THE UKSA NEWSLETTER

UKSA
UK Shareholders' Association

ISSUE 18

Chairman's message

Charles Henderson - Chairman of UKSA

Dear Members

It was about this time 15 years ago that I remember Lehman Brothers becoming bankrupt. I was on holiday in St Ives, Cornwall, watching from a distance what was going on through my Blackberry, since it affected Invesco UK and its customers' funds. This was a year after Northern Rock became insolvent. Both organisations appeared to have sufficient assets to cover their liabilities, but both failed to meet their liabilities as they fell due. No central bank or authority was prepared to help (as the Fed did for Bear Stearns and the UK taxpayer did for RBS). 15 years later, I am still not totally sure that anything has changed to allow us, as customers of financial institutions, to relax our vigilance on making sure our money is reasonably safe.

There was an FT Lex column (5 June 2023) about bank runs suggesting that rule changes ignore the root causes of such runs: i.e. what depositors are thinking and usually their resultant panic. Complicated rules tend not to forestall this panic. Would deposit protection schemes (such as the £85,000 one in the UK) or deposit insurance stop any panic? The job of banks and any other financial services provider is to do their best to protect their customers' money. One method, as we generally know as investors, is diversification. The Lex article suggests that banks should limit deposit concentration.

We would expect of our regulators, such as the FCA, that they help organisations to keep our money reasonably safe. However, the impression I have is that they still favour the providers rather than the customers of financial services; even though they have recently introduced new consumer duty rules and principles, which require firms to act in good faith – i.e. in a way that considers any foreseeable harm and ensures the delivery of good outcomes for retail customers. The problem may be because the FCA is answerable to the Treasury. There is a conflict of interest here, as the Treasury's interest will be in the tax revenues generated from the profits of the financial services industry. But as these days the consumer generally rules, putting the

consumer first is more likely to preserve the financial services industry.

I understand that the FCA is protected from paying any legal costs of any winning defendants of a challenge to the FCA in our law courts (the NHS is not so protected). This leads to complacency because they will inevitably believe that no one would challenge their accusations, as they will have no chance of recuperating their costs if they win.

Our policy team has repeatedly found it difficult to advise anyone at the FCA directly about issues relevant to the public good, our members or savers in general. However, we keep submitting responses to their consultations in the hope that they will listen. A recent FCA consultation is on financial promotions using social media – we have stated that the only way to keep consumers safe from financial promotions on social media is to ban them (in the same way as the Treasury is thinking of banning financial services cold calling). It would be welcome if the FCA became more enlightened on seeing the benefits of engaging with their main stakeholders, the retail consumers of financial services. If the Financial Reporting Council can do this, why not the FCA? The FCA has recently told asset managers to prove they offer value for money. It will be interesting to see what the FCA does about asset managers who cannot prove it.

Before I finish, I would like to mention the Policy Team's response to the FRC's consultation on proposed changes to the UK's Corporate Governance Code, reflecting some of the issues coming out of the restoring trust in audit and corporate governance reforms. Directors of companies that have to comply with the Code should find it less easy to avoid their responsibilities to shareholders for their internal controls, assurance and resilience. Thanks to Sue Milton for getting this across the line by the deadline.

I will finish by highlighting our joint response with ShareSoc to Sir Douglas Flint's Digitisation Task Force interim report. The news story and response can be seen here on our website. Our main concern is that the Task Force currently favours intermediaries rather than the ultimate beneficial owners of shares in the share ownership chain. For example, one of the interim report's recommendations perpetuates the stance that individual shareholders' voting rights are an optional extra for which they should pay additional fees. My particular thanks to Mohammed Amin, who coordinated the input to our response and was chief writer and editor.

In-person AGMs

We're not the only ones stressing the importance of in-person AGMs. Thank you to UKSA director Malcolm Hurlston for drawing our attention to this article in South Africa's Financial Mail.

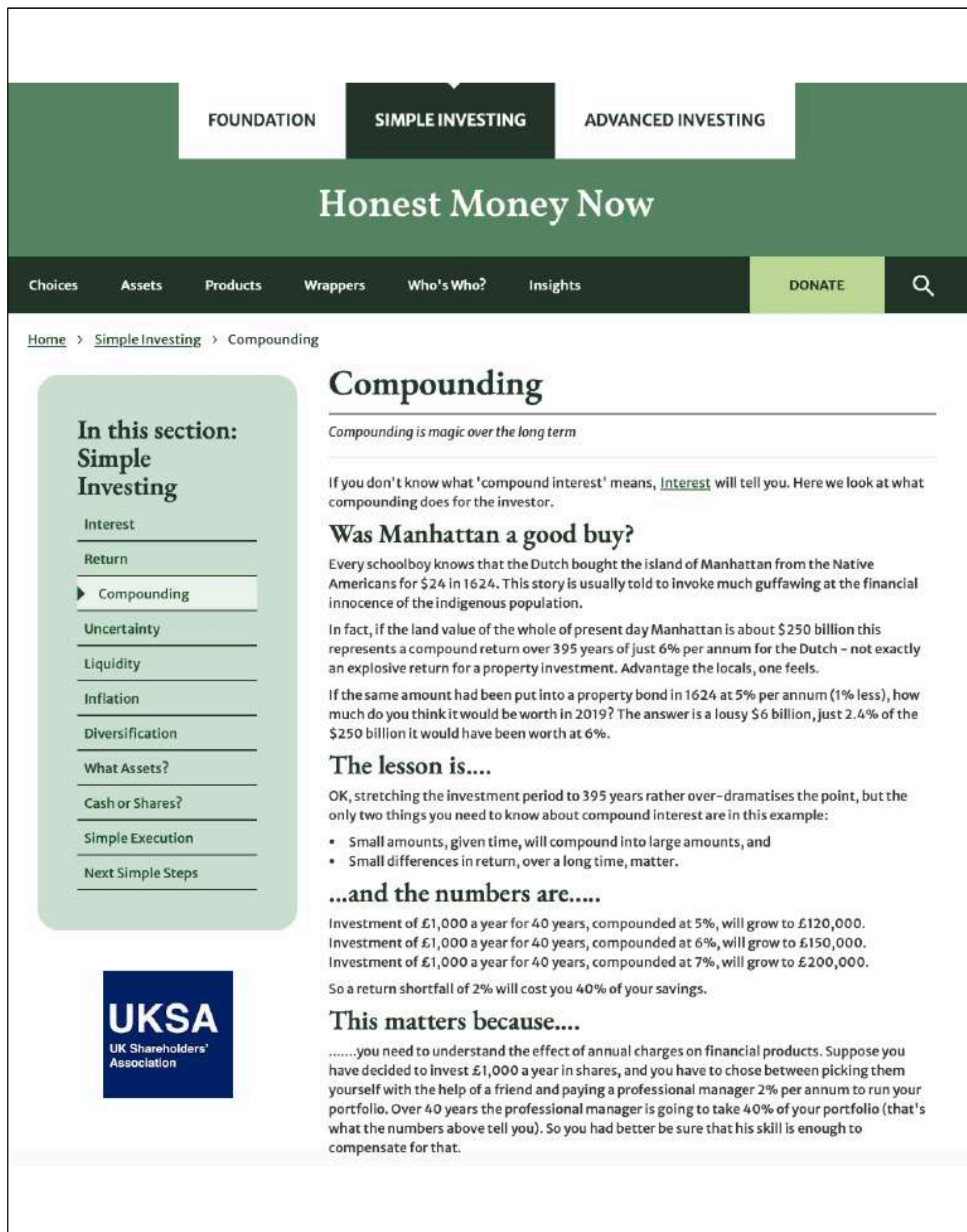
HonestMoneyNow

The HonestMoneyNow website, conceived by former UKSA Chairman John Hunter, has evolved into a powerful, independent source of information on saving and investment.

Recent improvements include overhauled navigation and an update to the information on financial product and advice costs.

Tip: the search tool is an efficient means of gathering concentrated information on particular topics.

User feedback is welcomed!



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Compounding

Compounding is magic over the long term

If you don't know what 'compound interest' means, Interest will tell you. Here we look at what compounding does for the investor.

Was Manhattan a good buy?

Every schoolboy knows that the Dutch bought the island of Manhattan from the Native Americans for $24 in 1624. This story is usually told to invoke much guffawing at the financial innocence of the indigenous population.

In fact, if the land value of the whole of present day Manhattan is about $250 billion this represents a compound return over 395 years of just 6% per annum for the Dutch – not exactly an explosive return for a property investment. Advantage the locals, one feels.

If the same amount had been put into a property bond in 1624 at 5% per annum (1% less), how much do you think it would be worth in 2019? The answer is a lousy $6 billion, just 2.4% of the $250 billion it would have been worth at 6%.

The lesson is....

OK, stretching the investment period to 395 years rather over-dramatises the point, but the only two things you need to know about compound interest are in this example:

- Small amounts, given time, will compound into large amounts, and
- Small differences in return, over a long time, matter.

...and the numbers are.....

Investment of £1,000 a year for 40 years, compounded at 5%, will grow to £120,000.
Investment of £1,000 a year for 40 years, compounded at 6%, will grow to £150,000.
Investment of £1,000 a year for 40 years, compounded at 7%, will grow to £200,000.

So a return shortfall of 2% will cost you 40% of your savings.

This matters because....

.......you need to understand the effect of annual charges on financial products. Suppose you have decided to invest £1,000 a year in shares, and you have to chose between picking them yourself with the help of a friend and paying a professional manager 2% per annum to run your portfolio. Over 40 years the professional manager is going to take 40% of your portfolio (that's what the numbers above tell you). So you had better be sure that his skill is enough to compensate for that.

John Hunter - former UKSA Chairman and creator of HonestMoneyNow

Is it possible to tell when shares generally are overpriced?

Martin White - UKSA Director and creator of Savers Take Control

We can learn a lot from stock market history. By looking back far enough, we can get a feel for the sorts of things that have happened in the past. It is worth doing this, as it gives you a healthy appreciation of the fundamental uncertainties that are out there. Most stock market discussions in the media will focus on the relatively recent, and the idea that the future could be dramatically, and suddenly, very different from the recent past is not one that you would pick up very readily from most stock market commentary.

In 2000, Andrew Smithers and Stephen Wright published a ground-breaking book entitled *Valuing Wall Street: Protecting Wealth in Turbulent markets*. For those with a love of reading investment books, I highly recommend it. At the time they wrote it, they believed that the market (especially the US market, that provides much better data for the kinds of analysis they did) was dangerously high.

If you are less inclined to buy the book (and I think you will be in the majority), there are still a lot of good discussions on YouTube. This was Andrew Smithers' first book, I think, and he has written some more since then as the sole author, always building on the discoveries and thinking of the first. The most recent book by Andrew is *The economics of the stock market*, which I would describe as setting out his understanding of how business works and how this relates to the investment world. The best read is probably the first book, as everything is discussed in some detail. The later books are deceptively packed with analysis and you would lose out by trying to read them quickly. A good compromise for the really interested investor would be to buy the first book and the latest one.

A good recent discussion can be found here. The related voice recording (not a video) can be found here. That discussion was held in June 2022.

A more recent online discussion, with a video of the event, was hosted by Pension Playpen on 12 September this year, and the YouTube link is here. One of Andrew Smithers' conclusions, informed by his study of markets and stock returns, is that conventional economic theory contains many assumptions that are disproved when you look at the data. His most recent book is an attempt to set out a more realistic interpretation of how the world works. In criticising conventional economic theories he does not always make friends, of course. But generally accepted economic theory is an important driver of political decisions. Some of his most important conclusions are:

- Stock markets sometimes get very overvalued, and this leads to crashes with bad economic and social consequences. And it is possible to detect when markets are seriously overvalued.
- Whilst he believes that the markets are generally fairly efficient, in

that share prices of companies relative to each other tend to be reasonably sensible, he does not believe that this efficiency extends to the overall level of the stock market. And it is at the overall stock market level that he applies most of his thinking.

- Consensus economic policies, which focus on getting the "right" level of demand whilst avoiding excessive inflation, are too simplistic, as they do not recognise that there is also a problem if asset prices get too high. So, economic policies need a rethink, with a ditching of some current beliefs, which meets with some resistance within the academic economic community. Unfortunately – and I can't really understand it – many economists seem reluctant even to engage in discussion with Andrew Smithers. You would have thought they were driven by intellectual curiosity to see whether there are really some valuable new insights to be had.

- The way that executives are incentivised leads to an excessive focus on short-term profits and share prices, to the detriment of company investment and also to the detriment of society as a whole.

If anyone feels moved to follow this story, to research Andrew Smithers and search out some of his talks and writings, I would be really keen to hear your thoughts!

In search of "safe" assets

Has anyone been following UK index-linked gilts? I know the Government has changed the definition of the price index that determines the dividend flow and ultimate capital repayment on index-linked gilts, but leaving this consideration aside, index-linked gilts are in many ways the safest means to protect your wealth from loss in real terms. If inflation goes mad and prices double, your income and capital repayments on ILGs will double too. And whilst the dividend income is taxable, your capital gains (and losses) on gilts are not taxable for UK investors.

Sounds simple enough? We are locking in returns for the remaining term of the ILG. If you buy an ILG maturing in 30 years at any given price today, that will give you a certain real gross redemption yield (the equivalent annual return that reflects both the dividend flow and the ultimate capital repayment in relation to your purchase price), **providing** you hold it to maturity.

Now this next point is vitally important, but not widely understood. Lord Paul Myners, a good friend to UKSA, used to have fun with this, asking senior politicians "Question 1: If interest rates go up, do the prices of bonds go up or down? Question 2: And how sure are you of that conclusion?"

An index-linked gilt that matures in 30 years turns out not to be "safe" at all if you will need to sell it well before the end of the 30 years! What happens in practice is that real interest rates can move a lot. We had an extreme case of this recently. Not so long ago, the real return on index-linked gilts was seriously negative, as low as -2% per annum or worse.

This was on the one hand because many pension funds, promising their members index-linked pensions, and worried about inflation risk, felt that they just had to hold at least some long-dated index-linked gilts. On the other hand, the Government had a policy of lowering interest rates to push up asset prices and encourage spending. So what happened when the financial markets had a change of view (a certain Liz Truss might have had something to do with it) and decided that they would now require a positive real return on index-linked gilts? The prices of ILGs immediately crashed, with the longer-dated gilts falling way more than the short-dated. What the people who had bought long-dated ILGs at really high prices had done was to lock in a guaranteed long-term real reduction of their wealth. (Incidentally, this guaranteed wealth reduction is also what happens when you agree to pay intermediaries a material percentage of your wealth every year, but unless you understand the principles of compound interest you won't realise it.)

So, back to our heading above – in search of "safe assets". When I believe that equity prices are so high that a major downwards move at some point in the future is worth being prepared for, I like to adjust my portfolio a bit, and my asset of choice for this, in spite of the warning tale above, is to make some use of index-linked gilts. BUT, and it's a big but, I won't buy the longer-dated ILGs unless the real yield on them is exceptionally good – which it hasn't been for decades and I feel it may never happen again. However, if you buy a mixture of ILGs maturing in say two to five years hence, their market prices will not be very sensitive at all to large general moves in real interest rates. But they will be 100% sensitive (apart from the three-month lag – the dividend and capital payouts are a function of the price index three months previously) to inflation. This is an ideal asset to be holding in the event that we get either a surge of inflation or a stock market crash, or even both.

But I'm running up against a technical problem. I can't find anywhere a table that shows me what the current real gross redemption yields are for each of the ILGs available. This information used to be readily available. I know how to work them out if I have to, but it's a hassle. And I am reluctant to invest in ILGs that guarantee me a negative real return, even a small one.

So, my question for readers is: any idea where there can be found, freely available, tables of the current real gross redemption yields for UK index-linked gilts?

And, of course, any comments, discussions, letters in relation to this topic will be much appreciated. Please also tell us whether you would like us to run an online discussion session for members on any topic.

External relations roundup

Sue Milton - External Relations Director

Corporate Governance – better board accountability is on its way

We have responded here to the Financial Reporting Council's consultation on changes to the UK's Code of Corporate Governance. The consultation is the next step in the many consultations on audit and governance reform since 2018. This one focuses on establishing a board's responsibility for internal control, assurance and resilience – so there is no escape for board members. They will have to comply or explain why they are not complying.

This is good news for retail shareholders, because we will have something tangible against which to assess company performance and behaviour. There is one big dependency, though, and that is that companies must share clearly what is material to the company, for example a coal-mining company should be stating that it is material to them that we are moving away from fossil fuels, or they plan to use artificial intelligence (AI) but have no clear governance over data and cyber security.

We have requested that both of these be addressed in the upcoming amendments to the Code.

Financial Conduct Authority (FCA) review of financial retained EU law

We need to be aware that the FCA, together with the Prudential Regulation Authority (PRA) and His Majesty's Treasury (HMT), is working through every piece of financial legislation and regulation to check what bits can be discarded, amended or carried over unchanged.

This is a long-term project. The FCA expects this to take up to 10 years. A lot will be done over the next two to five years, but there are some significant interdependencies across the different pieces of law, so repealing or changing any part may have significant consequences for what is retained. This is against a backdrop of many new pieces of law being made, rendering this work even more complex.

The FCA is having many formal and informal meetings with financial sector firms to check the level of consensus on what does and does not have to change. The aim is to have, for each piece of legislation, a draft update to the relevant FCA Handbook (an FCA Handbook contains the complete record of FCA Legal Instruments and presents changes made in a single, consolidated view), a draft set of statutory instruments (SIs) and draft guidance that will be issued as a consultation basis on which the financial sector can comment. This is to ensure that the law will work for business, institutional investors and the regulator.

Lawyers, whether General Counsel or part of a law firm, also have a big

task ahead of them. Many older and, therefore, senior lawyers no longer remember the process for making UK law and the younger lawyers will never have experienced it before. This is equally true for FCA, PRA and HMT staff.

A big challenge. One important aspect that is missing is the impact on retail shareholders, investors and savers. Once again, we are at risk of seeking market efficiency at the expense of consumer benefits.

This is the problem of the FCA having two remits – consumer protection and market efficiency – that inevitably pull in opposite directions.

UKSA/SIGnet closer relationship

Since our last newsletter, UKSA regional chairs and representatives have met with UKSA member Bill Fawkner-Corbett, who also happens to be the head of SIGnet, to see whether we can support each other's events in some way. Our main focus is on having more local opportunities for organising company visits and meetings, something that has lapsed because of not being able to guarantee participant numbers post Covid lockdowns.

Maybe, together, we can. Bill and the regions are working on this.

Latest UKSA-wide virtual meeting

In August, Paul Malone shared his personal experiences of the Russian/ Ukraine war on investments that are suddenly sanctioned.

I got a lot out of the meeting. The main points for me were:

1. Geopolitics covers more than war. It can involve sanctions against a nation, and might be driven by disincentivising investment in specific locations, e.g. stopping investment in nations that are not compliant with the Paris Agreement.

2. That led to a discussion on ESG, and how there is some pushback from investors and analysts because of greenwashing, the lack of clarity as to what is/is not material, several self-interested parties cherry-picking the science to suit individual company/nation needs, and increasing annoyance that we have not listened to history or science dating pack to the 19th and 20th centuries, when this was evidently already recognised.

3. If your company moves abroad, e.g. from Jersey to Kazakhstan, then retail shareholders need to do a lot of work to be able to remain a shareholder. The logistics include finding a broker willing and able to take on the task with you – possibly a broker other than the normal ones we use in the UK – and finding a bank willing to deal in the local currency.

4. There is the question of retaining our shareholder rights, such as our ability to receive dividends, vote and attend AGMs.

5. What are the red flags and what must we be aware of? One is if the

company chooses to delist. Moving, even from London to the Channel Islands, may give companies more room to manoeuvre, i.e. regulatory arbitrage, but it makes life for the retail shareholder more difficult.

6. Also, look out for nations and companies choosing to move towards dedollarisation to cut out the USA. Look out for those companies wanting to avoid sanctions and wanting to create a more bilateral, friendly arrangement by avoiding less friendly jurisdictions.

7. Provide tangible proof of share ownership in case the company delists or moves to another jurisdiction; we need to obtain paper share certificates. This is because the move disrupts the audit trail of proof of ownership when changes in brokers and platforms occur as a result of the delisting or move to another jurisdiction. Think about this, given the dematerialisation debate/consultations in the UK.

8. Enhance due diligence to consider geopolitical issues, impacts of delisting, impacts of companies listing in new and less well-known places and multiple listings. Talk to your bank and broker about investments in the non-obvious and often smaller centres abroad and what is possible, and outline some contingency plans.

9. To the extent that, ideally, investor interests are international and should not be constrained by the laws of any one country, shareholders have no control over constraints implemented by nations; companies will decide what to do for the best but without much useful shareholder engagement.

10. To the extent that retail investors have personal interests that they follow, these are expressed in their own investment choices but often without recognising the full implications of those choices.

A bit more about Paul:

Paul is a retired Central London milkman, having worked in this role for 45 years. He is a small retail investor with a share portfolio constituting one leg of his pension provision. He has been obliged to research shares since 2010, when the company he was working for switched from a final salary to a defined contribution scheme.

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The UKSA Board 9 October 2023