STOCKS | FUNDS | INVESTMENT TRUSTS | PENSIONS AND SAVINGS

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SHARES

WE MAKE INVESTING EASIER

THE BULL MARKET IS BACK

WHY STOCKS HAVE REBOUNDED 20% FROM RECENT LOWS

SECTOR REPORT

Everything you need to know about investing in the rail industry

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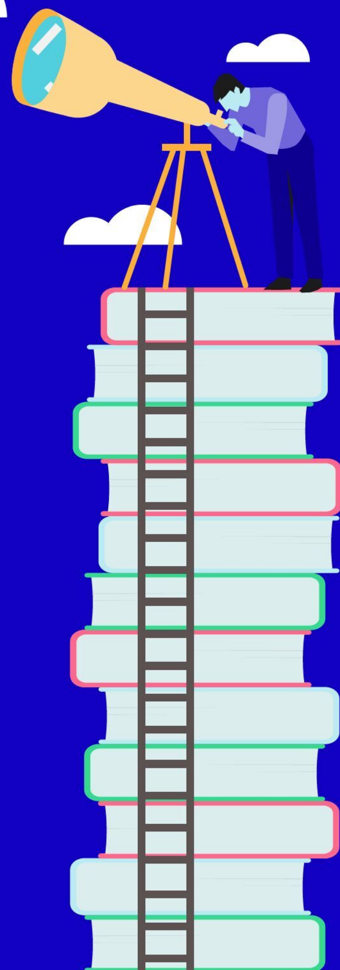
Discrete Performance*	Q4 2017 Q4 2018	Q4 2018 Q4 2019	Q4 2019 Q4 2020	Q4 2020 Q4 2021	Q4 2021 Q4 2022
Share price	-8.1%	22.1%	2.7%	11.9%	-9.8%
Net Asset Value**	-8.4%	21.3%	4.2%	15.8%	-10.2%
Benchmark#	-6.6%	20.1%	9.5%	19.9%	-6.2%

This financial promotion was approved by Witan Investment Services Ltd FRN: 446227 on 13 February 2023. Please note that past performance is not a guide to future performance. Witan Investment Trust is an equity investment. The value of an investment and the income from it can fall as well as rise as a result of currency and market fluctuation and you may not get back the amount originally invested.

*Source: Morningstar/Witan. Total return includes the national investment of dividends. ** The Net Asset Value figures value debt at fair value. # Witan's benchmark is a composite of 85% Global (MSCI All Country World Index) and 15% UK (MSCI UK IMI Index). From 01.01.2017 to 31.12.2019 the benchmark was 30% UK, 25% North America, 20% Asia Pacific, 20% Europe (ex UK), 5% Emerging Markets.



Contents

05 **NEWS**

- Cost of UK mortgages breaches 6% while June house prices fall for the first time in five years
- Why Vodafone's marriage of convenience with Three leaves questions hanging
- Unfavourable exchange rates leave many Japan fund investors lagging Japanese stock rally
- Shares in this US restaurant business more than doubled on its stock market debut
- Motorpoint shares slump as profit wiped out amid a multitude of factors

11 **GREAT IDEAS** — **New:** Oxford Instruments / Impax Environmental Markets
Updates: Midwich / Halma

15 **EDITOR'S VIEW** — Confused why unloved shares are rising in value? Could be a short squeeze

19 **FEATURE** — Standard Chartered: will it receive a new bid or ditch the UK stock market?

22 **FEATURE** — The bull market is back

29 **UNDER THE BONNET** — Dowlais shares worth buying after demerger from careful owner Melrose

33 **FUNDS** — Decent dividend yield and cheap shares: this fund has it all

38 **FEATURE** — The prospect of higher interest rates could create a scramble for income

40 **DANNI HEWSON** — Is consumer resilience under threat as rates keep climbing?

42 **SECTOR REPORT** — All aboard! How to invest in the rail sector and the stocks to watch

47 **ASK TOM** — Are there any benefits to delaying taking the state pension?

49 **PERSONAL FINANCE** — Cash savings account: should I go for a fixed or variable rate?

52 **INDEX** — Shares, funds, ETFs and investment trusts in this issue

Three important things in this week's magazine

1

Sector Report: How to invest in the rail sector

All aboard! How to invest in the rail sector and the stocks to watch

Some stocks in the rail sector have delivered double-digit compound annual returns over the past 10 years

US freight rail companies stand out from the pack in our review of investment opportunities in the industry

2

Feature: Standard Chartered

Standard Chartered: will it receive a new bid or ditch the UK stock market?

Discover why sentiment might soon change toward the bank

Might Standard Chartered be the next company on the UK stock market to look overseas for its share listing?

Ian Conway explores reasons why the bank could get a much higher valuation elsewhere or even a firm takeover bid in the future

3

THE BULL MARKET IS BACK

WHY STOCKS HAVE REBOUNDED 20% FROM RECENT LOWS

The bull market is back: nine markets have seen a 20%+ rally from recent lows

The US, Germany, France and Japan are among the locations where share prices are doing well

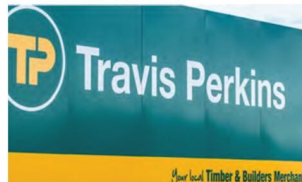
Visit our website for more articles

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

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

Why Goldman Sachs sees a healthier future for Weight Watchers

Canadian car dealer grabs the keys to Lookers in bumper £465 million buyout



Travis Perkins profit warning triggers sell-off in housebuilders, building materials groups and builders' merchants

Somero share price flattened as cyclical construction curse strikes again

Cost of UK mortgages breaches 6% while June house prices fall for the first time in five years

Despite seeing 12 base rate rises in the last year and a half to 4.5%, analysts expect more pain

The outlook for UK house buyers is about to get tougher after the average cost of two-year fixed mortgages crept back above 6% this week, according to data group Moneyfacts.

It is the highest level since last December in the wake of the disastrous mini-Budget last autumn when two-year fixed rates reached 6.65%.

It is not just buyers who are suffering. The Resolution Foundation, a think tank, estimates around three-fifths of the increase seen in annual mortgage payments has yet to be felt by households as they remain on older, lower-cost deals.

Around 7.5 million households are expected to see an increase in annual mortgage costs by 2026 according to the think tank. Ultimately, it predicts annual interest payments could tot up to £15.8 billion more than before the Bank of England started raising interest rates in December 2021.

Lenders have been busily increasing the cost of mortgages in recent weeks to reflect rising interest rate expectations. Two-year gilt yields are up more than 60% since March, rising from around 3.1% to 5% as investors price in the likelihood of further rate hikes from the Bank of England.

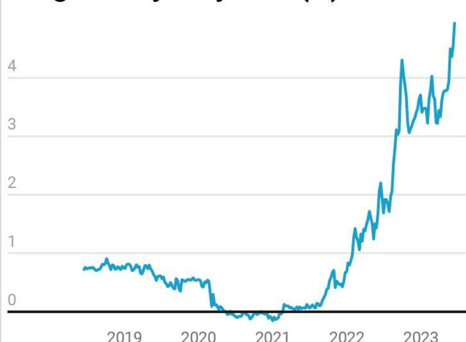


Chart: Shares magazine • Source: Refinitiv

Upside surprises to services inflation and private sector wage growth heap more pressure on the Bank of England to continue hiking rates when it meets this week (22 June).

Economists at forecasting group EY ITEM Club believe the Bank will hike rates by another quarter of a percentage point to 4.75% but suggest expectations of rates peaking at close to 6% is too pessimistic.

Chief economic advisor Martin Beck said: 'Recent surveys from the Bank of England and Citi/YouGov show inflation expectations among the public continuing to decline. The Bank of England's own Decision Maker Panel survey of businesses also suggested pay and price expectations have eased in recent months.'

The lagged effect of past rate hikes and damage inflicted by food inflation running close to 20% is already impacting consumer confidence.

On 16 June, builders' merchant **Travis Perkins (TPK)** issued a profit warning after blaming higher interest rates and sticky inflation on flagging consumer confidence.

Meanwhile, the Rightmove house price index showed its first fall in June since 2018 after the average UK asking price nudged down to £372,812. While buyer demand held up during the month and was 6% higher than June 2019 before the pandemic, the number of agreed sales dipped and remained 6% below 2019 levels.

Credit ratings group Moody's believes UK house prices could fall 10% over the next two years while a bigger drop would likely trigger a lengthy recession. [MG]

Why Vodafone's marriage of convenience with Three leaves questions hanging

UK regulator Ofcom will take a hard look at the proposal and the outcome could hang on a knife-edge

More than eight months since first mooting a possible tie-up, **Vodafone (VOD)** has confirmed plans to merge its UK operations with Three's UK arm.

If the proposed deal completes, it will create a UK mobile business on a par with rivals EE and Virgin Mobile/O2 in terms of subscribers, although still smaller in terms of revenue.

WHY DOES VODAFONE WANT THE TIE-UP?

Greater scale will allow the merged business to make the significant investment in next generation mobile network infrastructure to create what it believes will be a 'best in class' 5G network. This would cover 99% of the UK population by 2034, with average data speeds six-times faster than today and double the standalone capacity.

Vodafone has placed emphasis on its plans to invest £11 billion in 5G roll-out, with Ahmed Essam, Vodafone's UK chief, telling a media briefing that the 'case for the deal (to the regulator) stands on strong grounds'.

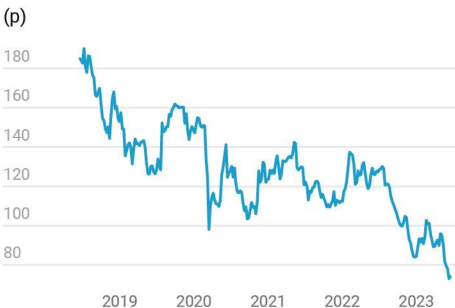


Chart: Shares magazine • Source: Refinitiv

Vodafone and Three say a combined business would introduce more mobile virtual network operator competition, where third parties buy bulk capacity to resell to customers, as **Tesco (TSCO)** does through its Tesco Mobile offering. This market is currently 90% in the hands of BT/EE and VM/O2, according to Megabuyte analyst Philip Carse.

Crucially, the proposed merger could have a huge impact on the pair's return on capital dynamics, which has previously irked investors. A deal 'clearly makes sense for both companies given their evident no/low cash flow returns,' says Carse.

MIGHT REGULATORS BLOCK THE DEAL?

This remains the key question. Communications watchdogs have previously been against consolidation in the European mobile space because of the potential impact on consumer choice. In 2015, EU competition authorities blocked O2 and Three UK joining forces, although this ruling was overturned in May 2020, obviously too late for that proposal.

Now, theoretically free of Eurozone intervention, the decision will be left to UK regulator Ofcom, which has been making more supportive noises about industry consolidation. The Vodafone/Three proposal is likely to be judged on its impact rather than a simple numbers/market share game.

IMPACT FOR VODAFONE INVESTORS

The agreement is complex, involving debt implications, various call and put options, that will allow Vodafone to buy Three UK's stake from parent Hutchinson after three years, assuming a minimum enterprise valuation of £16.5 billion. Vodafone will initially own a 51% stake in the merged UK operation, Three the remaining 49%.

Vodafone hopes to conclude the tie-up by the end of 2024, while new chief executive Margherita Della Valle says there will be no change to the company's dividend policy. However, integration could be a long and expensive process, which could alter shareholder payouts in future. [SF]

Unfavourable exchange rates leave many Japan fund investors lagging Japanese stock rally

The Nikkei 225 hitting a three-decade high hasn't necessarily made UK investors rich

Japanese stocks got their latest seal of approval from Warren Buffett as the legendary investor added to his holdings in Japan's five largest trading houses. Akin to conglomerates, these 'sōgō shōsha' trade in a wide range of products and materials.

Buffett has been rewarded for his faith in Japan's stock market, even if he says these investments are for the long-term and not just to make a quick buck.

The country's flagship Nikkei 225 index reached a three-decade high on 16 June as the Bank of Japan persisted with its loose policy setting – running counter to the approach taken by other central banks. There has subsequently been some profit taking but the Nikkei still remains among the best performing indices worldwide so far in 2023.

M&G Investments' Fabiana Fedeli says: 'Within developed economies, Japan remains one of our favourite markets. We have found a number of companies that are improving operational leverage with a positive impact on earnings growth, alongside increasing shareholder returns via raising dividends and share buybacks, even without the support of the macroeconomic backdrop.

'However, less well recognised in our view, alongside this culture of self-help and corporate reform, is the prospect of wage growth boosting consumption, providing a further potential tailwind for growth in the years ahead.'

Fedeli says that despite recent market strength, Japanese equities remain 'underappreciated' – though she does acknowledge currency as a factor for investors.

After all, a weak yen may be boosting Japanese exports and providing a tailwind for the country's stock market but it is making it difficult for UK investors to fully participate in the rally.

In sterling terms, the Nikkei has delivered a return of just 12% compared with 27% in yen terms. So even the mainstream index trackers and exchange-traded funds tracking the index have underperformed, if priced in sterling.

The table shows the performance of various Japan-focused funds and investment trusts priced in sterling and only one has managed to beat the yen performance of the Nikkei 225, being **Nippon Active Value Fund (NAVF)** with a 28% return year-to-date.

A currency hedged tracker, like **UBS MSCI Japan UCITS ETF (hedged to GBP) (UB02)**, which looks to balance out foreign exchange moves, would have allowed you to better participate in Japan's rally. It has returned 26% year-to-date. [TS]

A selection of Japan-focused funds and trusts

Fund/trust	Year-to-date performance (%)
Nippon Active Value Fund	28
Abrdn Japanese Investment Trust	20
CC Japan Growth & Income Trust	19
Schroder Japan Trust	13
M&G Japan	11
Fidelity Index Japan	11
CT Japan	11
JP Morgan Japanese Investment Trust	11
Fidelity Japanese Values	9
HSBC Japan Index Trust	9
Nikkei 225 (priced in yen)	27
Nikkei 225 (priced in sterling)	12

Table: Shares magazine • Source: FE Analytics, data to 19 June 2023. Total return in GBP

Shares in this US restaurant business more than doubled on its stock market debut

Investors have raced to own a slice of Cava even though the business is loss-making

Mediterranean restaurant chain **Cava (CAVA:NYSE)** made an explosive stock market debut on 16 June in New York, pushing its valuation beyond $4 billion.

The company priced its IPO (initial public offering) at $22 per share, above the expected range of $19 to $20. The shares then started trading at more than double the IPO price at $40.83, extending to a high of $45.25 a few hours later.

Cava in the long run is hoping to steal market share from US burrito chain **Chipotle Mexican Grill (CMG:NYSE)**. It makes Greek-inspired dishes using hummus, pitta wraps, rice bowls, grains and salad.

Founded in 2006, the restaurant reinvented itself as a fast-food chain in 2011 and spread across the East and West coasts of America. In 2018, Cava bought Zoës Kitchen, a rival Mediterranean chain, for $300 million. As of 16 April 2023, Cava has 263 restaurants.

Cava raised $318 million of new money at the IPO to fund new sites and for general corporate purposes.

It achieved 52% compound annual growth in revenue between 2016 and 2022 but the company remains loss-making. [SG]

Motorpoint shares slump as profit wiped out amid a multitude of factors

The spike in interest rates has caused negative issues at the second-hand car seller

Shares in second-hand car seller **Motorpoint (MOTR)** have fallen over 30% in the past six months to trade around the 102p mark – a far cry from the 385p level at which it traded just two years ago.

On 14 June, Motorpoint reported a pre-tax loss for the year ending 31 March 2023 of £0.3 million compared to a pre-tax profit of £21.5 million in the previous year.

Although its share of the nearly-new car market increased to 3.5% from 3.1% a year earlier, and its e-commerce revenue grew 5.7% to £660 million, the company said 'the UK's difficult macroeconomic conditions' had a 'knock-on effect' for the used car market, and the company's profitability.

The hikes in UK interest rates translated to lower finance commissions as affordability became more of an issue for customers, and they also resulted in a doubling of interest expenses to £7.1 million for Motorpoint.

The company also blamed the loss-making year on a decline in electric vehicle prices.

Analysts at Numis cut Motorpoint's earnings forecast for 2024 from a £2 million profit to a £3 million loss. [SG]

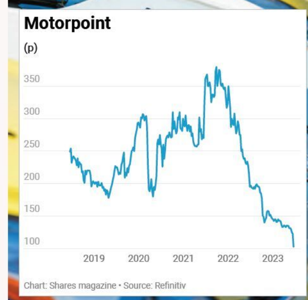


Chart: Shares magazine • Source: Refinitiv

UK UPDATES OVER THE NEXT 7 DAYS

FULL-YEAR RESULTS
June 26: SysGroup, Prospex Energy
June 27: CML Microsystems, Telecom Plus
June 28: SDCL Energy Efficiency Income Trust
June 29: Baltic Classifieds, Moonpig, De La Rue

TRADING ANNOUNCEMENTS
June 26: Associated British Foods. Fresnillo
June 27: Forward Partners Group
June 29: Time Finance

HALF-YEAR RESULTS
June 28: Schroder European Real Estate Investment Trust, Abrdn Private Equity Opportunities Trust, Harmony Energy Income Trust

Can Primark-owner Associated British Foods continue to beat the squeeze?

The diversified conglomerate has shown resilience in the face of the cost-of-living crisis, but its customers are feeling the pinch

FTSE 100 foods-to-fashion conglomerate **Associated British Foods (ABF)** updates on trading on 26 June, where investors will look for comment on the state of the consumer and (hopefully abating) cost pressures across its retail and food businesses.

Back in April, the conglomerate behind the Primark cut-price fashion chain and grocery brands ranging from Twinings and Ovaltine to Patak's, Kingsmill and Jordans reported a respectable first half performance. Group sales for the six months to 4 March 2023 were up 21% to £9.56 billion thanks to strong demand in both the food and retail divisions.

Food sales fattened up 23% to £5.33 billion, with the ingredients business performing 'exceptionally' well, according to the business, while Primark sales were up 19% to £4.23 billion driven by higher footfall, higher prices and higher volumes.

Associated British Foods in numbers

Year	Sales (£bn)	EPS (p)
2021 (A)	13.9	71.8
2022 (A)	17.0	126.0
2023 (F)	19.6	131.0
2024 (F)	20.4	150.0

Table: Shares magazine • Source: Stockopedia. EPS = earnings per share. A = actual, F= forecast

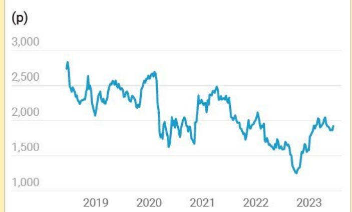


Chart: Shares magazine • Source: Refinitiv

However, investors were spooked by CEO George Weston's caution over the risks of an economic downturn and the effect that could have on consumer spending. Household budgets continue to face real pressures as a result of high inflation, increased interest rates and general economic uncertainty, putting the squeeze on the disposable incomes of the typical Primark customer.

While Weston and co expect Primark to deliver like-for-like sales growth in the second half, that growth is expected to moderate versus the first-half period.

On 19 June, clothing and home retailer **Next (NXT)** reported better than expected trading over the previous seven weeks, saying the warmer weather made a big difference to its performance. Associated British Foods shareholders will be hoping that Primark also experienced the same trend. [JC]

Nike expected to show earnings weakness at fourth quarter results

Supply chain costs and excess stock expected to be in focus

Sportswear giant **Nike (NKE:NYSE)** is scheduled to report its fourth-quarter earnings on 29 June and investors will be looking for evidence that problems reported earlier in the year are being ironed out.

Nike's margins might have been hit by trying to get rid of excess stock by offering steeper discounts towards the end of the fiscal year.

Although Nike reported a 14% increase in the group revenues in the third quarter, the firm was knocked back by unfavourable changes in foreign exchange rates and rising costs of moving goods around the world.

In the company's third quarter results conference call, chief financial officer Matthew Friend said: 'We expect fiscal 2023 gross margin to decline approximately 250 basis points at the low end of our previous guidance range. This reflects ongoing and accelerated actions to reduce inventory by year-end, elevated freight and logistics expenses, including higher supply chain network costs in North America, and 100 basis points of foreign exchange headwinds.'

The consensus forecast is for $12.57 billion of revenue in the fourth quarter, up from $12.39 billion in the previous three months. Pre-tax profit is expected to slip to $1.25 billion against $1.48 a quarter earlier. Earnings per share is estimated at $0.67 versus $0.79 in Q3. [SG]

Nike

($)

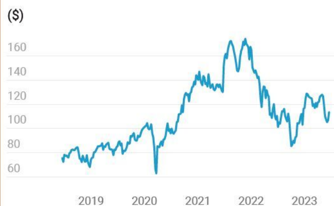


Chart: Shares magazine • Source: Refinitiv

What to expect from Nike's results

	Q4	Full-year
Revenue ($bn)	12.57	50.98
Pre-tax profit ($bn)	1.25	6.21
Earnings per share ($)	0.67	3.23
Dividend per share ($)	0.35	1.27

Table: Shares magazine • Source: Refinitiv

US UPDATES OVER THE NEXT 7 DAYS

QUARTERLY RESULTS

June 23: CarMax
June 26: Jefferies Financial, Ennis
June 27: Walgreens Boots, Roivant Sciences, Progress, Novagold

June 28: Micron, General Mills, National Beverage, Unifirst, Worthington Industries, Schnitzer, Virtus Equity
June 29: Nike, Paychex, McCormick & Co, Acuity Brands, Simply Good Foods, Lindsay, Smart Global

Buy Oxford Instruments: a company making big money from focusing on small things

The science kit maker has made improvements behind the scenes and is firing on all cylinders

OXFORD INSTRUMENTS (OXIG)
Price: £26.83 **Market cap:** £1.54 billion

Oxford Instruments' (OXIG) shares have typically traded above 20 times earnings over the last 10 years – a premium rating, but plenty of investors have regretted not buying them over the years.

It has delivered a total return upwards of 100% over that period and the company is becoming an even more high-quality business capable of generating yet more impressive returns.

Earnings forecasts have consistently been upgraded throughout the last 12 months and we see scope for that trend to continue, providing catalysts for further share price strength.

Oxford Instruments is one of those excellent UK industrial companies which flies under the radar but does something smart which enables it to generate strong margins. The company develops tools and technologies which facilitate nanotechnology research and industrial instrumentation. Put simply, its kit allows companies to measure, make and manipulate really small stuff.

Its end markets include life sciences, compound semiconductors, advanced materials and quantum technology. These chime nicely with themes like energy transition, healthcare technology and artificial intelligence which could dominate the next decade or more.

Oxford Instruments is in the middle of a restructuring to push its margins higher. This has included improving efficiency in the supply chain and becoming more focused on the wants and needs of its client base.

Evidence of the company's robust profitability can be seen in the results to 31 March 2023. Operating margins were maintained at 18.1% despite wider inflationary pressures. The portents for future demand look good too with order growth up 20.9% in the period.

The company has three divisions. Materials & Characterisation specialises in products which enable the fabrication and characterisation of materials and devices down to the atomic scale – covering everything from research and development support to the production of devices.

Research & Discovery helps customers carrying out scientific research to do imaging and analytical measurements down to the molecular and atomic level. Service & Healthcare is the part of the business which provides the customer service and support underpinning its products.

China has been the fly in the ointment in recent updates from the company, having been hit by export licence rejections in the country. It has responded by shifting focus to less 'politically sensitive' areas like healthcare and materials rather than semiconductors and quantum technology.

Oxford Instruments generates plenty of cash and has a little more than £100 million of net cash on the balance sheet. This provides the company with the firepower to invest in the business as well as allowing it to augment organic growth with bolt-on acquisitions. [TS]

Oxford Instruments

Chart: Shares magazine • Source: Refinitiv

How investors can clean up with Impax Environmental Markets

Excitement around all things ESG may have died down but the growth drivers are only getting stronger

IMPAX ENVIRONMENTAL MARKETS
(IEM) Price: 408p Market cap: £1.2 billion

Inflation and rising interest rates have created a tougher backdrop for higher growth companies including those operating in environmental markets, yet the investment case for businesses trying to make the world a better, cleaner place is only strengthening.

Drivers include the policy push towards net-zero emissions and actions to address energy security issues. One way to gain exposure to the ESG theme is **Impax Environmental Markets (IEM)**, the investment trust managed by Impax Asset Management.

Having historically traded at a premium to the value of its assets, a rare 4.3% share price discount presents an attractive entry point in a fund that has delivered 10-year compound annual returns of 12.7% and levies competitive fees of 0.81%.

Impax Environmental Markets seeks to generate long-term capital growth by investing in global small and mid-cap companies providing solutions to the world's environmental problems, particularly clean energy and energy efficiency, water treatment and pollution control, waste technology and resource management, including sustainable food, agriculture and forestry.

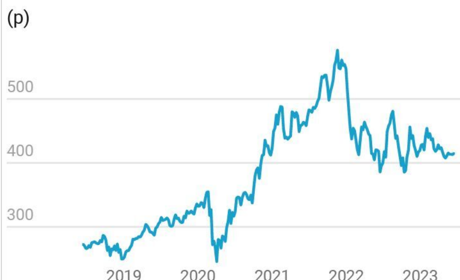


Chart: Shares magazine • Source: Refinitiv

Managers Bruce Jenkyn-Jones, Jon Forster and Fotis Chatzimichalakis believe that companies offering solutions to sustainability challenges will tend to outperform the wider market over the long term.

High fossil fuel prices and concerns about energy security, allied with efforts to mitigate and adapt to climate change, support the economics of energy efficiency investments and reinforce the case for the transition away from hydrocarbons and towards renewables.

'In the past 12 months, we have had very strong regulatory support for our end markets,' says Chatzimichalakis, citing policies such as the US Inflation Reduction Act including hundreds of billions of dollars in green technology subsidies. 'We are investing in proven and profitable businesses, not companies that overly rely on policy, but nevertheless policy is a driver for the end markets we invest in.'

While performance in 2022 was disappointing, with Impax Environmental Markets seeing a 15% decline in net asset value total return per share, portfolio valuations have been reset and takeover activity in environmental markets has picked up, which may help boost performance going forwards.

Investec recently noted the managers have been rotating towards cyclical and growth companies with strong balance sheets, where valuations have been beaten down.

Top 10 holdings span the likes of digital technology group **PTC (PTC:NASDAQ)**, hazardous waste disposal leader **Clean Harbors (CLH:NYSE)** and renewable energy project developer **Northland Power (NPI:TSE)**. It also invests in logistics business **Brambles (BXB:ASX)** and **Darling Ingredients (DAR:NYSE)**, which turns edible by-products and food waste into sustainable products and also produces renewable energy. [JC]

Why Midwich remains an underappreciated growth story

A capital raise supports a healthy near-term acquisition pipeline and reduces debt

Midwich (MIDW:AIM) 456p

Gain to date: 1.3%

We highlighted specialist distributer of AV (audio visual) equipment to the trade market **Midwich (MIDW:AIM)** as an opportunity to buy above-average growth at a below-average price on 23 March.

The shares are showing a small gain since we said to buy, but in general have drifted sideways while consensus earnings estimates have remained steady.

WHAT'S HAPPENED SINCE WE SAID TO BUY?

An integral part of the company's growth strategy is to augment organic expansion by acquiring two to four companies a year as it builds out new geographies and technologies.

The company announced its first entry in the Canadian market on 6 June after buying SF Marketing in a deal worth up to £27 million and simultaneously raised £51 million in fresh capital to part-fund the acquisition and pay down debt.

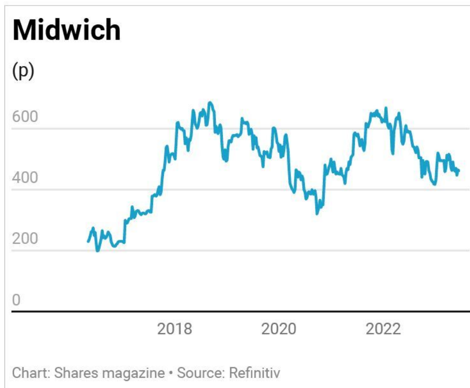


Chart: Shares magazine • Source: Refinitiv

SF Marketing is a leading Canadian value-add distributer of AV equipment with an estimated market share of 20% to 25% and a reputation for technical services. The region is estimated to be worth around $9 billion and expected to grow in mid-single digits.

Midwich is guiding for the acquisition to be earnings accretive in the first year of ownership. Berenberg upgraded its 2023 and 2024 earnings estimates by 1% and 3% respectively following the announcement of the deal.

Management said it has identified a near-term pipeline of at least six acquisition opportunities likely to be executed over the next six months.

Research group Megabuyte said the SF Marketing purchase is 'textbook' Midwich as it captures a new market, bolters a capability area, in this case professional audio and live events, and adds a decent new customer roster to push more developed offerings.

WHAT SHOULD INVESTORS DO NOW?

The company continues to demonstrate good progress against its growth ambitions. With an estimated 3% to 4% market share of an addressable market worth $33 billion, there is plenty of runway ahead.

The shares are a bargain, trading on 11.6 times forward earnings. Berenberg estimates the shares trade at a 35% discount to their historical average. Keep buying. [MG]

Reasons not to worry about Halma's recent share price decline

The health and safety engineer continues to reward its loyal supporterswith a perfectly executed expansion strategy

HALMA (HLMA) £22.77

Gain to date: 9%

Sometimes the market is hard to please. On 15 June, life-saving technology company **Halma (HLMA)** reported its twentieth year in a row of record full-year profit and its forty-fourth consecutive year of growing the dividend by 5% or more. However, the share price has since fallen by 6% over the space of three trading days.

Admittedly, we're still 11% ahead of our October 2022 entry price of £20.91, but it's worth exploring why the shares have fallen of late.

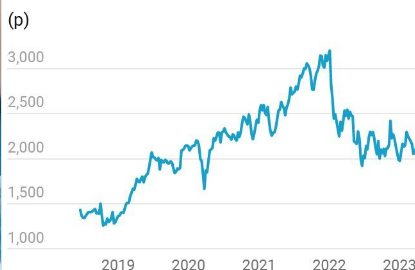


Chart: Shares magazine • Source: Refinitiv

WHAT'S HAPPENED SINCE WE SAID TO BUY?

It was a busy year for the company, ploughing close on half a billion pounds into a handful of bolt-on acquisitions. Historically, Halma has generated enormous value from such deals.

In that regard, Halma's commentary that it has a 'healthy acquisition pipeline across all sectors' should infuse shareholders with plenty of confidence for the company's future, now being led by Marc Ronchetti after Andrew Williams' near two-decade run, only the company's fourth chief executive in 50 years.

Halma believes it has a 'highly sustainable' growth model, based on long-run trends to create a cleaner, greener, safer world for future generations, and that's been the case for years.

Berenberg analyst Calum Battersby attributed last week's share price sell-off to weaker than expected margins in the safety division and upgraded guidance on interest costs. 'However, we see neither issue as meaningful,' he added. Safety margins are expected to improve this year and recent acquisitions are expected to generate margins well above the group average.

WHAT SHOULD INVESTORS DO NOW?

Analysts expect earnings to grow around 9% in the current financial year to 31 March 2024, and set against that expectation, the forward-looking price to earnings multiple stands at 28. That might look full to some investors, yet it is on the low side of historic valuations for Halma, based on Koyfin data.

It's worth noting the stock price remains 29% off the previous £32 high achieved in December 2021. Keep buying shares in this fantastic long-run growth company. [SF]

Confused why unloved shares are rising in value? Could be a short squeeze

It's worth monitoring the list of stocks where large investors are betting the price will fall

Ever looked at a rising share price and wondered what is driving it? We all want share prices to move higher so as to enjoy capital gains, but fundamentally it is important to understand the reasons behind the movement.

Looking at the list of recent big movers, two names stand out – **Ocado (OCDO)** and **Moonpig (MOON)**. Both have spent extended periods out of favour with investors for failing to deliver the kind of growth previously promised. So why has Ocado risen by 17% in a week and Moonpig by 38% in three months? The reasons partly lie with their presence on the top five most shorted stocks list.

According to Shorttracker.co.uk and based on FCA data, nine hedge funds or asset managers are short Ocado, with 6% of the stock on loan. In plain English that means nine institutional investors are betting that Ocado's share price will fall. If they are right, they will make a profit.

The process involves borrowing shares from someone else and selling them on the open market. If the shares decline in value, the short seller buys more stock at the lower price to give back to the original lender and then pockets the difference.

This can quickly unravel if the share price starts to rise, creating what is known as a short squeeze. This is when short sellers decide to cover their short positions or are forced to do so via margins calls – effectively buying stock as it rises, which in turn can push the price even higher.

> "buying stock as it rises, which in turn can push the price even higher"

In Ocado's case, a broker upgrade on 12 June caused the price to jump and it looks like a short squeeze might have taken it even higher. At one point in the day, it was up more than 10% as investment bank BNP Paribas Exane switched its rating from 'underperform' to 'neutral'.

Most shorted stocks on UK market

Company	Amount on loan (%)	Number of funds short
Ocado	6.0	9
Kingfisher	5.3	6
Boohoo	4.8	5
Moonpig	4.8	5
Hammerson	4.6	5

Table: Shares magazine • Source: Shorttracker.co.uk

Under normal circumstances, that would hardly be a major catalyst for the shares, certainly not as a powerful as moving to a 'buy' rating. After all, Exane is still effectively sitting on the fence with its rating. However, investors were pleased with what they read, with Exane saying the company was entering a more 'settled' phase after struggling to grow volume and excess capacity post-pandemic.

On 30 March, Moonpig said its full-year results would be in line with expectations and the share price has since moved higher, as investors take the view that life is not getting worse for the business following earlier problems.

Despite the higher share price, the amount of stock on loan has stayed fairly steady around the 5% mark, suggesting that short sellers are happy to keep their positions open. Keep your eye on the full-year results announcement on 29 June as positive news could cause a greater than normal share price reaction if the shorts need to buy more stock.

If sentiment remains poor towards a stock, it is easy to see the share price continue to drift lower until there is news to change the market's mind. Approximately 5% of **Boohoo's (BOO:AIM)** shares are out on loan to short sellers and its price has fallen by 24% in a month, meaning the shorts are cleaning up.

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Six coronations and counting for Dunedin Income Growth Investment Trust

Ben Ritchie and Rebecca Maclean, Investment Managers, Dunedin Income Growth Investment Trust PLC

The era of King Charles officially began on 6th May, making him the seventh monarch that has reigned since Dunedin Income Growth Investment Trust (DIGIT) was founded in 1873. While the ambitions of the portfolio remain the same as in the time of Queen Victoria – to invest in good companies, and benefit from the long-term growth of their revenues, profits, cash flow and dividends – the execution is a little different.

In those days, DIGIT invested in North American railroad bonds, the major structural growth theme of the time. Today, we see three major themes for the Carolean era; the first and most immediate is inflation. We are experiencing the highest inflation in a generation, which has been a real challenge for companies to manage. It has raised questions about affordability, about supply chains and forced companies to manage costs effectively. Inflationary pressures are shifting from raw materials and energy towards labour and we have sought to make sure the companies in our portfolio have robust pricing power, allowing them to pass on higher costs and protect margins

Another key theme is climate change and the energy transition – an issue close to King Charles's heart. This is a high priority for governments, as they seek to address challenges around energy security while meeting emissions goals. Vast investment is required to upgrade energy infrastructure and build renewable energy supply. DIGIT holdings **SSE** and **Total Energies** have a vital role to play in addressing that theme.

A third theme is productivity improvement. Companies that provide innovative solutions to help businesses become more efficient, through digitisation, or better use of data, are likely to be in high demand. We would highlight companies such as **Oxford Instruments**, which provides a range of technologies, including semiconductors and quantum computers.

abrdn

PRICING POWER

The recent corporate earnings round painted a surprisingly encouraging picture. Rising costs have challenged businesses as well as consumers, and there had been fears that this would dent profit margins and depress earnings. This hasn't happened, at least for the time being, with companies managing inflationary pressures better than expected. Companies have passed on rising costs to their customers successfully, preserving and even expanding profit margins.

That said, as time goes on, and end customers come under greater pressure, this pricing power may ebb. It could become more difficult to put up prices as customers adapt their behaviour to match their shrinking wallets. Some companies are seeing declining volume growth, even if they are maintaining profit margins. We suspect this may become more pronounced, separating the most robust companies from their weaker peers.

The pricing lever has been less important during periods of relatively low inflation, but it is now a key part of a company's armoury. If volumes start to fall, there will be diseconomies of scale, and companies need to recognise the problem. While the bounce in inflation hasn't been nearly as damaging for the corporate sector as might have been expected, there is nuance.

STOCK WATCH: GAMES WORKSHOP

Consumer cyclical companies haven't been a happy hunting ground for investment managers over the past year. Spending has come under pressure from higher interest rates and rising household bills for food and energy, leaving consumers with less disposable income. However, Games Workshop shows why investors shouldn't necessarily judge a book by its cover.

It specialises in tabletop miniatures, selling to gaming fans. It has a committed base of engaged and passionate users, which provides a strong moat for the business. It has significant intellectual property and has shown itself capable of consistent innovation. It demonstrates how companies with a strong position in a niche market can transcend a weaker sector.

The group is looking to expand in North America and Asia, which creates potential new pathways of growth for the business. The company has announced a new deal with Amazon, to bring its sci-fi Warhammer universe to screens around the globe. This provides a really interesting opportunity to create value for the business and raise brand awareness.

THE DIVIDEND LANDSCAPE

It has been a buoyant period for dividends in the UK market. UK dividends saw underlying growth of 16.5% in 2022. It was boosted by a strong performance from the mining sector, but almost every sector in the UK market has seen a double digit growth in payouts. The yield still looks attractive across the UK market, at around 3.7% for 2023.

However, this rapid growth rate is likely to slow over the next 12 months. Link is currently predicting anaemic growth of 1.7% in UK dividends for 2023 as a whole. This has various causes: the mining sector

has seen a bumper two years on the back of higher commodity prices that is unlikely to be repeated. A number of special dividends were paid last year and may not recur. Equally, there are headwinds from rising costs and a weaker global economy, even if China's reopening may compensate to some extent.

Against this backdrop, achieving dividend growth for the portfolio will require a focus on corporate balance sheets and cash flow, finding those companies that are generating surplus capital, investing appropriately and then passing the remainder onto shareholders.

There are always swings and roundabouts in dividend payouts. Dividend distributions tend to be late cycle and backward-looking, made on the back of results several months past. However, we always take a temperature check on the dividend prospects for our portfolio companies and those prospects remain encouraging.

Companies selected for illustrative purposes only to demonstrate the investment management style described herein, and not as an investment recommendation or indication of performance.

Important information:

Risk factors you should consider prior to investing:

- The value of investments, and the income from them, can go down as well as up and investors may get back less than the amount invested.
- Past performance is not a guide to future results.
- Investment in the Company may not be appropriate for investors who plan to withdraw their money within 5 years.
- The Company may borrow to finance further investment (gearing). The use of gearing is likely to lead to volatility in the Net Asset Value (NAV) meaning that any movement in the value of the company's assets will result in a magnified movement in the NAV.
- The Company may accumulate investment positions which represent more than normal trading volumes which may make it difficult to realise investments and may lead to volatility in the market price of the Company's shares.
- The Company may charge expenses to capital which may erode the capital value of the investment.
- Derivatives may be used, subject to restrictions set out for the Company, in order to manage risk and generate income. The market in derivatives can be volatile and there is a higher than average risk of loss.
- There is no guarantee that the market price of the Company's shares will fully reflect their underlying Net Asset Value.
- As with all stock exchange investments the value of the Company's shares purchased will immediately fall by the difference between the buying and selling prices, the bid-offer spread. If trading volumes fall, the bid-offer spread can widen.
- Certain trusts may seek to invest in higher yielding securities such as bonds, which are subject to credit risk, market price risk and interest rate risk. Unlike income from a single bond, the level of income from an investment trust is not fixed and may fluctuate.
- Yields are estimated figures and may fluctuate, there are no guarantees that future dividends will match or exceed historic dividends and certain investors may be subject to further tax on dividends.

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Standard Chartered: will it receive a new bid or ditch the UK stock market?

Discover why sentiment might soon change towards the bank

If most of us are asked to name a bank with large exposure to Asia, the likelihood is the first name that comes to mind is **HSBC (HSBA)** rather than its smaller rival **Standard Chartered (STAN)**.

In fairness, having been established in Hong Kong and Shanghai more than 150 years ago to help finance the burgeoning trade between the island, the mainland and Japan, the 'grande dame' of Asian banking HSBC is today not only the largest listed UK bank by market value at £120 billion but the third-largest stock in the FTSE 100.

By comparison, Standard Chartered is a minnow with a market value of just £18.4 billion, below that of all the major UK high street banks and putting it 31st in the FTSE 100, yet to a few seasoned fund managers and analysts it is a better investment.

POTENTIAL FOR DOUBLE-DIGIT RETURNS

Clive Beagles, manager of the **JOHCM UK Equity Income Fund (B03KR61)**, argues the bank's lowly valuation and low expectations are a good starting point.

'People have got a bit tired of perennial disappointment from the bank, so now it trades on less than half book value, whereas it used to trade on two to three times book value.

'If you go back to when it traded on those higher multiples, it had high growth rates and decent cost control, and to a degree people are right, it has underachieved because today it is only making a return on equity of about 8% whereas the aim is to get to 11% to 12%.

'But it is investing to grow, particularly in emerging Asian economies. People have got fed up with it not delivering double-digit return on equity, but we think the bank is on a clear path to get back there.'

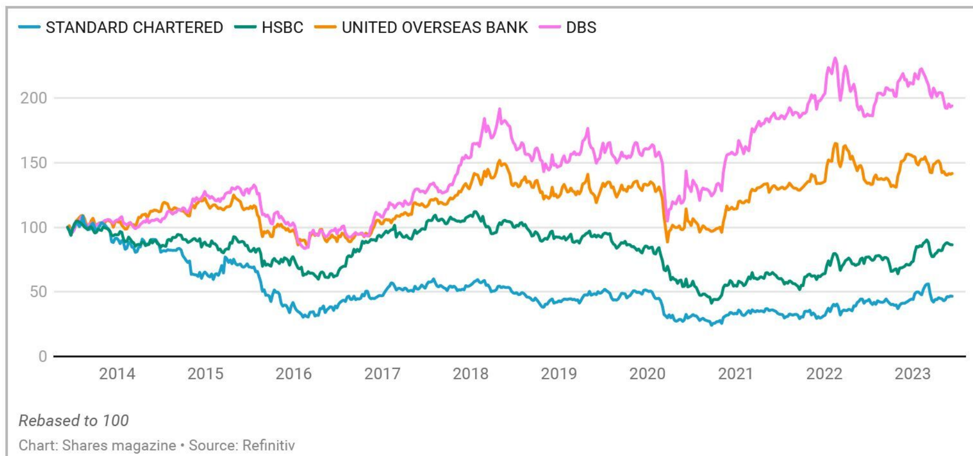
Beagles isn't alone in predicting a return to double-digit margins – Jefferies analyst Joseph Dickerson believes Standard Chartered could get to a 12% return on tangible equity as soon as next year, meaning the implied valuation is too cheap.

RIGHT-SIZED FOR ITS MARKETS

Past efforts to make Standard Chartered more efficient and less capital-intensive 'will allow it to fully benefit from a recovery in wealth business as Asia reopens and fund flows accrue to the region on structural grounds,' argues the analyst.

Having visited senior management in Hong Kong and Singapore earlier this month, Dickerson sees a vast opportunity in the region as wealth management activity and financial flows pick up with Greater China account openings in the first quarter of 2023 running 90% above pre-pandemic levels on an annualised basis.

Moreover, due to the reduced capital intensity



of the region and the cost efficiencies achieved in the last four years, Dickerson argues the bank – and its shareholders – stand a real chance of benefiting financially from its positive prospects this time round.

'We raise our wealth revenue forecasts by 8% through 2025 and reduce our risk-weighted assets estimate by 4% to reflect the better density already delivered in Asia,' he says.

'The former drives 3% higher pre-tax profit estimates while the latter enables 80% higher buybacks in 2024 and 2025. We see a 12% return on tangible equity in 2024 yet the shares are only on 0.5 times 2024 tangible book value.'

Analyst Peter Richardson at Berenberg also visited the bank earlier this month and says management accepts it needs to do more to prove it can generate sustainably higher returns, and it is taking a more dynamic approach as a result.

'Standard Chartered's smaller mass-market scale enables it to disrupt markets. Its virtual bank in Hong Kong is already used by one in five customers in its target market. We think this venture has provided a blueprint for the bank's digital activity in Singapore via Trust Bank, and over time could be used in large markets including India and Indonesia to materially support revenues.'

Meanwhile, in wealth management, Richardson says the bank's position in Singapore as well as other Asian markets can support above-market growth given wealth clients' diversification away from Hong Kong.

WHAT COULD HAPPEN NEXT?

There is also the small matter of takeover interest. In January, First Abu Dhabi Bank said it had been considering an offer for Standard Chartered but didn't take it any further.

Under UK stock market rules, First Abu Dhabi Bank is not allowed to make another approach for six months, but that restrictive window expires on 5 July meaning it could come back as soon as a fortnight's time with a bid, should it wish to do so.

Alternatively, management could decide to redomicile the bank in Asia to exploit higher ratings for local banks.

'Standard Chartered's geographic footprint is almost identical to **DBS (D05:SGX)**, the biggest bank in Singapore, yet its price to book multiple is pretty much a third,' observes JO Hambro's Beagles.

'We've already seen various UK-listed companies switch stock market listings to get a higher rating elsewhere. Does Standard Chartered need to be listed in the UK? Not really. If that valuation gap stays as wide as it is, it wouldn't be a tremendous surprise to see something similar happen to the bank or an external party like Abu Dhabi seeking to exploit that. To me, the risk/reward looks highly favourable at this valuation.'

By **Ian Conway** Companies Editor

BING!
BING!
BONG!

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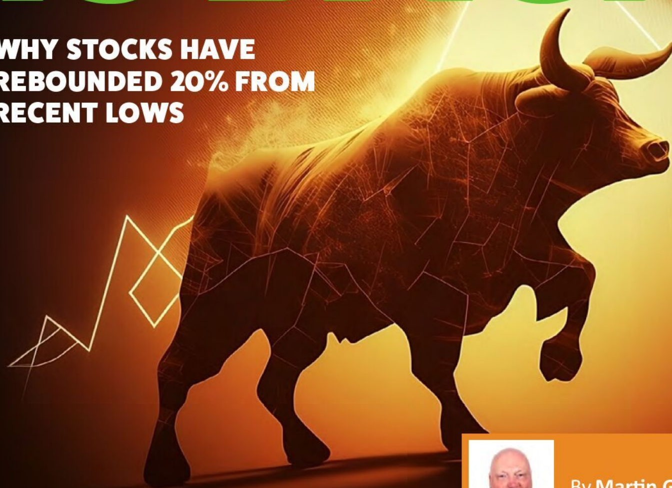
THE BULL MARKET IS BACK

WHY STOCKS HAVE REBOUNDED 20% FROM RECENT LOWS



By **Martin Gamble** Education Editor

The commonly accepted definition of a bull market is when an index gains 20% or more from previous lows and by this measure the S&P 500 index entered a new bull phase on 8 June 2023.

It isn't a hard and fast definition and there are investors who think it is a bear market rally rather than the real deal. There are good arguments on both sides of the debate and this article discusses them.

Naysayers point to a problem right off the bat which is that the rally has not been broad-based. In fact, that is an understatement. All gains have come from seven companies, which have been dubbed the 'Magnificent Seven'.

The seven firms are **Meta Platforms (META:NASDAQ)**, **Amazon (AMZN:NASDAQ)**, **Alphabet (GOOG:NASDAQ)**, **Apple (APPL:NASDAQ)**, **Nvidia (NVDA:NASDAQ)**, **Microsoft (MSFT:NASDAQ)** and **Tesla (TSLA:NASDAQ)**.

According to *Bloomberg*, gains range from 40% to 180% while the remaining 493 companies are flat. This means the performance of the S&P 500 is now the most concentrated it has been since the 1970s with the top five constituents making up a quarter of the index. In other words, the S&P 500 is losing its diversification benefits.

For investors worried about this, one alternative is to invest in an equal weighted version of the index.

Retail buying of Invesco's equally weighted S&P 500 exchange-traded fund registered its highest volume since launching 20 years ago, according to *Bloomberg*.

As well as **Invesco S&P 500 Equal Weight (SPEX)**, which has an ongoing charge of 0.2%, there is **iShares S&P 500 Equal Weight (EWSP)**, where the cost is the same, and **Xtrackers S&P 500 Equal Weight (XZES)** which is a few basis points cheaper at 0.17%.

The divergence between the two forms of the index has widened to over 10% since the start of the year.

Typically bull markets are characterised by broad participation with most stocks contributing to index gains and rotation between different sectors.

There have been some signs of rotation into the Russell 2000 and regional banking but not enough to be convincing so far. Russell 2000 is comprised of smaller, economically-sensitive companies which tend to be more value-oriented while regional banks have been recovering from the sector crisis triggered by the implosion of Silicon Valley Bank in early March.

David Bernstein, CEO and chief investment officer of Bernstein Advisors, told *Bloomberg* that the exceptionally narrow leadership in the S&P 500 implies a very bearish economic outlook.

The idea is that if investors can only get excited by a few big technology names it means they are bearish on the other 490-odd names in the index and by default the economy.

Bernstein views the rally as a late-stage speculative blow-off rather than the start of a new sustainable bull run. Morgan Stanley says this month has seen the largest buying spree in terms of net inflows into US equities since 2011, which can be a contrarian indicator.

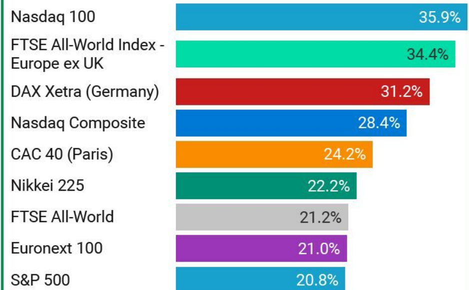
Meanwhile, the latest Bank of America fund manager survey shows institutions have reduced their cash levels from 'uber high' levels, which perhaps indicates some form of capitulation.

For an example of how the flood of money into a few big names is distorting the broader market look no further than the S&P 500's largest stock.

In early June 2023 Apple made a new all-time high, giving the tech giant a larger market value than the combined market value of the Russell 2000 and larger than all 100 companies in the FTSE 100 index.

SIGNS OF OTHER BULL MARKETS

The S&P 500 isn't the only index in new bull market territory. There are now 10 indices which have gained at least 20% from last October's lows.



The technology-focused Nasdaq 100 is up 35%, Japan's Nikkei 225 is up 22%, Germany's DAX index is up 34% and the French CAC 40 is up 24% with both the latter indices having made new all-time highs.

The US indices are around a tenth below January's 2022 all-time highs, but remarkably have regained

all the losses suffered since the US Federal Reserve started raising interest rates in March 2022.

WHAT IS THE BULL CASE?

Before chasing markets higher in the hope of making money, it is important to understand the bull case to ascertain if it stacks up and is therefore sustainable.

Stock markets are forward-looking and discount future earnings. With the S&P 500 close to all-time highs it would be fair to say investors don't appear too worried about an earnings recession.

The case for a new bull market rests on a so-called Goldilocks scenario playing out where the economy cools enough to see inflation come back down towards the Fed's 2% target without causing a recession, also known as a soft landing.

Bullish investors are therefore 'looking through' the current earnings trough and into the next upward phase in the earnings cycle.

S&P 500 EARNINGS MAY HAVE TROUGHED

According to Howard Silverblatt, senior index analyst at S&P, the latest consensus forecasts call for EPS (earnings per share) growth of 16.4% in 2023 to $201.12 per share followed by a 13% increase in 2024 to $227.28 per share.

Looking at the quarterly data, earnings are expected to decline for the second quarter of 2023 by 6.4% according to *FactSet*.

If this happens it would be the steepest decline since the second quarter of 2020 when earnings fell by 31.6%.

Analysts are then projecting a second-half recovery in earnings which increase by 0.8% in the third quarter and accelerate to 8.2% in the final quarter.

This turnaround in forecasts can be seen in net revisions data which is the three-month average of upward minus downward revisions to earnings estimates. According to Refinitiv data net revisions are back to zero, having troughed in the spring.

What is interesting at a company level is that the large technology companies are expected to be the biggest contributors to Q4 growth. But, excluding contributions from Amazon, Meta Platforms, Alphabet and Nvidia, S&P 500 earnings growth halves to 4.2%.

For Amazon, Meta Platforms and Nvidia, analysts are pencilling in 100% year-on-year EPS growth in the final quarter according to *FactSet*.

It is perhaps no coincidence that the big tech names are seeing the biggest share price gains, which merely reflects the pace of their expected superior earnings growth.

There is a disconnect between the earnings recovery that equity analysts are predicting and the recession that bond markets have been pricing for some months. However, not everyone believes in the Goldilocks scenario.

Morgan Stanley strategist Mike Wilson is in the bearish camp. He says: 'The earnings situation is way worse than what the consensus thinks.'

Wilson continues: 'We continue to forecast an earnings recession this year that we don't think is priced in, followed by a sharp EPS rebound in 2024/2025.'

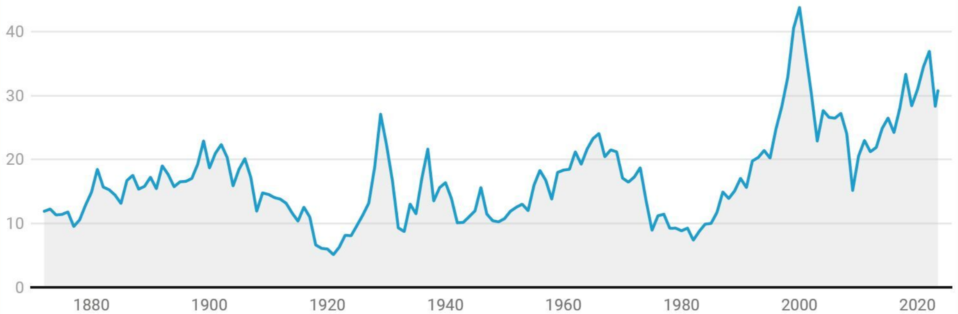
The strategist sees a 20% downside risk to the S&P 500 before paring losses towards the end of the year. In other words, before moving higher Wilson expects the index to trough between 3,000 and 3,300 points.

ARE VALUATIONS TOO HIGH?

In the short-term earnings can be volatile, and the pandemic distorted the picture even more as the economy ground to a halt only to reopen faster than many expected.

One way to smooth out earnings is to calculate cyclically-adjusted earnings. Professor Robert Shiller popularised this method and put his name to the Shiller PE, also know at the CAPE or cyclically-adjusted PE.

Shiller collects inflation-adjusted earnings from the previous 10 years and calculates an average to



compare against the price of the S&P 500.

The current reading shows a PE of 30.6 which historically has only been higher on two occasions. In January 2022 before the Fed started raising interest rates and in 2001 close to the peak of the 'dot-com' bubble.

It suggests investors are paying a premium valuation, indeed, a sky-high price for the current earnings outlook. At the very least this implies very little risk to earnings.

Some investors might baulk at using historic earnings which is fair comment given the forward-looking nature of markets. *Shares* has access to a cyclically adjusted earnings model which plots historic and forecast earnings against a long-term trend to estimate a cyclically adjusted PE.

Based on earnings data from 1996 the S&P 500 has a trend earnings growth rate of 5.7% a year. Forward earnings, if achieved, imply investors are paying 24.7-times or one standard deviation above the 35-year average.

Standard deviation is a measure of dispersion. One standard deviation is an extreme reading implying a stretched valuation.

The model is giving the same message as the Shiller PE, that future earnings are already fully priced even if they come in on target.

One final measure to consider is the Warren Buffett indicator which compares the aggregate value of US stocks to annualised GDP. The message from this indicator is the same as the other two. The current value of 172% is 1.4 standard deviations above trend according to *currentmarketvaluation.com*.

WHY DOES THIS MATTER?

Historically, new bull markets begin when consensus market expectations are already depressed and valuations are low. The current set-up doesn't fit the typical pattern which suggests the strong rally from last October's lows is a bear market rally.

The problem is that if US markets are in a speculative blow-off phase there is no way of knowing when it could end. Irrationality tends to lead to even more irrationality.

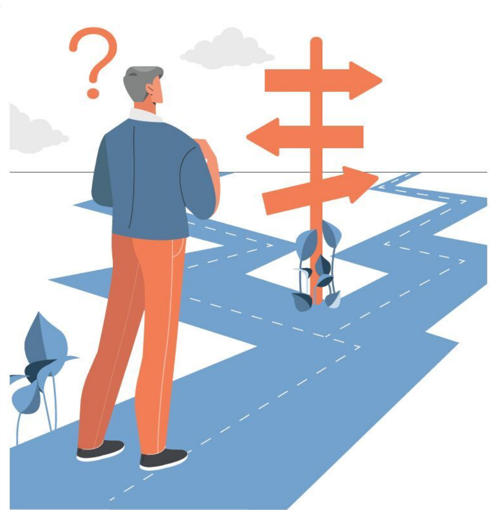
One approach is to give US markets a wide berth and diversify internationally which is a strategy David Bernstein is following. He told *Bloomberg* his portfolios currently have their lowest ever weighting to US equities.

Schroders

With cash earning 5%, **why risk money on the stock market?**

Savings rates have trebled in 12 months, and UK savers can earn over 5% on deposits. So doesn't it make sense to cut risk and stick to the safety of cash?

14/06/2023
Duncan Lamont, CFA
Head of Strategic Research



Cash savers are benefiting from the highest returns in almost two decades, with some popular accounts paying over 5%. The rise in returns has been rapid, with rates today many times higher than a year ago. Unsurprisingly savers are committing more to cash ISAs than at any point in the past five years*.

After a long spell in which nominal returns on cash were virtually zero, investors are now rethinking the role deposits should play in wider portfolios.

AREN'T INVESTORS RIGHT TO RECONSIDER CASH?

All savers' circumstances are different, and some may have excellent reasons to be holding cash. But just because savings rates are rising does not mean cash is keeping pace with inflation.

As shown, cash returns after inflation – or "real" returns – remain negative, even though rates have risen strongly. Negative returns mean losses. And the jump in inflation since early 2022 means that the value of cash is now eroding at a faster pace than for most of the previous decade, even if the cash earns today's top available rates.

So for many the key question of where to make long-

Popular UK savings rates vs inflation

Cash ISAs*	Jan 2022	June 2022	Jan 2023	30 Apr 2023	Best-buy June 2023**
Variable rate	0.3%	0.6%	1.7%	2.3%	3.9% (non-ISA)
2-year fixed rate	0.5%	1.6%	3.9%	4.1%	5.4% (non-ISA)
Inflation	**5.5%**	**9.4%**	**10.1%**	**8.7%**	**-**

Source: *Bank of England. **Moneyfacts, June 2023; ONS

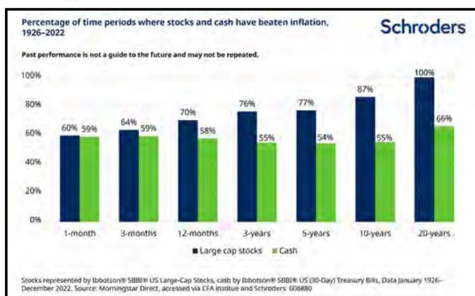
term investments remains as relevant as ever. In fact it is even more important.

CASH OR EQUITIES: WHAT ARE THE CHANCES OF BEATING INFLATION?

The certainty offered by cash lies only in its nominal value. £100 today will still be £100 in future years. There is no certainty its spending power will hold up, however. Low inflation will see the money retain its spending power to some degree, but high inflation will erode it quickly.

Time is the critical factor. Over short periods cash is likely to fare better against inflation. Over long periods, cash fares worse, even where inflation is relatively low.

The following chart crunches historic returns on cash and stock market investments over a range of timeframes extracted from 96 years' data. It then sets these against inflation over the same timeframes.



The results are stark. The chart shows that over very short periods – three months or less – there has not been much difference in the likelihood of cash or shares beating inflation. But for longer periods the gap widens conclusively.

- The likelihood of cash savings beating inflation has been about 60:40 for the majority of all timeframes.
- The likelihood of stock market investments beating inflation has reached 100% where the investments are held for 20 years.

In other words, for every 20-year timeframe in the past 96 years, equities delivered inflation-beating returns.

So while stock market investments may be risky in the short run, when viewed against inflation they have offered far more certainty in the long run.

THE STOCK MARKET HAS DELIVERED STRONG LONG-TERM RETURNS THROUGH VERY DIFFERENT CONDITIONS

The recent era of ultra-low interest rates, from which we're now emerging, has meant that cash has been unattractive for investors. That is despite the fact that inflation until recently has been low.

In the past five, ten and 20 years, cash savings have failed to keep up with price rises and so depositors would be worse off.

Over very long periods – during which inflation and interest rates have gone through both highs and lows – cash has retained its spending power, but only just.

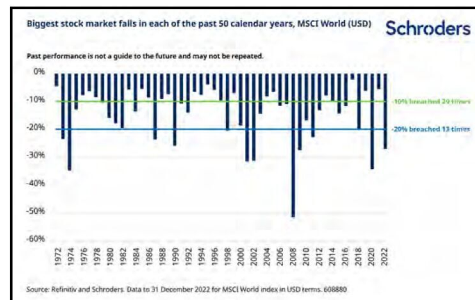
By contrast, stock market investments have delivered inflation-beating returns over all periods highlighted in the chart.

SO IT'S A NO-BRAINER: STOCK MARKET INVESTMENTS ARE A BETTER BET FOR LONG-TERM REAL RETURNS?

There are lots of reasons to hold cash, and savers' individual timeframes will differ. For many, this is where financial advice will be invaluable.

While long-term historic data strongly suggests stock market investments stand a better chance of beating inflation than other investments, they are also volatile.

So investors who opt for stock markets over cash need to be prepared for a bumpy ride.



- In approximately half of the past 50 years markets fell by at least 10%.
- In a quarter of the past 50 years markets fell by at least 20%.

In conclusion, different risks attach to both cash and stocks and shares. Cash is far from a risk-free asset: even at today's best available savings rates, deposits are likely to lose real value. And, as our data shows, cash can deliver real losses over longer periods too, including the past two decades. But shares also carry risk, especially when held for shorter periods.

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*Source: Bank of England, two-year fixed rate cash ISA, change from 30 April 2022 (1.19%) to 30 April 2023 (4.12%). ISA deposits from BoE Money & Credit tables. Data issued June 2023.

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Dowlais shares worth buying after demerger from careful owner Melrose

The automotive engineer looks well placed to tackle challenges in the sector and has an impressive focus on profitability

The name **Dowlais (DWL)** may not mean a huge amount to you but there is a good chance something it has made is sitting on your driveway.

An April 2023 spin-out from industrial turnaround specialist **Melrose (MRO)**, Dowlais is effectively the car engineering part of GKN. An institution in the UK industrials and engineering space, GKN was controversially purchased by Melrose for £8 billion in 2018.

Melrose has retained the aerospace assets and the demerged Dowlais encompasses GKN Automotive, whose components are present on 50% of new cars worldwide, powder metal specialist GKN Powder Metallurgy, whose management estimates that every car produced globally has around 23 parts manufactured by the business, and energy storage start-up GKN Hydrogen.

> **"Investing now could reward a patient investor"**

Melrose is sometimes compared with private equity but this is probably unfair (see box: *Melrose's approach*). Dowlais is not a case of a company being listed by a private equity firm with significant borrowings on the balance sheet and with all the best assets stripped away. Dowlais has instead benefited from investment and careful management by Melrose and debt is at a sensible level of around one-and-a-half times earnings.

Dowlais' challenges are different. It must contend with the cyclical nature of the wider automotive industry as well as the structural change of a shift to electric vehicles. Navigating these two tests will be key to whether the company proves a success as a demerged entity.

We think there are reasons to be confident in Dowlais' ability to handle both. Investing now could reward a patient investor, with the shares trading on a price to earnings ratio of just 8.5 times forecast earnings.

HOW DOES DOWLAIS MAKE MONEY?

We can leave GKN Hydrogen to one side in this analysis given it is pre-revenue. GKN Automotive is, no pun intended, the main driver of the group. It will account for more than 80% of 2023 sales and 73% of earnings according to estimates from investment bank Jefferies.

It can be split into two parts. Driveline, the part of a vehicle which transfers power from the engine and transmission to the wheels, where its main products

Dowlais

Chart: Shares magazine • Source: Refinitiv

are sideshafts and propshafts; and ePowertrain, which encompasses its all-wheel drive systems and eDrive technology.

The modular eDrive system is available as a complete, fully integrated three-in-one system with inverter, motor and transmission; as a two-in-one combination system; or as single modules and components. The first such system was fitted more than two decades ago and it now powers more than two million electric vehicles across the globe.

GKN Automotive is the market leader in sideshafts and propshafts and has a strong market position in China, having first entered this market 35 years ago. Around 90% of global vehicle manufacturers use GKN Automotive components.

After profitability was badly damaged during the pandemic, GKN Automotive has been rebuilding its margins, with a priority of hitting double-digits on this metric rather than pursuing growth for its own sake.

Dowlais 2023 forecast sales breakdown

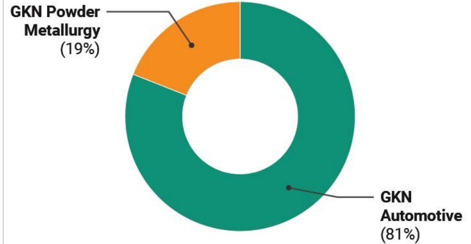


Chart: Shares magazine • Source: Jefferies

For the uninitiated, propshafts are the component which connects the gearbox in a car to the mechanical device (differential) on an axle which allows the wheels to rotate at different speeds. Sideshafts provide the connection between a vehicle's engine or power source and its driving wheels.

While propshafts will be rendered redundant in a shift to an entirely electric vehicle world, EVs require a larger number and size of sideshafts, creating opportunities for Dowlais.

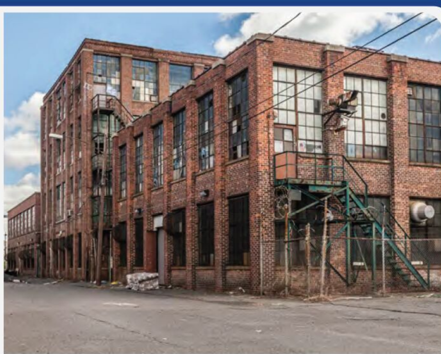
EDRIVE EXPECTATIONS ARE UNDERPOWERED

One sticking point for the market when it comes to the company is the destiny of eDrive, an area which is still requiring relatively heavy investment of around £50 million to £60 million per year.

The perception of this part of the group has been negatively impacted by carmakers themselves producing their own systems in-house. Jefferies quotes a figure of 80% of this process being insourced as opposed to 50% two years ago.

This has led to competitive pressures and raised questions about Dowlais' strategy of placing so much emphasis on profitability at the expense of market share.

Jefferies is still a believer in eDrive for several reasons. First, capacity issues may see a return to outsourcing, particularly as the number of electric vehicles on the road grows. Second, GKN



Melrose's approach

Melrose's model is relatively straightforward; it buys poorly managed manufacturing businesses which are suffering from a lack of investment, then looks to drive operational improvements and boost cash generation.

Although this approach has been compared to private equity Melrose can justly point to differences. It typically invests fresh capital in the businesses it acquires rather than simply stripping out costs.

When it achieves the targeted improvements, management will choose what it feels is the appropriate time to sell. Often this comes three to five years post-acquisition but there is a degree of flexibility.

Automotive has niche components which should be able to command higher margins. Third, the business may bring some of its own function in-house and finally, it argues, moving away from a focus on returns to pursuing unprofitable growth would be misguided 'at this point in the transformation story'.

It is also worth noting that the transition to electric vehicles is not happening as rapidly as some had anticipated. The improvement in GKN Automotive under Melrose means it can deal with this fluid backdrop as its production capacity is relatively flexible.

WHAT ABOUT THE POWDER METALLURGY BUSINESS?

The somewhat higher margin GKN Powder Metallurgy business is still a material contributor to profit and revenue. It is the number one sinter metals supplier and number two powder metals supplier globally. Powder metallurgy refers to an

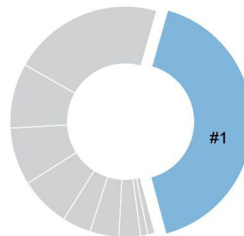
What has recent trading been like?

In the four months to the end of April, Dowlais achieved revenue growth of 9% at constant currency with margins above 7%. GKN Automotive posted 11% growth while GKN Powder Metallurgy posted flat revenue and margins of 8.3%.

The global leaders in drive systems

Sideshafts

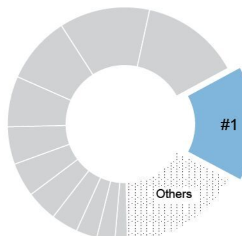
Market share



2x nearest competitor

Propshafts

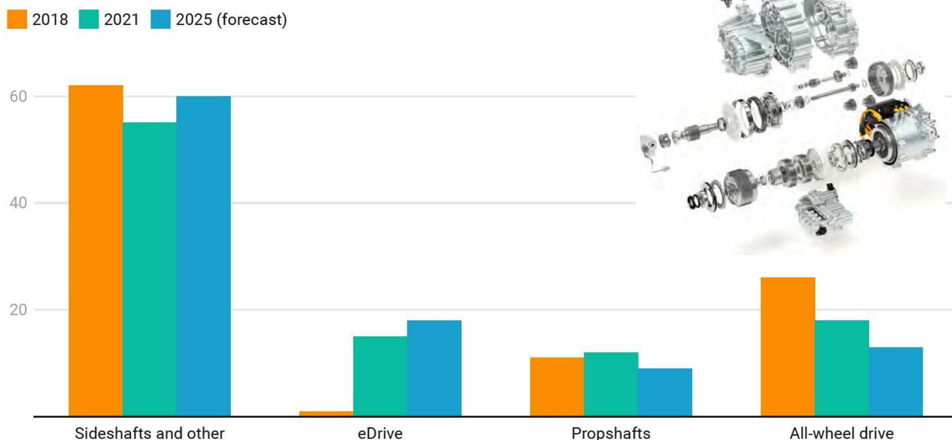
Market share



Global leader

Based on 2021 Product Volumes & GKN Auto Internal Data

Source: Dowlais



array of processes used to create structural metal parts and components.

Metal sintering is the process of fusing metal powders to create a solid object using heat and pressure. It creates harder, stronger materials and can be used to create more complex parts and shapes. The business produces metal powders and high precision metal parts for the automotive space (around 80% of sales) and other industrial sectors.

Edison estimates around 50% of its sales are at risk if the world's vehicles go 100% electric thanks to exposure to engine and gearbox components.

> "cash flow should underpin dividend payments"

The big hope is it can expand into producing the magnets required in electric vehicles.

An offer for the GKN Powder Metallurgy division of £1.6 billion in 2018 was considered unacceptable by Melrose at the time and yet the current enterprise value (market cap plus debt) of Dowlais as a whole is only around £2.6 billion.

To place this in context, GKN Powder Metallurgy is expected to account for less than 20% of 2023 sales. Dowlais may test the valuation of the Powder Metallurgy division sooner rather than later, saying it will consider its ownership of the business in the next two to three years.

Dowlais is highly cash generative (cash conversion is consistently above 90%) and it generated operating cash of £1.8 billion between 2019 and 2021. This cash flow should underpin dividend payments, with a forecast yield of 3.4%, and enable ongoing investment in the business as well as help fund mergers and acquisitions activity to augment growth too.

Who runs Dowlais?

The CEO of Dowlais, Liam Butterworth, previously served as CEO of GKN Automotive and before that was chief executive of US automotive firm Delphi Technologies. He led its demerger from Delphi Automotive in 2017 and subsequent listing on the New York Stock Exchange.

By **Tom Sieber** Deputy Editor

Decent dividend yield and cheap shares: this fund has it all

JOHCM UK Equity Income is a good way to play the discounts on offer with UK stocks

At 5.75%, the yield on **JOHCM UK Equity Income (B8FCHK5)** is the second highest it has ever been, according to fund manager Clive Beagles. You have to go back to the global financial crisis in 2008, when stock markets collapsed, to find a higher yield on the fund.

'I find that staggering because the balance sheets of our companies are in a miles-better place than in 2008,' he says. 'We only own three companies with net debt/EBITDA of more than two times. One third of the companies in the fund have net cash and the dividend cover (ratio of earnings to dividends) is the highest it has ever been.'

The £1.5 billion fund invests in UK stocks and has a value tilt – two things currently out of favour with investors. However, it provides investors with an opportunity to access decent companies at an attractive price. That is the foundation for a successful investment strategy over time.

Traditionally a high yield either suggests the market is worried about something wrong with a company, its dividend is too good to be true or because there are low growth prospects and it has little else to do with its spare cash than return it to investors.

Yet occasionally you can find high-yielding companies that simply out of favour but are offering good earnings growth and the financial strength to return generous dividends, and those qualities are ones sought by the JO Hambro fund.

HOW HAS THE FUND PERFORMED?

JOHCM UK Equity Income seeks companies paying an above-average dividend yield, which are attractively priced, and collectively have the potential to grow dividends each year by high single digits.

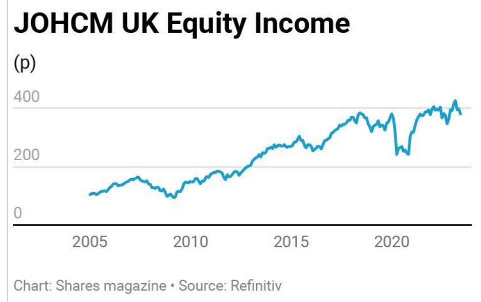


Chart: Shares magazine • Source: Refinitiv

Since launch 19 years ago, the fund has grown its dividend by 9% on average each year. Its annualised total return since inception has been 8.2% versus 6.7% from the FTSE All-Share index, according to FE Fundinfo, and it has a 0.71% ongoing charge.

'People are very negative about the UK,' says Beagles. 'We have not helped ourselves as a nation – our politics have been very messy for six to seven years so it is easy for international investors to not bother with UK stocks. Investors also still seem obsessed with tech and go-go growth even though discount rates have gone up, which to us looks slightly odd.

'The value of cyclicals relative to defensives is at a 50-year low. I do not think the world is in the gloomiest place it has been in for 50 years. To us it is an interesting time as valuations look attractive with UK stocks.'

WHAT'S IN THE PORTFOLIO?

One third of the fund is in financials, namely a mix of banks and insurance companies. Shares in banks rapidly went out of favour earlier this year when Silicon Valley Bank and Credit Suisse got into trouble, with stocks indiscriminately hit across the sector. The JO Hambro fund has stakes in the likes of **Barclays (BARC)** and **NatWest (NWG)** and both stocks have yet to recover from the February sell-off.

Aviva (AV.), **Legal & General (LGEN)** and **Phoenix (PHNX)** are the three insurers in the fund's portfolio, and Beagles says they are as big a beneficiary of rising interest rates as banks, as that is driving demand for bulk purchase annuities.

'When interest rates were close to zero, pension funds could not do anything. Now that rates are higher, deficits have reduced or removed, and companies are going to want to remove that risk from their balance sheet via a bulk purchase annuity.

'We think bulk purchase annuity volumes will be double or more this year versus last year – that growth could go on for three to four years. Yet look at valuations for those three stocks, they all trade on single figure multiples and on dividend yields of 8% to 9%, even though there is a structural tailwind ahead of them.'

STAYING CONFIDENT ON NATURAL RESOURCES

Concerns about a global economic slowdown have weighed on the mining and energy sectors in recent months, causing a drag on performance for the JO Hambro fund which has exposure to names such as **BP (BP.)** and **Shell (SHEL)**. Bank of America's latest survey of fund managers around the world even shows the lowest allocation to commodities in three years.

The JO Hambro manager seems relaxed, taking a long-term view on both sectors due to what is happening with supply and demand.

Oil companies have pulled back on investment in new capacity in recent years and yet it is clear that fossil fuels will still be in demand for a long time to come, despite efforts to shift the world to renewable energy. That suggests supply constraints down the line which could be supportive for the oil price.

UK oil producers typically trade on lower multiples of earnings than US peers, meaning the fund has cheaper exposure to a sector that is still generating significant amounts of cash. 'BP and Shell are on about five times earnings and returning 15% of their market value every year in buybacks and dividends.'

Shares in mining companies are influenced by GDP forecasts, what is happening with Chinese construction and manufacturing activity, and prices of the products being extracted and supplied. Beagles has selected certain miners to get exposure to metals needed for the energy transition including copper and cobalt.

'We will need an awful lot more of these transition metals and I do not think there will be enough supply. We are hardly discovering any more copper in the world, but where we are discovering it is in difficult political jurisdictions or difficult geological locations, and yet we need 50% more

copper in 10 years' time than we have today if we are to meet the ambitions for electric vehicle rollout and recharging networks.'

THE AIRLINE OPPORTUNITY

Shares in **EasyJet (EZJ)** have risen by 50% so far this year and Beagles believes there is more to come. He holds the airline in the JO Hambro fund and, while it does not feature in the portfolio's top 10 holdings, the manager observes, 'it is a big stock for us'.

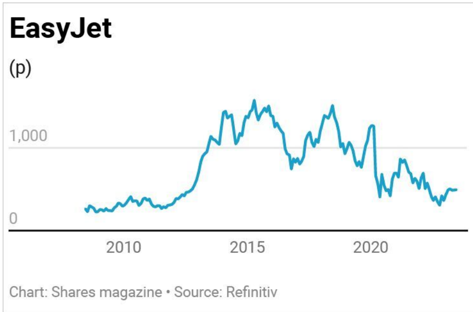


Chart: Shares magazine • Source: Refinitiv

There has been a strong recovery in travel demand post-pandemic despite the cost-of-living crisis, and EasyJet has made strategic changes to take advantage of this market dynamic. The business is bouncing back from Covid disruptions, but the market is not fully pricing in its capabilities, judging by the cheap share valuation. The shares trade on less than 10 times forecasts earnings for the year to September 2024.

'We spend a lot of time trying to think about earnings in more normal conditions,' says Beagles. 'EasyJet might get back to about 3.5% operating margin this year. Historically it made more like 8% to 10%. Can it get back to that level? Absolutely.'

EasyJet has focused on getting more money from customers through ancillary services and has also launched a package holiday business which is proving to be a big hit. The business launched just before the pandemic struck and could make £85 million of operating profit this year, according to Beagles. 'We think it could soon make £200 million of incremental profit in a year. Put that together, we think EasyJet could make over 100p of earnings in three to four years' time. Yet the shares are still only around 480p today which to us looks quite modest.'

While EasyJet has not paid a dividend since the pandemic struck, it is quite common to see income funds own such stocks if they believe the company could reintroduce the shareholder reward in the future.

IS THE FUND WORTH BUYING?

If you are looking to take advantage of cheap valuations among UK stocks and get a decent income, JOHCM UK Equity Income has a lot going for it. Like any investment you will need to be patient and accept there will be good times and bad. But having low valuations is a great starting point and this has them in spades. 'We find an awful lot of modestly priced shares in our market,' concludes Beagles.

'When I started in the finance industry the UK was the second largest stock market in the world. Today the market cap of the FTSE 100 is less than **Apple (AAPL:NASDAQ)** .

'Ultimately Apple is close to being a single-product company, whereas we have tremendous diversification across the FTSE 100 – which of those is least risky? Most global investors have more in Apple than in the UK stock market, I suspect. That is what needs to evolve and change, and there are signs that is beginning to happen. There are takeovers and a growing realisation that the UK economy is doing ok. But that valuation gap just looks too big.'

By **Daniel Coatsworth** Editor

GLOBAL X ETFs RESEARCH

The Case for a Defined Outcome Strategy

Authored by:
Global X Research Team

There are a few universal truths in investing, and one is that all investors daydream about trades that could have set them up for life. Whether buying shares of Amazon in the late 1990s, getting in early on the crypto currency revolution, or even riding the wave of a meme stock, everyone has had those "what if" moments. But the reality is that few investors have the ability or desire to make big wagers on untested startups or emerging technologies. In fact, there are many reasons why an investor might prioritize downside protection over upside potential, such as being at or near retirement, having short-term spending needs, or simply being concerned with current market conditions. For these and other investors, a defined outcome strategy could make sense. By accessing the options market via the implementation of a defined outcome strategy, investors can seek to obtain a specified level of downside protection for their portfolios while maintaining some upside potential.

WHAT ARE DEFINED OUTCOME STRATEGIES?

Defined outcome strategies have two primary objectives. The first is to provide a specified level of downside protection, while the second is to maintain equity upside participation, up to a cap. In essence, investors in these strategies are trading upside potential in exchange for downside protection. By utilising a combination of put options (the right to sell a security at a specified price within a specified timeframe) and call options (the right to purchase) on a defined reference asset, such as the S&P 500 Index, investors can receive a level of risk mitigation that is predictable and specified, should this type of strategy be held from the initiation of the option contracts to contract expiration.

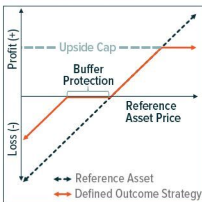
For example, the Global X S&P 500 Quarterly Buffer UCITS ETF aims to protect against the first 5% of losses on that reference index. So, in down markets, an investor would only take losses over a quarterly period should the losses of the S&P 500 exceed 5%. The trade-off is that in an uptrend, the investor would only receive full S&P 500 upside to a specified cap, depending on certain aspects of the options used. Given the specified level of downside protection offered from such a strategy, an investor implementing it receives a "defined outcome" of returns from the underlying asset, assuming it is held from contract initiation until contract expiration.

WHY SHOULD INVESTORS CONSIDER DEFINED OUTCOME STRATEGIES?

As mentioned, there are lots of reasons why investors may want to limit their downside exposure, though concerns about the near-term direction of markets are especially acute these days. While equity markets notched gains in the first quarter after a bruising 2022, uncertainty remains a hallmark of the current market environment. From interest rate policy to geopolitical tensions to a banking crisis, investors have had plenty to digest in recent months. Against this backdrop, concerns about a lower return environment proliferate. Consequently, many investors are looking to adjust their equity portfolios towards a more defensive stance.

After a period of low interest rates and strong equity performance for most of the past decade, the current inflationary environment has resulted in central banks across the globe increasing interest rates at an enhanced pace, in an attempt to bring down inflation. While the pace of hikes has slowed, rates may continue to climb, putting pressure on many of the same companies that benefitted from the previously low interest rate environment. Since bond prices fall when interest rates rise, the bond market has been adversely affected as well, with substantial losses for the typical 60/40 portfolio and a side effect of rising correlations between equity and fixed income markets. With the potential for ongoing uncertainty, it may make sense for investors to explore a defined outcome strategy for additional sources of portfolio diversification beyond typical asset classes.

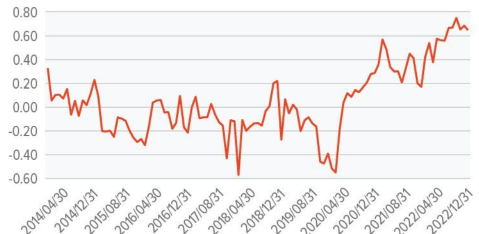
Defined Outcome Strategy



Defined Outcome Strategy Key Features
Level of downside protection on reference asset downside movements, specified by a put option overlay.
As a zero-cost premium strategy, this lowers options transactions costs for investors.
The outcome period of returns specified lasts over the life of the strategy's options contracts. The options overlay is reset at expiration.
Upside potential is capped as the reference asset appreciates beyond the strike price of a written call option.

FIXED INCOME ROLLING CORRELATIONS TO U.S. EQUITIES

Source: Global X ETFs – Morningstar (n.d.) [Correlation]. Data is measured as the monthly rolling correlation between the S&P 500 Index and the Bloomberg U.S. Aggregate Bond Index from April 30th, 2014 to April 30th 2023 and was retrieved on May 12th from Global X ETFs Morningstar Direct license.



CONCLUSION: A COMPLEX STRATEGY WITH A SIMPLE GOAL

While markets tend to rise over the long term, there are opportunities for investors to endure a less volatile experience. Using a defined outcome strategy within a portfolio may provide investors with a way to mitigate potential downside risks while also participating in rising markets. With an explicit level of downside protection over the life of the options overlay, defined outcome strategies have historically been utilised by investors to minimise equity volatility while avoiding the duration risks of fixed income securities to stay invested in equities for longer.

INTERESTED IN LEARNING MORE? EXPLORE OUR INSIGHTS AND SUBSCRIBE TO FUTURE UPDATES.

RELATED ETF

The **Global X S&P 500 Quarterly Buffer UCITS ETF (SPQB LN)** employs a defined outcome strategy in its goal to protect against the first 5% of losses on the S&P 500 from the purchase of a put spread each quarter.

By utilising a defined outcome strategy, the **Global X S&P 500 Quarterly Tail Hedge UCITS ETF (SPQH LN)** aims to provide a 9% buffer on the S&P 500, after the first 3% of losses on the same index.

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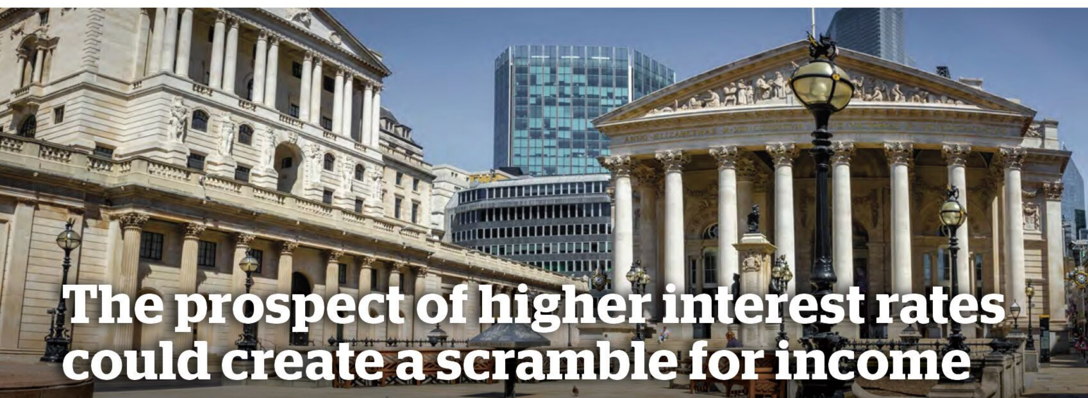


The prospect of higher interest rates could create a scramble for income

We identify a dozen firms with high yields and low valuations

If, as is being widely suggested, the Bank of England is likely to continue tightening monetary conditions by raising rates close to 6% in its effort to combat inflation, we suspect investors are going to want a higher degree of income protection than they have so far this year.

The good news for income-seekers is the UK market is a treasure trove of high-quality, high-yielding stocks on attractive valuations.

Moreover, as a recent Shore Capital note highlights, ordinary dividends tend to be fairly solid, although not set in stone, whereas share buybacks – which until now have provided significant support for valuations and earnings – are very much discretionary and may well decline in future as firms opt to hold onto their growing piles of interest-bearing cash rather than dish it out.

RATES TO GO HIGHER FOR LONGER?

As Laith Khalaf, head of investment analysis at AJ Bell, comments: 'The latest readings for core inflation and wage growth have come in hot, and that has spooked the market, sending gilt yields skywards and raising expectations of more interest rate hikes to come.

'The market is now firmly pricing in an interest rate rise at the Monetary Policy Committee's June meeting, and then four further hikes, taking us to 5.75%. A few hawkish comments from the Bank of England, or some more ugly inflation data, could easily tip those expectations up to 6%.

'While interest rates may not ultimately hit those heights, those expectations do set market pricing in the here and now for government bonds, cash accounts and mortgages.'

They also set expectations for investors looking for income, and with some FTSE 100 stocks offering close to double-digit yields the UK is a fertile hunting ground.

Meanwhile, if inflation readings, which are backward-looking by their nature, begin to subside by the end of the year, so will interest-rate expectations.

QUALITY STOCKS ON HIGH YIELDS

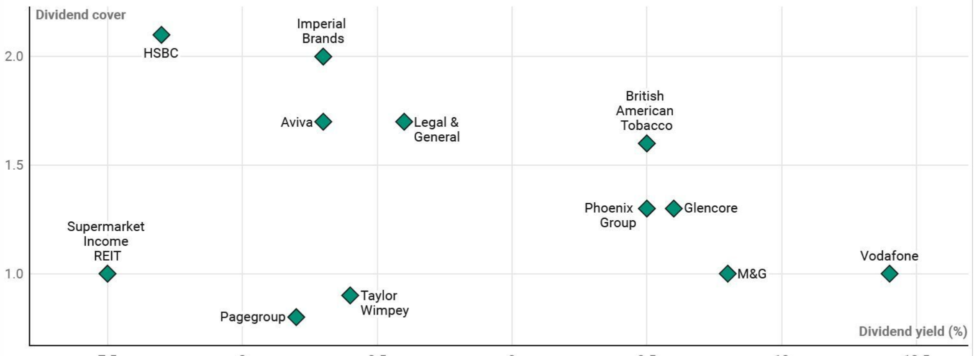
Analysts Graeme Kyle and Chris Bottomley at Shore Capital have screened the FTSE 350 index, ranking stocks by yield, gearing and price to earnings, while considering the underlying free cash flow yield and dividend cover to show whether the current payout is sensible/viable.

> "UK market is a treasure trove of high-quality, high-yielding stocks"

From that screen, we have identified several examples which offer a good combination of high income, liquidity and inexpensive valuation.

Among this dozen stocks are several financial firms, two tobacco firms, a mobile network operator, a mining firm, a recruiter, a housebuilder and a real estate investment trust.

All yield 7.5% or more, most have double-digit free cash flow yields, single-digit price-to-earnings ratios and low gearing, and all but two pay a fully covered dividend.



Dividend cover is defined as EPS (earnings per share) divided by DPS (dividend per share). EBITDA = earnings before interest, tax, depreciation and amortisation

Chart: Shares magazine • Source: Shore Capital

If we left out financial stocks, our list of 12 names would include another housebuilder, another miner, another property fund, a broadcaster and a home retailer, all with fully-covered dividends and a lowest yield of 6.5% which is still respectable compared with the index or indeed with the current 10-year gilt yield.

IS IT BYE, BYE TO BUYBACKS?

An added attraction of ordinary dividend income right now is it is relatively reliable, while capital gains, special dividends and even share buybacks look more vulnerable if interest rates keep rising.

In the first quarter of 2023, global dividend payments increased by 12% according to the Janus Henderson Global Dividend Index, but three quarters of this increase was due to one-off special dividends, currency movements and other factors, meaning underlying dividend growth was just 3%.

Last year, companies paid out $1.39 trillion in dividends globally, but as the Janus Henderson report highlights, they also spent a record $1.31 trillion on share buybacks.

In fact, buybacks have tripled in value over the last decade as companies have found themselves awash with cash earning little to no interest and without any incentive to invest in their businesses.

Buybacks were most prevalent in the US and among financial firms, but in Europe the UK was by far the biggest contributor to last year's total with $70 billion returned through share repurchases compared with just $29 billion in France and $20 billion in Germany.

Yet higher interest rates mean UK companies need to think again about paying out their surplus cash.

'Buybacks are seen as a "no strings attached" way for companies to return excess capital to shareholders,' say the Shore Capital team.

'But there is no commitment or expectation for buybacks to grow or even continue year after year if management find a more productive use for the capital.

'Contrast this to dividend payments where progressive dividend policies require year-on-year dividend per share growth. We think structurally higher interest rates may act to reduce buybacks as the interest earned on excess capital is starting to become significant.

'The corollary of this, in our view, is that demand should increase for stocks offering high dividend yields, with sustainable and growing dividend streams.'

DISCLAIMER: Financial services company AJ Bell referenced in this article owns Shares magazine. The author (Ian Conway) and article editor (Tom Sieber), own shares in AJ Bell. The author also owns shares in British American Tobacco referenced in the graphic.

By **Ian Conway** Companies Editor

Is consumer resilience under threat as rates keep climbing?

Retailer Next says trading is better than expected but the outlook is far from positive

British retail giant **Next (NTX)** is a barometer of the health of the high street so when it puts out an unscheduled trading update, markets pay attention.

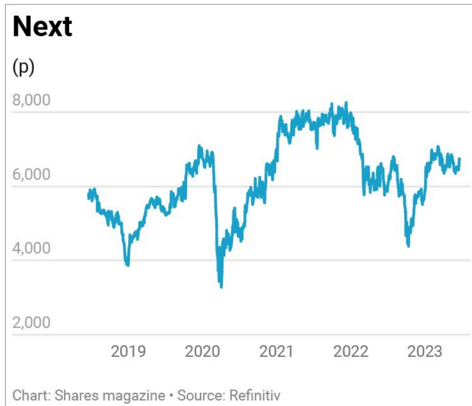


Chart: Shares magazine • Source: Refinitiv

It implied recent warm weather had encouraged to consumers to update wardrobes, a phenomenon that rival **H&M (HM-B:STO)** has also enjoyed as summer finally hit the continent in earnest at the start of June.

But what really captured the attention of analysts was the assertion from Next that those big pay rises from employers had led to a significant uplift of real household income which was mitigating the worst impact of inflationary pressures.

With Next perceived by investors as the expert in understatement, its shares shot to the top of the FTSE 100 risers immediately after its update, lifting a host of other retailers in its wake.

The key is consumer confidence and that is something that has been growing in recent months despite continued headlines about the cost-of-living crisis, stubbornly high inflation and a meltdown in mortgage markets.

Chart: Shares magazine • Source: Refinitiv

Wages might not have kept up with inflation, but nominal pay has grown at the fastest rate in 20 years (if you strip out the pandemic) and the tight labour market has prevented businesses from shedding staff, even if their sums do not add up.

Inflation is coming down in various places, even in parts of the food sector which has been a main cause for concern amongst households in recent months.

With grocers still under pressure to do more after allegations of profiteering which they strenuously deny, a new bout of price wars has commenced which is likely to put more money back in shoppers'

pockets. **Tesco (TSCO)**, **Sainsbury's (SBRY)** and **Marks & Spencer (MKS)** have all slashed the cost of everyday essentials.

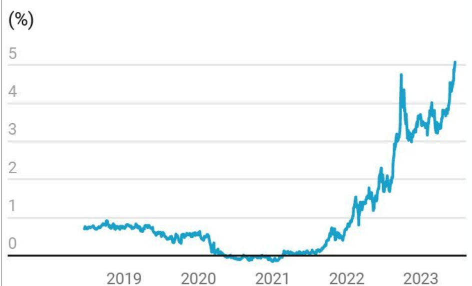


Chart: Shares magazine • Source: Refinitiv

The cure for bringing down inflation has created another economic ailment. The cost of government borrowing over two years has topped 5% for the first time since 2008 as markets price in further moves by the Bank of England.

It has piled even more pressure on lenders which have responded by pulling products or raising the rates on the average two-year fixed mortgage above 6%. For homeowners facing remortgaging the reality is pretty stark.

The Resolution Foundation has warned that just under half of the 7.5 million mortgage holders in the UK have not yet faced an increase in their payments, but 3.3 million households face that cliff-edge between now and 2026 – with the expectation that rates will not fall below 4.5% until the end of 2027.

It estimates the average jump in annual repayments will come in at £2,900, an amount that cannot help but impact the amount disposable income those consumers have to spend in shops like Next.

For its part, Next has always tried to under-promise and over-deliver, which is why its latest guidance was only moderately lifted as the company anticipates that the benefits of pay rises will be eroded by cost pressures.

SHIFTING DYNAMICS

Retail will not be the only sector warily watching mortgage movements. Middle earners with savings cushions were insulated from the worst of the energy crisis. But those saving cushions have been reduced and there are accounts of living standards having to be pared to the bone as those ultra-low rates of the past are resigned to the history books.

Will these consumers still be able to take that long weekend at places like Centre Parcs? The holiday park operator has done such a roaring trade post-pandemic that its business sale has attracted a wide range of interest from investors rumoured to include Pinewood Studios-owner Aermont.

And what of the housing market? So far, house prices have shown little sign of distress with Rightmove reporting that the average asking price dropped in June for the first time this year, but only by £82.

But it is predicting a fall in asking prices by 2% by the end of year and housebuilders are already redrawing plans.

Yes, the consumer has been resilient but the very thing that has shored up that resilience, those elevated wage increases, have sparked concern about a wage price spiral which UK central bankers are desperate to prevent.

Earlier comments by MPC members might have been clumsy at best but the underlying sentiment was sound and as a new cost-of living crisis emerges from the old there will be more calls for government intervention.

With an election in the offing quick fixes might be vote winners but inflation is a funny beast and one that economies around the world are still struggling to tame.

By **Danni Hewson**
Head of financial analysis at AJ Bell

All aboard! How to invest in the rail sector and the stocks to watch

There are multiple reasons why the industry should continue to grow

There are several reasons to invest in the rail sector. For one, there is continued investment by governments from the UK, US and Europe in rail infrastructure and technology.

The railway industry is starting to take notice of its own carbon emissions and is taking steps to cut its carbon footprint. For example, UK railway company Network Rail has a 30-year strategy to deliver a more sustainable network across the whole of Britain.

In Europe, France has recently banned domestic short-haul flights where train alternatives exist, in the country's attempt to cut back emissions by 50% by 2030.

Another reason to invest in the rail sector is because of legendary US investor Warren Buffett. If it is good enough for Buffett, there is a widely held view that it must be good enough for the average investor.

Buffett's investment firm **Berkshire Hathaway (NYSE:BRK.B)** owns rail company BNSF (Burlington Northern Santa Fe). Buffett believes his investment in US rail demonstrates his faith in the strength of the US economy.

Investors can put money into shares of companies involved in freight or passenger rail services – with freight names having typically delivered stronger returns in the past. There are also companies on the stock market which provide products and services to the industry.

FREIGHT RAIL

During the period 1 April to 31 March 2022 total freight moved by rail in the UK increased by 11.3% to 16.87 billion net tonne kilometres, 1.8% higher than April 2019 to March 2020, according to the Office of Rail and Road. This data shows that the amount of freight moved across the UK's railways has returned to pre-pandemic levels.

The reason for this increase in freight rail usage is not just because of environmental reasons. According to the International Energy Agency rail is among the most energy efficient modes of transport for freight and passengers. While the rail sector carries 8% of the world's passengers and 7% of global freight transport, it represents only 2% of total transport energy demand.

US rail freight operator **Union Pacific (NYSE:UNP)** reports one locomotive can move one tonne of freight more than 400 miles on a single gallon of diesel fuel. This generates a carbon footprint 75% smaller than trucks classified as heavy goods vehicles over the same distance, says the IEA.

FROM GLOBAL TO LOCAL LEVEL

Another reason why rail freight usage has grown is because of 'complicated geopolitical circumstances following the pandemic,' says Stephen Yiu, fund manager at the **Blue Whale Growth Fund (BD6PG78)**, so 'more goods will be produced in the West.'

Yiu says: 'Beneficiaries (of this theme which is called reshoring) are those companies which facilitate renewed industry and those that are already producing key items in benign territories.'

Reshoring (also known as onshoring) is the process of returning the production and manufacturing of goods back to the company's original country. It is the opposite of offshoring, which is the process of making goods overseas to try to reduce the cost of labour and manufacturing.

To play this reshoring theme, Blue Whale has invested in two rail companies in North America – Union Pacific and **Canadian National Railway (NYSE:CNI)**. 'With a comprehensive rail network between the two, they provide key infrastructure for North America to drive this era of reshoring.'

SHIPPING WOES

Rail freight usage has also benefited from the 'fallout' from shipping. The pandemic showed shipping goods in deep sea containers in a bad light – often the goods got stuck due to Covid restrictions, for example in China, causing suppliers to lose money and consumers not to get their goods. Rising inflation and the inability to get staff at the seaports also pointed to the unreliability of shipping goods by sea compared to rail.

An extreme example of when shipping goods went wrong occurred in March 2021, when one of the world's biggest container ships called the Ever Given got stuck in the Suez Canal for almost a week. By being stuck the Ever Given managed to hold up an estimated $9.6 billion of goods each day, according to Lloyd's List.

INVESTING IN OVERSEAS-LISTED RAIL SHARES

There are a number of US-listed rail companies that have delivered double-digit average annual returns over the past decade.

Union Pacific has delivered 11.6% annualised returns over the past 10 years. It connects the western two-thirds of the US by rail – from the West Coast and Gulf Coast ports to eastern gateways, Canada's rail systems and Mexico gateways. Last July, Union Pacific signed a $1 billion deal with **Wabtec (WAB:NYSE)** to modernise around 600 trains.

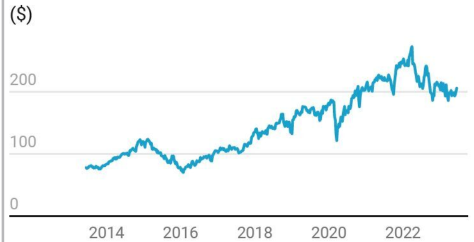


Chart: Shares magazine • Source: Refinitiv

Canadian National Railway operates from the Atlantic Coast in Nova Scotia to the Pacific Coast in British Columbia. It has a market capitalisation of C$90 billion and its biggest shareholder is the Bill & Melinda Gates Foundation at 8.1%. Over a 10-year period it has delivered a 13.4% annualised total return.

CSX (CSX:NASDAQ) is a US rail company which has customers in various markets including energy, construction and agriculture. Over a 10-year period CSX has delivered a 16% annualised return, according to Morningstar.

French rail transport company **Alstom (ALO:EPA)** makes rolling stock and has built, or is building, just under 40% of the UK mainline train fleet. It has been a more volatile investment, with its share price doubling between 2016 and 2020, however it has since lost most of those gains.

The company recently said it was testing its first regional hybrid train on the Toulouse / Mazamet

and Toulouse / Rodez lines. Christophe Fanichet, chairman and CEO of SNCF Voyageurs said: 'The skills of the SNCF and Alstom technical teams have made it possible to meet the challenge of integrating an innovative traction system into an existing rolling stock, thus paving the way for the

decarbonisation of regional trains.

'With the first hybrid regional train, Occitanie is the only region involved in all the trials of innovative rolling stock to reduce CO2 emissions, efficiently and quickly.'

INVESTING IN UK-LISTED RAIL SHARES

With Go-Ahead having delisted from the London Stock Exchange last October following a takeover, **FirstGroup (FGP)** is the only primary passenger rail company left on the UK stock market.

It is the UK's largest rail operator, covering long-distance, commuter, regional and sleeper services under such franchises as GWR, Avanti West Coast and Hull Trains. It also operates a variety of bus services.

FirstGroup's share price has increased by a third year-to-date as the company continues its post-pandemic recovery, although it did lose the TransPennine rail contract in May after the government took control of the franchise following a period of significant disruption to travellers.

Elsewhere, there are various rail-related companies on the stock market providing services to the industry.

Shares in ticketing platform **Trainline (TRN)** have been volatile since listing in 2019, hitting highs of 545p and lows of 164p. Admittedly the pandemic in 2020 derailed the business but it has struggled to win back the market's favour despite ambitions to be a bigger player across Europe.

Trainline

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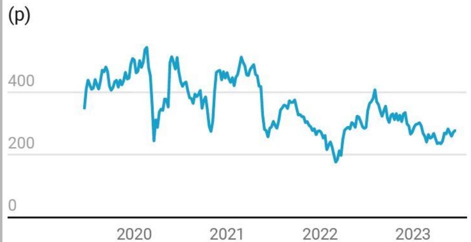


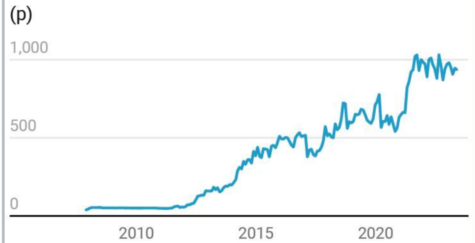
Chart: Shares magazine • Source: Refinitiv

Trainline reported a 72% rise in net ticket sales of £4.83 billion for the year ending 28 February 2023. Russell Pointon from research group Edison, said: 'Trainline expects further ticket sales and revenue growth of 13-22% in its FY24 outlook, and with its considerable expansion potential into new and existing European markets, it looks like the ticketing provider may just steam ahead to even higher profit growth given management's guidance on profit margin.'

Tracsis (AIM:TRCS) is a company specialising in software to help railway operators manage their operations, such as rail crew scheduling and resource management. It has expanded its operations to include ticketing, data analytics and geographic information systems. Over the past five years Tracsis' shares are up 68% to 933p.

Analysts at Stifel say Tracsis has 'a track record of growth, profitability and successful acquisitions' and it targets an average of 10% organic growth per year, which can be accelerated though acquisitions.

Stifel adds: 'Since 2010, Tracsis has delivered compound annual growth rate of 33% for revenue. The company raised £7 million at admission to AIM in 2008 and an additional £2 million in 2011. Since then, it has made 17 acquisitions while continuing to invest in product development and paying dividends.'



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By **Sabuhi Gard** Investment Writer

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Are there any benefits to delaying taking the state pension?

The key points to consider and how delaying works in practice

I am aged 65 and I will be eligible to draw my state pension later this year. However, I intend to carry on working another few years.

I am aware that I can effectively defer my state pension by not opting to take it. Is there any particular advantage to deferring or would I be better off to take the state pension as soon as I can?
Alex

Tom Selby, AJ Bell Head of Retirement Policy, says:

The UK state pension age is currently 66, although it is due to increase to 67 by 2028 and then again to 68 by 2046. The full flat-rate state pension is worth £203.85 per week (around £10,600 per year) and is protected by the 'triple-lock', a political promise to increase the benefit by the highest of average earnings, inflation or 2.5%.

However, not everyone will get the full state pension amount. You need to have 35 qualifying years on your National Insurance record to be entitled to the full state pension, with lower amounts paid to those with shorter records. You need to have a 10-year National Insurance record to be entitled to any state pension under this system.

Other factors, such as whether you 'contracted-out' under the old state pension system, will also affect your entitlement – although it is possible to buy extra National Insurance years to boost your state pension.

The government recently confirmed the deadline for people to buy extra National Insurance years going back to April 2006 has been extended until 2025. You can read more about how this works and the things you need to consider when paying voluntary National Insurance in this article.

STATE PENSION DEFERRAL:
Key points (for those reaching state pension age after 5 April 2016)

- You must defer your state pension by at least nine weeks in order to get an uplift
- Your state pension will increase by 1% per nine-week deferral, or just under 5.8% for a year
- This additional state pension entitlement will rise in line with inflation and NOT the triple-lock
- Based on someone receiving the full state pension amount (around £10,600) in 2023/24, a one-year deferral could boost their income by £11.82 per week for life
- It could take around 16 years for a one-year deferral to pay off financially*

*Assumes the full £10,600 state pension is deferred for one year and increases by 2.5% per year

YES, YOU CAN DEFER

It is possible to defer taking your UK state pension – and you'll receive an uplift for doing so. The level of this uplift will depend on when you reached state pension age.

For those who reached state pension age before 6 April 2016, the rate of uplift is 1% for every five weeks you defer, subject to a minimum deferral period of five weeks. This works out at a

> **"Meaning they no longer have to rely on riskier instruments to achieve their overall return targets"**

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- Can I use my tax-free cash lump sum to boost my pension?
- As a sole director of a limited company, how much can I make in employer contributions?
- What do I need to think about before accessing tax-free cash from my pension?

10.4% increase in your state pension if you defer for 52 weeks.

Based on the 2023/24 basic state pension of £156.20 per week, this works out at an extra £16.24 per week for life if you deferred for 52 weeks.

For anyone who reached state pension age on or after 6 April 2016, the deferral rate is 1% for every nine weeks they defer, or just under 5.8% for every 52 weeks. You have to defer for at least nine weeks in order to benefit from this boost.

This increase is applied to the flat-rate state pension. Based on someone receiving the full flat-rate state pension for 2023/24 of £203.85 a week, a person who deferred for 52 weeks would get an extra £11.82 per week for life.

Both of these examples assume there is no annual increase in the value of the state pension. If there is an annual increase, the amount you receive could be larger.

Whether or not state pension deferral is the right option will depend on your personal circumstances.

For some it simply won't be possible as they need the state pension income as soon as possible, while for others it might depend on their health and lifestyle. But if you are in good health then it could be worth considering.

HOW DOES IT WORK IN PRACTICE?

Take someone who reached age 66 in 2023/24 and is entitled to the full flat-rate state pension of £203.85 a week. If they defer taking this income for one year, they will forgo £10,600 in return for an extra £11.82 a week for the rest of their life.

Based on the state pension increasing by 2.5% each year, it could take around 16 years to take as much total income via deferral as they could have done by taking the state pension at age 66.

For someone with a state pension age of 66, this implies the point at which they might be in 'profit' from deferring the state pension could be around age 82.

Given average life expectancy for a 66-year-old man is around 85 and a 66-year-old woman is around 87, this suggests that, provided you are in good health, there is a decent chance delaying receiving your state pension could pay off financially.

DO YOU HAVE A QUESTION ON RETIREMENT ISSUES?

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

Please note, we only provide information and we do not provide financial advice. If you're unsure please consult a suitably qualified financial adviser. We cannot comment on individual investment portfolios.

Cash savings account: should I go for a fixed or variable rate?

What to consider if you're looking to put some of your money in the bank or building society

When it comes to cash savings accounts, the variety of options available can make your head spin if you're not careful.

A fixed-rate account promises you a specific return on your savings over a defined period. This can range from a single year, up to five, sometimes even more.

Your interest rate is constant, it does not matter whether the Bank of England's base rate rises, falls, or does a jig, your return stays the same.

There is an appealing certainty here. You know exactly what you will get, when you will get it, and you can plan accordingly. It also serves as a rather effective diet plan for your spending urges, because if you withdraw your money early, you will usually face a penalty.

In contrast, a floating or variable-rate savings account does not offer the comfort of predictability, with the interest rates bobbing up and down, typically tethered to the Bank of England base rate.

KEY ADVANTAGES

A key advantage is flexibility. Variable rate accounts generally allow you to dip into your savings whenever you want without any penalties.

The rates on offer from both types of account are a key consideration too, though it is difficult to predict over any time period whether fixed or variable rates will turn out better, because the latter are determined by what the Bank of England's interest rate setting committee decides at each of its meetings.

At the moment the best one-year fixed account is offering 5%, while the best variable easy access account is offering just under 4%, according to Moneyfacts.

However, with interest rates expected to rise over the rest of this year, the variable account should provide higher rates too in time.

WHERE MIGHT BASE RATES END 2023?

Currently the market is pricing in that base rate will rise to 5.75% by the end of the year, but these expectations can change at the drop of a hat.

Ultimately, they may not be borne out in reality either, that is entirely down to the Bank of England.

Easy Access savings – variable rates

Provider	Rate
Paragon	3.91%
Shawbrook	3.91%
Aldermore	3.85%

Table: Shares magazine • Source: Moneyfacts, correct as of 15 June 2023

Notice accounts – up to 60 days – variable rates

Provider	Notice	Rate
RCI Bank	14 days	3.95%
Aldermore	30 days	3.75%
OakNorth	35 days	2.10%

Table: Shares magazine • Source: Moneyfacts, correct as of 15 June 2023

Notice accounts – up to 180 days – variable rates

Provider	Notice	Rate
Investec Bank	90 days	4.50%
Family Building Society	120 days	4.45%
Hampshire Trust Bank	120 days	4.40%

Table: Shares magazine • Source: Moneyfacts, correct as of 15 June 2023

Fixed rate bonds – up to 1 year

Provider	Term	Rate
Al Rayan Bank / Raisin UK	9 months	5.00%
QIB (UK) / Raisin UK	9 months	5.00%
OakNorth Bank	9 months	4.97%

Table: Shares magazine • Source: Moneyfacts, correct as of 15 June 2023

Fixed rate bonds – up to 2 years

Provider	Term	Rate
QIB (UK) / Raisin UK	2 years	5.45%
OakNorth Bank	2 years	5.40%
Investec Bank / Raisin UK	2 years	5.36%

Table: Shares magazine • Source: Moneyfacts, correct as of 15 June 2023

In the meantime, with each month that passes with variable rates below fixed rates, the variable rate account also has to make up for the lost interest relative to the fixed rate account before breaking even.

However, if interest rates really take off, the return on the fixed-rate account could start to look shabby by comparison, and that is a bigger risk when fixing for longer periods because you would not be able to change account for a long time to take advantage of higher market rates.

TAX ISSUES TO CONSIDER

You should also be mindful of the tax situation. Variable accounts pay interest regularly throughout the year, whereas fixed-rate accounts will tend to pay once a year on the anniversary of you opening the account, and this determines the tax year in which the interest is taxable.

There may therefore be some value in choosing one rather than the other depending on your tax situation. For instance, if you are about to retire in six months' time and drop down a tax band from 40% higher rate to 20% basic rate, a one-year bond will push your interest into the next tax year when you're a basic-rate taxpayer.

Both fixed and variable-rate accounts are also available within a cash ISA, where all the interest is tax-free. However, remember to compare the rates.

Some non-ISA accounts offer higher interest rates that might outweigh the tax benefits of a cash ISA. And if you're a basic-rate taxpayer with savings interest under £1,000, you already have a personal savings allowance that shields your interest from tax. For higher-rate taxpayers this allowance is only £500 and for additional-rate taxpayers it is zero.

More people are likely to be breaching this allowance now that interest rates have risen so sharply, so a cash ISA might come in handy. The Treasury can always cut or do away with the personal savings allowance too, so putting money into an ISA protects you from further government meddling on that front.

The wide range of cash accounts does take a bit of effort to get your head around, but at least it does mean that you have lots of options which can be tailored to your individual needs.

If you have a variety of savings goals, like most people, you can split your cash up between variable and fixed-term accounts to hedge your bets a little, locking into some higher returns, but also maintaining some flexibility.

By **Laith Khalaf**
AJ Bell Head of Investment Analysis

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Index

Main Market

Associated British Foods 9
Aviva 34
Barclays 34
BP 34
Dowlais 29
EasyJet 35
FirstGroup 44
Halma 14
HSBC 19
Legal & General 34
Marks & Spencer 40
Melrose 29

Moonpig 15
Motorpoint 8
NatWest 34
Next 9, 40
Ocado 15
Oxford Instruments 11
Phoenix 34
Sainsbury's 40
Shell 34
Standard Chartered 19
Tesco 40
Trainline 44
Travis Perkins 5

Vodafone 6

AIM

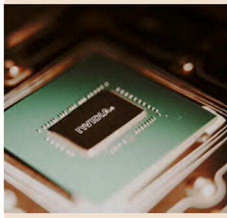
Boohoo 15
Midwich 13
Tracsis 45

Overseas shares

Alphabet 22
Alstom 43
Amazon 22

Apple 22, 35
Berkshire Hathaway 42
Brambles 12
Canadian National Railway 43
Cava 8
Chipotle Mexican Grill 8
Clean Harbors 12
CSX 43
Darling Ingredients 12
DBS 20

H&M 40
Meta Platforms 22
Microsoft 22
Nike 10
Northland Power 12



Nvidia 22
PTC 12

Tesla 22
Union Pacific 42
Wabtec 43

Investment Trusts

Impax Environmental Markets 12
Nippon Active Value Fund 7

Funds

Blue Whale Growth Fund 43
JOHCM UK Equity Income 19, 33

ETFs

Invesco S&P 500 Equal Weight 23
iShares S&P 500 Equal Weight 23
UBS MSCI Japan UCITS ETF 7
Xtrackers S&P 500 Equal Weight 23

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