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INVESTMENT MANAGEMENT & STOCKBROKING

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Curiouser And Curiouser …

For most investors, these post-EU referendum weeks will be remembered as amongst the most contradictory and confounding periods in living memory. On 23rd June, financial markets were buoyant, with *Remain* the red-hot favourite at 7-1 *on* to win with the bookies at the market close. Less than 12 hours later it was clear that *Leave* had secured victory and the futures market covering the top 100 companies was indicating that the index would open almost 600 points lower, or 10%. Almost overnight, the world turned into an *Alice In Wonderland* realm of inverted reality where the best international football teams came from the smallest countries, Novak Djokovic priced at 150-1 *on* suddenly loses at Wimbledon and Boris Johnson pulls out of the running for PM. So, *Leave* wins, we await the 'bloodbath in the financial markets' and though off on the Friday, the FTSE-100 goes on to have a full week of gains and finishes the month up 4.4%, the highest point since last August.

Of course, there was damage and this was mainly felt on the European bourses, with Italy, France and Spain all suffering 10%+ falls on the day of the result, with banks hit particularly hard. Further afield, Japan fell by 9% on the news but this probably says more about sentiment in the region that it does about future Anglo-Japanese trading relations. Also, the UK small and mid-cap sector took a knock, partly due to the impact of weaker pound and heightened risk-aversion.

Generally, anything denominated in US dollars has fared well. In stock market terms, the S&P-500 was practically flat over the month, but when translated back into sterling it returned almost 10%. This also helped most Asian and emerging markets. The big winner has been gold, which was up 8.8% and boosted by dollar strength (AKA sterling weakness) this made for a near 17% return for UK investors over the month making a gain of 50% for the year.

The winners and losers since the vote across the UK market make for interesting reading. Gold miners and US-centric consumer staples businesses generally came out at the top of the list, as one might expect and in the days from the close on 23rd June to the close 30th June, the Mexican silver and gold producer Fresnillo Plc led the way, gaining 35.2%. According to Bloomberg, of the 15 analysts covering the company's shares on the day of the referendum, six recommended selling, two said 'buy' and the remaining seven had 'hold' ratings.

The biggest losers tended to be banks and housebuilders with Persimmon the largest faller, down 30.6%. Only two of the 19 analysts had sell ratings on the company before the vote and Taylor Wimpey (down 29.7%), covered by 18 analysts had a huge majority of 16 saying 'buy', 2 saying 'hold' and none at all saying 'sell'. Barclays (down 24%) also had no sellers, but 17 buyers and 9 holders.

One might conclude that following analysts' recommendations is therefore a waste of time and on this evidence it seems difficult not to. However, this would be a very short-term judgement … and since the writer trained as an analyst covering businesses such as BTR and Rentokil, with a propensity to come out with incredible surprises some 20 years ago, one is inclined to reserve judgment, for now at least. A very clear conclusion that can be made, however, is that following the herd can prevent you from making serious money, indeed it can be downright dangerous.

At present, the 'herd' seems to be saying the following: US dollar is king and consumer staples (food producers, tobacco) are safe havens along with gold and government debt. The evidence for this would be the fact that sterling is at a 31-year low and gold, having hit a six-year low in December, is now at a two year high. Unilever is on a price earnings ratio of 24.5x, which compares to a five-year average of 19.1x, a 28% premium. (The higher the price earnings number, the more 'expensive' the valuation; in other words investors are prepared to pay an increasingly higher price for a given level of earnings). Similarly, British American Tobacco is trading on 21.2x vs 17.7x, a 20% premium to its average. Government bond valuations are even more extreme.

At the time of writing, the 10-year UK government bond (conventional gilt) is trading such that it will provide a yield of just 0.7% each year to the investor, if held to redemption in 2026. The equivalent yield in the US is 1.4%, and despite its huge unemployment levels and dysfunctional political system, Spain is almost the same at 1.2%. Borderline bankrupt Portugal is 3.0%, down from 16% in 2012. Going further into *Wonderland*, German government 10-year debt yields -0.2%, Japan -0.3% and Switzerland is -0.7%. Yes, holding these assets *loses* money year on year, i.e. it makes more sense to put money under the mattress.

These yields are the lowest on record, or in other words, the most expensive in history. Buying any of the bonds relies on interest rates being cut further so that they can be sold on at a higher price later on. Some see this as the greater fool theory, but to be fair, it has worked perfectly well over the last few years. The only problem is that when rates look as though they may start to rise, yields will recover and prices will fall and it could be dramatic. Consequently gilts should come with a health warning, or as Alice wisely remembered, 'If you drink a bottle marked "poison", it is almost certain to disagree with you, sooner or later.'

The 'herd' running towards an asset class is good news if you're already there, but not if you're there and you realise the herd is running away. Of late, this has been most noticeable in UK property and the recent suspension of several funds deserves some explanation. This all boils down to the difference between open-end funds (unit trusts, OEICs) and closed-end funds (investment trust). (Click here for a short video on the subject.) The former are priced by dividing the net value of the assets (usually individual shares and bonds) by the number of units; the latter are priced based on supply and demand. Imagine that the net asset value of a small-cap biotech unit trust is fairly static but there is a sudden rush of buy orders, but no sellers. In this case, the fund may take the cash from the investor put it in the fund, buy more assets and issue more units. This satisfies demand without diluting existing holders. However, if there is a sudden rush of buy orders for an identical biotech investment trust, because the number of shares cannot be increased and assuming holders refuse to sell, the price will necessarily rise. The fund value will likely rise beyond the fund's underlying net asset value, or in industry-speak, 'trade at a premium'. In reality, this is quite common and many specialist investment trusts trade at a premium reflecting investor confidence in the manager's ability to make shrewd stock selections. HICL, a niche infrastructure fund, jumps to mind immediately currently trading at a whopping 18% premium to net asset value.

When there is a sudden rush out of a fund, the reverse applies for investment trusts and the price could fall below their net asset value, in which case the fund would be 'trading at a discount'. For unit trusts this may not be a problem if they can quickly sell down the fund's underlying holdings in order to satisfy the requirements of those wishing to sell. In this instance, they will then liquidate rather than create units. This is fine when the fund is comprised of large, liquid holdings such as BP or Vodafone, but what if the fund is invested in an office block? In order to satisfy redemptions, it could take months to get the proceeds from the sale of a property. This is the problem faced by the likes of Aviva Property Trust and M&G Property Fund. Indeed nearly every open-end property fund in the UK at the moment as Brexit worries have prompted one almighty race for the exit, creating a very disorderly market. As a result, these funds have been temporarily suspended in order to manage the assets and to take some of the heat out of the situation. This last occurred back in 2008 but the difference this time is that yields are healthy and capital values are below previous peaks. We believe that this is an emotional, short-term reaction and investors should not be concerned that this will prove materially damaging.

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It overstates the point to say that there has been a post-Brexit panic or hysteria, but we believe that there have been some localised over-reactions by investors and the suspension of the open-end UK property funds is symptomatic.

Delving into the closed-end, investment trust world, we find some funds now trading on unusually large discounts. The table below shows a list of investment trusts, comparing their current discount to their five-year average premium or discount. (A negative indicates a discount.) The difference is effectively a signal by the market of a shortage of demand for the shares. This could be due to a lack of confidence in the manger, but could be due to large holders needing to liquidate. Whatever the reason, the discounts are at historically stretched levels and if one believes in reversion to the mean, there could be some meaningful gains to be made.

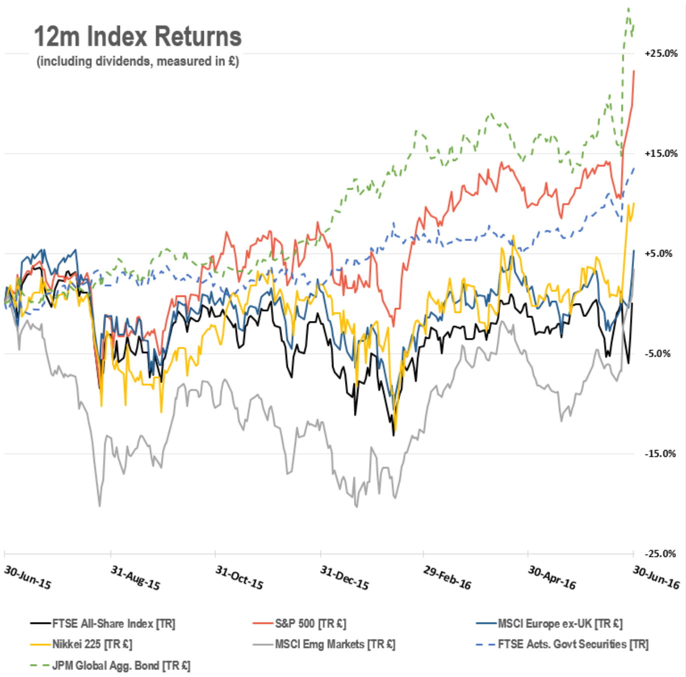
This list should not be treated as investment advice. Some could be at discounts for good reason that may not be immediately obvious, but it will be interesting to come back in 12 months to see the results. By then we will have some perspective and although there is scope for the world to look very different, one wonders how different things will actually feel. It remains to be seen whether or not Brexit actually occurs and it is plausible that a negotiated compromise takes place.

In the years since Lewis Carroll published *Alice's Adventures in Wonderland* (1865) and *Alice Through The Looking Glass* (1871) academics have been searching for hidden meaning and philosophical teachings in the books. At the end of both books, the dream is broken and the reader is left with the knowledge that despite all the excitement, nothing has actually changed. Could this in fact be the main lesson to be learnt?

Asset Class Focus	Investment Focus	Current Premium or Discount	2 Year Average Premium or Discount	Difference
Property	UK Property	-20.0%	-3.0%	-16.9%
Equities	Euro ex-UK	-12.5%	-0.3%	-12.2%
Equities	Euro ex-UK Small Cap	-20.7%	-9.7%	-11.0%
Equities	Global Technology	-13.8%	-3.3%	-10.5%
Equities	Global Utilities	-11.5%	-1.1%	-10.4%
Equities	Global Large Cap	-6.5%	3.9%	-10.4%
Fixed Income	Convertible Securities	-11.9%	-1.5%	-10.4%
Property	UK Property	-3.4%	5.3%	-8.7%
Equities	Global	-10.2%	-2.0%	-8.2%
Equities	UK Small Cap	-15.9%	-8.0%	-7.9%
Equities	UK Small/Mid Cap	-16.4%	-8.6%	-7.8%
Equities	Global Small/Mid Cap	-14.9%	-7.7%	-7.2%
Equities	Asia ex-Jap Small Cap	-15.4%	-9.0%	-6.4%
Equities	Emerging Markets	-1.2%	4.9%	-6.1%
Equities	UK Small/Mid Cap	-19.6%	-13.6%	-6.0%
Equities	Global Financials	-13.0%	-7.4%	-5.6%
Private Equity	PE Fund of Funds	-25.3%	-19.8%	-5.5%
Equities	UK Small Cap	-23.8%	-18.3%	-5.4%
Equities	UK Small/Micro Cap	-16.7%	-11.6%	-5.1%
Fixed Income	Corporate Bonds	-1.6%	2.8%	-4.4%
Equities	Global Equities	-3.5%	0.8%	-4.4%

Index Returns

Index	Region/Asset Class	30-Jun-16	Monthly Change	1 Yr Change	2 Yr Change
UK 100	UK	6504.33	4.4%	-0.3%	-3.6%
UK Mid Cap	UK	481.31	-3.8%	-4.9%	4.4%
UK Small Cap	UK	4471.55	-2.7%	-4.4%	0.7%
Dow Jones Ind Avg	USA	17929.99	0.8%	1.8%	6.6%
S&P 500 Index	USA	2098.86	0.1%	1.7%	7.1%
NASDAQ Comp.	USA	4842.67	-2.1%	-2.9%	9.9%
Nikkei 225	Japan	15575.92	-9.6%	-23.0%	2.7%
Euro Stoxx 50	Europe	2864.74	-6.5%	-16.3%	-11.3%
CAC 40 Index	France	4237.48	-6.0%	-11.5%	-4.2%
DAX Index	Germany	9680.09	-5.7%	-11.6%	-1.6%
MIB Index	Italy	16197.78	-10.1%	-27.9%	-23.9%
MSCI Emg Mkts (£)	Emg Mkts	406.23	13.2%	3.5%	6.7%
IBOVESPA Index	Brazil	51526.93	6.3%	-2.9%	-3.1%
MICEX Index	Russia	1891.09	-0.4%	14.3%	28.1%
S&P BSE SENSEX	India	26999.72	1.2%	-2.8%	6.2%
Shanghai SE Comp.	China	2929.61	0.4%	-31.5%	43.0%
Hang Seng	Hong Kong	20794.37	-0.1%	-20.8%	-10.3%
UK All Property	UK Property	6474.86	-2.4%	2.9%	17.5%
UK Govt Secs	UK Gilts	3566.56	5.6%	13.5%	23.5%
JPM Glob Agg. Bond	Global Bonds	798.47	12.0%	28.1%	30.8%
WTI Crude	Oil	48.33	-1.6%	-18.7%	-54.1%
Gold Spot $/OZ	Commodities	1322.20	8.8%	12.8%	-0.4%
£1 = US$	Currencies	1.33	-8.1%	-15.3%	-22.2%
£1 = €	Currencies	1.20	-7.9%	-15.0%	-4.1%
£1 = Yen	Currencies	137.37	-14.3%	-28.6%	-20.7%



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