UKSA
UK Shareholders' Association

THE PRIVATE INVESTOR

ISSUE 202 | OCTOBER 2019

Shareholder primacy

A week ago the FT carried an opinion piece entitled 'It's a good thing that shareholders always come first'. It was written by Jesse Fried, Dane Professor of Law at Harvard Law School.

Fried's column is a riposte to a statement by the 'Business Roundtable', whose members include Apple's Tim Cook and JP Morgan's Jamie Dimon, committing to running companies for the benefit of all stakeholders – customers, employees, suppliers, communities and shareholders. Fried accuses these CEOs of 'demoting' their shareholders.

In her article in the April edition of TPI, Sue Milton also asked whether we were witnessing the demise of shareholder primacy. She cited RBS's continued opposition to the creation of a shareholder committee and highlighted the inherent contradiction between the government's stated aim of better shareholder engagement and its refusal to legislate for practical means – such as a shareholder committee – by which that could be achieved. Fried levels similar accusations of insincerity, accusing the Business Roundtable of paying lip service to broader social concerns.

Both UKSA and ShareSoc have shareholder engagement in their DNA. ShareSoc's Cliff Weight has been tireless in pushing RBS on the shareholder committee issue for several years. At UKSA the company visits team builds strong, lasting relationships with the boards of major listed companies. The resulting engagement is evident not only in the analyst-style meetings they organise but also in the AGMs at which they hold boards to account, courteously but firmly.

Anyone who goes to an AGM now will be aware of the rising average age and dwindling number of individual shareholders attending. Listed company boards, and the government, could be tempted to believe that individual shareholders no longer want to engage. And yet, as Sue Milton points out, 'people like us', i.e. individual shareholders, are the very type of shareholder on which the principles of the joint stock corporation are based. These principles include a tight link between direct investors, the board and the company. In the UK that link has been broken by the pooled nominee system. To engage with the companies they own, individual shareholders must expend effort, so they are less inclined to do so.

Fried's conclusion is that attempts to substitute stakeholder primacy will ultimately fail because shareholder primacy is hard-wired into companies' articles of incorporation. The board is elected and can be replaced by shareholders. Shareholders may of course choose to ask companies to consider broader stakeholder interests, out of altruism or a belief that returns will ultimately be greater, but either way shareholders will have the last word.

Not everyone shares Fried's optimism. As minority owners of companies we need to be very aware of efforts to undermine our position. We need to demonstrate that shareholder primacy is not only profit-driven but also a social good.

Helen Gibbons

In this issue

Published by United Kingdom Shareholders' Association Limited (UKSA)

Registered in England no. 4541415

Registered office: Chislehurst Business Centre 1 Bromley Lane, Chislehurst, BR7 6LH

Tel: 01689 856691
E-mail: uksa@uksa.org.uk
Website: www.uksa.org.uk
Twitter: @UKshareholders

Chairman:
Colin Colvin chairman@uksa.org.uk

Policy Director: Peter Parry
01604 830267 policydirector@uksa.org.uk

External Relations Director:
Sue Milton sue.milton@uksa.org.uk

Company Secretary and Membership Director:
Rob McDonald uksa@uksa.org.uk

Europe & Media Director: Helen Gibbons
07876 231232 bizlang@mac.com

Administration:

Riches Assured Financial Services Ltd

01689 856691 officeatuksa@gmail.com

Editor: Helen Gibbons
07876 231232 bizlang@mac.com

Regional Contacts:

London & SE: Harry Braund
020 8680 5872 harrycb@gmail.com

South West and Midlands: Peter Wilson
01453 834 486 or 07712 591 032
petertwilson@dsl.pipex.com

North East: Brian Peart
01388 488 419 brianpeart@btinternet.com

North West: Julian Mole
07870 890973 julian.mole@btinternet.com

E-mail notifications

If you are not receiving e-mails about events but would like to, please send a request to the office by e-mail: officeatuksa@gmail.com

Privacy

UKSA takes your privacy seriously. Following the entry into force of the General Data Protection Regulation we have assessed our procedures to ensure compliance and have updated our Privacy Policy, which can be consulted on our website. Click here if you are reading the electronic version of this edition.

General information

Advertisements in The Private Investor will be clearly described as such where they are for paid-for products and services from third parties; advertorials will not be accepted. The Private Investor will not endorse advertisers and the editorial policy will continue to be independent of the interests of advertisers.

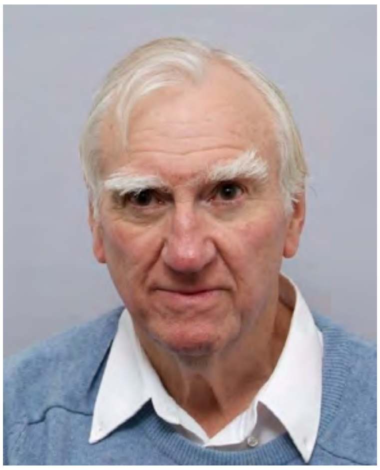
Revenue raised from advertisements will supplement UKSA's funds. UKSA believes that its members are capable of deciding whether an advertised product or service is suitable for their needs.

Note that the share-price graphs are courtesy of the leading investment website Digital Look www.digitallook.com.

Views expressed by contributors are not necessarily those of the editor or of UKSA. Nothing in this newsletter is intended to be or should be interpreted as investment advice, which can only be obtained from persons authorised in accordance with the Financial Services Act 1986 and subsequent legislation. Contributors and members may be invested in any of the companies mentioned.

Published accounts are consistent with fiction writing

by Malcolm Howard



In August I wrote to the Editor of Financial Management, the house magazine of the Chartered Institute of Management Accountants.

Dear Editor,

"I qualified with CIMA in 1976 and became a Fellow in 1981. In those days there were regular 'letters to the editor' in FM (11 issues a year) and members were involved in key decisions.

I am afraid those days have long gone – there are no letters in the magazine, members have no say and the number of issues has halved. Instead, most days we receive irrelevant American garbage on our phones, which we have to waste time deleting.

The standard of accounting has steadily deteriorated over the years. In my day we were taught what to look out for; there is no way complete fiction such as Patisserie Holdings would have got past even a first-year trainee, yet alone a supposedly qualified auditor.

The accountancy profession is now held in the same regard as estate agents. It has become embarrassing to say you are an accountant. What does CIMA do about it? Diddly-squat. You cannot discuss anything with the President; merely follow him on Twitter.

I would not recommend anyone to qualify with CIMA, this Global Management Accountant nonsense make it a laughing stock. In is very sad."

In the olden days this letter would have been published and several would come back largely disagreeing with me. But that is what is wanted, a decent debate. But these days all debate is stifled; the executive are in control! The Accountancy Bodies are completely impotent; their members know that IFRS Accounting is absurd, but they don't want to rock the boat and keep their collective heads down. The FRC are powerless; they have to play within the rules, which means effectively they do not do much, if anything.

Auditors themselves know how fictional IFRS accounting really is. The audited accounts of Burford Capital, for the year ended 31 December 2018, give it away. The Auditors Ernst & Young LLP write:

In our opinion, the financial statements:

- give a true and fair view of the group's affairs as at 31 December 2018 and of its profit for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards; and
- have been properly prepared in accordance with the requirements of the Companies (Guernsey) Law 2008.

Well, that's alright then, a clean bill of health. Not quite; read on and they state key audit matters:

- *Incorrect value of investments*
- *Incorrect goodwill impairment assessment*
- *Incorrect calculation of tax balances*
- *Incorrect recognition of investment management income.*

Ernst & Young then provide details, which they list under the heading 'risk'.

Incorrect valuation of investments and new initiative investments

Owing to the illiquid nature of these investments, the assessment of fair valuation is highly subjective and requires a number of significant and complex judgements to be made by management. The exit value will be determined for each investment by the contractual entitlement, the underlying risk profile of the litigation, a trial or an appellate outcome or other case events, any other agreements in respect of settlement discussions or negotiations as well as the credit risk associated with the investment value and any relevant secondary market activity.

It then goes on the say that there is the risk that inaccurate judgements have been made in the assessment of fair value.

So there you have it; under IFRS management have the sole responsibility of valuing 'fair value'; all the auditors can do is to point out the risk.

Even when 'fair value' is valued by a reputable independent assessor, it can result in disaster for an unsuspecting company. Intu Properties plc is a prime example. When property valuations were increasing due to ever higher rents being achieved, everything looked rosy. But with many retailers being forced into administration and rents crashing property values are having a big fall. Fair Value has led Intu Properties management into a false sense of security. The latest figures from its balance sheet, as at 30 June 2019, show:

	£m
Investment and development property	6,897.7
Net debt	4,983.4
Net debt % to property values	72.2%

The ideal percentage for this ratio is 25% and anything up to 50% is sustainable. 72.2% is far too high; the company's bankers will become unnerved if there are more significant property falls. This explains why the company's share price had fallen from 320p in September 2016 to 32p in August 2019. If we had kept historical (actual) cost accounting, things would have not looked bad and the company would not have been in a mess.

Then we have reverse factoring. David Cameron set up an admirable scheme whereby small companies, who were consistently being paid late, could get paid on time, ensuring they had sufficient cash flow. Under the scheme, once a creditor's invoice had been approved, they could be paid by the company's bankers. For example, a creditor had an authorised invoice with a value of (say) £5,000 due to be paid after 60 days from the date of invoice. After 16 days the creditor could go along to the company's bankers and be paid. The bank would deduct an amount to take account of the early payment. After 60 days the creditor would receive the full £5,000. Now, as the creditor has been paid in full, the correct accounting entry would be 'debit creditor', 'credit debt'. But no entry is made, so debt is significantly understated in some company's accounts. It was this that finally pushed Carillion over the edge. When the bankers added the debt sitting in creditors to the debt shown as debt they realised the position was unsustainable. Other companies, with Kier being a prime example, have significant debt included in creditors.

What makes it worse is that when companies play the game by not aggressively accounting, their honesty is rewarded by severely undervaluing the share price. A prime example of this is Haynes Publishing Group plc. Its earnings per share (EPS) are uninspiring:

2019	2018	2017	2016
9.2p	9.8p	9.0p	(11.8p)

However, unlike many companies who do not amortise their intangible assets, this company does, so its 'cash EPS' is entirely different

2019	2018	2017	2016
77.1p	63.2p	47.0p	41.7p

I first came across this company at a ShareSoc event and, being impressed, bought some of its shares at 199p. I have just sold half my holding at 298p and while I still think the shares are undervalued, it is impossible to second-guess the market and that is why I like to bet each way.

Finally, there are two key ratios that catch out companies who are maintaining aggressive accounts. The first one is the calculation of 'debtor days': debtors divided by annual sales x 365. Compare the figure with other accounting periods and with nearest competitors. If the number is too high, it either means sales are being taken early (usually the case) or the credit control department is not functioning.

In April 2001 I bought some shares in Cedar Group plc, paying 199p per share; they raced to 253p and I sold them. Being a volatile share they went back to 168p, so I bought them back. They went up to 222p, at which point the latest accounts came through the door. Debtor days were in excess of 365 days, so I sold straight away. Three months later they were down to 5p.

The other ratio is 'inventory days': inventory divided by annual cost of sales x 365. Unless the company is expanding rapidly, then inventory days should be relatively constant. If they shoot up, then there is something wrong. The classic case here was that Inventory days for Stanley Gibbons was 378 days in 2013, 531 days in 2014 and 799 days in 2015. These calculations showed something was wrong, but investors realising this could have got out at 300p. However, the banks got nervous and it was found out that the company was selling stamps on a sale-or-return basis and the shares collapsed to 11p.

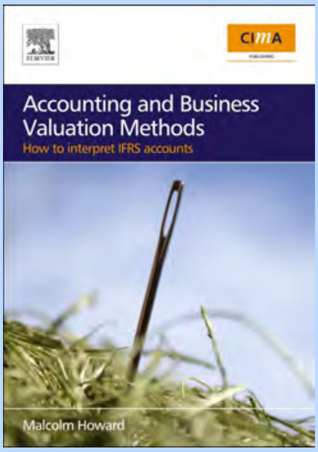
So, to summarise, IFRS accounts are fictional; neither auditors nor the FRC appear to recognise fake accounts, so investors must do their own checks. Nor does the 'market' appear to understand IFRS accounts, so we get some crazy prices.

I have reviewed my previous articles and have noted I have been banging on about the same thing for months. As I don't wish to bore the pants off members this will be the last regular article. I may produce one-offs in the future.

.

A word of appreciation

As editor of The Private Investor I owe a huge debt of gratitude to **Malcolm Howard** for his regular articles in recent years. They have not only been written in a highly engaging style, but have also given readers an early insight into news stories well before they hit the headlines in the financial press. Good examples are the accounting issues surrounding the failures of Carillion and Patisserie Valerie. Malcolm's previous articles can be found in the back copies of The Private Investor on the UKSA website, where there is also an archive of Malcolm's earlier articles.



Readers may also like to know that Malcolm is the author of "Accounting and Business Valuation Methods: How to Interpret IFRS Accounts", published by Elsevier. Full details can be found here.

Martin Morton

We were very saddened to learn earlier this year of the death at the age of 87 of Martin Morton, who as well as being an active UKSA member since 2002 served as Europe director for the decade up to his retirement at the end of 2015. He represented UKSA at meetings and events of Euroshareholders, one of the organisations that subsequently merged to form Better Finance in Brussels.

Martin spent most of his working life at the CBI with an industrial relations responsibility, both domestically and internationally. He subsequently became Director of the Engineering Construction Industry Association. He also served for 25 years on St. Pancras and then Camden Council. He was the Pensioner Trustee at the CBI, Chairman of his local Civic Society and Chairman of a Comprehensive School.

An obituary for Martin can be found here.

Our condolences go to Martin's widow Joyce.

Responsible investing - 10 years on

by John Hunter

The next few months sees the tenth anniversary of UKSA's booklet 'Responsible Investing'. I still use it frequently. Many of you will have glanced at it on publication and not looked at it since. More recent members won't have looked at it all. I am biased of course, but I think it's full of fundamental truths that, sadly, are still as relevant today as they were ten years ago. They still have to be repeated again and again in the responses that the policy groups led by Peter Parry and Cliff Weight make on your behalf to the consultations that emerge from the depths of government and regulation following each 'surprising' breakdown in the system. The tenth anniversary is a good excuse to remember and repeat.

The booklet was the idea of Eric Chalker – who subsequently drove the project, edited the drafts, provided chunks of text of his own and generally energised us all. Without him it would not have happened. It's in three parts: 'The Nature of Responsible Investing', 'Removing Obstacles and Constraints' and 'The UKSA Manifesto'. Derek Miles (former Board member) wrote the first part, I wrote the second and Eric wrote the Manifesto. Martin White was also a continual source of ideas.

On publication the press took little notice – with the notable exception of the Times, which pronounced it 'cogent, relevant, well-informed, astute and important'. I regret I can't remember the name of the (astute?) journalist who penned those words.

The section headings themselves read like a summary of all the issues that float UKSA's boat. It sometimes seems to me that they cover everything we ever want to say about the UK system of saving and governance: 'Private Investors: Leaders or Lemmings?'; 'The Responsible investor'; 'The Caring Investor'; 'Diversity is Strength'; 'Forces that Divide Investors from their Investments'; 'An Enabling Environment'; 'What is to be Done?'; 'Deprivation of Ownership Rights'; 'Savers Dependence on Agents'; 'A Disinterested Regulator'; 'Conflicts of Interest – Owners vs Managers'; 'Conflicts of Interest: Institutions – Owners or Businesses?'; 'Introducing a New Governance Mechanism'; 'A Platform for Reclaiming Private Shareholder Rights'; and then the Manifesto 'Relating to Companies and Directors'; 'Relating to Regulators'; 'Relating to Parliament'.

The UKSA publication 'Responsible Investing', published in 2010 and still available on our website

I have a favourite section, because it's possibly the most important and possibly the most ignored, and that is the one on institutional conflicts of interest; and within that the 300 words on 'Profit drivers of the financial services industry', which encapsulate the misaligned incentives that make the financial institutions such unsuitable stewards of the rights that should belong to real investors. Looking at it today I'm not sure I'd change much: the references to 'stockbrokers' are delightfully old fashioned (no mention of 'platforms'); and the absence of any reference to stock-lending – now the main mechanism by which institutional shareholders profit from their ownership of voting rights – is glaring. But the rest of it stands up pretty well.

Which is sad. Marvel that within the industry there are still businesses prepared to recognise responsibilities beyond making money for themselves. But don't expect anything much to change soon. Money talks.

Survey on MiFID and PRIIPs

Better Finance is currently conducting an implementation survey on MiFID II and PRIIPs across a number of European countries, including Austria, France, Germany, Denmark and Portugal. They are understandably keen to have the UK individual investor perspective represented in the results, which are due to be unveiled at an event in Brussels on 19 November.

To access the survey, which should only take a few minutes, please click here or type in the following URL:

www.surveymonkey.com/r/Z6BDP96

Pension freedom - A bracing breakfast

by John Hunter

Wearing my pension fund trustee hat, I recently attended a breakfast seminar on ‘partial transfers’ organised by our investment advisers (these are proper advisers – a reputable firm of actuaries). The advice industry has of course been making a pile of money out of ‘pension freedom’, and a real problem for trustees is finding some way of protecting members from poor ‘advice’. Pension transfers are in practice restricted to ‘all or nothing’, but there is now interest in removing that restriction – hence ‘partial transfers’. The audience of about 150 was stuffed with commercial interests.

The main speaker was Stephen (sorry, Sir Stephen) Webb, former Pensions Minister and now a cheerleader for Royal London Assurance. He chose to deliver a stinging attack on the regulatory resistance to contingent charging (the practice whereby transfer advisers only get paid if a transfer occurs). He addressed two regulator (FCA) delegates in the audience directly when they were not in a position to reply, and took some sideswipes at Frank Field’s game-changing Work & Pensions Committee Report into the British Steel affair which exposed a practice that nobody knew existed. This included a personal attack on Frank Field, suggesting that he had approached the report with preconceptions and his committee had twisted the facts to fit. (OK, probably some truth in the first part, they’re only human.)

I regret this caused me to lose my temper and at question time I stood up and called the practice of contingent charging 'corrupt’. I helpfully explained to Sir Stephen that corruption applied to a practice where advice was to be given on a choice between A and B and the adviser only got paid if the client chose A. I thanked him for being rude about Frank Field since that indicated that his report was being taken seriously in government circles (i.e. he was worth being rude about). I was also able to give public support for the FCA, acknowledging they were slow sometimes but noting they were under pressure from powerful interests.

I can’t remember what question I asked to justify this diatribe, but I felt all the better for it. The Chairman, caught between a rock and hard place, had the courage to say he ‘had some sympathy with my views’.

Lifting the Lid on the FRC – 2019 edition

The FRC will be holding its annual update event for private investors in collaboration with UKSA and ShareSoc. This year it will take place on Tuesday 5 November from 1.30 p.m. to 5.00 p.m. As in previous years, the venue will be the FRC's offices at 125 London Wall.

This promises to be a very interesting afternoon, which is expected include an address from Jon Thompson, the new CEO of the FRC, on his vision, strategy and priorities for the future.

This is a very popular event and places are limited, so contact UKSA Office as soon as possible to book your place (officeatuksa@gmail.com).

The pictures below are from last year's well-attended event, which was also supported by Better Finance.

A Financial Times feature on the new Chairman of the FRC, Simon Dingemans, who has said he will run a 'very different' regulator from that of his predecessor Sir Win Bischoff, can be found here.

Ethical investing approaches: screening and best-in-class

Dr Quintin Rayer

DPhil, FInstP, Chartered FCSI, SIPC, Chartered Wealth Manager

Head of Research and Ethical Investing at P1 Investment Management

Biography

Quintin has worked for actuarial and investment consultancy firms and a multi-national European bank, including wide experience in quantitative fund and risk analysis. He is a Fellow of the Institute of Physics, a Chartered Fellow of the CISI and a Chartered Wealth Manager. Quintin has applied skills gained from his Oxford University Physics Doctorate and while working in engineering to finance. He is the second UK graduate from the Sustainable Investment Professional Certification (SIPC) programme and joined P1 Investment Management in January 2017, founding their ethical and sustainable investing proposition.

Introduction

Previous articles asked why ethical investment matters [1], gave an introduction to Sustainable (environmental, social and governance, or ESG) investing [2] and a short history of ethical investing [3]. This article outlines how ethical investors use screening and best-in-class approaches to achieve their goals.

Ethical investors wish to allocate funds to areas they feel deserve investment selectively and to avoid businesses or activities that do not. Typically, they seek to avoid the so-called 'sextet of sin', which generally refers to alcohol, tobacco, gambling, pornography, armaments and nuclear power [4]. Different investors may wish to avoid different or more sectors than these, including areas such as animal testing, the fur trade and child labour.

Exclusions or 'screening' is only one strategy of several. Investors can ask themselves whether they wish to:

- Avoid unethical companies, but accept investment in ethically neutral companies, which do neither good nor harm? This is known as negative screening.
- Invest only in ethical companies, avoiding both unethical and ethically neutral companies? Called positive screening.
- Actively seek to influence corporate behaviours for the better. Examples would include positive engagement or shareholder activism.

The answers an investor reaches regarding these questions and how they might be implemented leads to a range of investment approaches.

Investment approaches

Ethical investors focus on activities that are seen as desirable or else avoiding undesirable outcomes. Sustainability, using ESG factors [2], can provide a helpful framework when it comes to determining whether a business activity should be seen as having a positive or negative impact.

Ethical investing means different things to different people, and institutional investors may answer to several stakeholders that differ in the conclusions they have reached between themselves. Despite different approaches available, some investors may feel that none of the primary methods fit their requirements. The focus here is on screening, and 'best-in-class', but other approaches include tilting, or influence and engagement. These will be considered in a later article.

Screening

Screening appears to be the most usual approach with investments tested against several requirements. These seek to identify companies' impacts as positive, negative, or 'ethically-neutral' (broadly doing neither good nor harm).

When considering screening, an investor must decide whether to avoid ethically-neutral companies (see Figure).

- Negative screening avoids companies deemed to be involved in unethical activities but invests in ethically-neutral companies.
- Positive screening only invests in ethically beneficial companies, avoiding both ethically-neutral and unethical companies.

A concern with screening is that it can generate portfolios with company size and sector biases, which could limit portfolio diversification.

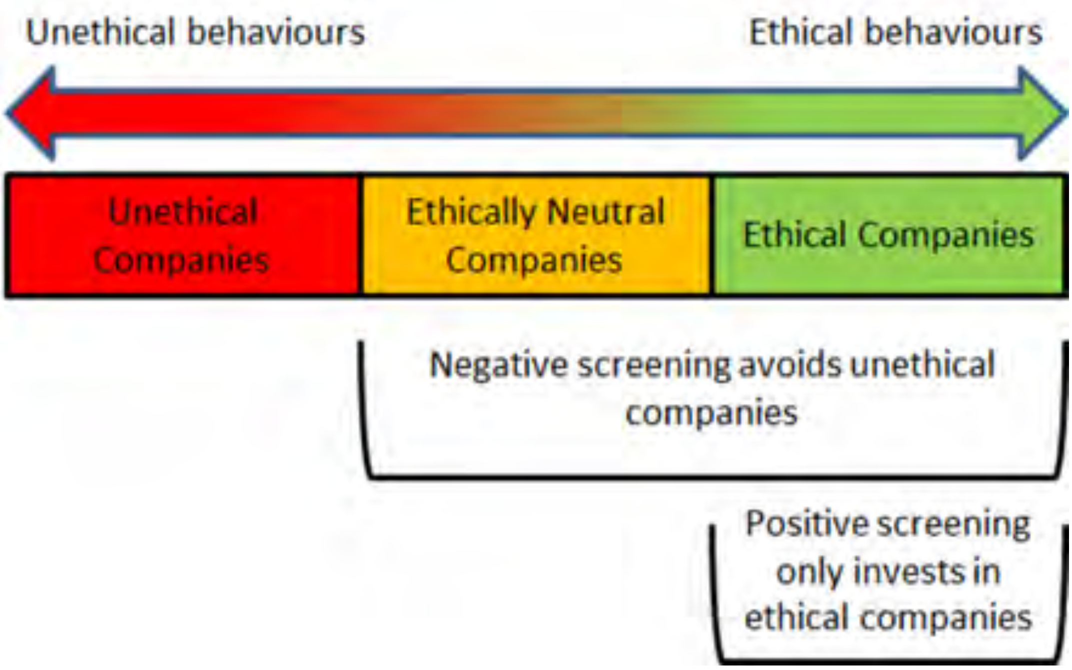


Figure: Positive and Negative Screening (reproduced from [5])

Best-in-Class

This approach includes companies and industries that are the best operators within the class considered, including the best companies within a sector. This can mean selecting the 'least bad' businesses in some sectors.

It can motivate companies in ethically-challenging sectors to improve. Consider a fictitious mining company against some different ethical investing strategies. Suppose the company has a weak record regarding environmental damage during extraction, pollution from refinery waste products, treatment of labour and indigenous peoples displaced or harmed by its activities.

Consider how different ethical selection methods might approach this company:

- Positive screening would exclude the company based on its sector or activities, which would likely be unacceptable. Management can take no action to make the company acceptable (apart, presumably, from winding the company's operations up), leaving them no motivation to improve.
- Negative screening would similarly exclude the company due to its sector or activities.
- Under best-in-class, the sector's 'least bad' companies can attract investment. By comparing with peers, management can improve their environmental and social record to be amongst the best in their sector and attract investment. In a competitive market environment, companies can be motivated by a 'race to the top'. This can generate real improvements for those affected by the company's activities, even if they will never be perfect.

For investors seeking to more actively engage, the best-in-class approach can provide benefits to those most affected by harmful company practices, but can mean a closer involvement with firms that not all will feel comfortable with.

How this helps Investors

By appreciating the approaches used by ethical fund managers when selecting companies, individuals who wish to invest ethically should be better placed to understand the strengths and weaknesses of techniques offered, helping them choose an approach best suited to their needs.

References

[1]

Q. G. Rayer, "Introducing Ethical Investing," The Private Investor, the newsletter of the UK Shareholders' Association, no. 199, pp. 12-13, April 2019.

[2]

Q. G. Rayer, "Introducing sustainable "ESG" investing," The Private Investor, the newsletter of the UK Shareholders' Association, no. 200, pp. 10-11, June 2019.

[3]

Q. G. Rayer, "A short history of ethical investing," The Private Investor, the newsletter of the UK Shareholders' Association, no. 201, August 2019.

[4]

C. Krosinsky, N. Robins and S. Viederman, Evolutions in sustainable investing: strategies, funds and thought leadership, John Wiley & Sons, 2012.

[5]

Q. G. Rayer, "Exploring ethical and sustainable investing," CISI, The Review of Financial Markets, no. 12, pp. 4-10, 2017.

Policy round-up

UKSA's Policy Director, Peter Parry, works closely with his ShareSoc counterpart, Cliff Weight. By working together the two organisations can achieve much more clout when lobbying for shareholder rights among government and private-sector organisations.

The close contact built up with the FRC in recent years is the result of this collaboration and this year's events with PWC are further evidence of the activity in the policy field.

Details of the upcoming PwC event can be found below, while on the adjacent page readers can find details of UKSA's and ShareSoc's combined response to a consultation on CMA recommendations.

The policy teams are currently working on a response to the Law Commission's review of intermediated securities, which is due to be submitted by 11 November. More news on this will be included in the next edition of TPI.

Environmental reporting – can investors help to save the planet…?

In May PwC ran a very successful event for us on environmental issues. A number of participants said that they would like a follow-up event – one at which they would 'be able to do some real work'. PwC has risen to the challenge and has developed a highly participative event which is scheduled for Wednesday, 27 November, starting at 2.00 p.m at PwC's offices at 7 More London Riverside (near London Bridge).

The event will consist of a short introductory panel session from a number of PwC's environmental experts. Attendees will then break into four groups. With help from the PwC experts, each group will be tasked with discussing one of four topics on a key environmental issue facing investors. The groups will then rotate, with each one discussing a second topic. The event will end with a plenary feedback session followed by a more general Q&A. This is a fairly specialised event which is likely to appeal to those with a strong interest in environmental and climate-change investment issues.

There are only 24 places available, so members who want to attend are advised to book as soon as possible. Bookings are now being taken by the UKSA Office (officeatuksa@gmail.com).

Market study on statutory audit services

UKSA-ShareSoc response to initial consultation on recommendations by the Competition and Markets Authority

On behalf of UKSA and ShareSoc, Peter Parry and Cliff Weight have submitted a joint response to the CMA market study commissioned by the government on statutory audit services. The consultation document issued by the Department for Business, Energy & Industrial Strategy can be found here.

The UKSA and ShareSoc teams made the following key points.

1. **Limitations of the CMA's remit;** the CMA was tasked with looking at the audit market and, in particular, considering ways of addressing deficiencies in current levels of market competition. The CMA has done this and has done it well. However, there is a risk in all this of losing sight of the main reason why audit has come under fire. The key requirement is for better standards of audit following the recent disasters of Carillion, Conviviality, Patisserie Valerie and others. A more competitive audit market should certainly over the long term help to ensure better audit quality. Whilst it is unsatisfactory that 97% of the FTSE 100 market is concentrated in the hands of the Big Four, some of the proposed mechanisms for achieving more competition, such as joint audits, pose potential threats to ensuring a high quality, coherent and seamless audit that provides investors with the assurance they want and need. In short, they may help to achieve more competition between audit providers but, in doing so, potentially jeopardise the main objective of achieving better audit quality, at least in the short term.

2. **Auditor appointment – an alternative approach to market management;** the suggestion made by Sir John Kingman that auditors should be appointed by a third party (probably the new regulator) we believe is a much better way forward. It avoids the potential complexities of trying to reshape the market using joint audits with the risks and uncertainties that this could involve. It has the potential to put a team of experts in charge of audit tendering and audit appointment for FTSE 350 companies as well as creating appropriate mechanisms for audit market management. It also avoids the waste of getting every FTSE 350 company to run its own tendering process (every ten years without the benefits of learning that go with a more regulated specialist team) yet with all the potential conflicts of interest that are inherent in the current system. Clearly, it would be inappropriate for the regulator to perform this function working in isolation. It will need to work closely with, say, a stakeholder panel or steering group consisting of representatives from shareholder groups, FTSE 350 companies and, possibly, other groups. Shareholders would still have an ultimate right of veto over the appointment of a specific auditor.

The objections to Sir John Kingman's proposal, primarily by the Investment Association (IA) and its members, we believe are entirely without merit or justification. Shareholders have not played any meaningful role in the appointment of auditors for at least the last fifty years. The notion that shareholders currently appoint the auditor is a sham, as the vote on the reappointment of the auditors at the AGM is invariably a formality and a foregone conclusion.

3. **A mechanism for holding auditors to account;** there is a real need for auditors and audit committees to be held to account by shareholders. At present there is no effective mechanism for ensuring that this can happen. We believe that the AGM should be in two parts:

   - Part 1: the normal business of the meeting, as at present
   - Part 2: a meeting between shareholders on the one hand and the auditors and members of the audit committee on the other.

   The detail of how this would work is discussed in our response to Question 1.

4. **The Big Four audit firms are effectively owned by the consultancy businesses;** some 75% of their income is from consultancy and we do not know what percentage of their profits, but we suspect it is more than 75%. Inevitably the power in the Big Four firms will therefore lie with the consultancy partners. Cultural norms tend to be driven by the consultancy business. This has not turned out to be good for the world of audit. It is a strong argument for the separation of audit and consultancy into separate firms.

The full 17-page response submitted by UKSA and ShareSoc can be accessed here.

Contracts for difference – a cautionary personal tale of shorting shares

by Rob McDonald

Following a discussion with a member some months ago, I thought I would share my own personal experience about the one occasion in my life when I have indulged in the practice of shorting shares. This may rankle with those members who view the practice as a kind of ethical transgression, not befitting a true shareholder, but I will deal with the ethical debate later. For now, this article is primarily focused on the process and the experience.

Not long after moving from the frozen north to a leafy London suburb several decades ago, my company introduced a Save As You Earn share scheme. These schemes have been around for nearly 40 years now, so most of our members will be familiar with them, although I know some aren't.

The essence of the SAYE is that employees are allowed to enter into a contract with the company, to save a fixed amount monthly for a period of three or five years, with the option at the end of the contract of using the savings to buy the company's shares at a price which is fixed at the start of the contract. The option price is based on the prevailing market price at the start of the contract, less a discount depending on the generosity of the employer.

From the employee viewpoint it was and remains an excellent way of saving and for many it was their first introduction to share ownership. It also made the company's performance and share price a hot topic over the works restaurant lunch table. From my point of view, it was an ideal and probably the only way of funding a house extension to provide more space for our young but growing family (I was already mortgaged up to the hilt, as anyone who has made a move from the north to London will be familiar with).

As the years went on, the share price rose substantially with a healthy profit and it looked on target in the final year to fund my building works. The share price, however, did experience some turbulence in the final year, as did the stock market at the time. The share price volatility, we were informed later, was because its shares were very thinly traded. Anxieties set in that as the end of the contract approached, those healthy paper profits would evaporate, and with them my planned building works. I desperately wanted to exercise the option prematurely and not wait a further eight months, but that was not permissible.

I researched heavily, sought advice with a view, in some way, to locking in the price. Research took me into the murky depths of financial derivatives and I discovered how it was possible to hedge share prices by covered short selling, using a financial derivative known as Contracts for Difference (CFDs). There were a number of specialist CFD providers at that time (more now) and they tended to cater for short-term traders and speculators, get-rich-quick merchants and not actual investors. Some members may be familiar with CFDs, but from discussions many members have not.

The essence of CFDs is that rather than actually purchasing or selling shares on the stock market, the client (me!) enters into a contract with the provider that mimics the process. At some point in time which the client decides (there is no expiry date, unlike a Traded Option) the contract is closed out by an equal and opposite transaction and the monetary difference between the two transactions is settled between the provider and the client – hence the term 'Contract for Difference'.

Because no shares actually change hands, stamp duty is not applicable, but to all intents and purposes the mimicry is quite complete.

The mechanics of the process are relatively simple. The client enters into a contract with the provider, to sell (go short) or buy (go long) on a quantity of shares at the real-time price as quoted on the relevant stock market. The proceeds of the sale are immediately deposited into the client's personal CFD account.

The provider of the derivative requires an initial deposit, in my case 10% of the contract size (referred to as the 'margin'), as a means of protecting the provider against a client defaulting on their obligations. The 10% margin must be maintained at all times and if it decreases, as a result of an adverse movement in the share price, it will result in a margin call on the client to restore it to 10%.

The provider is constantly matching trades with other clients entering into similar but opposite CFDs, i.e. to purchase or 'go long' for the same shares. By netting off the aggregate trades in this way, the provider minimises the number of shares that need to be actually purchased or sold in the stock market.

Since the client or short seller (me again) in this case has effectively 'sold' the shares, they are entitled to interest on the proceeds, but equally the new 'owner' of those shares is entitled to the dividends, which is funded by the short seller.

Having grasped the fundamentals, I decided to discuss opening an account with the CFD market leader. I expected a hard sell but it was quite the opposite; there was a lengthy telephone interview with me ensuring I clearly understood the associated risks. They even suggested a dummy account so I could trial the process, which I declined. The fact that I was using the CFD as a hedging instrument which involves much less risk meant that they could bypass some of the usual regulatory checks. Mine was classed as a covered short as opposed to a naked short. This was the regulatory environment that prevailed at that time.

Having opened the account I was free to open a CFD at any time. I recall clearly, decades later, the nervous doubts when making that transaction. Had I fully understood it? Despite reading the small print carefully, were there ‘unknown unknowns’. I made the transaction and that was it! Too late for any remorse, I’d done it and now whatever happened to the share price I was immunised against any further losses (or profits for that matter). I had given up any further upside potential in exchange for the security that my building modifications were covered. The daily anguish that I had been feeling when my computer kicked into life each morning, displaying the share price on the company’s intranet, was gone. For a little while, the share price continued to drop and the CFD began showing a profit, but as a result of an improving macro environment and investor sentiment, the whole stock market began to rise and with it the company share price. The CFD fell into loss and as expected, at 9.00 am sharp, the phone rang on my desk, a margin call! The young lady advised in quite a perfunctory manner that I needed to restore the margin with an immediate payment. Gone was the soft friendly sell of the frontline sales person, this young lady appeared to me to be on a mission to execute all the margin calls before her mid-morning tea break. No time for small talk while I dug out my debit card!

It was expected, of course, but I received another call the following morning, the share had gone ex-dividend and I needed to cover the dividend immediately. It wasn’t a lot and I was accruing interest on the proceeds of the sale. (There was not a huge difference in those days between the deposit interest and the dividend yield.)

As the market continued to rise, so did the frequency of the margin calls, always around 9.00 am. It wasn’t long before I had to transfer savings into my current account to cover the margin calls. It didn’t really matter materially of course; downsides on the CFD were offset exactly by upsides on SAYE contract but there were certainly cash management issues.

Eventually the share price reached a plateau and began to fall again and the margin calls ceased. When the SAYE matured the shares were sold and the CFD was closed out at a loss, but my building works were more or less covered.

Was it an ethical thing to do? In my own defence it was nearly three decades ago, I was new to investing and the ethics simply didn’t occur to me at the time. I knew it was legal, openly discussed it with colleagues and in my own eyes, saw it as nothing more than an insurance policy to protect me from an untimely downturn. Black Monday of 1987 when the market took a 20% hit in one day was still very much in investors’ consciousness.

Even with hindsight, since most CFD trading takes place outside of the stock market and has next to no impact on the company or its shareholders, I’m not sure I can see any ethical issues, but I am open to persuasion. I do not think it is ethical for main board directors whose share dealings are publicised and may be interpreted by shareholders as a measure of confidence in the company. I do not believe that at that time there was any regulatory requirement for directors to disclose CFD transactions and to my knowledge that may still be the case.

It is worth noting, however, that short selling within the market cannot occur without the facilitation by long-term shareholders such as unit trusts, pension funds ETF providers etc. who are willing to loan out their shares in return for a fee. There is also an argument that the process improves market liquidity and efficiency, especially in thinly traded shares, and hence improves the price discovery process. As an interesting digression, the well-renowned market index provider MSCI will not accept a stock market into its index system unless that market permits short selling.

Short selling within the market on a huge scale, primarily to depress share prices or impact a company’s credit rating, such as that which may have occurred during the financial crisis, is a completely different matter. That’s not so much an ethical as a systemic risk and market governance issue.

Would I recommend use of CFDs? No I wouldn’t! This applies especially for uncovered short selling which involves a highly leveraged asymmetric risk, with a limited profit potential (share prices can’t go lower than zero) but an unlimited loss potential. In any case I would never advise indulging in speculative share trading; it’s not a good place to be. According to European Securities and Markets Authority (ESMA) 74%-89% of all CFD clients lose money. It is interesting that the FCA, after recommendations from ESMA, have only this year introduced restrictions on leverage and marketing of CFDs.

There may be a limited use for somebody who intends to liquidate a large share portfolio, for example to purchase a property, but for personal reasons wishes to delay the execution (tax-related reasons, probate etc.) but worries about large unexpected market falls in the meantime.

Was it the right decision for me? Yes, at the time I think it was, despite the loss; it was a risk management exercise and good decisions can have bad outcomes, but the kids got their playroom, so I feel vindicated!

Stop-losses, fact or fantasy?

by John Hunter

Investors Chronicle occasionally carries articles on trading, often by Michael Taylor. In the 25 August edition was one entitled 'The Art of Stop-Losses'. After about a thousand interesting words on the subject the author turned to an academic paper of 2009 published by Lund University in Sweden entitled *'Performance of Stop-Loss Rules vs. Buy-And-hold Strategy'*. He explained that the research had examined the application of automated stop-loss rules to a portfolio of 30 major stocks quoted on the Swedish Stock Exchange in the period 1998-2009. It simulated the application of both 'traditional' and 'trailing' stop-losses with values ranging from 5% to 55% in 5% increments. The article reported that *'the only trailing stop-loss to perform worse than the buy-and-hold strategy was the trailing 5% level'*. It continued: *'Every single traditional stop-loss from the 5% to the 55% level produced better returns than the buy and hold strategy.* ***This is clear evidence that whether your position is a trade or an investment, a stop-loss should be used because it achieves better portfolio performance'***.

Now, I've never been a fan of stop-losses. They are an important weapon in the armoury of traders – to protect against irrational attachment to a position or to limit a one-position loss for financial reasons. But investment and trading are very different games that just happen to be played with the same deck of cards; like bridge and card tricks (although both games can be played at different times by the same person – indeed I once had a bridge partner who was a professional magician).

I am particularly not a fan of an across-the-board stop-loss strategy. It is illogical – because if it's effective it should be possible to develop an arbitrage strategy to generate profits without the bother of holding a portfolio. Worse, it would be demeaning, showing I had given in to my equally illogical behavioural loss-aversion bias. And in this case instinct told me that the results just couldn't be true for such a wide range of trigger levels.

So I decided to look at the research paper (Google on 'Lund' to find the university site and search on Yusupov – a co-author). I was particularly interested in its treatment of transaction costs, since these are what in practice kill any persistent stop-loss strategy for the private investor.

I found that the study was conducted by taking 30 major stocks on the Swedish market over an 11-year period, chopping it into quarterly periods (45 of them) and comparing a buy-and-hold strategy with the range of stop-loss strategies. After any trigger the proceeds are left in cash until the end of the quarter, then reinvested.

On page 26 I found the following sentence: '*We do not consider transaction costs since utilizing stop-loss rules in our case leads to the same number of transactions, hence the transaction costs are the same for stop-loss and the buy-and-hold strategy*.'

This is plain wrong. The authors have fallen into the trap of forgetting that when the three-month periods are strung together any stopped-out cash has to be re-invested. Further, in a generally clearly written paper the authors refer to the price data as the 'market price at the end of each day' without mentioning the spread or, indeed, the need to keep two sets of prices for each trade point in order to price both buying and selling.

Well, so what? This wouldn't have been the first technical mistake ever made by two students in a research paper. But it matters here because it has led to generalised investment advice in an authoritative magazine that is wrong – and particularly costly if adopted by a private investor for shares with a wide spread.

Also, am I being unfair in saying there is a nasty smell about relying on a 10-year-old piece of student research that encourages overtrading to benefit only the brokers? I emailed Chris Dillow (the IC chief numbers-geek) two days after publication and the editor a week later but received no response from either. Perhaps this article will encourage one.

Social media

Over the past month UKSA's Twitter account has covered stories such as the FRC, trading algorithms, financial education, Hargreaves Lansdown, a shareholder engagement conference and more besides. Follow us at @UKshareholders. You don't need to sign up to Twitter to view. Just go to https://twitter.com/ukshareholders from any web browser.

Financial education

Better Finance, the pan-European organisation that promotes the interests of users of financial services across the continent, and of which UKSA is a member, has some exciting new initiatives in the financial education area.

Key projects include the creation of videos explaining aspects of share ownership. At a time when people are increasingly time-pressured, classroom training is difficult to manage. Video-based training delivered in bite-sized YouTube videos offers far more flexibility and ability to watch on a computer or tablet at the viewer's convenience. The initial input in terms of writing, recording and editing each training view is obviously quite intensive, but it is certainly a worthwhile investment. Most financial education focuses on the elementary level, for example bank account operation. There is a clear need for organisations such as UKSA to provide education in more complex segments such as share investing.

Editor's note: I will be taking part in a meeting at the Bruegel think tank in Brussels next week on the potential for combining fintech with financial education. At the end of November I will join with other Better Finance member organisations to examine a way forward for video-based financial education and to see some of the work already done by our colleagues in Luxembourg.

Smaller UK-focused markets

by Helen Gibbons

Next month sees the start of a series of short articles on the markets of what has become known as the "UK family" of smaller jusrisdictions, including Gibraltar and the Channel Islands, from the perspective of the exchanges that operate there and the investors that use them. Tax obviously plays a role. For example, the fact that Gibraltar has no capital gains or dividend tax means there is no need to users wrappers, although tax on employment income tax is actually higher than the UK, making it less of a fiscal paradise than some might believe. Exchanges in these territories are of course small, and in some cases focused increasingly on innovations in blockchain and distributed ledger technology.

Left, Gibraltar's World Trade Centre, which is home to Gibraltar Asset Management, a member of the London Stock Exchange. Right, the Europort district, home to the Gibraltar Stock Exchange, GSX

CURRENT UKSA EVENTS

A photo ID is requested. Please bring it with you!

Meeting with Halma PLC – Monday 21 October 2019 or Friday 25 October 2019 (joint with ShareSoc)

Location	**Investec Bank PLC, 30 Gresham St, London EC2V 7QP**
Start	**11.00 (assemble from 10.30)**
Room capacity	**25**
Company contact	**Rosemary Kilcoyne**
Group leader / UKSA organiser	**Nick Steiner 020 8874 0977 n.steiner@btinternet.com**

Lifting the lid on the FRC – Tuesday 5 November 2019

Location	**125 London Wall, London EC2Y 5AS**
Start	**1.30**
Room capacity	**-**
Company contact	officeatuksa@gmail.com

Meetings of UKSA Croydon & Purley Group

Location	**Spread Eagle, High Street, Croydon CRO 1QD Next meeting: Tuesday 12 November** **Starts at 11:30 with coffee from 11:00 Chairman: Harry Braund harrycb@gmail.com**

UKSA BRANCHES – If no contact name or number is given, please contact UKSA office

Branch name	Leader	Administration	Main purpose	Description
London & South East Region	Harry Braund 020 8680 5872 harrycb@ gmail.com	Andrew Girvan 020 8788 1665 agirvan247@btinternet.com	To co-ordinate activities in London and the South-East	Meetings in Croydon three times a year
London company visits	Nick Steiner	Individual meeting organisers	To arrange private meetings with companies	20/30 meetings per year individually arranged
Specialist company visits	Adrian Phillips	Under review	To arrange and/or participate in events in conjunction with investor service companies	Meetings with small-company management, for experienced investors only
Croydon & Purley	Harry Braund 020 8680 5872 harrycb@gmail.com	Tony Birks 01322 669120 ahbirks@btinternet.com	Social meetings to discuss investment issues	Meetings in Croydon monthly
South West	Peter Wilson 01453 834486 07712 591032	Peter Wilson 01453 834486 07712 591032	To arrange and develop activities for members in the region	Company visits and social events as arranged
North East	Brian Peart 01388 488419	Julian Mole 07870 890973 julian.mole@ btinternet.com	To arrange and develop activities for members in the region	Company visits and social events as arranged
North West	Julian Mole 07870 890973 julian.mole@ btinternet.com	Julian Mole 07870 890973 julian.mole@ btinternet.com	To arrange and develop activities for members in the region	Company visits and social events as arranged
SmartCo	Charles Breese	Charles Breese	Arranging access to 'Smart Companies'	Programme awaiting start-up
Northern Rock Small Shareholders Action Group	Dennis Grainger nrssag@uksa.org.uk	Dennis Grainger nrssag@uksa.org.uk	Pursuing compensation for small shareholders affected by NR's collapse	Lobbying and awareness-raising activities