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SHARES

WE MAKE INVESTING EASIER

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WITH STOCKS AND FUNDS YIELDING MORE THAN 5%

THE INVESTMENTS WHERE YOU CAN SIT BACK AND LET THE CASH ROLL IN

WHAT TO DO WITH YOUR WORLDPAY TAKEOVER PROCEEDS: PAGE 9

Plenty of opportunities despite markets rallying

We talk to a smaller company fund manager about spotting investment ideas in the current environment

The markets have started the New Year in a bullish manner with a repeat of the same trend seen in 2017: mid and small caps are outperforming larger companies.

Many of you may assume high market levels make it harder to find decent investment ideas. In reality we're still finding plenty of stocks well worth buying at current levels.

The key is taking a long term view of a company and looking at its prospects versus rivals and broader markets. This approach resonates with how **FP Octopus UK Micro Cap Growth Fund (GB00BYQ7HN43)** manager Richard Power picks stocks for his portfolio.

He says there are still 'pockets of the market' that present exciting opportunities for investors. Indeed, eight new names were added to his portfolio in December 2017, which he says is unusual as it is higher than normal for the fund.

MARKETS REMAIN ATTRACTIVE

You may consider the large number of additions by Octopus to be a surprise given the widespread chatter that markets are overdue a correction. However, it illustrates how market experts are still finding opportunities.

Recent additions to the Octopus portfolio include gaming sector service provider **Sumo (SUMO:AIM)**. Power also picked up a stake in **Best of the Best (BOTB:AIM)** whose share price took a hit in December after the gambling company said it would have to pay higher taxes.

Some of the stocks in Power's portfolio have already seen significant gains since investment, yet he still sees potential for even more value appreciation in many cases.

For example, he reckons patent translation group **RWS (RWS:AIM)** and pharmaceutical provider/services firm **Clinigen (CLIN:AIM)** could double in size again over the next two to three years.

IMPORTANCE OF DELIVERING ON A PROMISE

The key to successful small cap investing is to back companies who deliver on their stated intentions. That might be making acquisitions which always add value; or being able to hit or exceed earnings guidance on a regular basis.

Power says management strength is one of the most important factors behind his investment decision making. He likes managers with a clear vision and who are able to deliver.

Big success stories for the Octopus fund no longer in the portfolio include **Fevertree Drinks (FEVR:AIM)** and construction group **Breedon (BREE:AIM)**. 'Unlike some micro-cap funds, we don't sell a stock when it is no longer a smaller company. We like to maximise the potential of a business.

'We sold Fevertree when it was worth £2.6bn due in part to Schweppes' comeback. We sold Breedon when it was worth £1.3bn as it had by then already seen earnings upgrades and made a large acquisition.'

As for future potential portfolio stars, Powers says **Angling Direct (ANG:AIM)** could be 'the next Gear4Music' referring to the musical instruments retailer which has increased more than five-fold in value since summer 2016.

He also favours media group **Future (FUTR)** which is also one of *Shares'* top stocks for 2018.

On that note, I'd like to wish everyone the best of luck with their investing this year and hope you continue to find *Shares* a valuable source of news and opinion to support your investment journey. (DC)

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BROKER RATINGS EXPLAINED:

We use traffic light symbols in the magazine to illustrate broker views on stocks.

Green means buy, Orange means hold, Red means sell.

The numbers refer to how many different brokers have that rating.

Eg: 4 2 1 means four brokers have buy ratings, two brokers have hold ratings and one broker has a sell rating.

The traffic light system gives an illustration of market views but isn't always a fully comprehensive list of ratings as some banks/stockbrokers don't publicly release this information.

Is Mothercare a takeover target after share price slump?

The stock is down by 64% since June 2017

As *Shares* goes to press, the flurry of festive updates from retailers is arriving and proving something of a mixed bag.

Set against low expectations, particularly for non-food categories, high street bellwether **Next (NXT)** fared better than feared over the Christmas period and **WM Morrisons Supermarkets (MRW)** also beat expectations and maintained positive like-for-like sales momentum. On the flip-side, department store **Debenhams (DEB)** reported dire trading and issued a full year profit warning.

The one company that really caught our attention was ailing maternity brand **Mothercare (MTC)**, whose shares collapsed to 46p following a worrying festive update (8 Jan) and full year profit alert.

Supermarkets and cheaper online rivals are evidently eating into Mothercare's business and value investors should be wary of viewing this sell-off as a buying opportunity.

The self-styled global retailer for parents and young children saw UK like-for-like sales slump 7.2% in the 12 weeks to 30 December. Mothercare paid for its 'conscious decision' to avoid discounting before Christmas, then discounted more heavily in the end of season sale.

In the third quarter, 'international trade was challenging', albeit with a return to growth seen in the Middle East and Russia in more recent weeks.

'Although there are welcome signs of stabilisation in the International division, the acute operational gearing in the domestic business causes its full year 2018 profit before tax expectations to fall further to a range of between £1m and £5m,' says Numis analyst Matthew Taylor, whose previous estimate was £10m.

EARNINGS COLLAPSE

Taylor now forecasts a year-on-year pre-tax profit slump from £19.7m to £2.5m for earnings per share of 1.2p (2017: 9.2p), leaving Mothercare looking expensive relative to depressed earnings on a 38 times price-to-earnings mulitple.

Though Mothercare's heritage brand name continues to resonate overseas, uncertainty over trading trends and the absence of a dividend would perhaps deter financial or trade buyers.

We see merit in the view of Canaccord Genuity's Sanjay Vidyarthi, a seller with a downgraded price target of just 29p. The Canaccord number cruncher believes 'there is a place for Mothercare in the UK, but the right-sizing of the store portfolio needs to happen faster' and also flags liabilities potentially topping £400m.

'This makes Mothercare a difficult take-out candidate, despite the potential strategic value of the business,' explains Vidyarthi. 'The reality is, in our view, that the UK business would already have gone through administration (and potentially come out a stronger, right-sized business) were it not for the cash flows of International keeping it afloat.' (JC)

Which UK-listed stocks are affected by US tax reform?

We look at some of the firms affected by changes on the other side of the Atlantic

The green light for US tax reform is a potential boost for several UK-listed businesses with significant US operations.

Some are taking hefty charges as they recalculate deferred tax assets. However, these one-off charges will have no cash impact and a cut in corporation tax from 35% to 21% is expected to provide a long-term boost.

4imprint (FOUR) – The 97% US-based promotional products firm sees no 2017 impact but its tax rate is expected to fall from 30% to low 20s going forward.

Barclays (BARC) – The bank faces a £1bn hit in its 2017 financial year.

BP (BP.) – The oil major flags a $1.5bn one-off charge in its fourth quarter 2017 results but there should be a future positive impact.

CRH (CRH) – Stockbroker Davy sees 5% earnings boost to building materials firm CRH.

Keller (KLR) – It expects to have a one-off $10m credit, plus a reduction in future effective tax rate by 5% to high 20s.

Melrose (MRO) – The industrial buy-out specialist sees no impact in 2017. A reduction in 2018 effective tax rate to 24% would be beneficial to asset valuations, as well as potentially cutting any tax liability should it sell part of its Nortek business.

Royal Dutch Shell (RDSB) – The Anglo-Dutch oil firm highlights $2bn to $2.5bn charge in Q4.

Somero (SOM:AIM) – FinnCap has upgraded 2018 earnings at construction equipment group by 19.7% as a result of the US tax reform.

Eco Atlantic gets Exxon discovery boost

OIL EXPLORATION firm **Eco Atlantic Oil & Gas (ECO:AIM)** has enjoyed a storming start to 2018 with its share price up 90% year-to-date to 33.4p. The rally is thanks to US oil major ExxonMobil announcing a sixth big discovery on the Stabroek block, Guyana.

This asset neighbours Eco's 40%-owned Orinduik block. French energy giant Total is currently working through seismic data with an option to acquire a 25% stake in Orinduik for $13.5m. (TS)

Christmas boost for grocers

BOOSTED BY significant inflation, overall supermarket sales shot up by 3.8% in value over the 12 weeks to 31 December, an additional £1bn ringing through the tills versus the 2016 Christmas period. So says Kantar Worldpanel, whose latest grocery market share figures (9 Jan) reveal the average household shrugged off economic worries to spend a record £1,054 on groceries in the three month period. **Tesco (TSCO)** was the fastest growing of the big four supermarkets, with sales up 3.1%. (JC)

Coal hits one-year high

POWER-GENERATING thermal coal has reached its highest levels since late 2016 above $100 per tonne as strong manufacturing activity in Asia and China supports prices.

A lack of new projects amid environmental concerns means supply is tight. Most observers expect any strength in coal to be short-lived as emerging markets eventually follow Europe in phasing out the fossil fuel. (TS)

Dialight banking on new leadership

Execution is key to operational and share price recovery

Shareholders in LED lighting systems designer **Dialight (DIA)** are pinning their hopes on new leadership drawing a line under manufacturing execution problems.

The £195m company is at the cutting edge of LED technology, specialising in lighting solutions for hazardous and challenging industrial applications, such as mobile masts, power plants and oil rigs.

Struggles to meet output led to the decision last year to outsource manufacturing to Silicon Valley-based Sanmina. That move has been beset with problems, including product launch and production delays. This led to two profit warnings during 2017.

The problems cost former chief executive Michael Sutsko his job, but analysts believe his successor, Marty Rapp, has the engineering and manufacturing background to turn things around.

Rapp is a former executive at electronics designer **Laird (LRD)**. He also held engineering positions at Monsanto, the Fortune 500 agriculture giant.

'His main priority is to accelerate the recovery after the relationship with contract manufacturer Sanmina began so poorly,' say analysts at Investec. They believe there could be 60% share price upside from the current 600p if he gets it right.

However, Berenberg believes there may have been large market share declines during months of upheaval. In our view there is scope for recovery but evidence of better execution is needed. (SF)

The week in a minute

A snapshot of good and bad corporate news

GOOD NEWS

- **Plus500 (PLUS:AIM)**: Trading is yet again ahead of market expectations, prompting analysts to upgrade forecasts.
- **Johnson Service (JSG:AIM)**: Expects full year results to be ahead of management expectations.
- **H&T (HAT:AIM)**: Says full year pre-tax profit will be ahead of market expectations.
- **Carr's (CARR)**: Positive trading update leads Investec to say Carr's is on track to grow profit this financial year following a setback in 2017.
- **Craneware (CRW:AIM)**: Significant contract win with a major US healthcare provider, plus positive trading update.

BAD NEWS

- **Shire (SHP)**: The drugs firm said it wouldn't hit a $20bn sales target for 2020 and added that a break up of the business won't happen near-term as some had previously speculated.
- **Be Heard (BHRD:AIM)**: Profit warning after reduced activity in part of its business and deferral of some existing and new contracts.
- **Elegant Hotels (EHG:AIM)**: Cuts dividend, says revenue per available room fell 4.6% in its 2017 financial year.

Where to invest your Worldpay takeover proceeds

Shareholders are about to get a mixture of cash and shares as acquisition by Vantiv is approved

Shareholders in payment processing group **Worldpay (WPG)** will receive a mixture of cash and shares later this month in relation to the FTSE 100 member's takeover by US peer Vantiv.

They will get shares in the enlarged business which will be renamed Worldpay Inc and be listed on both the London and New York stock exchanges.

WHAT ARE THE TERMS OF THE DEAL?

Worldpay shareholders will receive 55p in cash, 0.0672 new shares and additional 4.2p cash as a special dividend for each Worldpay share they own. The cash component represents approximately 13% of Worldpay's market value.

Worldpay's current shares will be suspended from trading on 15 January. The cancellation of the old shares and admission to trading of the new shares will happen on 16 January. The cash payments are scheduled to be made on 30 January.

WHAT WILL THE ENLARGED BUSINESS DO?

Vantiv and Worldpay look like they will fit well together. Vantiv is the number one merchant acquirer in the US, specialising in the retail, restaurant, grocery and drug sectors, and business-to-business markets. Worldpay specialises in digital services, the travel sector and online retail, and is the number one merchant acquirer in the UK.

The combined business will be the number one global acquirer, according to a presentation by the two companies.

They cite 'significant opportunity' to cross-sell business-to-business services into the combined customer base, plus expand integrated payments into the UK and across Europe.

DECISION TIME FOR INVESTORS

Worldpay shareholders have a choice with what to do with the proceeds of the Vantiv deal:

1. Keep the new Worldpay shares and use the cash component to buy more Worldpay stock

2. Keep the new Worldpay shares and use the cash component to invest in something else

3. Sell all the new Worldpay shares and use the proceeds, along with the cash component, to invest in something else

4. Sell some of the new Worldpay shares and invest the proceeds along with the cash component in something else

Shareholders wishing to use the cash component, and potentially sell some or all of their new Worldpay shares to generate additional cash to make other investments, may wish to look at alternative ways of playing growth in the e-commerce sector.

For example, the rise in people returning items ordered online plays into the strengths of **Clipper Logistics (CLG)** which helps the likes of **ASOS (ASC:AIM)** and **Superdry (SDRY)** with their e-fulfilment and returns management.

Polar Capital Technology Trust (PCT) may interest someone looking for diversified exposure to some of the biggest names in digital industries including e-commerce.

The investment trust's top holdings include retail giant Amazon, Google's parent company Alphabet, Apple, Microsoft and Chinese e-commerce, retail and technology conglomerate Alibaba. (DC)

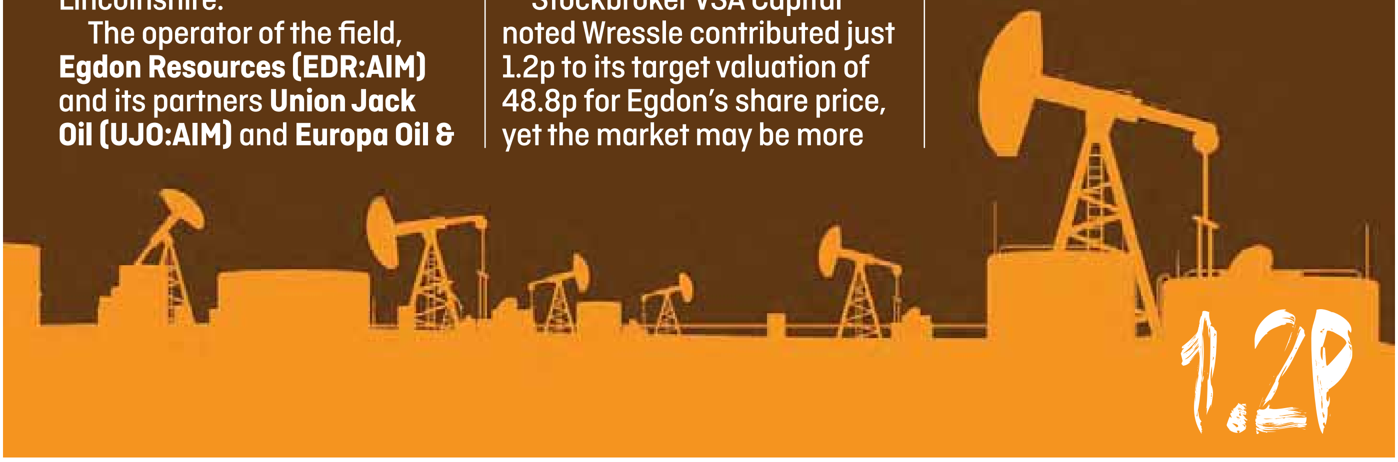
HOW SERIOUS IS WRESSLE SETBACK FOR EDGON RESOURCES?

Company's appeal over key project is rejected by planning authority

ON 5 JANUARY it emerged that the Planning Inspectorate had unexpectedly upheld a decision to block the development of the Wressle oil discovery in North Lincolnshire.

The operator of the field, **Egdon Resources (EDR:AIM)** and its partners **Union Jack Oil (UJO:AIM)** and **Europa Oil & Gas (EOG:AIM)** all suffered big share price falls. In particular, Egdon fell 1.44p to 6.7p in the immediate aftermath of the news.

Stockbroker VSA Capital noted Wressle contributed just 1.2p to its target valuation of 48.8p for Egdon's share price, yet the market may be more concerned about the loss of projected production of 120 barrels of oil equivalent (boepd) and the cash flow associated with this output.



OPPORTUNITY FOR PROPERTY FUND ON MACAU GROWTH SURGE

Macau Property Opportunities Fund (MPO) has laid out several reasons in its fourth quarter update as to why it could enjoy a prosperous year in 2018.

Average rentals have grown by 6.4% quarter-on-quarter to HK$19.95 per square foot per month at The Waterside, one of the few waterfront living residential developments in Macau.

Occupancy for the property stood at 59%. The fund is hopeful that Macau's VIP gaming segment will continue to recover and boost rental values and occupancy rates.

Last October, the International Monetary Fund revised the GDP growth rate for Macau from 2.8% to a whopping 13.4% for 2017.

DEBENHAMS' ALARMING RENT BILL

FUTURE AGGREGATE minimum payments under 'non-cancellable' operating leases amount to more than £4.5bn at **Debenhams (DEB)**, according to the ailing department store operator's 2017 annual report and accounts. The fact the hard-pressed British brand is locked into very long-term leases will hinder CEO Sergio Bucher's attempts to turn round Debenhams. Disappointing Christmas sales and a return to heavy discounts lay behind a severe profit warning (4 Jan), which has prompted brokerage Liberum Capital to downgrade its full year pre-tax profit estimate by 35% to £52.1m.

£4.5BN

Wey Education is primed for rapid profit growth

Online education provider has the cash to help build scale

A new injection of cash could help online education provider **Wey Education (WEY:AIM)** to build scale, which is key to sustaining momentum in the share price.

Some of the £5m raised in late 2017 have already been used to acquire Academy21, a company that should bolster Wey's ecademy business-to-business division.

Its services are primarily aimed at schools and local authorities who need to provide alternative education services to children who find attending mainstream school difficult.

The new cash should also help Wey Education gain more students for its online school, InterHigh, among other endeavours by adding firepower to its marketing and advertising efforts.

Executive chairman David Massie says the primary method of gaining customers is via promotions on Google, Twitter and Facebook, costing between £50 and £100 to recruit a student. The company is also using billboard and display advertising at London's Waterloo station.

InterHigh is a non-selective fee paying secondary school providing live, interactive teaching of GCSEs, A Levels and some vocational courses.

Stockbroker WH Ireland says InterHigh has already proved its ability to generate significant cash returns, despite being in its infancy. It believes Wey should be able to grow much more rapidly than a traditional education establishment and potentially start paying dividends from 2020.

WEY EDUCATION
BUY
(WEY:AIM) 38.5p
Stop loss: 27p

Market value: £49m

Money will be deployed to beef up the company's overseas presence, especially in the Middle East and parts of the Commonwealth where there is a history of teaching the British curriculum.

The overseas marketing will mainly benefit Wey's online language school, Quoralexis, and Infinity Education which is Wey's selective, premium fee-paying online school.

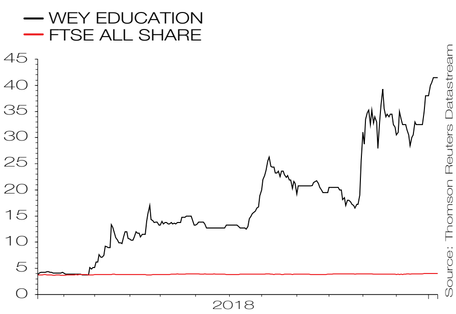
Wey wants to be a leader in the use of artificial intelligence in the classroom and will initially use AI to establish the knowledge levels of students, to help apply appropriate teaching resources.

'We believe education businesses can derive high returns for shareholders,' says WH Ireland. 'After factoring in the effects of (Wey's) recent placing and acquisition, we see near-term fair value to be closer to 50p. However, after an initial investment phase to August 2018, revenue and profit have the potential to increase rapidly.'

WH Ireland forecasts revenue will double to £4.8m in the year to August 2018 – and then effectively double again to £10.3m in 2019. It forecasts £0.16m pre-tax profit this year and £2.16m next year.

Don't be troubled by the current year's price-to-earnings ratio which is a sky-high 98.7 times. The rating dramatically falls over the next few years as earnings shoot up. This looks like a classic fast-growth business with the right ingredients to excite investors. (DS)

BROKER SAYS: n/a



Grab a 9% dividend yield from property expert

Regeneration specialist U and I looks an absolute bargain at current levels

Property regeneration group **U and I (UAI)** is one of the most compelling value opportunities in the property sector and investors should snap up the shares before the wider market cottons on.

U and I trades at a 33% discount to net asset value per share of 300p, according to stockbroker Peel Hunt. Yet it is on track to deliver one of the most substantial total returns in the sector if management guidance is met.

The company hopes to deliver a post-tax return of 12% a year in the next three years, underpinned by annual development and trading gains upwards of £50m. This helps support a prospective yield of nearly 9% based on forecast ordinary and special dividends. Over a three-year period, the yield is expected to average 7.5%.

The business, formerly known as Development Securities, changed its name and strategy in October 2015 following the £27.4m acquisition of regeneration specialist Cathedral Group. It is now focused on large regeneration projects in London, Dublin and Manchester.

Following the completion of the £34m sale of its Blackhorse Road site in north east London to **Telford Homes (TEF:AIM)** at a price which topped guidance (20 Dec), U and I is on track to deliver guidance for trading gains of £65m to £70m in the financial year ending 28 February 2018.

U AND I BUY
(UAI) 200p
Stop loss: 160p

Market value: £250m

PPP FOCUS WILL PAY OFF

The company has secured a lot of public private partnership (PPP) work since its relaunch (£1.2bn worth over the last 18 months) where it teams up with local authorities to unlock public land for development.

Peel Hunt reckons this focus will deliver several benefits for the business. 'We believe that a focus on larger, increasingly PPP led schemes, should not only improve profitability but also leverage on the core strengths and skills of the business.'

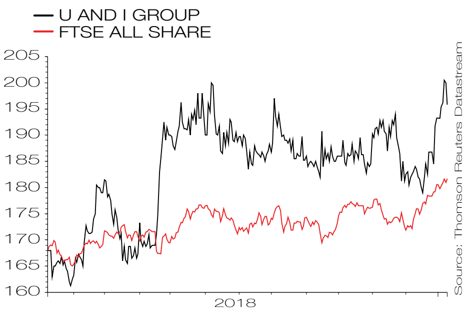
U and I books profit from trading assets in the short-term and from a portfolio of assets which includes its own completed developments and other projects with regeneration potential.

Admittedly, previous performance from this investment portfolio has been disappointing and this, along with historic cost issues, helps account for the discounted equity valuation.

By more closely aligning the portfolio with regeneration it is hoped this underperformance can be addressed.

Combined with the development of trading gains in line with management guidance and growing confidence in the recurring nature of supplemental dividends, we think the share price will do well in 2018. (TS)

BROKER SAYS: 1 0 0



G4S

(GFS) 285.9p

Gain to date: 11.6%

Original entry point:

Buy at 256.2p, 16 November 2017

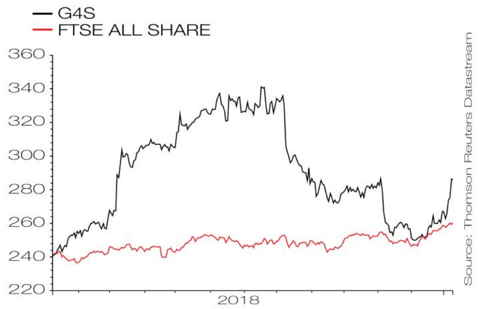
FTSE 100 SUPPORT services company **G4S (GFS)** looks to be back on track after a torrid time last year when the company flagged issues that hurt its share price.

Investment bank UBS says now is the time to buy the shares, echoing our bullish view which we published two months ago.

UBS suggests G4S could undergo a period of selling assets and potentially undertake a radical strategic shift for its Cash business.

It suggests G4S could raise up to £480m of cash from disposal proceeds and use that to reduce its net debt to EBITDA ratio to below 1.5-times for the first time in over a decade. That in turn could lead to higher dividend payments.

An alternative could to be sell its Cash business or even demerge it as a separately-listed entity, says UBS.



G4S will next update on trading when it reports full year results on 8 March.

SHARES SAYS: ↗

While G4S has had some well publicised problems in the past, we believe sentiment is improving and the business is good value trading on 14.5 times forecast earnings for 2018.

BROKER SAYS: 9 5 1

SOPHEON

(SPE:AIM) 450p

Gain to date: 36.4%

Original entry point:

Buy at 330p, 22 June 2017

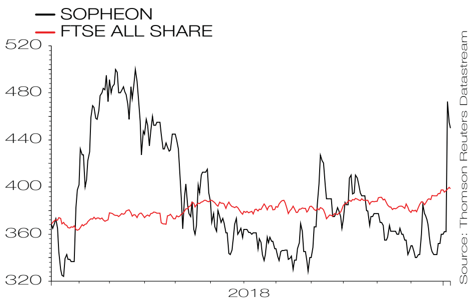
A VERY STRONG end to 2017 means **Sopheon (SPE:AIM)** will beat forecasts for 31 December 2017 on both revenue and profit. That's behind an impressive near 30% jump in the share price on 4 January, putting our *Great Idea* firmly in the money.

What's more, the company is confidently talking up its software-as-a-service model, bolstering recurring revenues that provide increasingly visible performance into 2018.

Sopheon is the innovation management solutions supplier we first flagged back in June. It helps enterprises manage all aspects of new product development lifecycles, allowing customers to make smarter decisions about which products to develop and how to bring them to market faster.

Details of the scale of the beat were not given but the firm's broker, FinnCap, felt it prudent to suspend 2017 and 2018 estimates until more information is available. That suggests to us that the outperformance is substantial. Sopheon will report full year results on 22 March 2018.

Interestingly, FinnCap now says that its previous 620p target price is a 'minimum' expectation, implying close on 40% further upside remains on the table.



SHARES SAYS: ↗

We'll resist the temptation to talk valuation until new forecasts are published. But the backcloth is highly positive and the shares are still a buy. (SF)

BROKER SAYS: n/a

DECHRA PHARMACEUTICALS

(DPH) £20.58

Gain to date: 19%

Original entry point:

Buy at £17.29, 27 July 2017

VETERINARY PRODUCTS DEVELOPER **Dechra Pharmaceuticals (DPH)** continues to deliver strong trading with a 10.5% jump in sales in the second half of 2017.

The upbeat performance was driven by a 20% increase in North American sales and a return to growth in Europe of 5.5%.

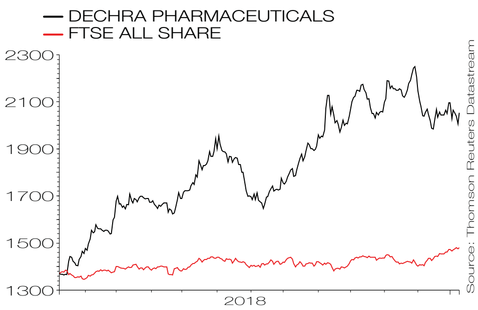
Dechra has registered poultry vaccine Avishield IB H120 and released all dosage sizes of dog antibiotic Amoxi-Clav tablets in the US.

It also launched *Vetoryl* to treat excess hormone production in dogs and *Osphos* to help lameness in horses in Mexico. This should drive growth and margins according to stockbroker Cantor Fitzgerald.

There is also a potentially positive impact from sweeping US tax reforms, which cut the corporate tax rate from 35% to 21%.

Dechra expects the reform to be beneficial and provide a material one-off non-cash credit. Analysts anticipate earnings upgrades, but await more details when Dechra reports its results (26 Feb).

Cantor Fitzgerald's Brian White says the US performance is 'noteworthy' and believes 2016's Putney acquisition is proving to be a good fit as it delivers scale and a pipeline of companion animal generics.



SHARES SAYS: ↗

We remain bullish on Dechra's prospects as it continues to roll-out its product pipeline. (LMJ)

BROKER SAYS: 4 3 0

GIVE YOURSELF AN INCOME BOOST WITH STOCKS AND FUNDS YIELDING MORE THAN 5%

THE INVESTMENTS WHERE YOU CAN SIT BACK AND LET THE CASH ROLL IN

Generating an income from investments is one of the key reasons why people put money into the markets. The average yield on FTSE 100 stocks at present is 3.8% which is significantly higher than both the current rate of inflation (3.1%) and the top rate of interest on cash savings accounts (1.3%).

As Alex Crooke, head of global equity income at asset manager Janus Henderson, observes: 'The absolute level of dividend yields remains very attractive to investors when compared to other asset classes.'

THE AMOUNT OF MONEY PAID IN DIVIDENDS BY FTSE 100 COMPANIES IS EXPECTED TO INCREASE BY 7% IN 2018, ACCORDING TO AJ BELL'S LATEST DIVIDEND DASHBOARD REPORT. IT SAYS THAT EQUATES TO A 4.3% YIELD.

In this article we look at the 40-plus shares in the FTSE 350 index which offer a prospective yield of 5% or more, as well as a range of funds, investment trusts and exchange-traded funds doing the same.

We also examine in more detail how you can find, protect and grow the income from your investments over time.

Elsewhere in this week's issue of *Shares*, we look at small cap companies which also have 5%+ dividend yields and discuss the pros and cons of special dividends.

HOW TO FIND INCOME

The income from shares and funds comes in the form of a dividend. This payment is typically made in cash twice a year, although sometimes more frequently.

For individual company shares, dividends are paid from the cash flow left over after the business has met all its other financial obligations. Funds pay dividends generated by the income from their underlying holdings (which is likely to contain dividend-paying companies).

Not all shares and funds pay a dividend, unlike other asset classes such as bonds. Individual companies can cut or cancel a dividend entirely at their management's discretion. Some companies have never paid a dividend as they may prefer to recycle all their cash generation back in to the business to fund growth – or they have negative cash flow, such as some early stage miners, drug firms or tech companies.

The decision to start or resume paying a dividend can often act as a positive catalyst for a share price. Paying a dividend puts a stock on the radar of fund managers and other investors who ignore non-dividend payers, for example.

Companies who restart dividends after a period of not paying out cash to investors can be viewed as businesses who have fixed a problem which previously led to the payout's suspension.

A company considering a maiden dividend suggests it has reached a point in its development where it is financially comfortable and capable of sustaining dividend payments.

Income is usually measured by way of yield. For equities, this is calculated by dividing either the forecast or historic annual dividend per share by the share price and multiplying by 100.

For example, oil major **Royal Dutch Shell (RDSB)** trades at £25.63 and is forecast to pay 138.5p per share in 2018. This translates into a dividend yield of 5.4%.

HOW TO BENCHMARK YOUR INCOME

Measuring the generosity of yield offered by a prospective investment requires benchmarks. There are several you can employ.

Investing in shares is riskier than holding cash on deposit so you want to generate a higher return than the best rates available on cash savings which are around 1.3%, unless you are prepared to tie up your cash for several years.

You also need to beat the current rate of UK inflation which is 3.1%. For a dividend yield to be truly generous it should be higher than approximate 4% average for the FTSE All-Share index.

Just watch out for overly-generous yields, such as anything above 7%. Occasionally a company's business model can support this level of dividend return. However, in most cases a high yield is the result of a falling share price – the market's way of saying that it doesn't believe current earnings (and therefore dividend) forecasts.

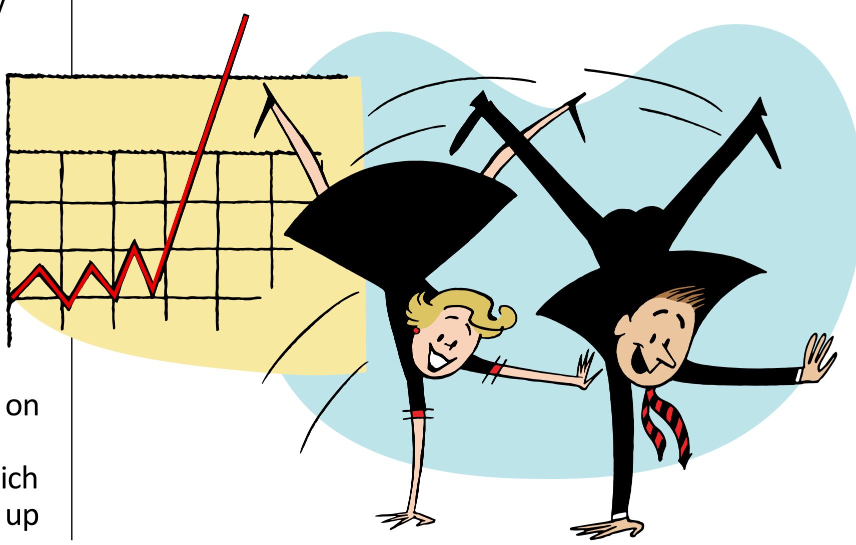
DIVIDENDS – THE KEY POINTS TO CONSIDER

Think about these points when you're considering a stock as an income investment:

- Are the company's earnings per share comfortably greater than its dividend per share?

- Look at current earnings strength – if trading is poor, this increases the risk of there being insufficient cash generated to fund the dividend.

- A prospective dividend yield above 7% is rarely sustainable unless there are significant levels of cash generation and the money isn't needed elsewhere. Even then, check to see if the company is reinvesting cash to sustain and grow its business. It if isn't, then why not? It should be.



TOP YIELDING FTSE 350 STOCKS

COMPANY	EPIC	FORECAST DIVIDEND YIELD (%)
Centrica	CNA	8.2
Card Factory	CARD	8.2
Bovis Homes	BVS	7.9
Galliford Try	GFRD	7.5
Direct Line Insurance	DLG	7.4
RDI REIT	RDI	7.4
SSE	SSE	7.3
Taylor Wimpey	TW.	7.3
Capita	CPI	7.3
Stagecoach	SGC	7.1
Saga	SAGA	7.1
Marston's	MARS	6.8
Lloyds Banking	LLOY	6.7
Barratt Developments	BDEV	6.6
Crest Nicholson	CRST	6.6
Inmarsat	ISAT	6.6
Kier	KIE	6.6
Go-Ahead	GOG	6.6
NewRiver REIT	NRR	6.5
Phoenix	PHNX	6.5
Stobart	STOB	6.3
GlaxoSmithKline	GSK	6.0
Admiral	ADM	6.0
Legal & General	LGEN	6.0
Imperial Brands	IMB	6.0
Greene King	GNK	5.9
Marks & Spencer	MKS	5.8
BT	BT.A	5.8
Aviva	AV.	5.7
BP	BP.	5.6
Intu Properties	INTU	5.6
AA	AA.	5.6
Vodafone	VOD	5.5
Esure	ESUR	5.5
Standard Life Aberdeen	SLA	5.4
Royal Dutch Shell	RDSB	5.4
National Grid	NG.	5.3
ITV	ITV	5.3
Drax	DRX	5.3
Royal Mail	RMG	5.2
Jupiter Fund Management	JUP	5.2
Dixons Carphone	DC.	5.2
TalkTalk Telecom	TALK	5.1

Source: Shares, various analyst notes, SharePad

TOP YIELDING FTSE 350 STOCKS – BEHIND THE NUMBERS

THE ACCOMPANYING TABLE shows 43 companies in the FTSE 350 index which have a prospective dividend yield in excess of 5%. This is based on the share price at the time of writing and the dividend payout forecast by analysts for the latest financial year still to be reported.

Some of these names could represent genuine opportunities for income-hungry investors.

UK bank **Lloyds (LLOY)** used to pay very generous dividends until the financial crisis hit. It stopped paying for a while and resumed dividends in 2015. The payments are forecast to keep rising for the foreseeable future and the stock now trades on a 6.7% prospective yield.

Over-50s financial services and travel specialist **Saga (SAGA)** trades on a 7.1% yield. Historically it has been a 4.5%-5% yield stock; the yield has recently shot up as a result of the share price falling on a profit warning.

Analyst forecasts still imply progressive dividend growth for the company, yet investors may wish to tread carefully until more information is released from Saga as to why its broking business has recently disappointed.

Pub companies **Marston's (MARS)** and **Greene King (GNK)** offer 6.8% and 5.9% prospective dividends respectively. Our preference as an investment is Marston's. It has been selling bad pubs and building good ones. It refuses to discount food and drink which is helping to protect profit margins – the opposite of many other companies in the leisure sector.

The business's property estate is 94% freehold and it has a net asset value of 147p per share – versus a 114.8p current trading price.

Construction business **Galliford Try (GFRD)** trades on a heavily discounted valuation thanks to problems on legacy construction contracts. However, underpinned by its housebuilding and regeneration arms, it has a credible-looking plan to boost profit more than 60% out to 2021. This should support the dividend which has a 7.5% prospective yield.

WARNING SIGNS

High dividend yields can often be a warning sign that the market lacks faith in earnings forecasts – so don't rush to buy any company off our list of 5%+ yielders without proper research.

'Over the last 18-24 months, there has definitely been a theme of dividend cuts from some very high-profile companies,' says David Goldman, co-manager of **BlackRock Income and Growth Investment Trust (BRIG)**.

'When you look at the FTSE 350 by number, the vast majority are still growing their dividends. You've still got 75-80% of FTSE 350 companies growing their dividends with the balance being split between those that are keeping the dividend flat and the odd cut.'

So which companies look vulnerable to a cut? A profit warning from **Centrica (CNA)** in November 2017, which saw 2017 earnings per share guidance cut to 12.5p (from consensus of 15p), makes us far less confident that its dividend will be maintained.

The business is being hit by competition alongside the threat of price caps and increased regulation. Analysts are already pencilling in lower dividends, so don't go chasing this stock expecting to make 8%+ yields a year.

Other stocks potentially in line for a dividend cut include satellites network operator **Inmarsat (ISAT)** and telecoms business **TalkTalk (TALK)**.

The former has a stretched balance sheet after spending heavily on infrastructure with net debt upwards of $2bn.

TalkTalk faces a highly competitive environment and suffered significant brand damage after a cyber-attack in October 2015. Despite already cutting the dividend by 50% in May 2017, some analysts think further cuts are necessary.

HIGH DIVIDEND YIELDS CAN OFTEN BE A WARNING SIGN THAT THE MARKET LACKS FAITH IN EARNINGS FORECASTS

HOW TO PROTECT YOUR INCOME

DIVIDENDS ARE NEVER guaranteed to be paid. If a company endures poor performance, a big financial shock or spends all its cash on a big acquisition the dividend could be trimmed, suspended or even cancelled outright. In these circumstances investors can face a double whammy as they lose the income and suffer a fall in the value of their investment as negative news on the dividend affects the share price.

Anyone owning a fund should benefit from diversification in this situation. A setback with one portfolio holding in a fund wouldn't have as much of an impact as compared to an individual stock. We'll talk about income funds later in this article.

SAFETY CHECKS

For investors owning individual stocks, it is fairly easy to carry out safety checks on a dividend. The most straightforward is to see how many times it is covered by earnings. This is known as dividend cover.

Dividend cover of less than one suggests the dividend is being paid out of debt or cash savings which is unsustainable in the long-term or perhaps through shares in the form of a scrip dividend which can dilute existing shareholders over time.

As a rule of thumb, dividend cover of two times or more is generally seen as safe. However, it is important to stress that dividends are paid out of cash rather than earnings which can be massaged by clever accounting.

Free cash flow can be a better way to test a company's ability to pay dividends than earning per share. Free cash flow is the amount of cash generated from operations minus capital expenditure. It is excess cash used to expand production, develop new products, make acquisitions, reduce debt and pay dividends.

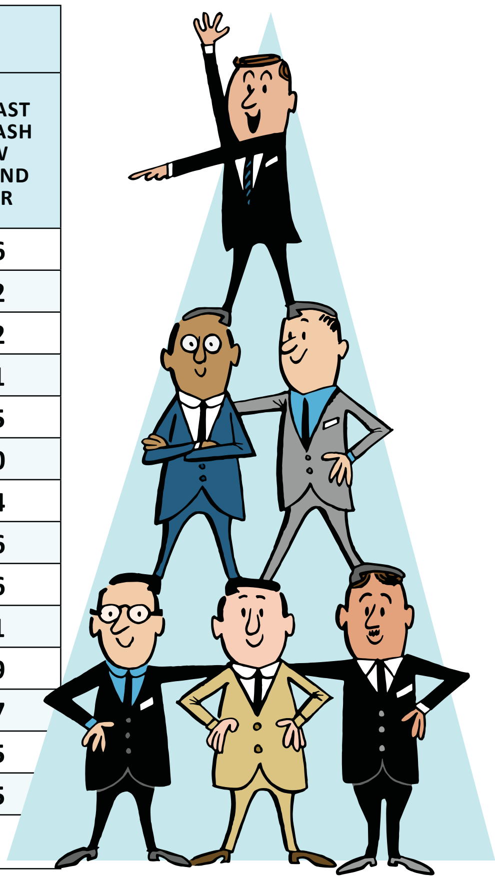
'When we think about dividend cover, we feel it is very important to differentiate between companies with a high payout ratio because they are capital light and can afford to have a high payout ratio, and those with high payout ratios which operate in very capital-intensive industries (mining, oil and gas), and those make us more nervous,' says Goldman at BlackRock Income and Growth Investment Trust.

In the next table we highlight companies whose generous dividends are comfortably covered by free cash flow. All the names included in our table have yields above 5% and forecast dividends covered at least 1.75 times by cash flow.

CASH-BACKED DIVIDENDS

COMPANY	EPIC	FORECAST DIVIDEND YIELD (%)	FORECAST DIVIDEND PER SHARE (P)	FORECAST FREE CASH FLOW PER SHARE (P)	FORECAST FREE CASH FLOW DIVIDEND COVER
AA	AA.	**5.6**	9.3	34.0	**3.66**
Maintel	MAI	**5.9**	37.3	112.8	**3.02**
Greene King	GNK	**5.9**	33.2	97.0	**2.92**
Phoenix	PHNX	**6.5**	50.2	131.1	**2.61**
STM	STM	**5.3**	2.0	5.1	**2.55**
Ashley (Laura)	ALY	**6.8**	0.5	1.2	**2.40**
Drax	DRX	**5.3**	14.4	32.3	**2.24**
Lakehouse	LAKE	**7.0**	2.5	4.9	**1.96**
Redde	REDD	**6.7**	11.6	22.7	**1.96**
DFS Furniture	DFS	**5.2**	10.6	20.2	**1.91**
Royal Mail	RMG	**5.2**	24.0	45.3	**1.89**
SCS	SCS	**6.7**	15.0	28.0	**1.87**
Marks & Spencer	MKS	**5.8**	18.5	34.2	**1.85**
Crest Nicholson	CRST	**6.6**	36.5	64.0	**1.75**

Source: SharePad, 4 January 2018



Among the names on the list, **Redde (REDD:AIM)** with a 6.7% prospective yield provides a range of accident management and legal services to motorists and insurers. It is well known for having a generous dividend policy.

'Redde's model releases significant operational and financial resource for insurer partners and allows them to focus on optimising underwriting returns whilst maximising the propensity for policyholders to renew through an efficient and simple service offering delivered well,' said stockbroker N+1 Singer in September 2017.

'New contracts with new insurer partners have been secured and existing partners are working more closely with Redde. Key competitors have fallen away or are seeking other strategic goals.

'We feel that it is fair to assume that there are clear opportunities for Redde to outperform our forecasts, even if new opportunities do not reach the same scale as existing relationships.'

Elsewhere, **Phoenix (PHNX)** has a prospective yield of 6.5%. This highly cash-generative company is Britain's largest owner of life assurance funds closed to new customers.

Phoenix says this business model enables it to focus all of its energy and expertise on improving the performance of funds without being distracted by the need to win new customers.

THE BENEFITS OF INCOME DIVERSIFICATION

Because it is impossible to eliminate the risk of a dividend cut entirely it is better to run a diversified portfolio of dividend-paying stocks (or invest in a fund).

This way if one company cuts its dividend your overall income is not too heavily impacted. Given the cost and practicalities involved in running a large portfolio yourself it can make sense to use income funds to achieve this diversification.

If you want genuine diversification, make sure you check the holdings of a UK-focused equity income fund to ensure the product isn't overly reliant on a handful of sectors to generate that income.

Financial stocks and oil and gas companies account for 43% of the total forecast cash dividend payments from the FTSE 100 in 2018 according to AJ Bell.

And just two companies account for a quarter of all FTSE 100 cash dividend payments in the year, being Royal Dutch Shell (14%) and **HSBC (HSBA)** at 9%.

	FORECAST PERCENTAGE CONTRIBUTION TO FTSE 100 CASH DIVIDEND PAYMENTS IN 2018
Royal Dutch Shell	14%
HSBC	9%
BP	7%
British American Tobacco	5%
GlaxoSmithKline	4%
Vodafone	4%
Lloyds	4%
AstraZeneca	3%
Rio Tinto	3%
Glencore	2%

Source: AJ Bell, 8 Dec 2017

AJ Bell's data shows the average forecast dividend cover for the FTSE 100 in 2018 is 1.63 which is lower than at the height of the financial crisis 10 years ago.

The highest yielding stocks in the FTSE 100 have even lower dividend cover at just 1.37 times on average.

The 10 companies with the lowest dividend cover in the blue chip index include three of the highest dividend yields: Centrica, **Direct Line (DLG)** and **BP (BP.)**.

All but two of them – **Hargreaves Lansdown (HL.)** and **St James's Place (STJ)** – are forecast to yield significantly more than the FTSE 100 as a whole.

	DIVIDEND COVER 2018*
Centrica	1.24
Hammerson	1.22
Hargreaves Lansdown	1.22
British Land	1.19
Direct Line	1.12
Royal Dutch Shell	1.07
St. James's Place	1.05
Admiral Group	1.03
HSBC	1.00
BP	0.99
Vodafone	0.70

Source: AJ Bell, 8 Dec 2017.
*Ratio of earnings per share to dividend

HIGH YIELDING FUNDS

GLOBAL EQUITY INCOME funds are likely to fall short of the 5%+ yield target we've set in this article. For example, most investment trusts in this category have a 3% to 4% yield.

One exception is **Liontrust Global Income (GB00B56S8Y21)**, a unit trust which yields 5.4%. It only invests in high-yielding stocks with 'unusually' strong cash flows where investors have low profit expectations.

It says: 'Strong company cash flows (after investment spending) are a good indicator of strong growth in future reported profits.' Some of its holdings include Russian steel group Severstal and South African mobile communications group Vodacom.

In general, you may have to look at more specialist funds such as one investing in infrastructure assets or emerging markets, or one with 'enhanced' income, in order to hit the 5%+ yield goal.

For example, **Threadneedle Emerging Market Local (GB00B88S8291)** yields 7.5%. It invests in emerging market government debt and companies which are based in, or have significant operations in, an emerging market.

Fidelity Enhanced Income (GB00B87HPZ94) has a 7.1% yield and is not your typical equity income fund. It invests in a range of higher yielding UK shares to form a portfolio similar to a traditional equity income fund and it also uses derivatives. That latter involves selling some of the potential future capital gains in exchange for a higher income today.

L&G Dynamic Bond Trust (GB00B1TWMY10) yields 6.6%. This strategic bond can invest in a wide range of fixed income assets, from government bonds to high yield, and make use of derivatives to enhance returns.

Among investment trusts, there are numerous funds invested in debt which offer yields typically in the range of 9% to 14%. For example **Carador Income Fund (CIFU)** yields 13% and invests in secured loan portfolio through CLO (collateralised loan obligation) transactions.

INVESTMENT TRUSTS AND ETFS FOR HIGH INCOME

Lower down the yield spectrum, there are some property-related investment trusts with yields in excess of 5% such as **Impact Healthcare REIT (IHR)**. It yields 5.9% and invests in properties linked to the UK care home market. Additional value is expected to be generated through refurbishments and

HOW TO GROW YOUR INCOME

CONSISTENT DIVIDEND GROWTH is typically a hallmark of a high-quality company with the ability to generate plenty of cash flow. This may well be rewarded by a higher share price as investors rush to gain access to this cash flow.

You can review historical dividend growth by looking at dividend payments over previous years on financial data websites like SharePad and Stockopedia, as well as on *Shares*' website. Some larger companies may even publish this information on their own websites, as is the case for HSBC among others.

And if you are in a position to reinvest the income from your holdings in dividend growth stocks, rather than taking the cash straight away, you can in theory benefit by steadily increasing your exposure to an income stream which itself is already growing.

AJ Bell's *Dividend Dashboard* report shows the positive impact dividend growth can have on the total return from a stock. Of the 26 current members of the FTSE 100 which have grown their dividend every year for the last decade, only utility firm **SSE (SSE)** has not comfortably outperformed the index on a total return basis.

extensions.

Exchange-traded funds can also be used as investments to obtain income, although you must consider that products tracking the highest yields may be higher risk than you think.

They may provide exposure to companies whose yields are high as a result of their share price being low – which, as we discussed earlier in this article, can be a warning sign which may lead to a dividend cut.

iShares UK Dividend ETF (IUKD) is a relevant example and has a 5.19% yield. 'We do not believe that this fund has the potential to outperform its category peers over the long term,' says Hortense Bioy, an analyst at Morningstar.

'The iShares UK Dividend ETF is part of a shrinking cohort of passive offerings that focus on the highest-yielding stocks with no dividend sustainability screens. The ETF offers exposure to 50 UK stocks with the highest one-year forecast dividend yield.

'This strategy may suit investors seeking high and regular income, but it may come at the expense of long-term capital appreciation as companies that pay large dividends may do so at the expense of their growth or overall financial health.

'Also, simply selecting the highest-yielding stocks can be risky as some high-yielding stocks may be companies with poor fundamentals whose stocks are trading at low prices, reflecting the fact that the company may be in trouble,' adds Bioy.

INVESTMENT TRUSTS WITH A HISTORY OF DIVIDEND GROWTH

The Association of Investment Companies (AIC) publishes a list on its website of 'dividend hero' investment trusts which have increased their dividends each year for 20 years or more.

Most of these trusts yield less than 5%, although you'll find plenty of good examples of funds that deliver returns in excess of 5% when also factoring in capital growth.

Just look at **Bankers Investment Trust (BNKR)**: it yields 2.1% and has managed to give investors more dividends every year for the past 50 years. Over the past 12 months it has delivered 30% total return.

Simply looking for the highest yield isn't always the best route to finding a good investment, as we've explained earlier in this article.

For example, investment trust **British & American (BAF)** yields 13.5% and has increased its dividend every year for the past 21 years, thus it is classified by the AIC as a dividend hero. It invests mainly in investment trusts and UK quoted companies. While its yield sounds appealing, this trust provides a good lesson in also checking the share price performance and being comfortable with the underlying assets.

British & American's shares have been fairly weak since summer 2017. Its net asset value has fallen by a third over the past year, according to Morningstar. Add back the dividend income and you're still nursing a loss for the 12 month period. On a share price total return basis, you would have lost 15.8%. (TS/DC/JC)

Small caps with more than 5% dividend yields

Income investors often focus on large established companies but some smaller names also offer generous yields

You may be surprised at the number of smaller companies which pay dividends. Many investors may assume that dividends are only the domain of mid and large caps, yet we demonstrate in this article that you can find plenty of opportunities further down the market cap spectrum.

We've analysed the market using data from SharePad and found more than 330 companies valued at less than £500m which are forecast to pay dividends over the next year.

Within this group, more than 50 have prospective dividend yields in excess of 5% and we'll now focus on that segment. Just remember that dividends aren't guaranteed to be paid and analyst forecasts aren't always correct.

PROPERTY AND MORE

Property regeneration group **U&I (UAI)** has a 9.1% prospective yield, boosted by forecasts for a generous special dividend. We explain the investment case for U&I in more detail in the *Great Ideas* section of this week's digital magazine.

MedicX Fund (MXF) is a specialist primary healthcare infrastructure investor and yields 7% based on a forecast 6p per share dividend for the year to September 2018. Its portfolio contains 153 modern purpose-built assets such as doctors' surgeries.

At the moment MedicX's dividends per share far exceed its earnings per share which is normally a warning sign that the dividend is unsustainable. Investment bank Canaccord Genuity says there is a strategy in place to improve the dividend cover.

'The investment pipeline is £175m with £90m in Ireland offering relatively attractive yields. The successful conversion of this pipeline into portfolio investments will be an important development for MedicX, and should lead to welcome improvements in both dividend coverage levels

MedicX's properties are used as medical centres

and cost ratios,' said Canaccord on 13 December 2017. Since then, Medicx has spent €7.8m on an Irish medical centre.

APQ Global (APQ:AIM) floated in August 2016 with an objective to invest in companies, currencies and corporate/government bonds linked to emerging markets and achieve 6% dividend yield. It has so far paid 4.5p for the 2017 financial year and said in October that it was on track to meet its 6p full year dividend target.

SERVICE BUSINESSES

Connect (CNCT) has been popular among investors over the years for its generous dividend payments, even if the share price performance hasn't exactly been great. It operates in the highly competitive world of logistics, distributing newspapers, magazines as well as parcels through its Tuffnells and Pass My Parcel operations.

A SELECTION OF SMALL CAPS WITH HIGH DIVIDEND YIELDS	
COMPANY	PROSPECTIVE YIELD
Debenhams	10.2%
U and I	9.1%
Connect	8.8%
NAHL	8.7%
Epwin	7.9%
Gattaca	7.7%
Trinity Mirror	7.4%
M Winkworth	7.2%
Moss Bros	7.1%
Laura Ashley	7.1%
MedicX Fund	7.0%
GBGI	6.9%
Belvoir Lettings	6.8%
SCS	6.7%
SafeStyle UK	6.7%
UP Global Sourcing	6.7%
Capital & Regional	6.6%
Shoe Zone	6.6%
Low & Bonar	6.4%
City of London Investment	6.4%
Quarto	6.4%
Centaur Media	6.3%
International Personal Finance	6.3%
Manx Telecom	6.1%
KCOM	6.0%
Property Franchise	6.0%
Global Ports	6.0%
APQ Global	5.9%
Maintel	5.9%
Pan African Resources	5.8%

Source: Shares, SharePad, Analyst notes

The business recently sold its books division for £11.6m to focus on its early morning and mixed freight distribution. While an 8.8% prospective dividend yield seems enticing, just consider that parcels distribution is a highly competitive business and Connect has very thin operating margins so little room for error if profits come under pressure.

Personal injury marketing specialist **NAHL (NAH:AIM)** currently has an 8.7% prospective yield based on 2017's dividend forecast of 15.9p. Dividends are expected to fall in line with profit as the company adapts to changes to the regulatory set up for personal injury claims due to be introduced in October 2018.

However, the company's policy of paying a dividend covered 1.5 times by earnings is unchanged and, based on SharePad's data, this still implies a generous looking yield of 7.3% based on the 13.2p forecast dividend payment for 2018.

AND A FEW MORE

The meat of **KCOM's (KCOM)** business is running a copper and fibre optic network in Hull and East Yorkshire, but the company also provides its corporate clients with other communications and cloud services.

This is low-growth, cash generative stuff although there's a pension deficit to manage. Operational own goals have not helped recent performance but its home network is a cash cow capable of underpinning the dividend for the time being. Analysts forecast 6.1p dividend per share for the year to March 2018 and the same for the following year, implying a 6% prospective yield based on the latest share price.

Investors shouldn't expect dividend growth until more of KCOM's customers are on its fibre network, potentially creating cost savings by switching off the copper connections.

Even with a recent share price chart that flows upwards from left to right, Sunderland-based sofas-to-flooring seller **ScS (SCS)** offers investors an attractive dividend yield of 6.7%.

Shore Capital forecasts dividend improvement from 14.7p to 15p for the year to July 2018, ahead of 15.3p in 2019 and 15.5p in 2020. Flagging ScS' strong free cash generation, net cash pile and committed debt facilities, as well as competitively priced products and variable costs that breed resilience, the broker believes the dividend is sustainable. (DC/TS/JC/DS/SF)

The dangers associated with special dividends

We look at the stocks handing out the cash and the key points to consider when looking at attractive headline yields

Special dividends can put a smile on the faces of investors. They are typically generous cash gifts which are sometimes greater in value than normal dividends paid by a company.

We calculate that 120 companies currently in the FTSE 350 index have paid one or more special dividends over the past 25 years, with a noticeable increase in companies making payments over the past five years.

Unfortunately the growing number of companies paying special dividends on a regular basis can also create false hope with regards to future income levels. The payments can also be unwelcome to some investors from a tax perspective, as we explain later in the article.

WHAT IS A SPECIAL DIVIDEND?

Special dividends are typically declared when a company has excess cash to its own investment needs, or when it is sitting on a one-off lump of cash as a result of an asset or business disposal. Some or all of this excess cash is subsequently returned to shareholders.

Special dividends are different to normal (also known as 'ordinary') dividends which are a share of a company's profits passed on to shareholders on a periodic basis, typically twice a year.

The increasing number of stocks paying special dividends in recent years has led many investors to believe they will always be recurring payments. Special dividends inflate the overall cash return to an investor and so the total dividend yield can look quite high on many occasions, potentially 7% or 8%.

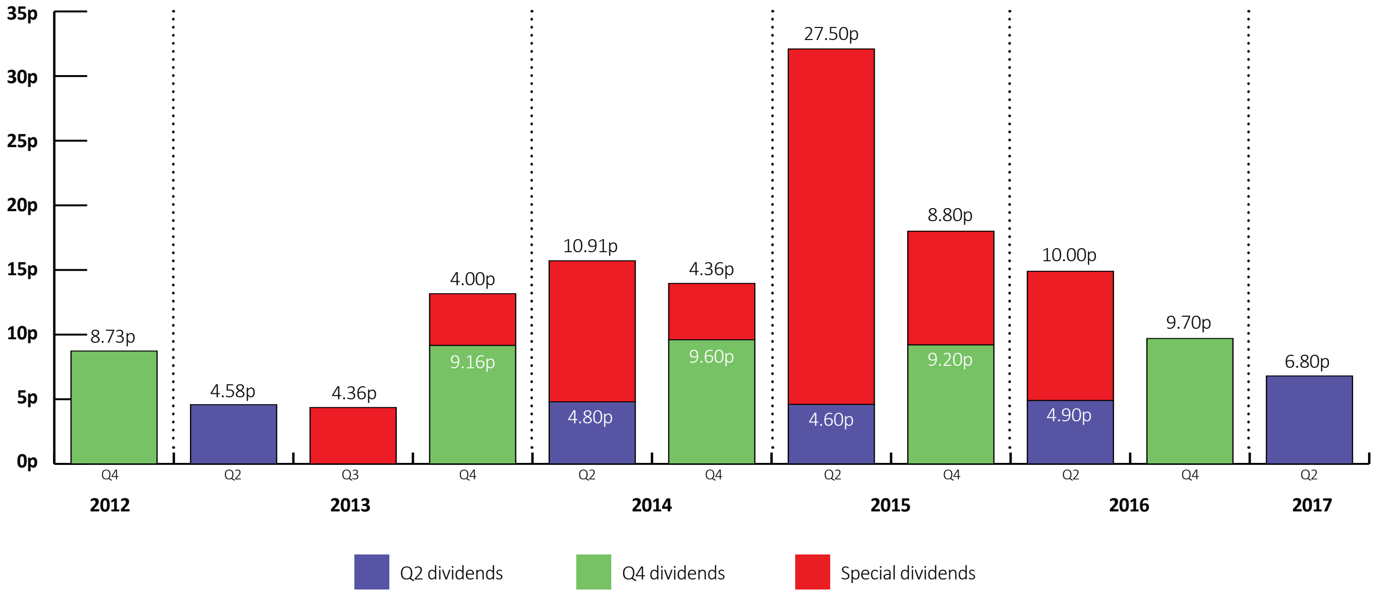
Numerous companies, particularly those in the insurance sector, have developed a habit of paying special dividends every year on top of normal dividends. For example, **Admiral (ADM)** has paid a special dividend every single year since it floated on the London Stock Exchange in 2004.

DON'T DEPEND ON SPECIAL DIVIDENDS

Many investors have got used to receiving special dividends from their investments and assume they will keep getting them in the future, and as such yields will stay high.

In reality, special dividends should only ever be viewed as a pleasant surprise, rather than a sure thing.

DIRECT LINE INSURANCE:
SPECIAL DIVIDENDS SUDDENLY STOPPED



Insurer **Direct Line (DLG)** and investment platform provider **Hargreaves Lansdown (HL.)** are two examples where investors were caught out with special dividends. Both companies had a long history of paying special dividends yet they both recently stopped paying due to issues facing their businesses.

Direct Line has historically declared a special dividend at its full year results each March but no payment was announced when its 2016 numbers were published on 7 March 2017. The business was derailed by changes to the rules governing compensation for serious injuries called the Ogden rate.

The company did increase its normal dividend by 5.6% and it did pay a 10p special dividend in September 2016. However, the total payment for 2016 was half the level of the previous year (24.6p versus 50.1p), when there were two special dividends.

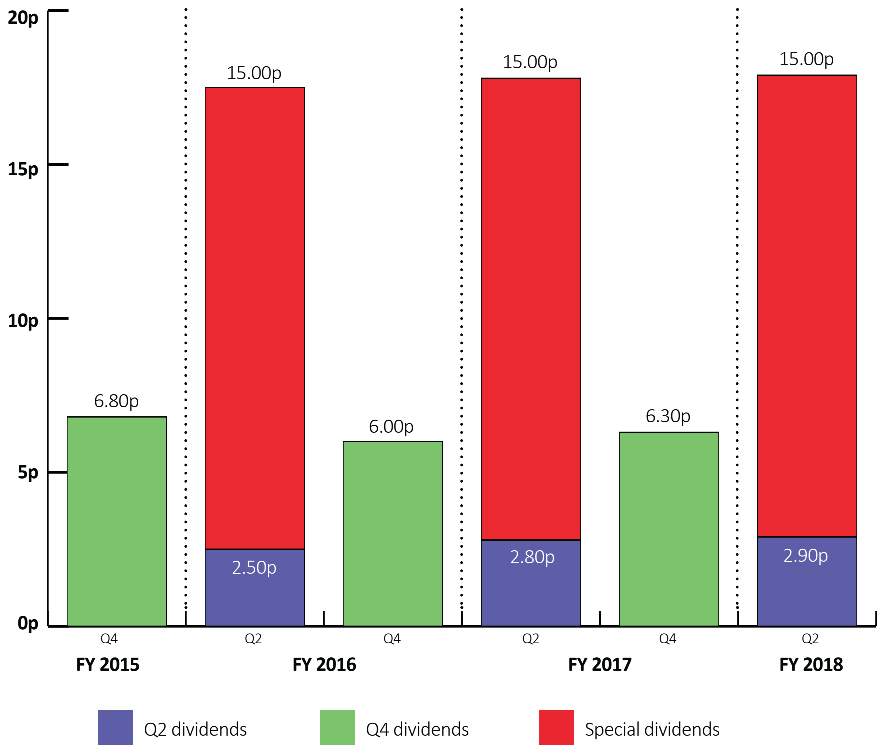
> SPECIAL DIVIDENDS SHOULD ONLY EVER BE VIEWED AS A PLEASANT SURPRISE, RATHER THAN A SURE THING

Hargreaves Lansdown said in August 2017 that it wouldn't pay a full year special dividend for the first time since joining the stock market 10 years earlier.

It said the business had to retain an additional £50m of capital after the Financial Conduct Authority, a regulator, announced plans to 'reassess' Hargreaves' capital requirements.

'The revised assessment would mean the group's regulatory capital surplus during 2018 is insufficient to meet our risk appetite levels if we paid a special dividend for the year ended 30 June 2017 in line with market expectations,' it added.

CARD FACTORY



SPECIAL DIVIDENDS CAN MAKE UP A LARGE PROPORTION OF OVERALL INCOME

The proportion of overall dividend payments that comes from special dividends can be quite high. For example, 62% of all dividends paid by retailer **Card Factory (CARD)** in its financial year ending 31 January 2017 came from special dividends.

And nearly half of insurer **Beazley's (BEZ)** dividends in its 2016 financial year came from special dividends.

A high weighting towards special dividends means investors could be in for a shock if something goes wrong with such businesses.

Card Factory saw its share price hammered in September 2017 after revealing a 14% drop in pre-tax profit as it struggled with the wider retail sector challenges. Yet its chief executive Karen Hubbard said special dividends were still on the menu thanks to a highly cash generative business model.

TURNING OFF THE SPECIAL DIVIDEND TAP

Beazley said in November the frequency and severity of natural catastrophes in 2017 would affect its results.

The insurer has paid a special dividend every year between 2011 and 2016 bar one, which may have led some investors to expect 'specials' permanently going forward. However, analysts don't believe Beazley will pay one when it reports 2017's full year results.

Indeed, comments at the analyst meeting after the 2016 financial results were published in February 2017 'strongly suggest' special dividends are coming to an end for Beazley, barring abnormally quiet loss years, said Stockdale analyst Joanna Parsons at the time.

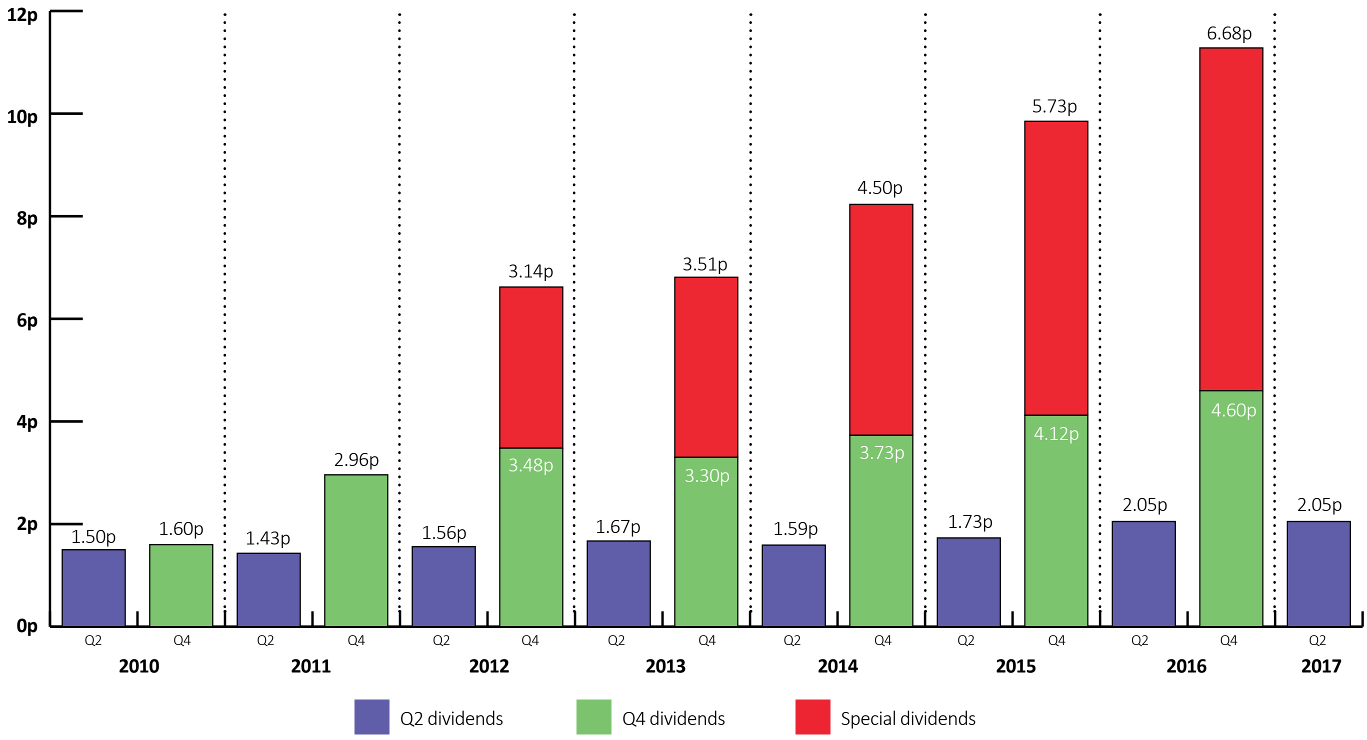
Chemicals group **Elementis (ELM)** may follow suit, judging by a recent shift in strategy. The FTSE 250 business has paid special dividends every year for the past five years, the latest referring to its 2016 financial year.

EXAMPLES OF PROLIFIC SPECIAL DIVIDEND PAYERS

Company	Frequency of special payments
888	5 since 2013
Antofagasta	12 between 2005 and 2013
British Empire Trust	7 between 2005 and 2012, plus one more in 2016
Ferrexpo	5 since 2013
Fidessa	8 since 2010
InterContinental Hotels	3 between 2004 and 2007, 5 between 2012 and 2017
Lancashire	11 since 2009
Next	7 since 2014
Savills	7 since 2011

Source: Shares, SharePad

ELEMENTIS:
SPECIAL DIVIDENDS COMING TO AN END?



Stockbroker N+1 Singer forecasts the total dividend for 2017 to nearly halve to 8.5c (2016: 16.8c). That essentially means the business is going from being an approximate 4.5% yielding stock to one that only yields circa 2.3%. We'll find out for certain when Elementis reports its full year numbers, expected to happen in early March.

A new management team was installed in 2016 and they've expressed a clear willingness to deploy cash to grow the business rather than keep handing it back to shareholders. Elementis has already done one such deal, being the acquisition of SummitReheis in February 2017, and further acquisitions look likely.

> NOT EVERYONE WANTS SPECIAL DIVIDENDS DUE TO TAX REASONS

THE DOWNSIDES OF RECEIVING SPECIAL DIVIDENDS

The other issue to consider with special dividends is that not everyone wants them due to tax reasons.

In the UK you get a £11,500 personal allowance which is the amount of income you don't have to pay tax on. On top, everyone is allowed to receive up to £5,000 in dividend income before you have to start paying tax on investments held outside of an ISA or SIPP (self-invested personal pension) wrapper.

From April 2018 the personal allowance rises to £11,850 but the dividend allowance falls to just £2,000. That could potentially result in some investors having to pay tax on their dividends for the first time.

As such, there are a growing number of investors who don't want special dividends, preferring a company with surplus cash to find other ways to return money such as share buybacks or conducting a tender offer.

National Grid's (NG.) £4bn disposal of the majority of its UK gas distribution business in 2017 attracted criticism from some investors as £3.1bn of the proceeds were paid as a special dividend and thus triggered a tax bill for many shareholders. (DC)

Why Asia Pacific may appeal to income investors

Henderson Far East Income fund manager explains how he is able to find investment opportunities

Global economic power has moved decidedly eastward to the world's most populous region over the past few decades, China and India in particular. Growth and income hungry investors should therefore take a good look at the Asia Pacific region to see if it fits their risk profile, also factoring in investment time horizon.

Far East earnings are seeing their best trend in seven years. Equity valuations are attractive versus world markets and relative to the region's own history, and dividend payments are growing at a rapid clip.

Asian companies have undergone a change; while growth in many instances has moderated, cash flow is strengthening and, in many cases, is being returned to shareholders in a rising tide of dividend payments that continues to boost regional returns.

This is positive news for **Henderson Far East Income (HFEL)**, a Janus Henderson Investors-managed investment trust whose objective is to provide shareholders with a growing total annual dividend, as well as capital appreciation, from a diversified portfolio of companies from the Asia Pacific region.

PERFORMANCE OVER PAST FINANCIAL YEAR

For the financial year to August 2017, the investment trust delivered an impressive net asset value (NAV) total return of 17.7% and a share price total return of 17.3% in sterling terms.

Although past performance isn't a guide to how the investment trust will perform in the future, it is worth noting that the past financial year's capital returns were all the more encouraging for not being boosted by weak sterling, as was the case in the strong previous year.

Investors were treated to a 4% improvement in the total dividend to 20.8p (2016: 20p), a distribution fully covered by the company's revenue and increased ahead of UK inflation once again, indicative of fund manager Mike Kerley's confidence in the growth and sustainability of Asian dividends.

In a year dominated by political, geopolitical and economic uncertainty, Henderson Far East Income's positive returns reflected an improvement in the underlying fundamentals of the Asia Pacific region.

For the first time since 2009, Asian earnings have been upgraded since the start of 2017 rather than the previous trend of downgrades, thereby helping the Asia ex-Japan region outperform its developed market peers.

POSITIVE OUTLOOK FOR THE REGION

Kerley is cautiously optimistic on the medium-to-long term outlook for Asia Pacific ex-Japan. Speaking to *Shares*, he explains that while Asian markets have risen, valuations on a price-to-earnings basis have not changed markedly, because earnings growth has kept up with share price movements.

Kerley notes this is not the case with developed markets which are trading at, or close to, all-time highs, yet look fully valued since they lack the same kind of earnings support.

Price-to-earnings is a popular valuation metric and is calculated by dividing the share price by earnings per share.

Despite the strong performance in some of the expensive new economy sectors, the portfolio manager insists he'll stick to his discipline of focusing on well-managed companies with attractive valuations which have the potential to sustain and grow their dividends in the years ahead.

As Kerley outlined at the company's annual financial results (3 Nov): 'Our focus remains on domestic orientated areas which are exposed to the improving spending power of the consumer across the region.

'The outlook for dividends in Asia Pacific is still a compelling story. Asian companies have low levels of debt, a pragmatic view on capital expenditure and strong cash flow generation which should allow dividend payout ratios to continue to rise in the years ahead.'

The dividend payout ratio is the amount of dividends paid to shareholders relative to the total net income of a company. Investors should note that dividends aren't guaranteed to be paid on a regular basis and dividend payments can go down as well as up.

HENDERSON FAR EAST INCOME
ANNUAL PERFORMANCE (WITH INCOME) (%)

YEAR	PRICE CHANGE	NAV CHANGE
2017	+12.6	+11.1%
2016	+36%	+36.2%
2015	-12%	-8.6%
2014	+6.3%	+4.7%
2013	+13.3%	+9.6%

Annual performance runs to 30 September, apart from 2017 which runs to 29 September; and 2013 which runs from 28 September 2012 to 30 September 2013.
Past performance is not a guide to future performance.
Source: Janus Henderson, Morningstar.

LOOKING FOR DIVIDEND OPPORTUNITIES

Kerley is able to put money to work across the region, but he isn't expecting too much growth from more mature markets in his investable universe, such as Australia and New Zealand, markets which already have pretty high dividend payout ratios.

'The real opportunity lies outside of those in terms of dividend growth,' he says, citing a 30-35% payout ratio for the rest of the Asia Pacific region, a ratio which has plenty of room to expand.

'My view is that dividend growth outstrips earnings growth in Asia on a five year view, because I think payout ratios will rise,' says Kerley, whose portfolio offers investors a compelling combination of dividend yield and growth.

Stocks in the portfolio offering a high yield today include the likes of Macquarie Korea Infrastructure, Digital Telecommunications, Mapletree Greater China Commercial Trust and National Australia Bank.

Dividend growth stocks in his portfolio, typically names where strong earnings growth is being translated into progressively rising dividends, include Samsung Electronics, the South Korean technology conglomerate which historically hasn't paid dividends.

The smartphones, memory chips and televisions maker is becoming more shareholder-friendly and could double the level of its dividends in the next three years, according to Kerley.

Other dividend growth stocks in the portfolio include Dali Foods, a Chinese producer of snacks, energy drinks and soya milk based products, which boasts growing brand recognition backed by strong earnings, cash flow and dividends.

Another compelling dividend growth play part owned by Henderson Far East Income is Chinasoft. Kerley says the Hong Kong-listed software developer is moving into cloud services, adding that penetration of cloud computing in China remains quite small and implying significant scope for growth.

BOOSTING EXPOSURE TO CHINA

The investment trust increased its exposure to China in 2017, saying the country has the best combination of value, growth and dividend growth in the Far East.

'We own banks, property, and consumer staples, as well as electric bus manufacturers and the owner of the hydro dam on the river Yangtze,' he adds, referring to hydro-electric power producer China Yangtze Power.

Besides biggest position Samsung, Henderson Far East Income's top 10 holdings include names such as China Construction Bank. It also has a stake in Bank of China, the corporate-to-personal banking services provider which is now the world's largest bank by market capitalisation.

Shareholders in the investment trust are also gaining exposure to the cash flows of another market leader, namely Taiwan Semiconductor, the globe's largest dedicated independent semiconductor foundry whose customers include tech titans Apple and Qualcomm.

HENDERSON FAR EAST INCOME'S GEOGRAPHICAL BREAKDOWN (AS AT 31 OCTOBER 2017)	
CHINA	25.7%
AUSTRALIA	18.5%
SOUTH KOREA	16.3%
TAIWAN	15.9%
HONG KONG	6.6%
THAILAND	6.0%
SINGAPORE	5.8%
NEW ZEALAND	1.8%
UK	1.8%
INDONESIA	1.6%

Source: Janus Henderson Investors

'The internet and tech sector globally have been driving markets,' explains Kerley, who refuses to overpay for market darlings whose shares are priced for perfection.

Yet he makes the point that amid synchronised global economic recovery, investors may still be able to access growth without paying high earnings multiples for fast growth tech names.

The fund manager suspects 2018 will see investors start to look at value rather than growth stocks. 'A switch to value would help us, because we do have a value bias in Henderson Far East Income,' he remarks. (JC)

New investment trust factsheets could be 'misleading'

Industry experts worry that scenarios for potential returns in the future are too optimistic

A new document required to be published by all investment trusts could be misleading to investors, according to experts.

Called the Key Information Document (KID), it is meant to help prospective investors understand the nature of a fund, the target investor base, its expected risks/returns and costs.

Introduced on 1 January 2018, the KID has actually left experts wondering if it will do more harm than good.

WHY IS THE NEW DOCUMENT CONTROVERSIAL?

Typical fund factsheets contain historic returns. That's not allowed in the new investment trust KID. Instead, there is an illustration of the potential return under four performance scenarios: stress, unfavourable, moderate and favourable; over one, three and five years.

These scenarios are ultimately based on share price returns over the past five years. There has been a bull market for the five years since 1 January 2013, so a strong chance that many investment trusts will have done very well.

Florence Buron, a director at consultancy Deloitte, comments: 'To assume the market is going in the same direction as the previous five years is not guaranteed as no one knows the future'. This suggests that the future scenarios in the document might not be of much use, if any.

> THE SCENARIOS IN THE KIDs OFTEN APPEAR 'HIGHLY OPTIMISTIC'

EXAMPLES OF FUTURE SCENARIOS

Stockbroker Numis believes there are a number of flaws with KIDS that make them 'misleading' for investors. In particular, it says the scenarios in the KIDs often appear 'highly optimistic'. It says: 'For instance, **Scottish Mortgage (SMT)** shows five year (annual) returns of 23.1% under the moderate scenario and 10.7% per year under the unfavourable scenario.'

Scottish Mortgage has made 25.7% annualised total return over the past five years, according to Morningstar, but 'only' 15.3% on a 10-year basis. **HarbourVest Global Private Equity's (HVPE)** KID features data implying you could make 14.5% per year over five years under the unfavourable scenario. **Baillie Gifford Japan Trust (BGFD)** has 13.1% potential annual return over the same period in its unfavourable scenario.

The scenarios are created by the European Securities and Markets Authority and not by the investment trusts.

MANY UNFAVOURABLE CONDITIONS STILL IMPLY YOU CAN MAKE A PROFIT

All the data we've seen for the stress scenario has a negative return, yet we believe investors may struggle to differentiate between the words 'stress' and 'unfavourable', as they both imply bad market conditions. As such, they may focus on the unfavourable scenarios with the hope that the worst case situation could still be profitable.

Indeed, we've seen a list containing nearly 30 investment trusts analysed by Numis which have a positive annual return under the unfavourable scenario over five years.

'The stress scenario provides an indication that investors can lose money, but we believe it is hard for investors to gauge the likelihood of this happening, particularly for funds where the returns are high even under the unfavourable scenario,' adds Numis.

Ian Sayers, chief executive of the Association of Investment

Companies is not happy with the future scenario set-up among other complaints. He goes as far to say that he finds himself in the odd position of being head of a trade organisation which has been 'inundated by complaints from his members that a regulator is forcing them to overstate their performance and understate their risks.'

WHAT ELSE IS WRONG WITH THE DOCUMENT?

Other criticisms of KIDs include a lack of consistency in how costs are calculated across the sector. For instance, some funds include stamp duty as a cost but most do not (in line with the latest AIC guidance). Some seem to have excluded finance costs and performance fees, and a few show absolute figures rather than annualised, and others seem to include errors.

Also under the new regulation, investment trusts must disclose transaction costs whereas typical unit trust or OEIC funds don't have to.

Some fear that by showing transaction costs for one type of product and not another, it may sway the decision to invest.

This may be even more galling for investment trusts due to their closed-end structure. Trust fund managers do not have to trade the portfolio when people buy and sell their shares, as opposed to an open-ended fund manager who has to buy/sell investments as investors move in/out of the fund.

Therefore it is likely that transaction costs are probably lower in an investment trust than a typical unit trust or OEIC, but if you are only shown the costs of one type of investment it is hardly transparent.

WILL INVESTORS IGNORE THE DOCUMENT?

'The real question is to what degree the data in the KID will influence investors when buying investment trusts,' comments Numis. 'We believe the return scenarios in the KID are likely to be ignored by most investors, although we expect investors to continue to rely heavily on past performance (which ends up with similar results).

'We certainly discourage anyone from interpreting the moderate scenario as the likely outcome over the next five years,' it adds.

Numis believes there is a strong argument for the KID document to be ignored by investors. It believes many investment trust managers share this view, given the difficulty in finding the KID on many individual trust websites. (DS)

DISCLAIMER: Editor Daniel Coatsworth has a personal investment in Scottish Mortgage mentioned in this article

Free Spirit toasts fantastic first year as a fund

Experienced investor Rosemary Banyard on the hunt for quality stocks

'It has been a good year, but it is still early days,' says Rosemary Banyard, manager of the **CFP SDL Free Spirit (GB00BYYQC271)** fund, a £7.2m OEIC which has just celebrated its one-year anniversary (3 Jan 2018).

The investment objective of this concentrated fund is to achieve real growth in capital and income over the long term, through investments mainly in UK equities listed on the LSE, AIM or NEX Exchange. For Banyard, 'real growth' means growth in excess of CPI inflation and 'long-term' means over a minimum investment horizon of five years.

According to FE Trustnet, the fund has made a strong debut, returning 18.5% on a 1 year cumulative basis, ahead of the IA UK All Companies sector's 13.4% haul and leaving the fund with a top quartile ranking. This comes despite running with high cash balances in the early months post-launch while Banyard set about deploying funds.

The highly experienced fund manager, best known in investment circles for her previous stewardship of various small and mid cap funds at Schroders, joined Manchester-based Sanford DeLand (SDL) in 2016 to launch and manage the Free Spirit fund.

This followed a late 2015 introduction to Keith Ashworth-Lord, who has garnered a healthy investor following as manager of SDL's flagship **CFP SDL UK Buffettology (GB00B3QQFJ66)** fund.

The introduction proved to be a veritable meeting of minds. The pair found they shared a passion for fundamental analysis, long-term thinking and so-called 'Business Perspective Investing'.

The latter is Ashworth-Lord's guiding principle and a successful philosophy and strategy associated with Warren Buffett and other disciples of Benjamin Graham. Buffett apprentice Ashworth-Lord likes to quote the sorcerer himself in this regard: 'Only an excellent business bought at an excellent price makes an excellent investment.'

IDENTIFIABLE ENTRY BARRIERS

'Both of us start from the perspective that we are looking at the business first. It is the business that generates wealth for shareholders, not the stock market,' explains Banyard, when quizzed on points of differentiation between Free Spirit and Ashworth-Lord's Buffettology fund.

'We're agreed on the basic principles,' she says, referring to Ashworth-Lord, 'so the differences are in the details and the individual shares that we buy.'

The pair has different circles of competence and sector preferences. 'My largest exposure is to IT software and services,' says Banyard, contrasting this with Ashworth-Lord's 'greater comfort' in leisure roll-outs such as **Domino's Pizza (DOM)** and **Restaurant Group (RTN)**.

'Another difference is that I will entertain IPOs, but Keith doesn't,' adds Banyard, whose fund is invested in relative stock market newcomer **Alfa Financial Software (ALFA)**, the fast growing, strongly cash generative enterprise software supplier to the asset and consumer finance industry.

Banyard looks for 'identifiable barriers to entry' in the businesses she backs. 'Usually, you find evidence for barriers to entry in the return on equity, return on capital or the return on operating assets.'

MANAGEMENT NEED TO HAVE SKIN IN THE GAME

Firms that currently meet

Banyard's investment criteria include retailer **Superdry (SDRY)**. 'I've been tracking the company for some years,' recalls Banyard. 'Superdry has been in transition from something of a cottage industry into a very successful international branded business and we are now getting to a point where it is starting to fire on all cylinders.'

Flagging the leading portfolio position's rapid retail, e-commerce and wholesale growth, Banyard explains: 'Superdry generates a 20% return on equity, has a serious international business, a net cash position and quite large ownership by the founders and board of 37.6%. That is a comfort which I like.'

Other portfolio examples with significant management ownership include **Craneware (CRW:AIM)**, the Edinburgh-headquartered healthcare software play whose management holds sway over 12.6% of the equity. 'The weighted average management ownership of the whole portfolio is 14%,' explains Banyard.

In the software and services sector, she likes Cambridge-based **AVEVA (AVV)**, the engineering software company 'in the process of quite a complex reverse takeover' with long-run suitor Schneider Electric.

Banyard believes the deal, which will create one of Britain's biggest software businesses, will yield material cost and revenue synergies for an enlarged group that will remain listed on the London stock market.

'When it re-lists', early in the opening few months of 2018, 'it will be a business valued at over £4bn,' says Banyard. 'It is one of only two or three companies in the world that have software that is used by oil and petrochemical giants to design their plants. And the switching costs are very high for the customer, which gives AVEVA resilience.'

Another beneficiary of high switching costs is **Fidessa (FDSA)**, the Woking-based fintech company and global leader in trading software systems and data to financial institutions. Banyard argues Fidessa will become ever more important to traders under new market rules called MiFID II.

ABOUT FREE SPIRIT

OEIC	3 JAN '17	30-35	£7.2M
FUND TYPE	LAUNCH DATE	NUMBER OF HOLDINGS	FUND SIZE (03/11/2017)

TOP TEN HOLDINGS (AS AT 30/11/2017)	
Superdry	4.00%
Craneware	3.72%
VP	3.38%
Fidessa	3.36%
A.G.Barr	3.35%
Alfa Financial Software	3.16%
Hargreaves Lansdown	2.99%
Relx	2.97%
Park Group	2.95%
MJ Gleeson	2.94%

Source: Trustnet/Sanford DeLand Asset Management

STRONG PERFORMERS

Among the strong portfolio performers have been the likes of motor finance specialist **S&U (SUS)** and **VP (VP.)**, the equipment rental specialist whose shares rose on the announcement of the purchase of Brandon Hire, a deal offering opportunities for geographical expansion and cost savings.

Amid a seemingly never-ending bull market that is pushing valuations higher across the board, Banyard concedes it is currently tough for her to find suitable excellent businesses at excellent prices: 'Any new purchase has got to replace something that is already in the fund and it is challenging to find good buys.'

New investments have however included **Mortgage Advice Bureau (MAB1:AIM)**, which is building a technology-based platform in the UK mortgage broking market. (JC)

Making changes to auto-enrolment

We outline the Government's plans to improve part of the pensions system

The UK is in the midst of a quiet savings revolution. After years of declining private sector pension saving rates, the automatic enrolment programme first introduced in 2012 has the potential to transform the retirement prospects of millions of people.

According to the latest Office for National Statistics (ONS) data, the number of people actively saving in defined contribution (DC) plans – where you build up a pot of money of your own which you can convert into an income in retirement – was 6.4m in 2016, up by 62.5% from 3.9m in 2015. In fact as recently as 2012 this figure was as low as 1m.

The Government wants to go further in its efforts to turn the UK into a nation of savers and just before Christmas, it announced a series of planned changes to auto-enrolment.

SO WHAT'S CHANGING?

While auto-enrolment has clearly been successful in boosting the number of people saving for retirement, not everyone benefits.

At the moment you have to be aged 22 or older in order to qualify for auto-enrolment. However, the Government wants to extend the reforms to workers aged 18 and over.

Policymakers also plan to increase the amount going into people's pensions through auto-enrolment. Under existing plans from 2019 all companies will pay in 3% of an employee's earnings and the employee will pay in 4%. In addition, the employee will automatically get an extra 1% through pension tax relief.

At the moment the minimum contribution is based on a portion of your salary, referred to in the rules as 'banded earnings', rather than the whole lot. This means that your contributions are calculated on earnings between £5,876 and £45,000. So if you earn £27,000, for example, and your total contribution (including tax relief) is 8%, that's 8% of £21,124 (or £1,670 a year).

This is set to change, with the Government planning to alter the rules so that every pound of salary qualifies for your auto-enrolment contribution. That said you will still need to be earning at least £10,000 in order to qualify for auto-enrolment.

Finally, the Government has pledged to test a number of 'targeted interventions' to encourage self-employed people to save for retirement – although it seems unlikely a mechanism will be introduced so they can get a 'matched' contribution in the same way employed workers do.

WHEN WILL ALL THIS HAPPEN?

While change is coming, we don't know exactly when this will happen. The Government has only pledged to make the changes in the 'mid-2020s', by which time policymakers should also have reviewed – and potentially increased – the minimum contributions under auto-enrolment.

Tom Selby,
Senior Analyst, AJ Bell

How to invest ethically

We analyse the investment case for ESG and reveal the experts' top fund picks

Ethical and sustainable investing used to be thought of as a charitable endeavour that places principles before profits, but there is growing evidence to suggest it can lead to better long-term returns.

There are now around 200 funds in the UK that claim to invest sustainably, putting much more choice at investors' fingertips.

You need to dig deep to ensure the fund meets your criteria because managers have yet to reach an agreement on what ethical and sustainable really means.

CAN ETHICAL INVESTMENTS OUTPERFORM?

The biggest argument against investing ethically is that if excluded sectors like oil, mining, tobacco, alcohol and armaments perform well, your portfolio could lag the overall market.

Some ethical funds have underperformed their benchmarks over certain time periods. But Simon Howard, chief executive of the UK Sustainable Investment and Finance Association, says investors need to take a long-term view.

'The investment case is that over time returns from unsustainable activities will tend to be very poor,' he explains. 'So fossil fuel stocks will see declines as tax and regulation bites, whilst some agricultural practices are clearly unsustainable and that will damage values in various food supply chains.'

Tanya Pein, an independent financial adviser at In2 Planning, a specialist in responsible investment, warns that investors run the risk of losses or lower performance if they don't take environmental, social and governance (ESG) factors into account.

When Volkswagen was found to have programmed its diesel engines to activate certain emissions controls only during laboratory emissions testing, its share price went into steep decline. There were many funds that suffered an immediate loss as a result of holding Volkswagen.

'Another example of where there can be substantial risks in not taking an ESG-focused approach is climate change,' says Pein.

'The valuation and dividend risks in the traditional oil and gas sector continue to increase sharply as governments and businesses commit to reducing oil consumption and carbon emissions, in line with the legally binding commitments made in the Paris Agreement two years ago.

'This leaves the FTSE 100, with its predominance of oil and gas companies, a high-risk option – on a financial returns basis alone, why take that risk?'

IS ETHICAL INVESTING LESS DIVERSE?

Another argument against ethical or ESG investing is that it reduces the diversity of a portfolio.

This argument has become slightly less convincing in recent years as numerous ESG funds covering all of the main asset classes have been introduced.

Matthew Coppin, manager, financial advice at Castlefield Advisory Partners, says it is sometimes possible to seek exposure to excluded 'unethical' sectors in a forward-looking way. For example, you could have mining exposure through a business that mines landfills for sought-after materials like plastics, computer components or precious metals.

'Obviously the more restrictive [the client is] on what they want to exclude and include, the more difficult it becomes to find viable assets in the investment universe,' he adds.

HOW DO I INVEST?

Before searching for a fund it's helpful to think about your definition of ethical and what types of companies you want to include and exclude.

There is a big difference between funds that have an ESG focus and those that are ethical.

Ryan Hughes, head of fund selection at AJ Bell, says many investment houses include an element of ESG in their process, but very few let this be a determining factor in their investment decisions.

'Ethical investing takes this to a new level, with the majority actively screening out stocks that do not meet set criteria. Even then, some funds employ a much stricter screening approach than others, taking a so-called "dark green" approach,' he explains.

Some funds use terms like ethical, socially responsible or stewardship in their name despite investing in companies that most people would regard as unethical.

Castlefield Advisory Partners says these 'spinners' include **Vanguard SRI European Stock Fund (IE00B76VTL96)**, which invests in **British American Tobacco (BATS)** and **Royal Dutch Shell (RDSB)**; and **Aberdeen Ethical World Equity (GB0006833932)**, whose third-biggest holding is EOG Resources, a firm accused of illegally burying waste and open-air burning of natural gas.

There is some evidence to suggest ethical and sustainable investments can outperform, but because the industry is relatively new it isn't conclusive.

An analysis by Morgan Stanley's Institute for Sustainable Investing found that over a period of seven years, sustainable investments usually met and often exceeded the performance of traditional investments.

Four FTSE Russell indices, which select companies involved in energy efficiency, water technology and other green applications, have all outperformed their benchmark, the FTSE Global All Cap Index, since the financial crisis.

PICKING THE ETHICAL WINNERS

AJ Bell's Ryan Hughes suggests **Kames Ethical Cautious Managed (GB00B1N9DX45)** is a good starting point for investors. The fund is a mix of equities and bonds and it screens out stocks that don't meet its strict ethical criteria, such as gambling, tobacco and alcohol companies.

Other well-regarded ethical funds include **Liontrust UK Ethical (GB00B8HCSD36)** and **Rathbone Ethical Bond (GB0030957137)**.

If you want a fund that specifically invests in the environment, Hughes recommends **Impax Environmental Markets (IEM)**. The trust has exposure to themes such as energy efficiency, water technology and pollution control.

An alternative is **FP WHEB Sustainability (GB00B8HPRW47)**, which focuses on environmental and social challenges such as sustainable transport, cleaner energy, health and education.

The passive ethical investment space is much smaller, but one to consider is **iShares Global Water UCITS ETF (IH20)**. The exchange-traded fund tracks an index comprising 50 of the largest global companies engaged in water-related businesses, such as American Water Works and **Severn Trent (SVT)**. (EP)

FRIDAY 12 JANUARY

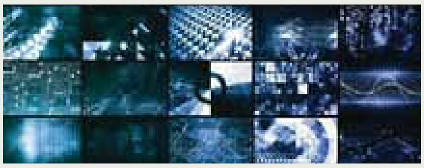
TRADING STATEMENTS	
Tarsus	TRS
XP Power	XPP
AGMS	
JPMorgan Elect Managed Growth	JPE
JPMorgan Elect Managed Cash	JPEC
JPMorgan Elect Managed Income	JPEI
Nanoco	NANO

MONDAY 15 JANUARY

FINALS	
Watkin Jones	WJG
INTERIMS	
1pm	OPM
TRADING STATEMENTS	
Rio Tinto	RIO
ECONOMICS	
UK	
Rightmove	HPI

TUESDAY 16 JANUARY

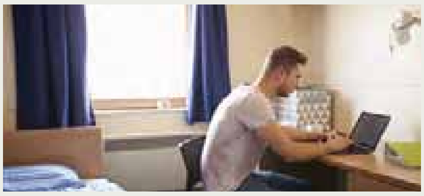
INTERIMS	
K3 Capital	K3C
NCC	NCC
TRADING STATEMENTS	
Ashmore	ASHM
Dunelm	DNLM
Greggs	GRG
JD Sports Fashion	JD.
Johnson Matthey	JMAT
AGMS	
Baring Emerging Europe	BEE
Plus500	PLUS
ECONOMICS	
UK	
HPI, PPI, CPI, RPI	



Emerging market specialist asset manager **Ashmore (ASHM)** releases a trading update on 16 January and investors will be hoping it reflects the upward trend in the regions in which the company invests.

The MSCI Emerging Market index has had a great start to the year, following on from a superb 2017. However, the index is a measure of emerging market equities and although Ashmore do provide equity funds, the company is really more of debt specialist.

Therefore, despite a recent rally in Ashmore's share price, if US interest rate hikes have hurt emerging market borrowers, both sovereign and corporate, the news might not be as rosy as investors might expect.



Student accommodation builder **Watkin Jones (WJG:AIM)** is expected to report satisfactory full year results on 15 January, given it has already hinted at good progress in a trading update on 31 October 2017. Last week it said it had secured planning permissions on six new sites.

The market is likely to focus on margin performance and guidance to see if the company is facing cost pressures seen in parts of the broader construction industry.

WEDNESDAY 17 JANUARY

TRADING STATEMENTS	
BHP Billiton	BLT
Burberry	BRB
AGMS	
Majedie Investments	MAJE

THURSDAY 18 JANUARY

TRADING STATEMENTS		
Associated British Foods	ABF	
Experian	EXPN	
Headlam	HEAD	
Halfords	HFD	
Royal Mail	RMG	
Ten Entertainment	TEG	
William Hill	WMH	
Whitbread	WTB	
AGMS		
Avacta	AVCT	
Keystone Investment Trust	KIT	
Equatorial Palm Oil	PAL	
Standard Life Equity Income Trust	SLET	
EX-DIVIDEND		
Ashtead	AHT	5.5p
Autins	AUTG	0.8p
Compass	CPG	22.3p
Consort Medical	CSRT	7.44p
CYBG	CYBG	1p
Dewhurst	DWHT	8.5p
EasyHotel	EZJ	0.22p
Ramsdens	RFX	2.2p
Shaftesbury	SHB	8.1p
SSE	SSE	28.4p
Titon	TON	2.7p

Multi-price discounter **B&M's (BME)** third quarter and Christmas trading update (12 Jan) will reveal if momentum has continued with the multi-price value retailer, a beneficiary of the cash-strapped shopper's quest for value. New customers have been driving strong growth at B&M. Building on this it is opening new stores in the UK and Germany and is a recent entrant into the attractive convenience shopping space following last year's acquisition of Heron Foods.

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A strong run in iron ore price since the fourth quarter of 2017 bodes well for **Rio Tinto (RIO)** which publishes a trading update on 15 January. Iron ore is the dominant commodity for the group in terms of contribution to earnings.

However, it is worth noting the Australian government predicts a 20% drop in iron ore prices in 2018 because of rising global supply and moderating demand from China which is a major importer.

KEY

- Main Market
- AIM
- Fund
- Investment Trust
- Exchange-Traded Fund