yet the opposite happened in the financial crisis.

- **And finally... It's a danger to global capitalism.** Two things. First, indexers believe in the capital markets more than anyone; we believe they work and that, over time, they deliver fair returns to those who patiently invest in them. That hardly makes us communists. Second, indexing allows consumers to invest in far more stocks, far more efficiently and far more cheaply than ever before. Surely, if anything, indexing is the very essence of capitalism.

PERFORMANCE OF SECTOR VS INDEX IN 2008



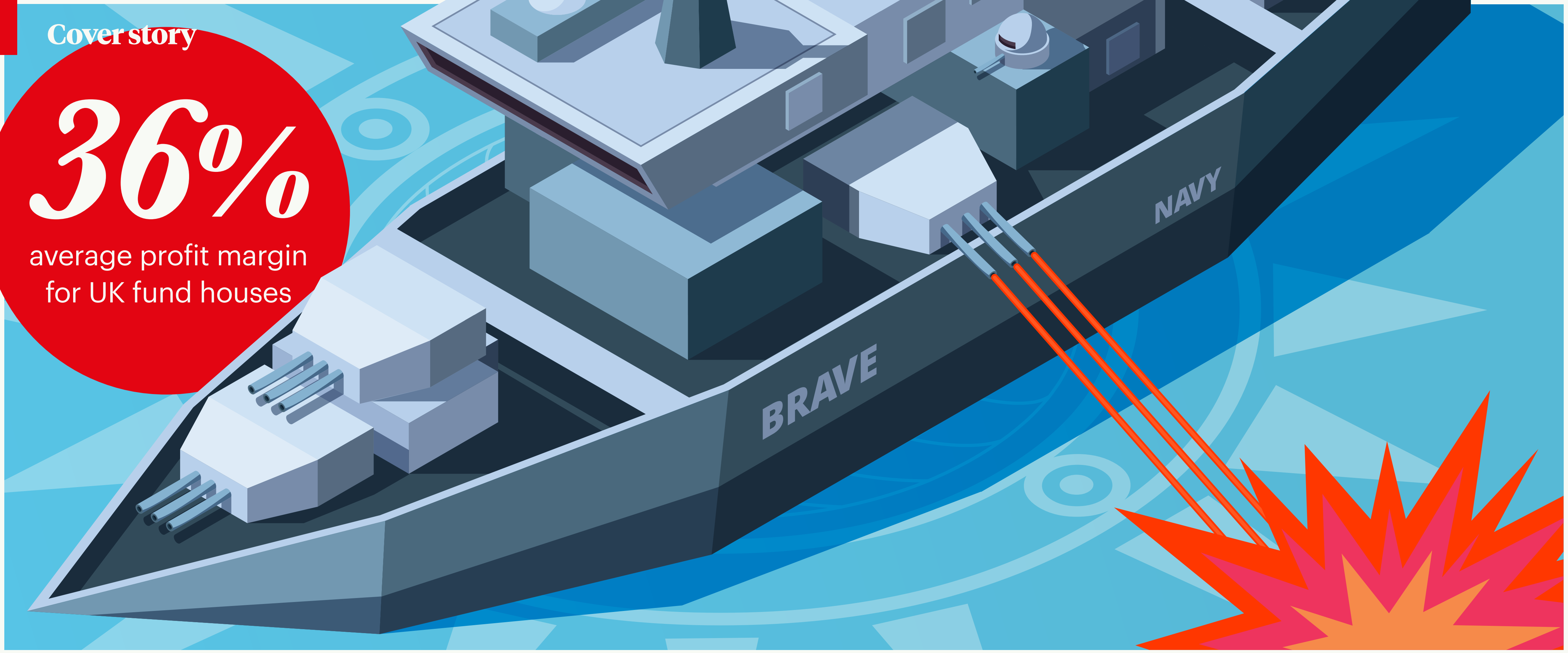
Source: FE Analytics

consistent outperformer in advance, net of costs, is almost impossible.

Simple arithmetic

Logically, none of this should be surprising. Active managers effectively are the market. In aggregate, they deliver the market return. But they charge handsomely for this service and, when added to the trading expenses they incur, these costs are substantial. Compounded over decades, they can easily wipe out a third or more of the investor's eventual returns.

The average passive investor, then, must outperform the average active



> "Never has so much been taken from so many, by so few, for so little in return"

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investor. That's not a theory or an opinion; it's a mathematical fact.

All of this makes uncomfortable reading for active managers. After all, they're paid substantial salaries, as are their chief executives. Then there are the shareholders of the big asset management firms, who've earned generous returns over the years. As last year's FCA report on competition in asset management showed, the average profit margin for a UK fund house is 36 per cent.

Active management, in short, has been a jolly good wheeze. In the words of Michael Johnson from the Centre for Policy Studies, "Never has so much been taken from so many, by so few, for so little in return."

The bottom line is that managing other people's money is, to quote Vanguard founder Jack Bogle, "awesomely lucrative". This fact alone goes a long way to explaining all those articles I mentioned, warning of dire consequences if investors continue deserting active management in their droves.

"Bogle's Folly"

Of course, none of this is new. When we interviewed Bogle, he recalled the criticism of his first index fund for retail investors, launched in 1975. They called it "Bogle's Folly"; some even said it was "un-American". Fidelity chairman Edward Johnson remarked: "I can't believe the great mass of investors are going to be satisfied receiving average returns."

Fidelity has long since given up on holding back the tide. It's now the second-largest provider of index funds, after Vanguard, and it recently introduced the first zero-fee index funds into the US market.

Threatened livelihoods

So can we expect any let-up in the propaganda war? I'm afraid the answer has to be no.

Larry Swedroe, the US investment author, recently wrote: "Proponents of active management will continue to attack passive investing. In almost every case, these attacks not only are without foundation, they also are absurd and easily exposed as such. But that doesn't stop them. The reason is simple: passive investing threatens their livelihood."

It isn't just active managers whose livelihoods are threatened by indexing. Financial advisers no longer receive commission on products they sell, but many intermediaries still have a vested interest: stockbrokers and investment consultants are obvious examples.

What I, as a journalist, find interesting are the changing attitudes in the financial media. There's always been a symbiotic relationship between the media and the fund industry. The industry knows that, more than anything, it's stories that sell financial products, while the media needs not just the advertising revenue, but the constant supply of subjects to write about.

It's hard to bite the hand that feeds it, but in my experience, journalists want to be hacks, not flacks, and help their readers achieve better outcomes. There are encouraging signs that journalists today are less inclined to let the industry get away with saying some of the things they were willing to print in the past.

Investors need to hear the other side of the story. Thank you to FE Trustnet Magazine for allowing me this opportunity to put it to them. •

Baillie Gifford's **Milena Mileva** says that despite the gloom around the UK market, it contains some "tremendously exciting businesses" that are world leaders in their field

UK market ripe for stock pickers

Being a UK equity fund manager may seem a somewhat depressing occupation these days. As the spectre of the country's exit from the European Union looms large, there are plenty of doomsayers taking the view that investing money in UK stocks is a foolish thing to do. Why would anyone bother evaluating UK investment opportunities when you could invest in the innovative dynamism of certain parts of corporate America, or the allure of China's fascinating journey to global economic dominance? Against these competing attractions, the fate of UK PLC seems a sorry one.

We, however, refuse to be disheartened. Rather than being dull and futile, investing in the UK market is for us a greatly rewarding exercise. This is simply because there are some tremendously exciting British businesses which we wish to help grow to become multiples of their current size in the years to come. Some of these companies might not be household names, but they are true world leaders in their fields. They have built enviable competitive positions that rivals find hard to match. They are run with ambition and a real sense of purpose, confidently unlocking large growth opportunities which often span the globe. They feed on powerful, deeply entrenched social trends and, through innovation, aim to solve some of the most intractable challenges facing the industries they operate in. We believe that these companies' prosperity will not be

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Rather than being dull and futile, investing in the UK market is for us a greatly rewarding exercise

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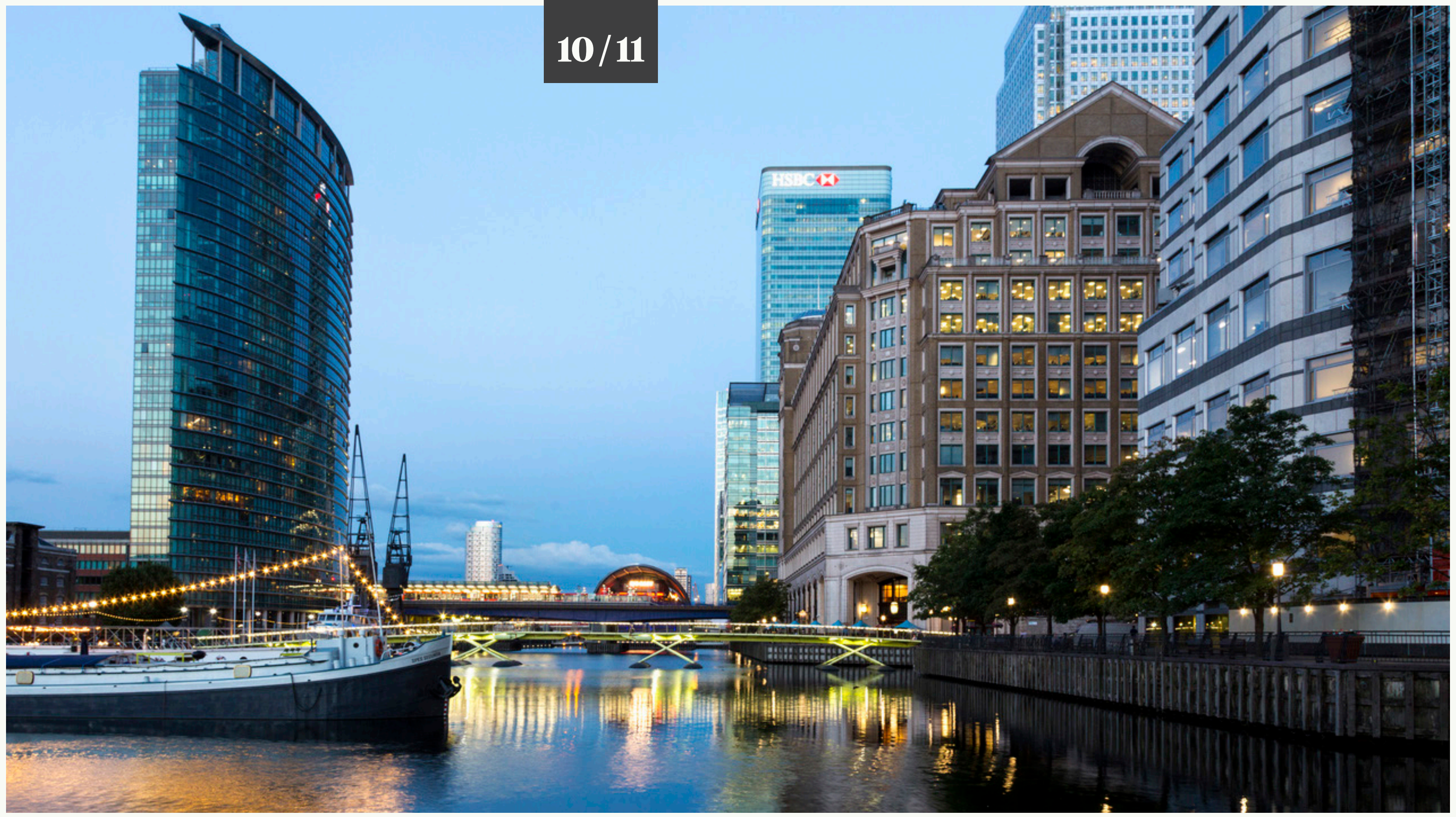
easily derailed. Their strengths and adaptability should enable them to drive their vision, even amid evidently seismic political and economic events. And, by continuing to be sizeable, highly committed and patient shareholders of these businesses, while acting on our clients' behalf, we have put ourselves in the privileged position of taking a disproportionate share of any future success.

We are unashamedly bottom-up investors. You will not hear us muse on, or attempt to predict, the daily twists and turns of economic data, stock market sentiment, or government policy. We do not think we can add much on those issues. Our enthusiasm for some of the exceptional UK growth businesses spans a wide variety of different industries.



Long-term winners and the need for a strong corporate culture

At Baillie Gifford, we have learnt a lot by owning great businesses and hope we can use some of those lessons to spot other big winners in the future. One of the key things we have observed is just how crucial unusual corporate cultures have been to their excellence. This manifests itself in a number of ways. First, they are all united by an unwavering focus on the long term. Whilst most companies tend to pay lip service to long-termism, it seems to us that precious few have the courage to consistently follow this belief. For most, a quarter or two of weak demand or missed earnings expectations is sufficient to result in ad hoc cost cutting and various forms of financial engineering to shore up the numbers. Second, great UK growth businesses all have strong identities and a vision which extends far beyond the imperative to generate profit for shareholders. This in turn tends to result in them having a strong alignment with their customers and employees.

Conclusion

We are not arguing that conquering these new horizons will be an easy task for the companies in our portfolios. Setbacks along the way are inevitable, just as they have been in the past. However, the scale of the opportunity truly excites us. It is only through our continued patience and commitment as shareholders that we and our clients will be able to fully benefit from this great potential.

The value of your investment and any income from it is not guaranteed and may go down as well as up and as a result your capital may be at risk. •

Milena Mileva – co-manager Baillie Gifford UK Growth Fund plc

Milena completed her MPhil in Politics at Oxford University in 2009, having graduated with a BA in Social & Political Science from the University of Cambridge in 2007. She joined Baillie Gifford in the same year and is an Investment Manager in the UK Equity Team. Milena became a member of the Pan-European Portfolio Construction Group in 2014.

The trust's exposure to a single market may increase risk. For more details on the Baillie Gifford UK Growth Fund plc, including the Key Information Document, please see our website at **www.bailliegifford.com**

Holly Black looks at some of the most obscure areas of the market you can access via ETFs

Weird and wonderful

Many investors think of exchange-traded funds as a cheap and easy method of tracking a chosen stockmarket. But ETFs are a fast-evolving part of the investment landscape, moving into an ever-growing number of areas based on investor demand.

Adam Laird, head of ETF strategy at Lyxor, says that previously if you had a conviction in a particular trend, you would need to carry out your own research and select individual stocks.

"There were a few thematic funds, but the choice was limited," he adds. "But as more data has become available, ETFs are able to build an index targeting a specific sector or trend and that has allowed the launch of some quite specific investments at low cost."

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> "Investors have always factored in the long term when building portfolios, but what is new is the ETF providing an access point for this kind of long-term theme"

Thematic offerings are becoming common among tracker funds. The Global X Millennials Thematic ETF, for example, aims to invest in firms likely to benefit from the rising spending power of those born between 1980 and 2000. Top holdings include Twitter, Nike and Netflix.

At the other end of the spectrum, the iShares Ageing Population ETF tracks companies that generate their revenue from people aged 60 and over; its top holdings include online travel company Webjet and hospice group Encompass Health. Lyxor also offers a Gender Equality ETF, which, as its name suggests, focuses on firms that score highly for gender equality.

Buy low, sell high

One of the more unusual offerings is the Marijuana Life Sciences ETF. The Canada-listed vehicle tracks the North American Marijuana index, which follows businesses focused on so-called cannabis stocks – primarily

BEST- AND WORST-PERFORMING ETFS OVER 10YRS

ETF	1yr (%)	3yr (%)	5yr (%)	10yr (%)
Lyxor UCITS ETF Nasdaq-100 Daily Leverage	60.93	254.16	515.18	2251.54
ProShares Ultra QQQ [2x Nasdaq-100 daily]	60.97	259.44	529.92	2021.41
ProShares Ultra Consumer Services	66.75	165.77	339.87	1635.45
ProShares UltraShort Real Estate	-6.91	-38.64	-60.61	-99.09
ProShares UltraShort Semiconductor	-38.11	-83.37	-92.34	-99.54
ETFS 2x Daily Long Natural Gas	-29.09	-78.49	-94.4	-99.99

Source: FE Analytics

healthcare and pharma businesses. Driving this trend is the fact cannabis has been legalised for medical use in 29 US states and for recreational use in eight. Legal cannabis sales in the US are expected to surpass £18bn by 2021. The ETF has returned 162 per cent over the past year.

BlackRock's ETF business, iShares, has launched a range of thematic trackers to tap the "megatrends" driving economic, technological and demographic change. Its Healthcare Innovation ETF, for example, tracks companies developing new healthcare technologies, while the Digital Security ETF looks for businesses that protect individuals and companies from online attacks.

Rob Powell, lead strategist at iShares, says: "Thematic investing is not a new phenomenon. Investors have always factored in the long-term when building portfolios, but what is new is the ETF providing an access point for this kind of long-term theme."

Other ETFs offer exposure to a specific region. The iShares MSCI Korea ETF, for example, follows more than 100 stocks listed in Korea; it has returned 75.14 per cent over three years but is down 1.5 per cent over one.

However, while a portfolio containing more than 100 companies may sound well diversified, it's an example of how checking under the bonnet of an ETF is just as important as for any other investment: Samsung Electronics accounts for 26.2 per cent of the fund's assets.

"Absolutely pointless"

Peter Sleep, senior investment manager at 7IM, is concerned that the rise of niche ETFs could spur investors to follow short-term fads and trends, rather than investing for the long term. "There are lots of these

"Investors should consider what they're hoping to achieve when they choose an investment and not just get side-tracked by an impressive presentation"

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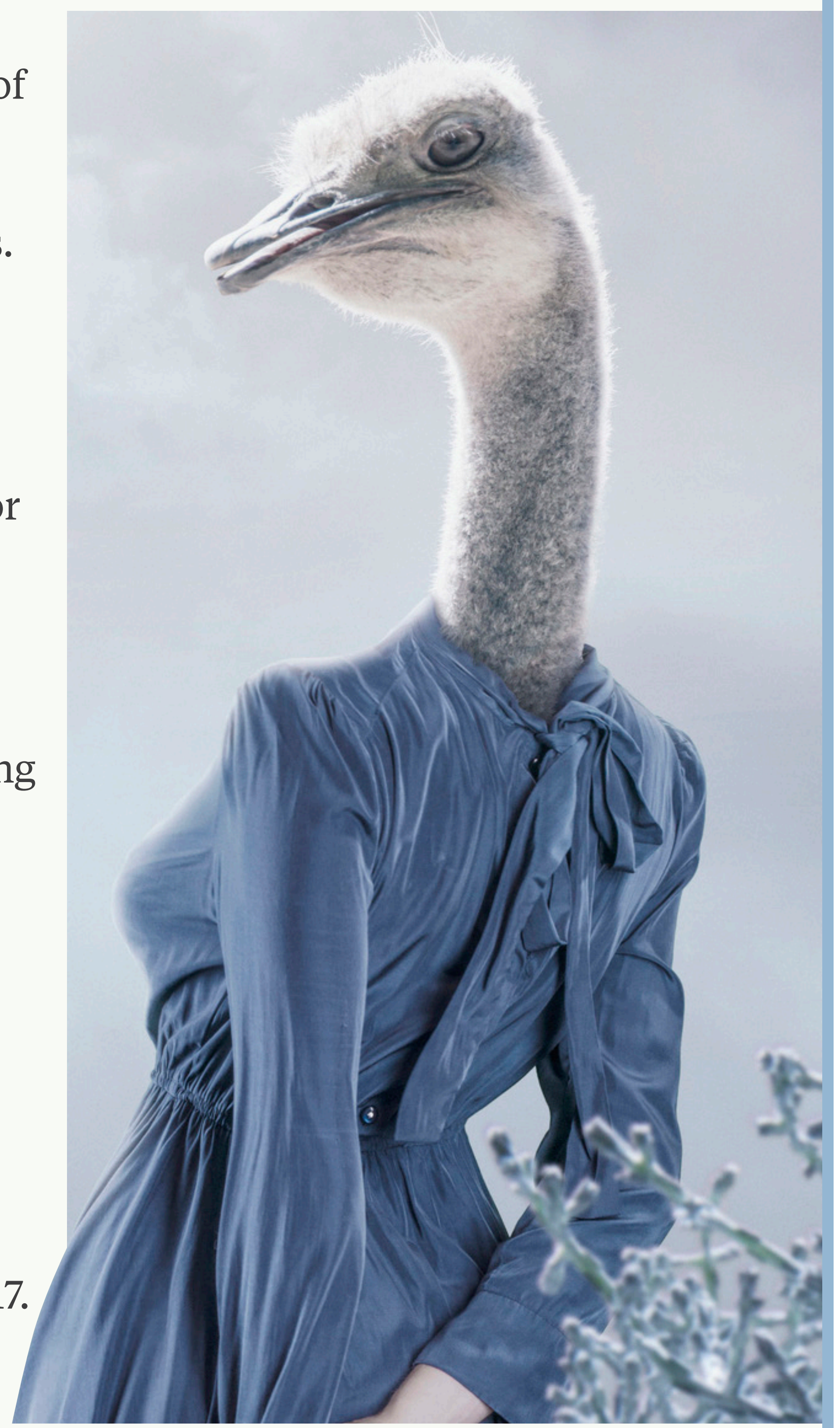
investments around, including three absolutely pointless water ETFs, an IPO ETF, two CoCo ETFs, a number of robotics trackers, those which focus on fintech, batteries, digitalisation and even a 'wide moat' ETF," he says.

The manager fears the specific fields these trackers home in on are often too narrow with too few viable investment opportunities, making them a riskier proposition for investors. Often the more "faddish" of these themes tend to rise and fall quickly as investors move on to the next area of interest. Sleep points to coal mining, nuclear and shipbuilding ETFs as examples of previously popular areas that have crashed and burned and are no longer available. He fears many of today's themes could go the same way.

Yet others argue ETF providers are simply responding to demand. BlackRock points out thematic ETFs saw a compound annual growth rate of 128 per cent between 2014 and 2017.

Powell says the demand is driven by people who want to invest in themes "they can understand and that resonate with their everyday lives".

Laird adds: "There are a lot of good ideas in ETFs but there are a lot of questionable investments too. Investors should consider what they're hoping to achieve when they choose an investment and not just get side-tracked by an impressive presentation."●



ADVERTORIAL FEATURE

IT'S DÉJÀ VU ALL OVER AGAIN

by Alasdair McKinnon, manager of the Scottish Investment Trust

Even though the late Lawrence 'Yogi' Berra was an outstanding baseball player, he is possibly best known for his 'Yogisms' – apparently nonsensical comments attributed to him that contain a cryptic life truth. After all, who can disagree that "the future ain't what it used to be" and "you can observe a lot by watching". However, this outlook is titled with the Yogism that reflects the resigned inevitability of watching a re-run of a situation you've already experienced.

Those who have already read my previous articles will be aware that a simple philosophy underpins our approach to investment. At the core of this philosophy is a recognition that investors are not, in aggregate, dispassionate calculating machines but instead retain human emotions.

As humans, we have many differing emotions, desires and motivations but one apparent constant, which is maintained across cultures and geographies, is a desire to be part of the group. This crowding instinct has been a great benefit to humanity and living standards are unquestionably far higher than if we operated as individuals. Working as a group allows division of labour, specialisation and economies of scale.

However, we believe that this crowding instinct does not usefully translate into financial markets as the crowd is inherently a momentum beast. Crowds naturally gravitate towards what has recently been successful and shun what has recently been unsuccessful. The crowd voice, which is always alluring, is driven by individuals who seek to align themselves with success and disavow failure.

In financial markets, chasing momentum works. Until it doesn't. By the time an investment has performed sufficiently well (or badly) for it to become an accepted wisdom, conditions are ripe for the trend to change. It is this momentum mentality which creates the business cycle and the numerous bubbles (and subsequent busts) which have bedevilled investment markets.

We do not attempt to follow investment fashions and instead seek investments in which we can foresee long term upside. We actively seek unpopular areas because this is where the balance between risk and reward can be most favourable. Rather than perpetual trends we believe in cycles, which brings us neatly back to the déjà vu referenced in the title.

Investors currently exhibit remarkably low levels of scepticism about 'hot' investment themes, particularly in the technology area, which mentally transports us back to the late 1990s when similar enthusiasm reigned (it didn't last). The collapse of Long-Term Capital Management (LTCM) in 1998 and the subsequent Central Bank response, arguably, created the conditions for the dotcom bubble. Following the bailout of LTCM, the investment mood swiftly became feverish, with the best performing investments defined by their elevator pitch (a simple conceptual story with grand visions) and eyeballs (the gathering of unprofitable user views). Sales of IT hardware and services boomed both to salve the impending 'Millennium Bug' and due to an increased desire for personal computers. Those companies that had benefited from this trend became valued as if the good times would never end.

> "By the time an investment has performed sufficiently well (or badly) for it to become an accepted wisdom, conditions are ripe for the trend to change."

Things are different today, but in some ways they are the same. Once again, investors are excited by concept investments even if the most speculative of them all, the cryptocurrencies, have already disillusioned their fan club. Investors continue to reward the new 'eyeball' metric which, these days, is instead unprofitable user growth. Internet shopping, food delivery, ride hailing services, music and video streaming, to name just some, are all subsidised at the point of use by investors. Meanwhile, investors show scant concern that the premium smartphone boom has peaked and have only recently started to consider that companies operating in the 'Wild West' space of internet advertising may be about to meet the posse (courtesy of the Facebook data scandal). ■

Ben Lofthouse, Fund Manager of Henderson International Income Trust, shares his view of overseas income markets and the momentum behind global dividend growth

Sharing the spoils of global income markets

It's been a fascinating year so far with a lot of the trends around economic growth continuing, which has led to some changes in the global macroeconomic landscape.

There have been some notable surprises, too. One of those was the US corporate tax cut, which has made life a lot more profitable for US companies with domestic earnings, which I think has received less attention than the repatriation element of the legislation for overseas dollars. Whichever way you look at it, we are seeing strong earnings growth in the US, partly as a result of these tax reductions.

The other big surprise is the extent to which politics has acted as a destabilising force on markets. Against a backdrop of relatively good economic growth, we have had two or three significant events. Firstly, the President of the United States has been much more forceful than many of us expected on trade, and while so far this has not had a direct impact, it has certainly caused regions like China, Asia and, to some extent, Europe, to underperform.

Another thing we've seen is an Italian election which resulted in two parties taking power that weren't expected to and some of their communication has led to significant uncertainty once more around Europe. Although the European economy has been OK, we've seen destabilisation in European stock markets, particularly in financials. The underlying economic data has been quite good but sentiment-wise and in terms of political news, it's become a tough environment to sit with.

The US is the biggest exposure that we have at about 31% of the portfolio, so we have been pleasantly surprised by the tax cuts, which have been beneficial to the companies we own

Performance, politics and profits

At Henderson International Income Trust (HINT), we haven't made any particularly large changes to the portfolio this year. The US is the biggest exposure that we have at about 31% of the portfolio, so we have been pleasantly surprised by the tax cuts, which have been beneficial to the companies we own and we have seen good earnings growth coming from there. Earlier in the year we reduced some of our exposure to companies that had performed well in recent years, in particular Asian growth companies where we were able to realise some very attractive profits.

These changes have derived from valuation changes rather than macroeconomic concerns and in the

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same vein we have added European stocks to the portfolio during the past four or five months. Amid the sell-off of European stocks we have found that they do exhibit very good value – particularly global stocks that are domiciled or listed in Europe but derive a significant proportion of their earnings from overseas. We see those trading at quite a big discount to their peers elsewhere.

At the moment we are not using the gearing facility. We have been very active with gearing in the past and generally we use gearing in a countercyclical manner. That means we've used gearing when we see markets selling off significantly during periods of volatility and valuations come down to the point that they offer very attractive opportunities.

We've had quite strong markets for a few years and we've got quite a lot of political noise as I discussed earlier. I think we'd like to keep a bit of powder dry and hold back on gearing simply to make sure we have some room to take advantage of opportunities if they arise. These opportunities may not come at the complete market level, but they could come in specific areas and sectors as a result of trade discussions, for example.

I am often asked about gearing and recently I've been asked about the effect of rising interest rates on the cost of borrowing money. What you find is that any changes to the income characteristics of a portfolio as a result of small interest rate changes tend to be insignificant. So, the benefit that you get from being geared in a rising market would outweigh the additional cost of gearing and in the same way if markets fall significantly, the lower cost of gearing that you might get from interest rates going down doesn't really help you anywhere near as much as the impact of falling net asset value (NAV).

Glossary

Gearing: A measure of a company's leverage that shows how far its operations are funded by lenders versus shareholders. It is a measure of the debt level of a company. Within investment trusts it refers to how much money the trust borrows for investment purposes.

Volatility: The rate and extent at which the price of a portfolio, security or index, moves up and down. If the price swings up and down with large movements, it has high volatility. If the price moves more slowly and to a lesser extent, it has lower volatility. It is used as a measure of the riskiness of an investment.

Countercyclical Investing: Picking stocks that move in the opposite direction to the overall economic cycle – rising when the economy is weakening and falling when the economy is rising.

I think we'd like to keep a bit of powder dry and hold back on gearing simply to make sure we have some room to take advantage of opportunities if they arise

Optimism overseas

Looking ahead to the remainder of the year, what I can say is we're meeting a lot of companies that we own, of which there are many that are reporting on their financial health at the moment, and generally the trends are good.

Janus Henderson publishes a Global Dividend Index each quarter which effectively shows the corporate health of the world's largest companies and how willing they are to distribute their cash. On the basis of the second quarter of 2018, things are going well. We have seen headline growth of just over 12% and underlying growth of 9.5%; we are seeing it broadly spread over industries and regions; we've had some records for some regions, such as the US, Japan and Europe; and we've seen some strong growth from sectors such as mining and the financial services areas, particularly banks.

The growth is so strong that we had to increase our global dividend forecasts for the year from 6% to 7.4%, so in the absence of further geopolitical events it would seem we are set for a bumper year for dividend growth. We think the portfolio is well positioned and well diversified to capture dividend growth outside the UK, where there is good momentum and earnings growth potential across many regions. ●

Anthony Luzio finds out whether algorithms pose a threat to computer-based tracker funds

Get with the program

When footage emerged of one of Uber's self-driving cars running over and killing a cyclist in Arizona earlier this year, it confirmed what many people had long suspected – no matter how advanced computers become, there are some tasks that are so important, only human oversight will do.

This suspicion seems to apply to managing money as well. Despite the wealth of evidence showing that the vast majority of investors would be better off in passive funds, these still account for less than 20 per cent of the money run by the asset management industry.

Fear of the unknown

Part of this may be driven by a fear of the unknown and the speed with which technology is developing – algorithms, for example, have been

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blamed to some extent for corrections of every shape and size in recent years. However, while the market tends to quickly rebound from these temporary setbacks, is there a danger that algorithms could eventually pose a long-term threat to investments left on "autopilot" in tracker funds?

Christopher Gannatti, head of research at WisdomTree, thinks this is unlikely.

High-frequency trading

"Most of the time when the question comes up about algorithmic trading, it is under the umbrella of high-frequency trading," he says.

"A lot of work has been done on this and it found the biggest issue for these algorithms is the location of the servers. You have these high-frequency trading hedge funds for which money is no object which spent vast amounts of money on fibre optic cables in a perfectly straight line between Chicago and New York to ensure they had the fastest overall trading experience."

Gannatti says the reason these funds are so obsessive about speed is they use the algorithms for front running. This means that through analysing patterns they can determine whether a large order is about to be placed for a company's shares, allowing them to buy in first to benefit from the subsequent uplift in value.

> **"Having done it before, you would have a trading record as long as your arm and high-frequency traders would rip your legs off"**

"The analogy you frequently see is picking up pennies in front of a steam roller," Gannatti continues. "The reasoning being that if you find a way of making a tiny amount of money, but you do this many times and have a bit of leverage, ultimately you have an attractive investment strategy."

But with these hedge funds using algorithms to profit from the actions of professional fund managers, surely it is only a matter of time before a "pump and dump" version is developed that could take advantage of the vast amounts of retail investors' cash flowing into passives?

For example, with passive funds buying every stock on an index, an algorithm could take advantage of this by pumping money into one stock, forcing the tracker funds to buy it at the close of trading, pushing up its price. The algorithm could then short it and sell out, so forcing the index trackers to sell out as well, deflating its price – before repeating the process ad infinitum.

However, when this question was put to the experts, they said there was so much wrong with it, they didn't know where to start.

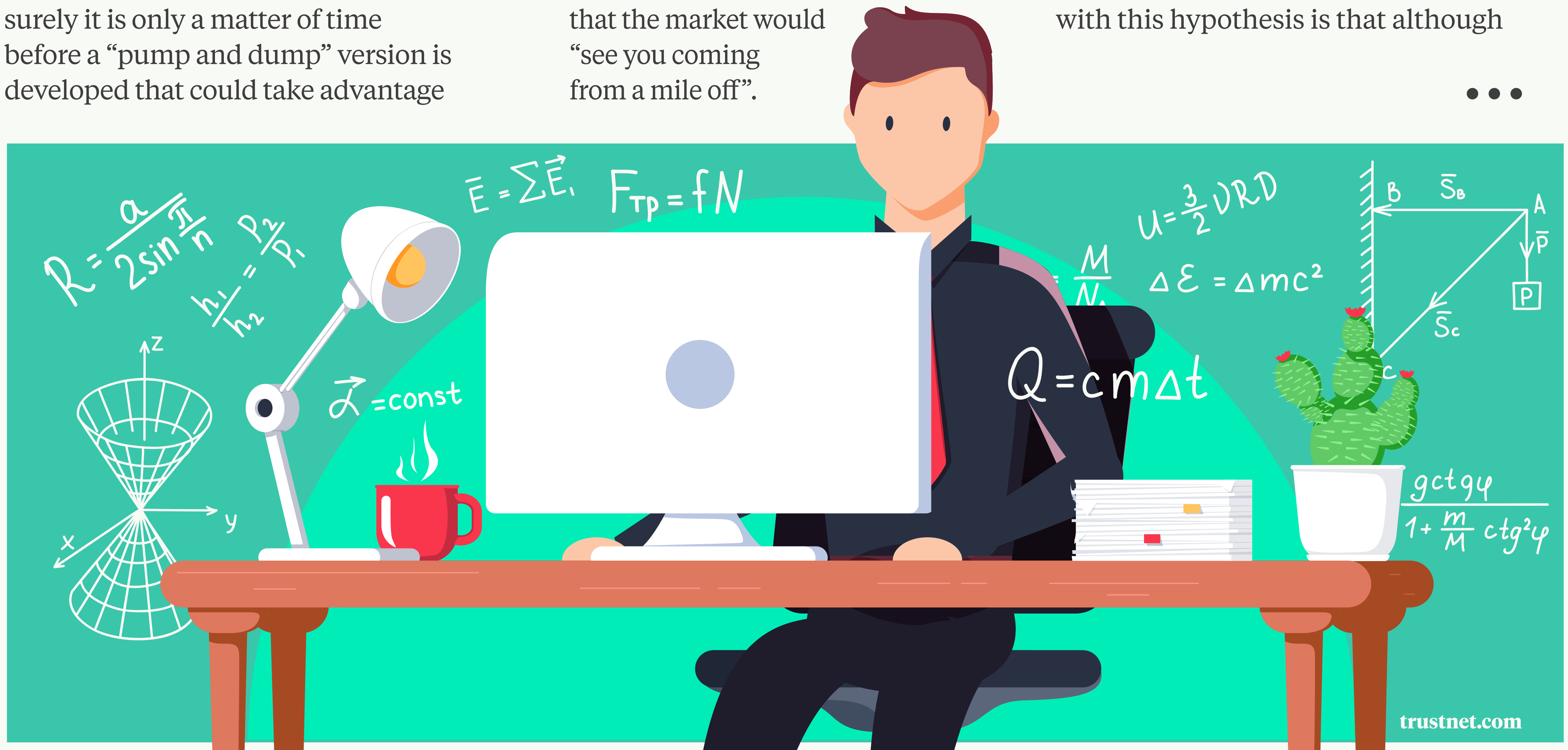
Alex Tarver, analyst at QuotedData, says the first problem is that the market would "see you coming from a mile off".

"Extraordinarily large pockets"

"The securities regulator and the FCA would be all over it, because it is market manipulation," he explains. "And you would need extraordinarily large pockets to lift the share price and keep it there. Having done it before, you would have a trading record as long as your arm and high frequency traders would rip your legs off."

However, while pushing up the price of individual stocks like this would be incredibly difficult – not to mention illegal – in the likes of the S&P 500 and FTSE 100, what about in more obscure markets where the stocks are a fraction of the size and the regulators take more of a "hands off" approach?

Gannatti points out the problem with this hypothesis is that although



"Although passive funds and ETFs have a mandate to track an index, what is not written in the prospectus is the way they have to track it"

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passive funds and ETFs have a mandate to track an index, what is not written in the prospectus is the way they have to track it.

Stratified sampling

"It would be rare they buy every stock in an index, except in the case of say US large caps where all the stocks are large and have to be followed," he says.

"If you are talking about small caps, what is much more typical is the portfolio managers weigh up the pros and cons and say 'what is the most efficient way of tracking an index?'. They won't buy every stock in the same way as not every stock is equally liquid and their transaction costs would be higher."

Tarver says in most markets, trackers follow indices using a technique called stratified sampling where rather than owning every share they buy representatives of a sector.

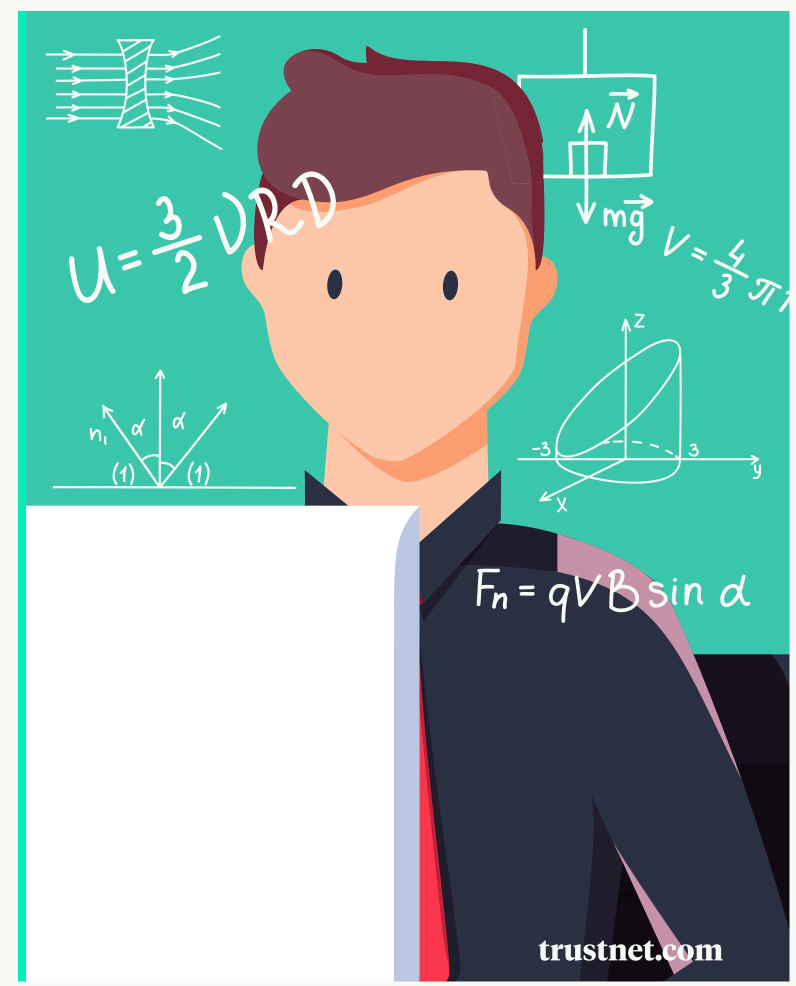
"So, say you have a small-cap index with some fairly illiquid stocks, you might own a basket of these and put an option against them to take out the risk," he explains.

Low-hanging fruit

However, Gannatti says the main reason why passives have nothing to fear from algorithmic trading attacks is far simpler than anything to do with trading strategies or regulation.

"If you think about the amount of resources these market participants have," he adds, "and how smart they are, if it was profitable and easy to do, the low-hanging fruit would have been picked up by this point."

Regardless of how many analysts say there is nothing to fear from passives, many people will stick with an active manager, perhaps unable to shake the image of a driverless Uber killing a cyclist. While this is your choice, it is worth remembering a single factor was blamed for 93 per cent of US car accidents last year: human error. ●



This growth-focused fund is in the top quartile of its sector over one, three, five and 10 years

Baillie Gifford European

After what looked to be a breakout period for European investors last year, the shine seems to have come off the market in 2018.

While the MSCI Europe ex UK index is in positive territory for the year, up 1.27 per cent, it is a long way behind the 14.2 per cent gains of the S&P 500.

This is not a flash in the pan, either, with the European index underperforming its US counterpart by 186.55 percentage points over the past decade.

The flipside to this is that with the European market further behind in the economic cycle than the US, it may not have as far to fall in the next correction, and it could also be well placed if value makes the comeback so many investors have been waiting for over the past decade.

However, while Europe may look attractive from a valuation point of view, much of the value "bucket" in the region consists of under pressure banks, disrupted automakers and maligned miners. One option then to play this market is to use a fund focused on growth but in an area of the market that is undervalued relative to the US.

One option for investors who are thinking of using this strategy is the five FE Crown-rated Baillie Gifford European fund, run by Stephen Paice, Moritz Sitte and Tom Walsh.

Premier Asset Management's Simon Evan-Cook recently described Baillie Gifford as "like a stick of rock", adding: "Growth goes all the way through them and you know that over a 10-year period they are still going to be here and running a growth style."

The fund certainly looks as if it has made the most of the bull run and is in the top quartile of its sector over one, three, five and 10 years.

It has made 138.15 per cent since Paice – the longest serving of the three managers – joined in April 2011, making it the third best-performing trust in the sector over this time.

Baillie Gifford European aims to invest for the long term in fast-growing companies that typically have a strong competitive position or an owner-orientated management team.

It is made up of between 40 and 80 stocks and aims for portfolio turnover of less than 20 per cent.

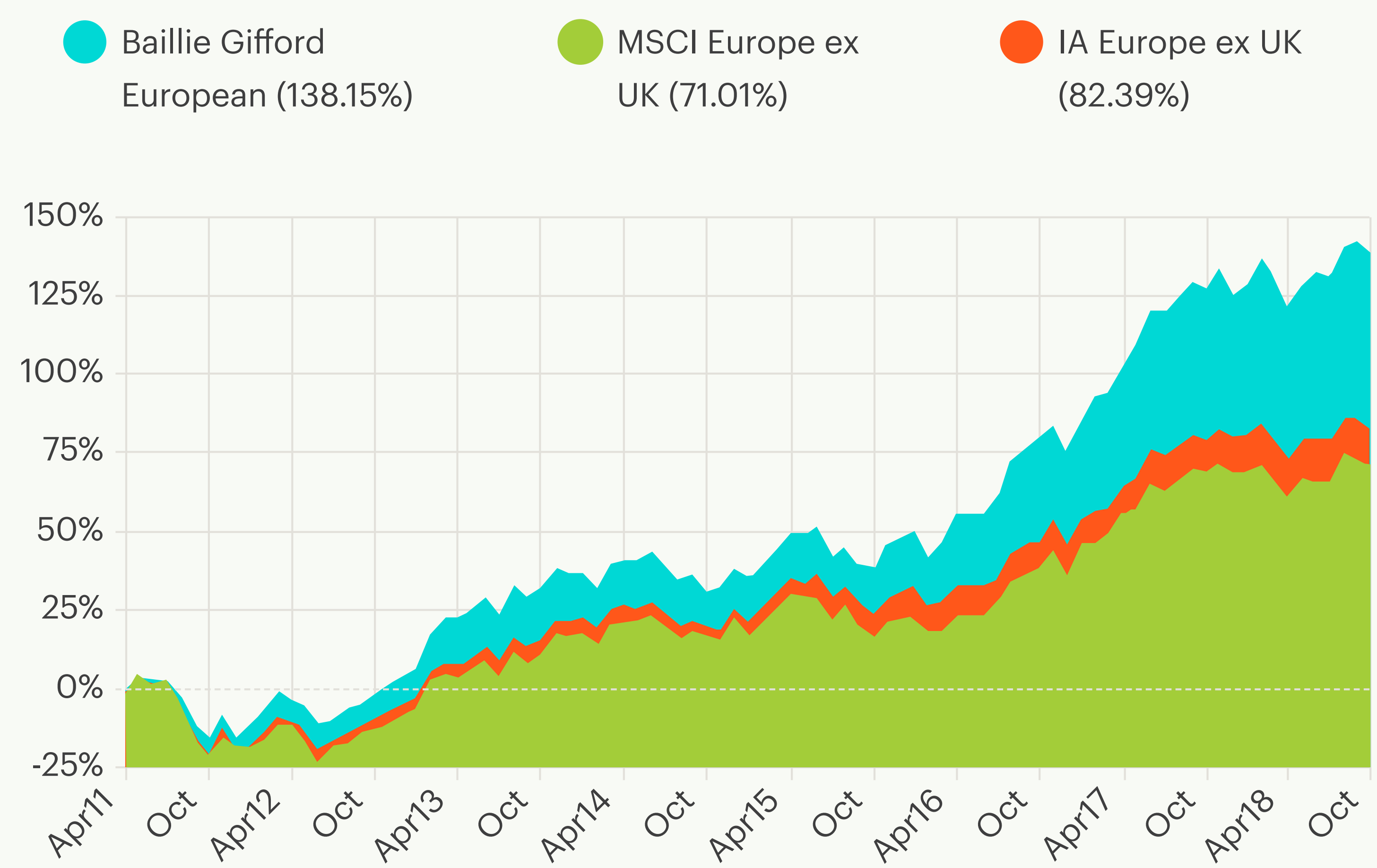
As a growth fund, it has a low exposure to financials and miners, but is overweight industrials, consumer goods and healthcare. ●

FACT BOX

MANAGERS: **Stephen Paice, Moritz Sitte and Tom Walsh** / LAUNCHED: **06/01/2000** / FUND SIZE: **£473.5m** / OCF: **0.59%**

FE CROWN RATING

PERFORMANCE OF FUND VS SECTOR AND INDEX OVER MANAGER TENURE



Source: FE Analytics

Manager Robin Geffen says using property as a diversifier in pension funds is “practically criminal”

Neptune Balanced

Investors are not taking enough risk to meet their retirement goals and are putting money into the wrong types of diversifiers, according to veteran investor Robin Geffen.

Geffen, who manages the £455m Neptune Balanced fund, believes the shift away from defined benefit schemes towards defined contribution ones has created a shortfall in pension pots.

“There are an awful lot of people who are currently in the long-term savings market whether they like it or not,” he said.

While the end of the market cycle may be approaching, he said that it would be wrong to exit equities given their ability to beat inflation over the long-term.

As central banks begin to withdraw the monetary and fiscal stimulus measures introduced since the financial crisis, anxious investors are likely to want to diversify. However, Geffen said bonds are unlikely to deliver the kind of returns many investors have grown accustomed to over the past 30 years.

He pointed out that bonds sold-off at the same time as equities in the market correction at the start of 2018, bringing into question their perceived diversification benefits.

Another asset class traditionally used as a diversifier is property, making up 5 per cent of the average balanced fund. However, Geffen also issued a warning about this sector.

“We have zero per cent, we have always had zero,” he said. “If you think about it, many of the people approaching retirement are empty nesters and are about to downsize.”

“So, loading them up with property in any kind of long-term pension fund when they’re reaching retirement is practically a criminal thing to do.”

Instead of traditional diversifiers, Geffen said he prefers to use put options to hedge against short-term equity market drawdowns.

The equity bias can be seen in the Neptune Balanced fund where 82 per cent of the portfolio is held in the asset class, with just 13.5 per cent in fixed income.

Another area of conviction is emerging markets – in which it has a 13.6 per cent weighting – where companies are currently trading at significant discounts to developed market peers, but have the potential to grow faster.

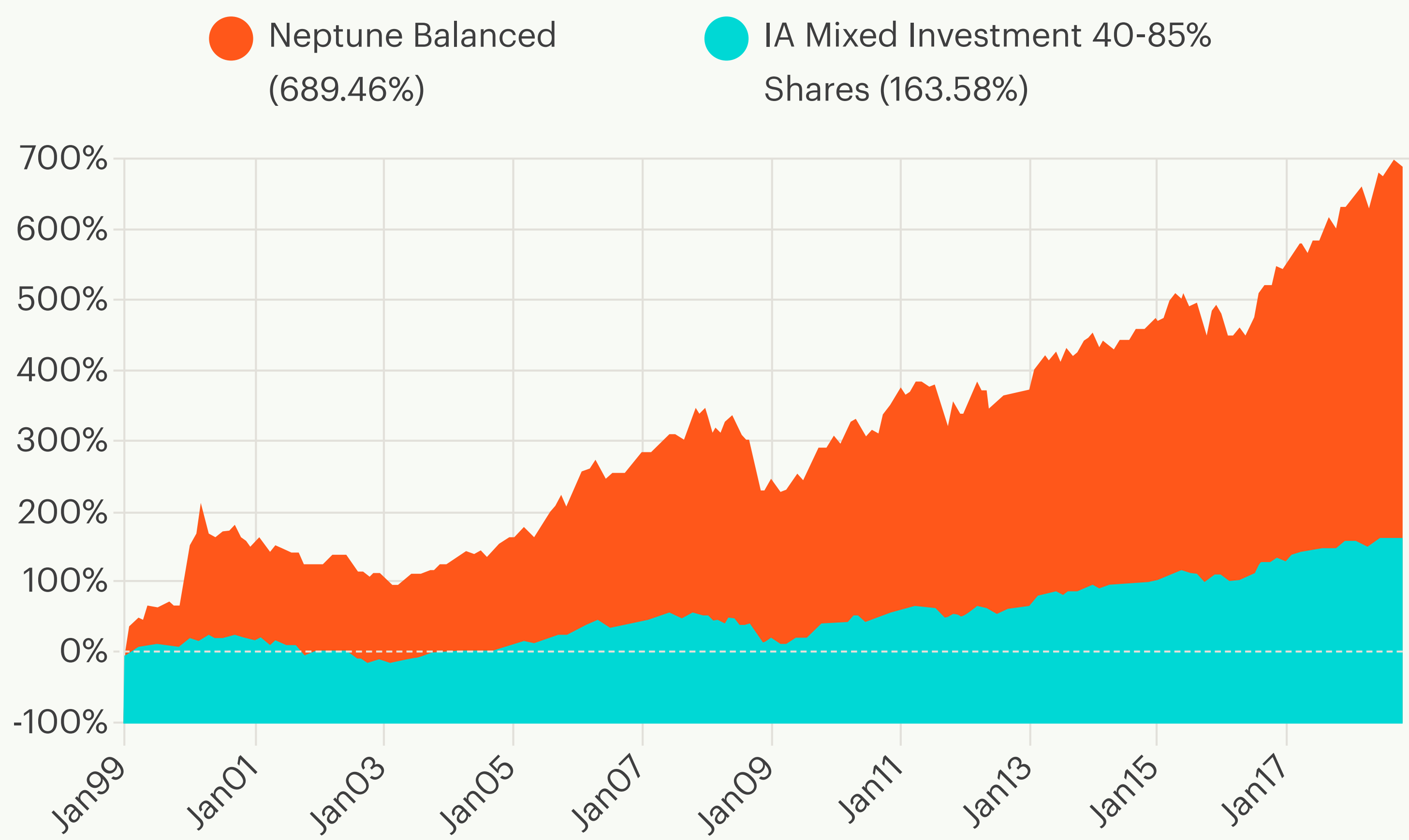
The Neptune Balanced fund has delivered a total return of 689.46 per cent since launch at the end of 1998 compared with gains of 163.58 per cent from the IA Mixed Investment 40-85% Shares sector. ●

FACT BOX

MANAGER: **Robin Geffen** / LAUNCHED: **31/12/1998** / FUND SIZE: **£455m** / OCF: **0.87%**

FE CROWN RATING

PERFORMANCE OF FUND VS SECTOR SINCE LAUNCH



Source: FE Analytics

Manager Lucy MacDonald believes a focus on quality stocks is likely to be the best option for investors as the end of the market cycle approaches

Brunner Investment Trust

The debate over whether growth or value will be the best style for optimising returns going forward has continued to cloud many investors' decisions.

However, Brunner Investment Trust's Lucy MacDonald believes quality is likely to be the best option for investors as the end of the cycle draws near.

The manager said the changing economic backdrop is likely to mean a more challenging period in markets from this point.

"Our view is that we are entering a period where we think overall capital returns will be flatter and a bit more volatility will begin to creep into the market after a period of exceptionally high returns," she said.

"We think that because we are getting to peak liquidly following the quantitative easing, from the fourth quarter this year liquidity will begin to be drained out as it turns into a withdrawal."

MacDonald believes growth will likely tail off as 2019 approaches, with the market adjusting to changes in both monetary and fiscal policy and the expectation of lower profits – in particular, she said the 10 per cent growth seen in earnings this year is unlikely to be repeated.

Instead, she has tilted her portfolio towards quality stocks.

"In a period where you have limitless liquidity then quality is not a feature which is valued," she explained.

"But as we move into this [new, post-quantitative easing] environment we think it will get reviewed and we think it's already starting to come true."

The return of volatility to markets in 2018 after a relatively benign – and unusual – 2017 has thrown up some other opportunities for MacDonald to add some quality stocks to the portfolio at more attractive valuations. Other opportunities have arisen from Brunner's decision to adopt a new benchmark, allowing it to increase exposure to companies based overseas.

Meanwhile, the renegotiation of costly debentures has seen the trust's discount narrow.

"It went out to 20 per cent and then a combination of performance and what we've been doing to the trust has brought it in," said the manager.

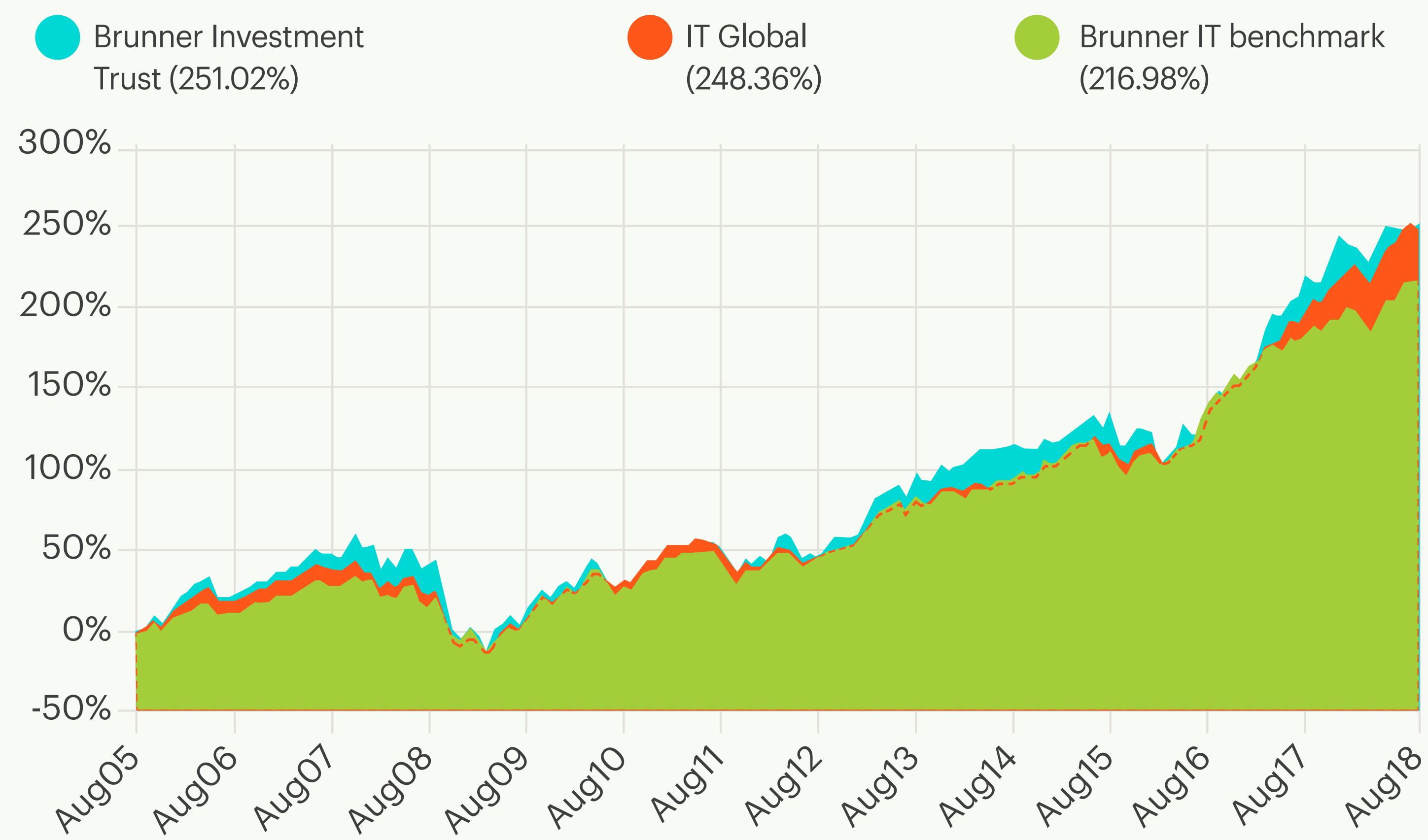
The trust has made 251.02 per cent since MacDonald joined in July 2005, compared with 216.98 per cent from its benchmark, split 70/30 between the FTSE All World and All Share. ●

FACT BOX

MANAGER: **Lucy MacDonald** / LAUNCHED: **03/12/1927** / PREMIUM/DISCOUNT: **-12.6%** / OCF: **0.72%**

FE CROWN RATING

PERFORMANCE OF TRUST VS SECTOR AND BENCHMARK OVER MANAGER TENURE



Source: FE Analytics

Even the biggest proponents of active investing are willing to throw in the towel when it comes to the US, writes **Adam Lewis**

Admitting defeat

When it comes to investing in the US, there is an old rule of thumb that you are better off investing in passive funds, because few, if any, active managers have consistently beaten the index.

For a long period of time, Legg Mason's Bill Miller was the exception to this rule after his Legg Mason Value Trust outperformed the S&P 500 for 15 consecutive years between 1991 and 2005. As the name of the fund suggested [it has now changed its name to Legg Mason ClearBridge Value], Miller was famed for his value style of investing, but as the market cycle turned and conditions began to favour growth, the portfolio began to underperform, once again raising questions over the effectiveness of active strategies in the US.

Stepping back

Ignoring the active vs passive debate for one moment, the US market as a whole has been a great place to be invested since the end of the financial crisis, with the S&P 500 up 296.83 per cent over the past 10 years. However, the average IA North America fund is up only 268.33 per cent over this time, giving credence to the idea investors may be better off going passive.

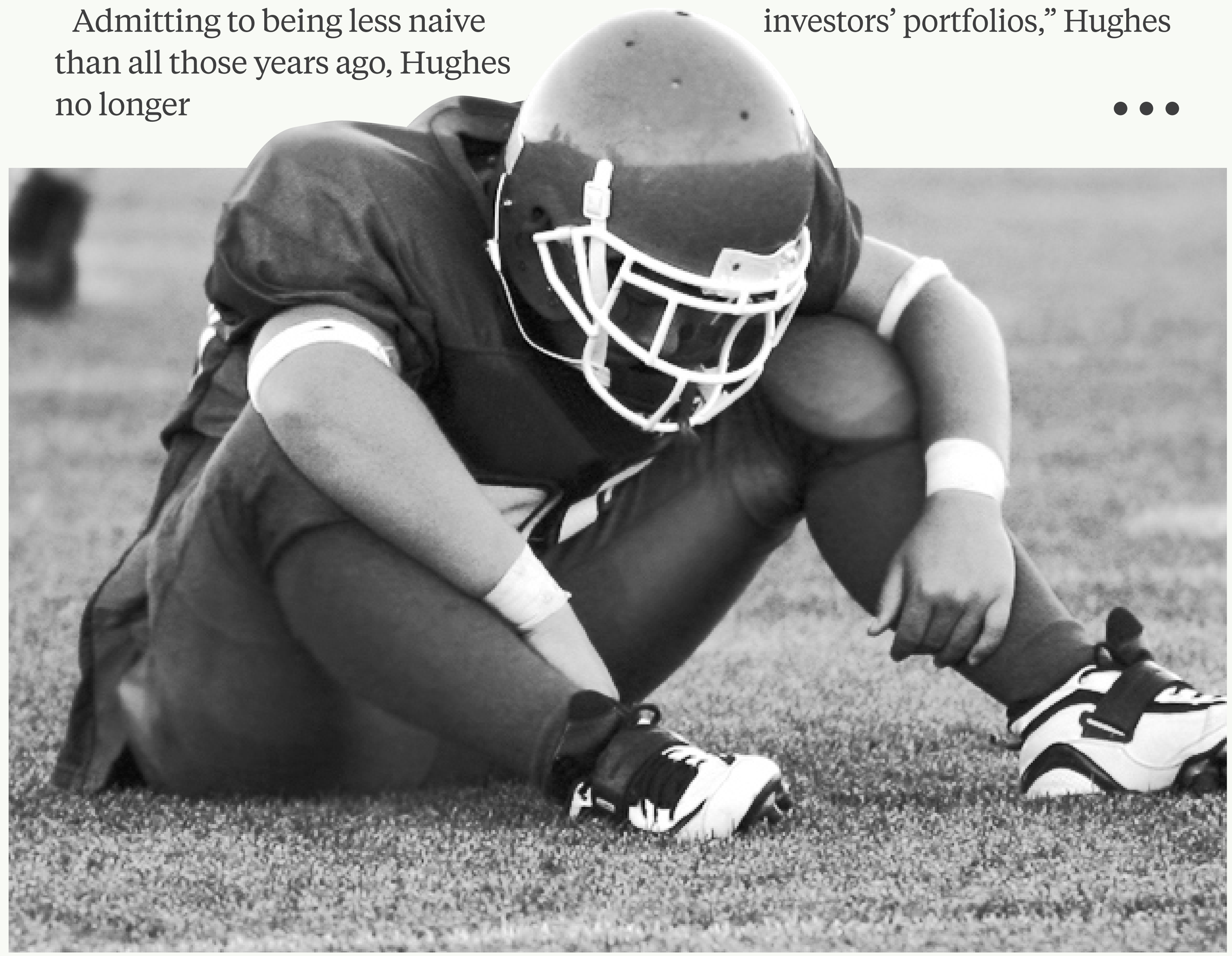
This outperformance repeats itself over one, three and five years as well, and while the IA North American Smaller Companies sector has beaten the Russell 2000 over the past decade, their returns have been broadly in line with each other over the three shorter periods. So is there any point to trying to beat the market by taking an active stance?

"Having been investing in markets and researching investments for nearly 20 years, one of the rules you learn over your career is that you don't try to beat the S&P 500 because you can't," says Ryan Hughes, head of active portfolios at AJ Bell Investments. "As a proponent of active investing, this is always a difficult concession, but the weight of history is on this side of the argument."

> **"One of the rules you learn over your career is that you don't try to beat the S&P 500 because you can't"**

Admitting to being less naive than all those years ago, Hughes no longer sees it as his duty to try and beat the market in everything he does. He says he now adopts a more objective approach and only looks to use active managers if he is confident they can outperform the market after fees.

"This may sound obvious, but it is only in recent years that we have started to see a blend of active and passive investments in professional investors' portfolios," Hughes



says. "Within the AJ Bell Active MPS [managed portfolio service], we take the view that we should only use active managers where we think it is justified."

"As a result, in our US exposure, the core element of our positioning is made through a passive holding, Fidelity Index US. The ability to gain US exposure for just 0.06 per cent per year is compelling and seriously raises the bar for active managers."

Hughes' main problem with the active universe in the US is that few fund managers have a genuine "core" investment approach – meaning they can outperform in both rising and falling markets – and, as a result, lack consistency.

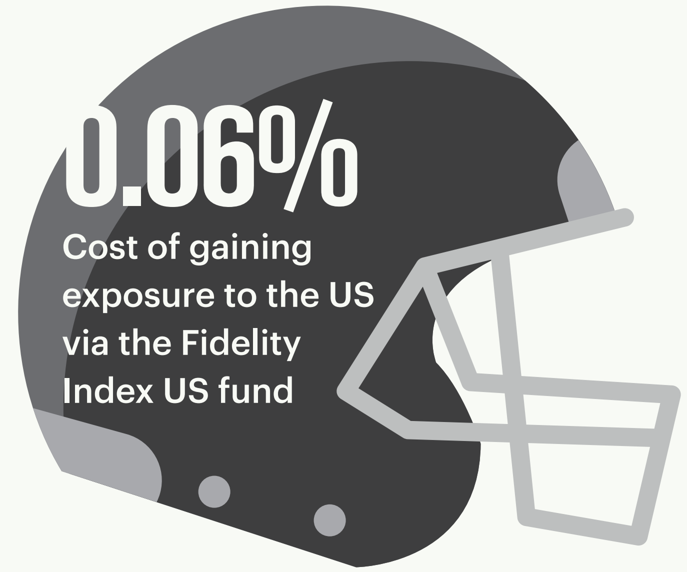
He adds that while some growth managers have done well recently, such as Artemis, value managers have become "almost as rare as hen's teeth".

"The polarised universe makes it very difficult to find consistency among the active funds and pushes investors further towards the passive solution," Hughes continues.

"This is not helped when we look at the S&P 500 as the US benchmark in the UK, whereas US-based managers are more focused around the Russell indices which are a little broader."

"Those managers are also much more explicit in focusing on a specific style, with many measuring themselves against more relevant benchmarks than the generic S&P 500, which of course has its own style bias now given the phenomenal rise in technology companies."

"The polarised universe makes it very difficult to find consistency among the active funds and pushes investors further towards the passive solution"



Wavering belief

Ben Yearsley, a director at Shore Financial Planning, admits he does not like passive funds. Over the long run, his preference is to have a good active manager, of which he says there are plenty to choose from in most markets.

"However, one market where my belief in active wavers is the US," he admits. "Whether it is the size or efficiency of the market, I don't know, but many US active managers have promised, but under-delivered. Where are the Nigel Thomases or Anthony Crosses of the US?"

Yearsley notes that some good managers have delivered in the US small cap space, but this becomes rarer the further you travel up the market capitalisation scale.

"Many value managers did well in the 1990s, but what we need is an active fund with the ability to tilt between growth and value," he says. "Instinctively I favour active, however I would blend a core active fund with a quantitative process – such as Ian Heslop's Old Mutual North American fund – with something that has a freer hand, such as Tyndall North American or Artemis US Equity."

PERFORMANCE OF SECTORS VS INDICES

Name	1yr (%)	3yr (%)	5yr (%)	10yr (%)
IA North America	19.33	77.91	110.96	268.33
S&P 500	20.61	84.08	131.3	296.8
IA North American Smaller Companies	21.06	86.4	106.03	312.13
Russell 2000	18.13	84.39	105.86	276.5

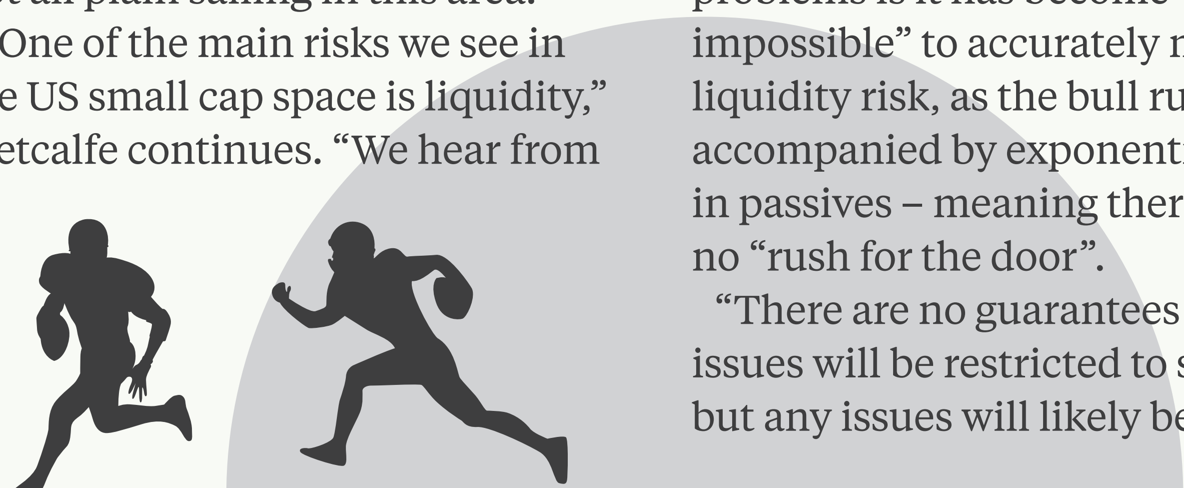
Source: FE Analytics

Looking down

Turning to small caps, Chris Metcalfe, investment director at IBOSS, notes IA North American Smaller Companies has made 1,100 per cent over the past 25 years, almost double the 640 per cent made by IA North America.

The small cap sector has outperformed in 18 out of the 25 calendar year periods, which Metcalfe says has been heavily influenced by the performance of tech stocks, which make up approximately 20 per cent of the US sector. However, it is not all plain sailing in this area.

"One of the main risks we see in the US small cap space is liquidity," Metcalfe continues. "We hear from



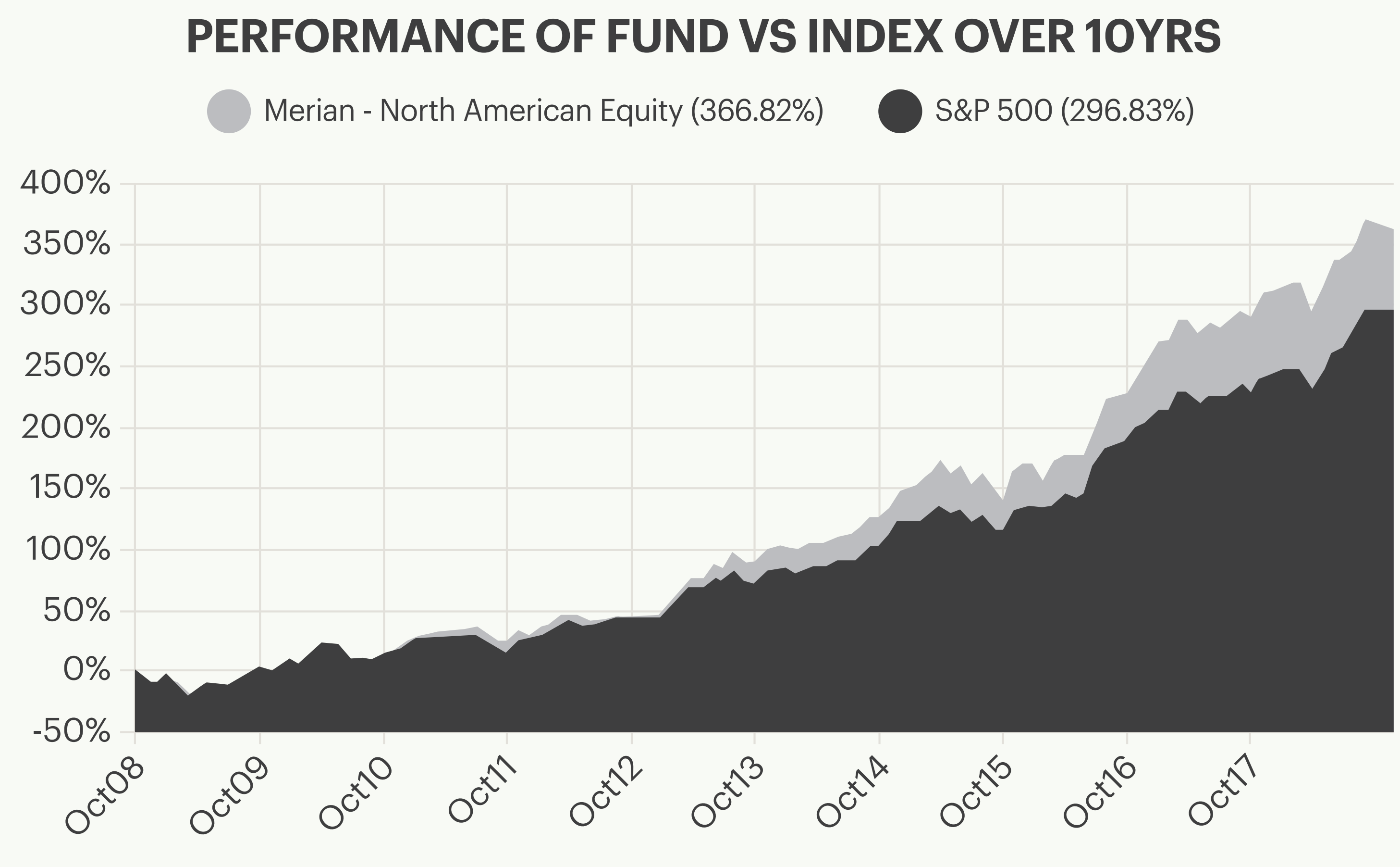
> **"We hear from almost every manager and across asset classes the same concerns surround the ability to trade in a market downturn/sell off"**

almost every manager and across asset classes the same concerns around the ability to trade in a market downturn/sell off. Yet while many managers have this fear, investors seem to be ignoring it."

For Metcalfe, one of the main problems is it has become "almost impossible" to accurately model liquidity risk, as the bull run has been accompanied by exponential growth in passives – meaning there has been no "rush for the door".

"There are no guarantees liquidity issues will be restricted to small caps, but any issues will likely be worse for them," he says. "Alongside these fears is the relative valuation argument and small caps look expensive relative to large cap peers and historically."

"We accept Trump's tax cut and attempts to reduce red tape are arguments to be buying small caps, but overall we don't think the investment case is currently made for us to re-enter the US small-cap space – especially at this point in the cycle."



Source: FE Analytics

The value option:
Dodge & Cox US Stock

While the core of Hughes' US exposure is to a passive product, he notes there are still some pockets of excellence in active management, which is why he holds Dodge & Cox US Stock. He adds that while Dodge & Cox is not well known in the UK, it is an old and well-established US manager. "This is a large cap strategy, but with a value bias as this is a style we want exposure to," he explains. "The manager is very long term, essentially being a bottom-up research house that looks for well-established businesses that can deliver earnings growth and cashflow."

The perfect blend:
Merian North American Equity

Ben Yearsley says the blend of styles is key to this Merian (formerly Old Mutual Global Investors) fund, which is run by Ian Heslop. "Heslop believes that the biggest risk comes from having too much style bias within a portfolio and that by having a blend you help reduce downside risk," he explains. "This fund is much more quant orientated, with five components to the process including company management and analyst sentiment. Stock bets are limited to +/- 1 per cent and the portfolio is clearly large- and mid-cap focused."

The passive pick:
Fidelity Index US

AJ Bell uses the Vanguard S&P 500 ETF in its passive MPS, but the £1.4bn Fidelity Index US fund in its active one. "The fund is very low cost with a strong record of tracking the index," says Hughes. "Fidelity works on a full replication basis, which is what we prefer to see from our passive solutions. We are broadly agnostic on fund structure and in this case, there is little to choose between Fidelity's fund structure versus an ETF."

Crunching the biggest trends down into figures

Index tracking: The facts

0

– number of Dutch active funds that beat the market in the five years to 2016

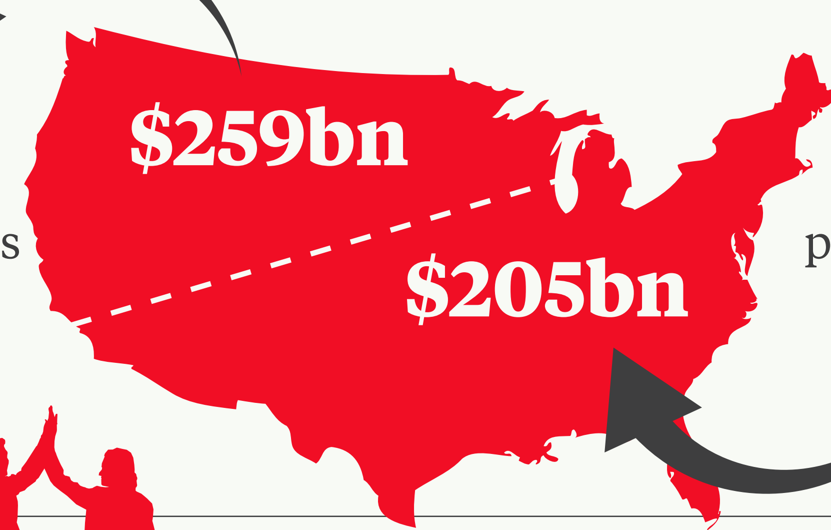
44

different types of fee may contribute to total fund charges figure

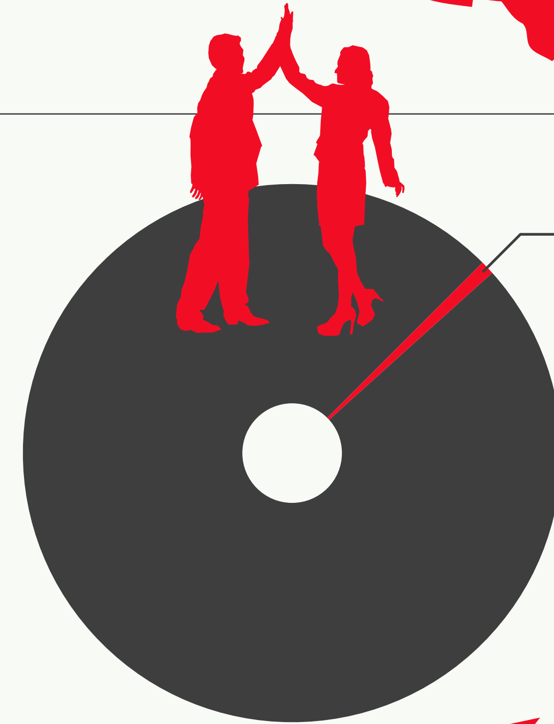
40%

of pension returns could be wiped out by paying **2%** a year in charges rather than **1%**

outflows from US active funds in 2008



inflows into US passive funds in 2008



1% of active managers beat the market over the long term on a risk- and cost-adjusted basis

5%

– total trading volume in markets accounted for by index investing

1.7%

of funds in the IA universe made top-quartile returns in each of the last three 12-month periods

The ongoing charges of the most expensive active fund in the IA North America sector are **58x** as much as the cheapest passive

Source: The Evidence-Based Investor; David Blake, Cass Business School; BMO Global Asset Management; Standard & Poor's; Ritholtz Wealth Management; Work & Pensions Committee; Vanguard; Bloomberg; FE

Often regarded as a way to make a quick buck, buying into IPOs can see you nursing significant losses if you don't do your research, writes AltRetire's **John Blowers**

Float like a butterfly/ stung like a bee

In India, investment platforms now ask you to complete a paper application form to open an account and there exists a veritable army of employees whose sole purpose is to move up and down the country collecting these documents from prospective investors. The application forms are around 60 pages long, which makes the online process in the UK look extremely efficient. Here, we can begin investing in around 10 minutes, whereas in India it can take up to a month.

Why? A few years back an Indian photographer, who specialised in passport photos, was found guilty of opening thousands of trading accounts (using the photos of his clients in his fake applications), so he could buy into a string of initial public offerings (IPOs). These flotations were limited to a certain amount of money per person, but the outcomes were always the same. Investors were doubling, trebling or even quadrupling their investments, such was the enthusiasm for these high-growth businesses in a high-growth economy.

The photographer was investing all the money he could lay his hands on and putting it through thousands of trading accounts, so he could multiply his gains. I believe he is still in jail and the regulator took such a dim view of this strategy it introduced draconian levels of due diligence and identity-checking surrounding the opening of online investment accounts.

If you see Sid...

There was money to be made from IPOs in the UK back in the 1980s as utility companies and nationalised businesses were privatised, and more recently in the dotcom boom when companies that promised to revolutionise entire industries came to market via a flotation.

The winners of the dotcom era have – and will continue to – change the world

We won't dwell on the dotcom crash, but although many of the investments in those companies came to nought, the winners have – and will continue to – change the world.

One of the UK's first platforms, Interactive Investor, floated on the London and Nasdaq markets in 2000, raising more than £70m. At one point it was trading at a valuation of more than $1bn, but it didn't last long and the shares plummeted along with the rest of the market. I remember it well. I worked there!

Enough nostalgia. Back to the here-and-now and it's happening again. Not only do platforms promote IPOs of all shapes and sizes, but they are starting to float themselves.

I wanted to clarify this foggy area in two ways. First, is investing in IPOs via a platform a good idea, and second, should I invest in a platform business itself at flotation?

There have already been two platform IPOs so far in 2018, while investment

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platform and SIPP administration business AJ Bell will also offer its shares to customers who have opened an account by 15 October.

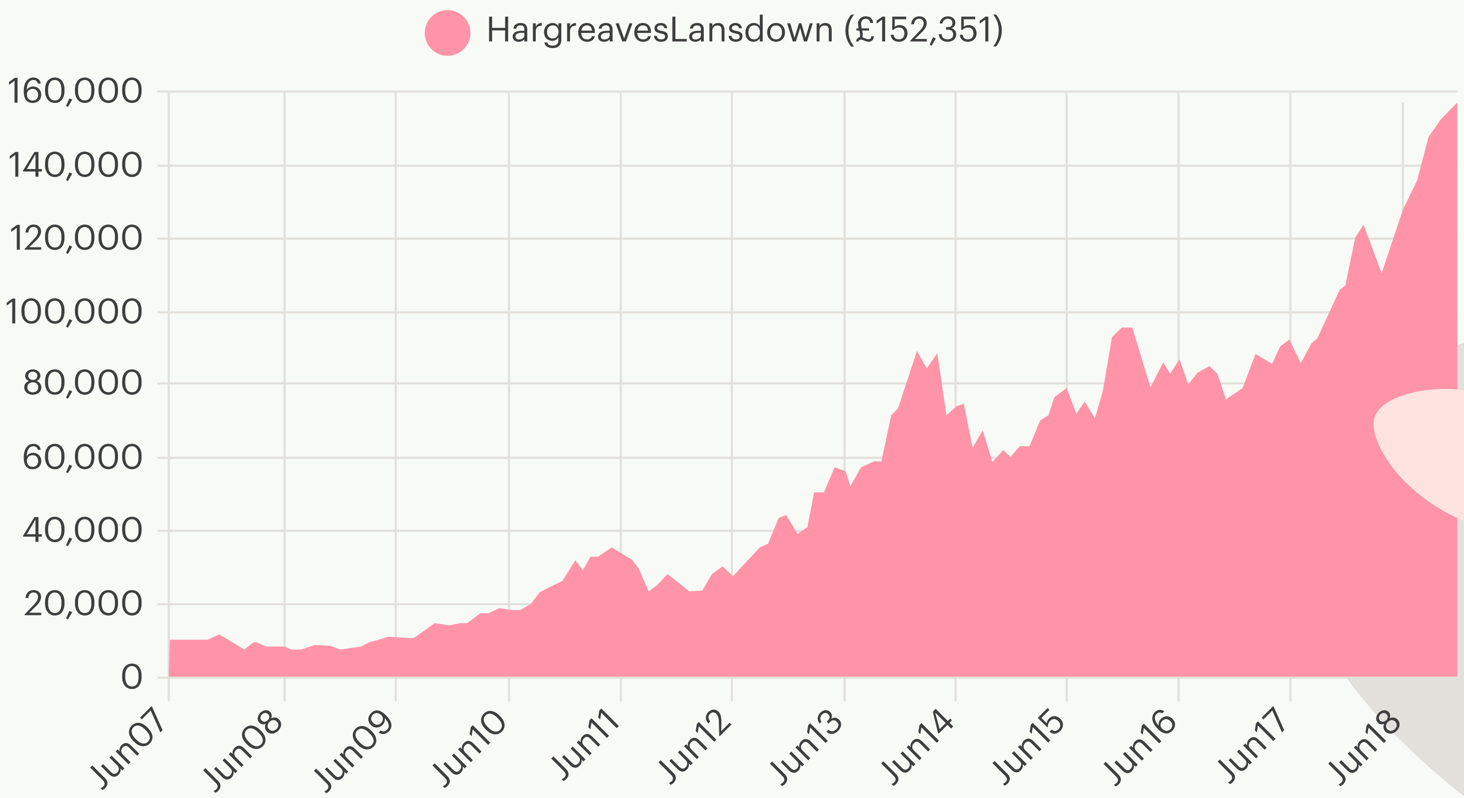
This raises the first point about IPOs. The City is a powerful place and one of the top-two destinations in the world to raise money via a flotation, with institutional investors tending to hog all of the shares in the most promising companies. Private investors rarely get a look-in as offering shares to this demographic adds an expensive layer of complexity. And why would you bother if the investment banks and pension funds can buy all the stock?

So, when an IPO comes along that private investors can participate in, surely there must be something wrong with this particular company? If the investment professionals don't want the stock, you have to ask yourself why?

If only it were that simple, because some companies want to encourage private investors as new shareholders, even though it's expensive and difficult to do.

Look at it this way: if all of a listed company's stock is held by institutions in large blocks, when one of these investors sells it can have a hugely detrimental impact on the share price. When lots of small private investors are buying

PERFORMANCE OF STOCK SINCE IPO



Source: FE Analytics

Another reason to invite private investors to participate in your share offering is to form a closer bond with customers

and selling a company's shares, it provides liquidity which typically has a beneficial effect on the share price.

Another reason to invite private investors to participate in your share offering is to form a closer bond with customers. Take investment platforms, for instance. They tend to have tens of thousands of customers who can be a pretty disloyal bunch, sensitive to service issues and price rises. But if I were a customer and a shareholder, I would certainly think twice about leaving a service that I had a commercial interest in.

This same rule applies across many other industries, with some companies offering shareholder perks to incentivise and align customers and shareholders.

What types of IPOs are offered on platforms?

In addition to the standard shares and funds available on investment platforms, many offer the chance to participate in retail IPOs. There are typically two different types.

- Investment trusts
- Government sales and high-profile flotations (for example Saga and one day, possibly, Lloyds Bank)

A quick whizz around the Hargreaves Lansdown, Interactive Investor, Charles Stanley Direct and AJ Bell websites demonstrates this pattern. There are half a dozen new investment trusts looking to raise money from the public (late September 2018), falling broadly into two categories. First, there are "standard issue" investment trusts,

I'm still of the view that paying someone to run a well-diversified and actively managed portfolio of shares in a fund seems to have the best outcome for most investors

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which are looking to invest in global equities, Japan and so on. Then there are the REITs, the property cousins of investment trusts, which tend to invest in building property, such as student accommodation, commercial property or social housing. These represent interesting opportunities to get in at the ground floor, where surely the only way is up?

Not quite. I recently put a slug of my own portfolio into two trust IPOs, Neil Woodford's Patient Capital Trust and Terry Smith's FEET (Fundsmith Emerging Equities Trust).

£152,351

Value now of £10,000 invested in Hargreaves Lansdown at IPO

While FEET is up around 5 per cent since launch in June 2014 (not terribly impressive given the stellar performance of Fundsmith Equity), Woodford is testing my patience with losses of around 20 per cent.

In Woodford's defence, he has left shareholders under no illusion he is investing for the long term in early stage businesses which, if they succeed, will do exceptionally well. This means we will just have to put up with some losses on the ones that will inevitably fail.

So, I'm hanging tight, but I wish that I had put my money in now rather than at the beginning, such is the power of hindsight.

Then there are the companies looking to grow to the next level. At present, Funding Circle is lining up an IPO and there are rumours of offerings from Compare The Market, 02, Jaguar Land Rover and Sky Betting & Gaming.

The question is, will any of these firms offer their shares to private investors through an IPO and will their value rise once they float?

Saga was one company I had high hopes for when I invested at its IPO back in 2014 and at one point it was flying. Now I'm nursing a 31 per cent loss.

In fact, all of my direct share investments, including investment trusts, are looking a bit sorry for themselves, down 7 per cent on average, compared with my fund portfolio, up nearly 37 per cent.

So, what's the answer?

Whether an investment is made at IPO or afterwards, the same rules apply. Do your research and analyse whether you believe the prospects of the company or trust are sound.

I still believe paying someone to run a well-diversified and actively managed portfolio of shares in a fund seems to have the best outcome, given my own experience, but I might change my tune over the longer term.

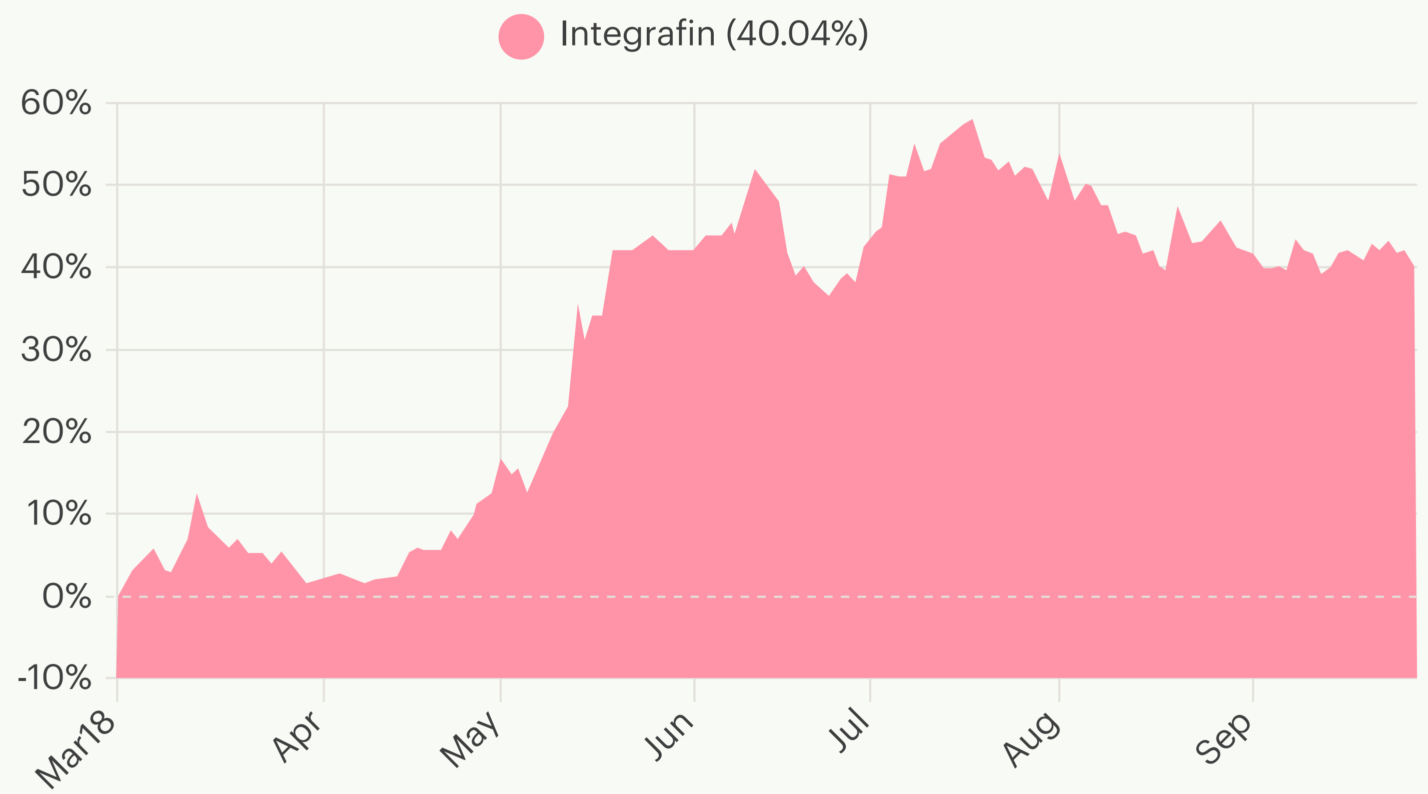
Investment platform IPOs

Which brings me on to the subject of investing in platforms. The original "Daddy" of platforms, Hargreaves Lansdown, floated in 2007 and was an instant hit. From a tiny fund-marketing business started in one of the founders' bedrooms in the 1980s, it is now valued at £10.71bn. If you'd invested £10,000 when it floated, you'd now have £152,351.

The two that have floated in 2018, Integrafin (Transact) and Nucleus, have got off to mixed starts. Integrafin is up 40 per cent since March, while Nucleus is down 26.76 per cent since July. AJ Bell, up next, is the biggest platform after Hargreaves to float.

There is no doubt this market is fast-growing and the scale players will do well. The question is, will AJ Bell make it to the heights that makes Hargreaves so valuable? ●

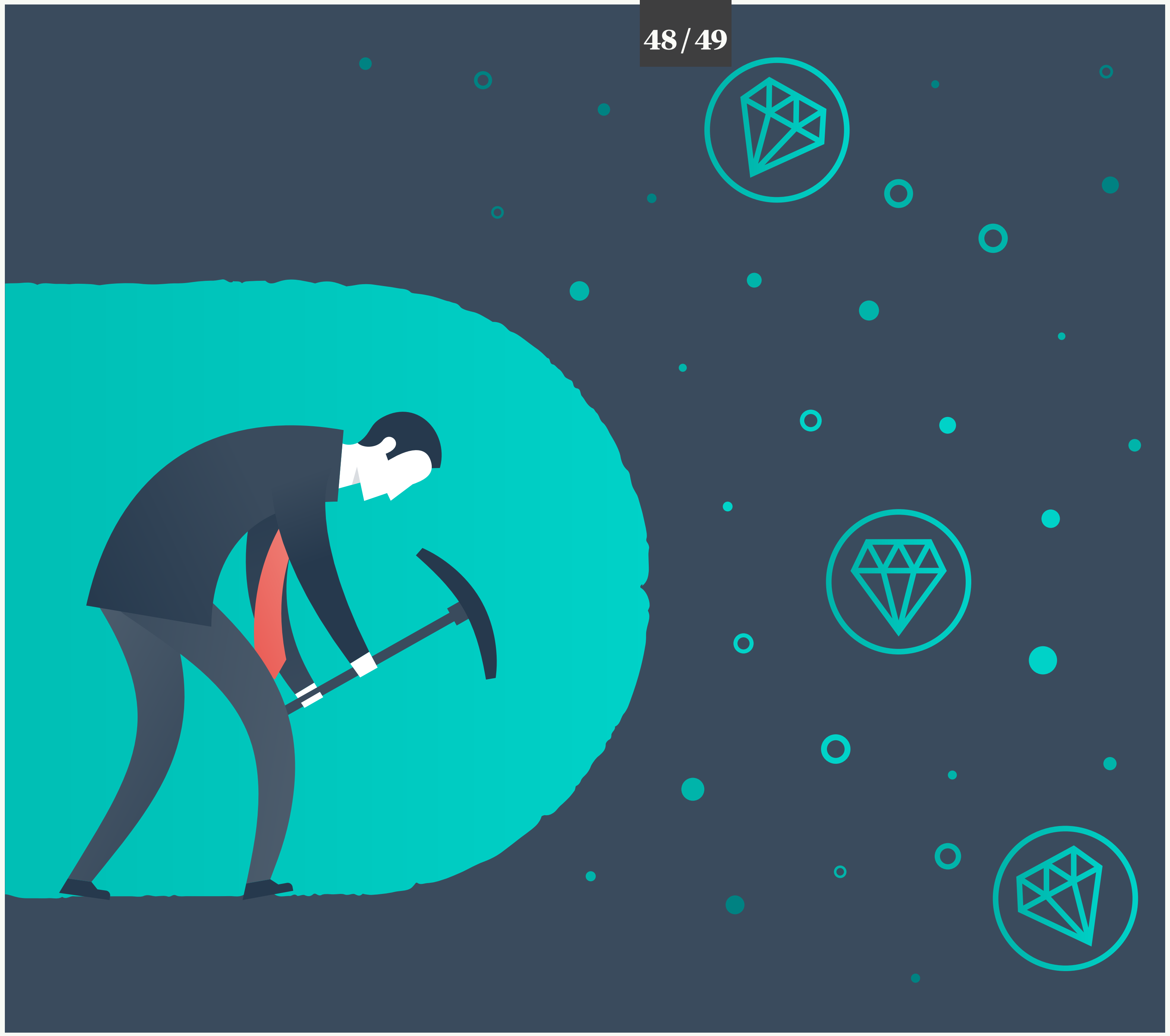
PERFORMANCE OF STOCK SINCE IPO



Source: FE Analytics

Richard Power, manager of the FP Octopus UK Micro Cap Growth fund, names three "hidden gems" that are under £50m in size

Under 50s



Although smaller companies have consistently outperformed over recent years, there are still hidden gems to be found

The AIM index has matured a lot over the past five years, with the average market cap now just over £100m. Today AIM remains a stockpicker's market, and although smaller companies have consistently outperformed over recent years, there are still hidden gems to be found. The team at Octopus scours the breadth of the market in search of earlier stage companies that have the potential to become substantially more valuable in time. Below are three under-the-radar investment opportunities that all have market caps of less than £50m, but which each offer exciting upside potential. ●

MyCelx Technologies

US-based MyCelx has developed technology that removes oil and hydrocarbons from water. Having navigated the downturn in the oil & gas sector, it is now seeing an increase in demand for its products. Sales last year were up 74 per cent to $13.8m, and first half figures to June 2018 were up 107 per cent, well ahead of expectations. The order book has expanded significantly and given the current momentum, further earnings upgrades are likely. A partnership with Schlumberger should provide another avenue of growth, from which MyCelx recently announced its first order. It is valued at £34.8m.

Angling Direct

Angling Direct is the UK's largest specialist in-store and online retailer of fishing tackle. The company already has 21 stores across the UK, however opportunities lie in the fragmented domestic market and online growth potential, where it has established a leading position: website revenues increased by 58 per cent last year and the company now exports to 40 countries. Angling Direct is expected to report a profit of £1.1m on revenues of £41.3m, an increase of over 35 per cent year-on-year, while margins should also expand as the company achieves further scale. Angling Direct is valued at £44.9m.

Mi-Pay Group

Mi-Pay is a real minnow and a great example of inefficient pricing among the smallest public companies. It provides mobile payment and fraud management services to Tier 1 mobile network operators and digital content providers, which typically sign up to long-term contracts. The company has also identified growth opportunities selling its fraud management solutions into other sectors. Revenues of just £3.4m are expected this year, however their recurring nature and the company's growth platform mean there is substantial upside from the current market cap of £4.5m.

Fairstone Group's **Oliver Stone** says this is one of the few funds that can back up its claim of taking a genuine long-term outlook

GAM Star Japan Equity

We like funds whose managers are committed to their own investment process and who are not afraid to back themselves

We have recently bought GAM Star Japan Equity, run by Ernst Glanzmann and Reiko Mito; a fund that exhibits many of the attributes we look for when allocating clients' capital.

Japan is an idiosyncratic market, requiring a deep knowledge of the country and its culture. It is somewhere we feel is still undervalued in relative terms, while still enjoying good technical support, particularly in the form of accommodative monetary policy.

We like funds whose managers are committed to their own investment process and who are not afraid to back themselves. Glanzmann and Mito run a highly concentrated, large-cap growth mandate, investing for the very long term in an equally weighted portfolio of between 20 and 30 stocks (23 at the time of writing).

Walking the walk

While many fund managers often talk of long holding periods or low turnover rates, few can point to evidence of this within their funds. However, the team on GAM Star Japan Equity have executed just 18 buy and sell transactions since their "Leaders" strategy launched in 2008, translating to a turnover of just 8 per cent a year and an average holding period of 12 years.

The eighth wonder

The investment process, developed by Glanzmann during his formative years, is highly disciplined and patient. The managers believe the key to long-term outperformance is holding high-quality companies over a long period of time and allowing their earnings to compound. After an initial screening process to isolate stocks with strong historic sales and profits growth, high returns on equity and a minimum of cyclicality, the managers make a 10-year financial forecast.

Given the potential for large margins of error with such a long timeframe, the managers must have faith that winning companies will be able to sustain their competitive advantage for longer than the market is pricing in. This follows a rigorous analysis of the underlying business model, involving examinations of pricing power, financial strength and management. A process such as this one can take years to mature before a position is initiated, but once complete, it becomes a supervisory exercise of business drivers and profits over time.

While the managers have only headed up the fund since 2015, they have implemented the strategy across other portfolios since 2008, delivering excellent absolute, relative and risk adjusted performance, with maximum drawdown particularly low relative to peers.

A safe pair of hands

We believe that given time, and in the right hands, this style of management can lead to outsized long-term returns for investors, and in this case we feel comfortable in aligning ourselves with the managers' vision. •

__Oliver Stone__ is group head of research and portfolio manager at Fairstone Group

FE Trustnet

magazine

November preview

Small is beautiful

After focusing on passive investing in this issue, the next edition of FE Trustnet Magazine will look at one part of the market where active managers have traditionally had the edge – small caps. While this has been the place to be in almost every region over the past decade, are investors in this area set for a nasty shock with the end of the cycle approaching? And can small caps still outperform over the long term anyway?