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A new-look TPI

This is the first edition of The Private Investor in an updated format. It is designed for better screen reading, with a new typeface and more embedded links to documents and other content.

But let's get straight down to business. This month we turn the spotlight onto pre-emption. We explain the basic problems (p. 6), tell the story of one particular recent placing as a practical example of the issues (p. 7) and raise some questions about a non-statutory body of great influence called the Pre-Emption Group (PEG).

The Pre-Emption Group: Who? and What?

PEG is one of those strange quangos that floats in its own space – unattached and unaccountable. The Financial Reporting Council (FRC) 'provides its secretariat' but is careful not to say it is responsible in any way. PEG has a website, but googling doesn't find it and searching the FRC website only finds announcements made by it. A general enquirer can't find who its members are or how they are appointed (although the PEG has confirmed that it has no members who represent private investors). The recent announcement of the new Chairman by the FRC used the give-away passive voice: 'The FRC is pleased to announce that Simon Fraser has been appointed......'.

The PEG issues 'principles of best practice governing the use of pre-emption'. The standard PEG guidance has for years been fixed at what is called '5+5'. That is to say, placings in any one year are limited (unless shareholder approved) to 5% of capital without a reason and a further 5% for a defined purpose. The onset of Covid potentially put many companies in jeopardy and from April 2020 the rule was replaced by the rule of 20 – i.e. in emergency, companies could raise up to 20% of capital by a placing. The extent to which the word 'emergency' was invoked or defined was left for each company to decide. The announcement of these revised principles offers a good flavour of the way PEG operates.

Why does this matter? Read the articles on pages 6 & 7 and come to your own conclusions.

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When accounting standards are correct in theory but dangerous in practice

by Mohammed Amin
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Editor's note: although Amin is a member of UKSA's Policy Team, he is writing in a personal capacity.

I know that writing *"IFRS 17 Insurance Contracts"* will make most readers' eyes glaze over. However, buried in the standard is a perfect example of how standard setters' desire to be theoretically correct can lead to accounting standards that are dangerous in the real world.

Required common understanding

Before looking at the standard, I want to ensure that all readers share a common understanding of the basics. To simplify, I avoid the details you encounter with real insurance companies.

Assume that an insurance company's year-end is 31 December 2020. On the morning of that day, for a price of £150, it sold an annuity contract under which it is obliged to make just two payments to the customer:

- £100 on 31 January 2021
- £100 on 31 December 2070

The insurance company invests the £150 in some investment assets, say quoted shares or bonds. It has no other assets or liabilities. (If you insist that it must have some share capital, assume that is an ignorable 1p!)

What does the company's 31 December 2020 balance sheet look like? How about:

Assets	£150.00
Liabilities	(£200.00)
Net assets (negative)	(£50.00)
Shareholders' funds (deficit)	(£50.00)

A Victorian might have accounted as above. However, we know that the above balance sheet is nonsense.

The obligation to pay £100 on 31 January 2021 is not the same as the obligation to pay £100 on 31 December 2070, so adding them together to show total liabilities as of 31 December 2020 of £200 is not valid.

How onerous on 31 December 2020 is the obligation to pay £100 in 50 years' time on 31 December 2070? The slightly unsatisfactory answer is that "it depends". What it depends on is the discount rate.

Most of us will remember the compound interest formula from school:

Future Value = Present Value x $(1 + \text{rate})^{\text{Time}}$

In this case "rate" is the constant periodic compound interest rate applicable throughout the entire 50-year period.

If we use 5% per year for the rate, then with some simple maths:

Present value = £100 / $(1 + 0.05)^{50}$ = £8.72.

The 31 December 2020 balance sheet is then as follows:

Assets	£150.00
Liabilities	(£108.72)
Net assets	£41.28
Shareholders' funds	£41.28

On the other hand, if the interest rate is 0.01% per year, then we calculate:

Present value = £100 / (1 + 0.001) ^{50} = £95.13

On this assumption, the 31 December 2020 balance sheet is as follows:

Assets	£150.00
Liabilities	(£195.13)
Net assets (negative)	(£45.13)
Shareholders' funds (deficit)	(£45.13)

This gives a very different picture.

With this common understanding, we can now turn to IFRS 17.

Insurance company investment assets

Accounting for investment assets, such as listed shares or bonds, where there is a proper market, is straightforward. Put them in the balance sheet at market value, referred to in accounting standards as the "fair value". This comes from IFRS 9 Financial Instruments, paragraph 5.1.1.

The £150 used in the example is assumed to be the market value or fair value of the investments. Much more challenging is computing a balance sheet figure for the liabilities.

What IFRS 17 says about discounting long-term liabilities

The starting point is paragraph 36 of IFRS 17:

> *"An entity shall adjust the estimates of future cash flows to reflect the time value of money and the financial risks related to those cash flows, to the extent that the financial risks are not included in the estimates of cash flows. The discount rates applied to the estimates of the future cash flows described in paragraph 33 shall:*
>
> > *a. reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;*
> >
> > *b. be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity; and*
> >
> > *c. exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts."*

"An entity shall adjust the estimates of future cash flows to reflect the time value of money and the financial risks related to those cash flows" is telling you to discount the future payment obligations. The obligations are in sterling, and fixed definite obligations. Accordingly, one would normally look at sterling gilt yields to find the discount rate.

A gilt such as Treasury 2.5% 2065 pays you £2.50 each year, and then £102.50 on the redemption date.

What you actually want is a discount rate to discount a single £100 payment due on 31 December 2070. If you know the prices of enough gilts, or look up the prices of gilt strips, you can compute what is known as the zero-coupon spot rate to discount from 31 December 2070 back to 31 December 2020. The details

would unduly lengthen the article. The key point is that normally one just discounts at the risk-free rate.

However, paragraph 36(a) tells you to reflect "the liquidity characteristics of the insurance contracts". This is further explained in Appendix B paragraph B79:

"B79

For cash flows of insurance contracts that do not vary based on the returns on underlying items, the discount rate reflects the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, adjusted to reflect the liquidity characteristics of the group of insurance contracts. That adjustment shall reflect the difference between the liquidity characteristics of the group of insurance contracts and the liquidity characteristics of the assets used to determine the yield curve. Yield curves reflect assets traded in active markets that the holder can typically sell readily at any time without incurring significant costs. In contrast, under some insurance contracts the entity cannot be forced to make payments earlier than the occurrence of insured events, or dates specified in the contracts."

The published application guidance for IFRS 17 tells you what this means in greater detail in paragraph BC194 below:

"BC194

The Board concluded that, in principle, the discount rate for a group of insurance contracts should reflect the liquidity characteristics of the items being measured. Thus, the discount rate should equal the return on the underlying non-tradable investment (see paragraph BC193(a)), because the entity cannot sell or put the contract liability without significant cost. There should be no deduction in the rate for the implicit premium for the embedded put option, because no such put option is present in the liability."

Our insurance company's obligations, £100 payments due on 31 January 2021 and on 31 December 2070, are completely fixed. They cannot be accelerated, and the insurance company presumably cannot transfer them away without significant costs. They clearly fall within the definition of being illiquid.

Paragraph BC 193 of the application guidance goes on to explain in more detail:

"BC193

Discussions of the time value of money often use the notion of risk-free rates. Many entities use highly liquid, high-quality bonds as a proxy for risk-free rates. However, the holder can often sell such bonds in the market at short notice without incurring significant costs or affecting the market price. This means that the holder of such bonds effectively holds two things:

(a)

a holding in an underlying non-tradable investment, paying a higher return than the observed return on the traded bond; and

(b)

an embedded option to sell the investment to a market participant, for which the holder pays an implicit premium through a reduction in the overall return.

In contrast, for many insurance contracts, the entity cannot be forced to make payments earlier than the occurrence of insured events, or dates specified in the contract."

Coming back to our illustrative gilt, Treasury 2.5% 2065 is of course a liquid investment. You can sell it any day you want.

The above guidance says that you cannot use the yield on such gilts to arrive at your discount rate. You first have to estimate how much of the price of Treasury 2.5% 2065 consists of the value of the theoretically embedded option within the gilt to sell it.

Treasury 2.5% 2065 was quoted on 30 December 2020 (I could not find a 31 December price) at 107.05. i.e., £100 face value of the gilt would cost you £107.05.

Suppose the Government offered to issue you with a special Illiquid Security 2.5% 2065. This also pays £2.50 per year for every year until 2065 and £102.50 on redemption in 2065. There is a special condition which is that once the security is issued to you, it can never be sold; it can be inherited, but your heirs also cannot sell it; it must be held until maturity. That is what being illiquid means.

You would never pay the Government £107.05 to buy £100 face value of Illiquid Security 2.5% 2065. Why should you when you can buy Treasury 2.5% 2065 for the same price, and you can sell that any day you want. You would only pay less for Illiquid Security 2.5% 2065.

Assume you would only pay £90. The yield to maturity of Illiquid Security 2065 would be higher than the yield to maturity of Treasury 2.5% 2065, since both have identical future cash flows, but Illiquid Security 2.5% 2065 only costs £90 while Treasury 2.5% 2065 costs £107.05.

That means when you discount your insurance liabilities based on the discount rate derived from Illiquid Security2.5% 2065, you compute a lower number for the 31 December 2020 balance sheet than if you discount based on Treasury 2.5% 2065.

That is what the language of IFRS 17 and the related application guidance is telling you to do.

Why is this a problem?

Gilt securities exist in the real world, and you can compute their yield to maturity, and compute discount rates. Other people can check them, since everyone can look up gilt prices.

There is no such thing as Illiquid Security 2.5% 2065, and the Government is never going to issue it because it would cost the Government more in interest payments than normal gilts which can be bought and sold.

You may argue that if Illiquid Security 2.5% 2065 did exist, its price would be £90 (as assumed above), but there is no way of confirming that. Accordingly, the standard forces insurance companies to use discount rates that are essentially matters of judgment, in place of discount rates that are directly computable from observed market prices.

Does this matter?

The above discussion looks theoretical. However, the real-world implications are very large, because insurance company liabilities are very large.

I looked at the 31 December 2019 balance sheet of a large UK-listed insurance company. Its accounts do not quantify the impact of using calculated liquidity adjusted discount rates instead of rates from the gilt yield curve. However, by consulting the regulatory return which the company also has to file, I estimated that the impact of the adjustment was of the same order of magnitude as the entire balance sheet value of shareholders' funds.

What should be done?

IFRS 17 is a global standard. After leaving the EU, the UK has set up its own Endorsement Board to officially adopt international accounting standards for use in the UK. The EB cannot modify the standard; only accept or reject it in whole or in part.

However, I would like the EB to require all insurance companies using IFRS 17 to add the following additional disclosures in their accounts:

A. Quantum of the insurance liabilities as stated in the balance sheet using discount rates computed using IFRS 17.

B. What the quantum of the insurance liabilities would have been using discount rates derived from the prices of risk-free government securities denominated in sterling, dollars, euro, etc (as appropriate) without any IFRS 17 adjustment of those rates for liquidity.

C. The difference between A and B.

This would be very useful information for shareholders, and it is not something shareholders can ever compute for themselves. It would allow each shareholder to assess how well capitalised they think the insurance company is.

If the Endorsement Board asked for this, I am confident that insurance companies would comply, even though the disclosure is not required by IFRS 17.

Placings and pre-emption: a child's guide

by John Hunter

When you buy shares in a company, you have a set of rights, enforced by law and regulation, in the future activities of that company (typically dividends, voting and surpluses on winding up). These total rights belong to the total of shareholders in proportion to their holdings. If you own 1,000 shares in a company with 100,000 shares in issue - Widgets PLC - you own 1% of all the rights accruing to total shareholders.

Subject only to their Articles, companies may issue more shares. For example Widgets might issue another 100,000 shares. If they did so to third parties, and that's all they did, the number of shares in issue would double to 200,000, you would still hold 1,000, and your share of shareholder rights would have halved to ½%. If those rights have value (which is what a share price tells you), then half that value would have been stolen from you.

So companies don't do that. But what they do do is raise money from third parties by issuing new shares at a price. But that price matters to you – an existing shareholder. If Widgets PLC is priced at £20 per share, it's worth £2million and your holding is worth £20,000. If the company wants to raise another £1million, it could do so by pricing its 100,000 new shares at £10 each. The extra million would make the company worth £3million, the total number of shares in issue would be 200,000, each of those shares would be worth £15, your holding would be worth £15,000 and you would have lost £5,000. *In fact £5,000 would have been stolen from you and given to the subscribers of new capital.*

This is clearly unacceptable, and without protections in place no outsiders would ever buy shares. So these protections exist; they are called 'pre-emption rights'. The process of raising money from a restricted set of insiders is called a 'placing'.

Suppose, in the Widgets example, that existing shareholders were allowed to participate in the placing in proportion to their holdings. So you, as a holder of 1,000 shares, would be allowed to buy another 1,000 shares at the reduced price. You would make a 'profit' of £5,000 on the new shares to offset your 'loss' of £5,000 on your existing investment by 'pre-empting' the investment opportunity of the placing insiders.

It is this dynamic – the trade-off between the practicalities of raising money fast and protecting the rights of existing holders – that makes the question of pre-emption rights so difficult. And it is the potential for favouritism to insiders that makes it so important. This can be avoided by a 'rights issue', but these can be slow, expensive and bogged down in regulation. That's why placings are favoured by companies and by insiders.

So there are rules, or at least recommendations, that restrict placings. Well actually there aren't rules, there are 'best practice recommendations'. These recommendations are made by the Pre-Emption Group (PEG) (*see front page*).

A placing story: Bacanora Lithium

by John Hunter

Context: 'Bacanora Lithium' (BCN) is an AIM company capitalised in late January at around £145m. It has a 50% share in a new lithium mining facility being developed in Mexico jointly with 'Ganfeng Lithium Co' (GLC), a Chinese company and the world's largest lithium producer. GLC owns 30% of BCN. In February BCN announced a placing of shares to raise $60m to finance its 50% share of a development of the facility. The placing was made open to other investors through the Primary Bid (PB) platform.

Here's what happened on the evening of 2 February 2021:

- 5.08pm, 2/2/21, announcement on RNS of a fundraise of $60m (£45m).
- 5.28pm,2/2/21, extension of offer to clients of Primary Bid subject to a max of EUR8m.
- Price 45p/share.
- 8pm offer was closed to further applicants as allocation was taken up.
- 7.00am, 3/2/21 offer announced as successfully completed.

Shares in issue pre-placing: 223m, shares in placing 101m, total after placing 324m

Prices at close:

23/11/20 47p)These earlier prices are chosen to simplify the story. Inevitably
30/12/20 65p)the whole graph is more ambiguous

25/1/21 65.5p
26/1/21 63.8
27/1/21 60.5
28/1/21 58
29/1/21 59
1/2/21 57
2/2/21 56 (placing evening)
3/2/21 47
4/2/21 46

17/2/21 46

Now, one of several things may be true

1) 65p is the fair value of the company. The £45million being raised will indeed generate £45m of value. The correct valuation of the enlarged company is £145m+£45m =190m. The correct share price of the enlarged company is 190/324= 59p. There has been a transfer of wealth from the old shareholders of 6p per share on 243m shares to the new shareholders at 14p per share on 101m shares. These two sums each amount to £14m.

OR

2) As 1) but insiders are aware that the offer is going to reduce this value to 59p and the share price drift results.

OR

3) As 1) & 2) but pre-issue trading has driven the price down to make the offer look more attractive.

OR

4) 45p is the fair value of the company. The price was driven to 65p on expectations of benefits from the planned Mexican expansion. When the actual details were announced these expectations

were reduced.

OR

5) As 4) but insiders have profited from the share price uplift driven by expectations and the subsequent pull-back driven by the information released as part of the offer.

No criticism of the company or its advisers is implied here. The point is that the process is open to abuse by insiders and it is extremely difficult to determine whether abuse has occurred. Therefore there need to be strong controls around the process and clear guidelines on what is acceptable and what is not. Those controls lie entirely in the hands of the Pre-Emption Group (PEG) (*see front page*).

Gamification

some observations by Helen Gibbons

In the wake of the GameStop trading frenzy, John Authers wrote in Bloomberg Opinion on 8 February:

"The issue of whether Robinhood and others really engaged in 'gamification' — making trading more like a game, and helping to get people addicted to it — needs to be addressed."

This week brings news in the Financial Times of a significant rise in individuals in Germany, France and the Netherlands owning shares directly, particularly among the under-30s. Part of the rise is attributed to the emergence of neo-brokers offering low- or zero-commission trading on user-friendly apps.

No one is accusing all neo-brokers of gamification; young investors, like everyone else, will be keen to chase higher returns in a low-interest environment where pension systems are often deficient. Moreover, the appeal of app-based trading is undisputed.

Having opened a cryptocurrency account as background for a financial translation project, I placed the crypto app alongside the share-trading app on my smartphone. The similarity in the user interfaces is striking, to say the least.

Whether the asset is Bitcoin or Tesla – for example – there are bound to be traders who are driven as much by social media hype as by an understanding of the nature of the asset.

and on that note...

Writing in the Financial Times, Rana Foroohar quotes the US sociologist and management professor Jerry Davis, author of a forthcoming book on the changing nature of the corporation, as saying: "Robinhood easing access to stock trading does not democratise the stock market any more than Purdue Pharma democratised opioid addiction. Democracy is about voice, not trading."

As John Hunter points out, the last six words are close to being a permanent tag line for UKSA.

Caught short...

Prompted by a change in the short-selling regulations, Cliff Weight (who is the Policy Director at ShareSoc and also an UKSA member) has written to remind us that, regardless of what you think about short sellers, their investment strategies and tactics are worth watching. There can be little doubt that the 'shorts' are diligent with their homework. They do not always get it right, but checking whether a share is being shorted is a wise step when making personal investment decisions. Cliff takes up to story as follows:

"On 6 January 2021, the Treasury published the Short Selling (Notification Thresholds) Regulations 2021 No. 5 to amend the notification threshold under Article 5(2) of the Short Selling Regulation from 0.2% to 0.1% of the issued share capital of an issuer. This change will come into force on 1 February 2021 and follows the decision made by the EU (ESMA) in March 2020 to reduce the notification threshold.

This means that from 1 February 2021 the notification threshold for issued share capital of a company that has shares admitted to trading on a UK trading venue (UK Regulated Market and UK MTF) will be 0.1%.

The FCA publishes short positions daily – See the public short positions disclosed to us – daily update (XLSX).

I find this very useful, as a short position is often a red flag and a good idea to sell. I learnt this lesson the hard way when I held IQE and it was 12% shorted and I did not sell. I held on and eventually sold at 57p, and after I did so I found I was able to sleep more comfortably as I watched IQE decline further, although it has now gone up to 74p and is now 1.77%, so I am happy not to be invested.

I noted the following short positions:

- *Sainsbury 9.4%*
- *Morrisons 3.38%*
- *Hargreaves Lansdown 2.56%*
- *St James Place 1.39%*
- *AJ Bell .72%*
- *Saga .59%"*

Editor's note:

Cliff added the following disclosure: *I hold shares in Saga, but none of the others mentioned above.*

Climate investment risk: floods and droughts

by 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 in January 2017, founding their ethical and sustainable investing proposition.

Introduction

Investors may feel that extreme flood and drought events linked to global warming present risks that may not be reflected in some companies' share prices [1], [2]. Such events can be incredibly destructive. Should high CO2-emitting companies or sectors be held at least partially accountable for their activities?

Damages amounting to 1-2% of market capitalisations (or share prices) for seven top carbon-emitting, publicly listed companies, were previously estimated from North Atlantic hurricane seasons [3]. This article outlines a project by the author and others (Dr Karsten Haustein and Dr Pete Walton, both University of Oxford) extending the climate liability concept to estimate the impact of global flood- and drought-related damages on fossil-fuel firm share prices.

We estimate that climate change-related global flood and drought damages for 2012-2016 amount to approximately 2-3% of the top nine carbon-emitting companies' market capitalisations. Financially quantifying emissions illustrates how science can inform decisions, for both investors and companies, arising from a changing climate.

The Economic Impact of Floods and Droughts 2012-2016

Global warming increases the risks of extreme daily temperatures and extended warm spells. It enhances evaporation, with further drying in already-arid areas. Thus, although average rainfall might remain unchanged, there could be a simultaneous increase in floods and more frequent droughts.

Between 1900 and 2016, floods and droughts caused an estimated 19 million deaths and over US$900 billion in damages globally. Over 2012-2016, flood and drought damages totalled $265 billion in inflation-adjusted 2016 US dollars [4].

Who are the carbon emitters?

Atmospheric CO2 rose from 290 ppm (parts per million) in 1880 to 410 ppm in 2018 [5]. Cumulative CO2 emissions are the primary cause of global climate system changes [6], making the allocation of historical responsibility relatively straightforward.

Nine top-emitting publicly owned companies collectively accounted for 14.5% of Scope 1 and 3 emissions between 1751 and 2017 [7]. The 'scopes' classify emissions' origin from an organisation. Scope 1

emissions are from sources directly owned and controlled, for example, fuel used by company vehicles. Scopes 2 and 3 cover indirect emissions. Scope 2 emissions from energy use, with Scope 3 covering all other indirect emissions, including customers. Emissions over the 1751-2017 period include those from companies that are no longer extant but have become part of another through mergers and acquisitions. For example, Royal Dutch Shell acquired BG in 2016. The historical production data and emissions are attributed to the extant company [7].

Producer	Cumulative 1751-2017 emissions from Scopes 1+3, %
1 Chevron Corp	3.13%
2 ExxonMobil Corp	2.98%
3 BP PLC	2.29%
4 Royal Dutch Shell PLC	2.18%
5 ConocoPhillips	1.08%
6 Peabody Energy Corp	0.92%
7 Total SA	0.83%
8 BHP Billiton Ltd	0.57%
9 CNX Resources (CONSOL)	0.56%
Total	14.5%
Cumulative 1751-2017 industrial greenhouse gas emissions from Scopes 1+3, % [7]	

Financial implications

The nine companies' combined market capitalisation was $1358 billion in August 2018, although their market values fell during the COVID19 pandemic [8]. Conservatively, consider the 2018 values. If hypothetically, these firms contributed 14.5% of the $265 billion estimated damages from floods and droughts between 2012-2016, this would be $38.4 billion. This figure corresponds to 2.8% of their market capitalisations (or share price). The sum is significant, considering that similar contributions might arise regarding other past and future extreme weather events. During the COVID19 pandemic, lower share prices made the damages more significant as a proportion of market capitalisation.

As global warming causes more intense flood and drought events, more significant financial losses will result. Hypothetically, suppose a climate liability regime develops. In that case, these high-emitting companies' damage contributions might be anticipated more frequently with each annual wet or dry season.

Didn't Floods and Droughts Occur Before?

Floods and droughts occurred before human-made global warming, so only costs linked to additional extreme weather frequency or intensity are relevant. Estimating pre-global warming baselines is not easy. Increases in frequency or intensity do not straightforwardly follow atmospheric CO_2 concentrations or temperature rise.

We considered case studies, including floods, droughts and heatwaves (often associated with droughts) from South Africa (2015-2017), Thailand (2011), Russia (2010) and Siberia (2020). Between 57.5% and 99.8% of these events' increases in frequency or intensity arose from human-made global warming. The mid-estimate of 79% reduced the $38.4 billion damages above to $30.3 billion (2.2% in share price terms).

Don't the Fossil Fuel users Share Responsibility?

Beyond the fossil fuel extractors' responsibility, what about fuel users, such as motorists in cars, or home heating? It seems counterproductive to argue that the onus lies with motorists—in practice, their choice is not whether to emit, but whether they require a car. Fossil fuel-free cars are still relatively expensive and historically not readily available. Much responsibility lies with companies to provide efficiency gains and alternative technologies to enable fossil-free transport.

One allocation is the current split between industrial and non-industrial emissions. In 2015, around 77% of all human emissions were industrial [9]. In the 1960s, it became clear that CO2 emissions were damaging the climate. The leading carbon producers could see their products were harmful from then on. A moral responsibility to "do no harm" required leading carbon producers to reduce that harm by capturing CO2 emissions or developing safe substitutes, such as carbon-free energy [10]. Instead, fossil fuel firms compounded their responsibility by active climate denial [11]. Based on the above, we suggest 88.5% as the appropriate responsibility share for fossil extraction firms.

Both the pre-industrial baseline and producer-user share are relevant. Jointly, the initial damage estimate of $38.4 billion should potentially drop to $26.9 billion (2.0% in share price terms). These figures and other analyses not reported here help us arrive at our 2-3% estimated share-price detriment first mentioned.

We have only considered floods and droughts. Including other global warming impacts, such as hurricanes and sea-level rise, could easily contribute much larger sums. The analysis also neglects the likelihood of increasingly powerful climate responses as global warming intensifies [3].

How this helps investors

How should investors respond to the possibility of companies having or deciding to make contributions to climate damages associated with their past emissions? Some investors have reacted already. The City of New York is seeking to divest fossil companies from its $189 billion pension schemes in a way consistent with fiduciary responsibilities.

Investors might be concerned, especially if they are uncertain whether the relevant companies' share prices reflect these risks. A movement towards an active liability regime could risk fossil fuel company shares becoming stranded assets, with other investors reluctant to buy them, except at a significant discount. Given the mounting evidence and potential risks, some cautious investors may feel they wish to steer clear.

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A sideways look...

Here's a quote from Terry Smith's annual letter: "What are the similarities between a forecaster and a one-eyed javelin thrower? Answer: Neither is likely to be very accurate, but they are typically good at keeping the attention of the audience."

More from UKSA's YouTube pioneer...

Harry Braund has added to the set of YouTube videos on his Illuminating Investing channel, including a look at the Decline and Fall of the British Motor Industry.

We think videos like this are a great way to get key messages across to a broad group of novice investors.

If you have a yen to get into video and would like to work with us on investing videos, please get in touch with the Editor.

Capital gains tax simplification: the self-invested savings account

by Toby Keynes

I'm sorry that Roy Colbran is unimpressed by the Capital Gains Tax proposal that I developed last year, and which was submitted to the Office of Tax Simplification (OTS) by UKSA and ShareSoc ("Capital Gains Tax Simplification", Private Investor 209).

The OTS's CGT brief, in relation to private investors, was to "identify… simplification opportunities relating to administrative and technical issues affecting individuals, …as well as areas where the present rules can distort behaviour or do not meet their policy intent." (CGT Scoping Document, July 2020).

This is precisely what the proposal sets out to do, for individuals who are not able to put all their investments into ISAs or SIPPs.

The basic principle is that a new investment account, the SISA, would be created, with no limit on the amount that can be put into the account; CGT liability only arises when cash is removed from the account, based on capital growth within the account and the percentage of the account value being withdrawn. So, for example, if you withdraw a tenth of the current value of the account, CGT is calculated based on a tenth of the capital growth that has accumulated within the account.

For investments held within an account, and for funds withdrawn,

- the calculation of CGT liabilities is massively simplified: all the complex calculations of the taxable gain or loss on every sale are replaced by straightforward calculations made whenever cash is paid into the account or withdrawn from the account, and one inflation adjustment calculation on 6 April each year. All these calculations are made by the platform provider, and reported to the account-holder. The account-holder only has to report one figure – their net capital gain/loss on withdrawals - to HMRC each year.
- there is no need for the investor to retain full records, potentially going back many years, of all sales, purchases and other capital events for each of these holdings.
- investment decisions are no longer driven and distorted by tax issues: the account-holder is no longer encouraged to sell and replace investments within their portfolio each year just to make use of their annual CGT tax-free allowance; they are no longer encouraged to hold onto shares they want to sell, so as to defer CGT or to avoid being thrown into higher-rate CGT. Capital tied up in overvalued or poorly performing companies can be freed up for investment elsewhere, successful long-term investments that have grown larger than is prudent can be slimmed down, and they can adjust their investments as their needs change – for example, from capital growth to dividend income – all without creating an immediate CGT liability.
- there are no more perverse outcomes: the account-holder who makes capital gains of around £25,000 each year and the account-holder who makes no gains for three years and then £100,000 in the fourth year are treated exactly the same; under the present system, the former pays far less CGT than the latter.

The proposal would also offer significant benefits to the government:

- A major reduction in the cost to HMRC of calculating and administering CGT, and monitoring compliance;
- Better reporting by investors of CGT liabilities, because of the ease of reporting.
- Reduced evasion of CGT liabilities, because HMRC would be able to cross-check tax returns against the platform provider reports.
- The release of capital for investment in newer growth industries with greater need for capital investment, because investors would be able to release funds from mature holdings for reinvestment without incurring immediate tax liabilities.

All this within a new investment envelope that can be described in full detail, including all the necessary calculation formulas, and a fully worked example, in just six pages.

Critically, this is not just a self-interested proposal to reduce the actual tax burden on personal investors, to add to the extraordinarily generous tax benefits of ISAs that already cost the exchequer a huge amount each year. This proposal is about simplifying tax, not reducing it.

I do encourage members to read the proposal in full, in the joint UKSA/ShareSoc submission to the CGT review, pages 10 to 15.

Online investor group meeting with UKSA and SIGnet members

Would you like to attend an online investor group meeting with other UKSA and SIGnet members to be held on Saturday 6th March 2021, from 12 noon to 2pm?

The intention of the meeting is to engage in useful, enjoyable discussion with like-minded members of the private investor community. The meeting will be chaired with positive intention. It will run through some presentations from other SIGnet group members to give an idea of future meeting content. This will be presented for discussion, not as a lecture. The group can then consider what they would like the group to be and what they would want from it. Investing is the study of everything with constantly changing parameters. There is certainly more than one route to take.

Your investments are private to you and you are welcome to discuss them to the extent you are comfortable. The meeting will be inclusive and empowering.

Please register by clicking here if you would like to attend.

The future of corporate reporting

by Peter Parry

In the good old days, when I still had my Crest account, annual reports would be starting to drop through the letterbox round about now with a heavy thud. As often as not the doorbell would ring and the postman handed me an envelope that was too big to squeeze through the letterbox.

That has all changed. With my shares now held by a nominee I have to go online to see copies of annual reports. I don't miss the paper tomes that often ended up cluttering up the kitchen table. Much of what they had to say was marketing puff, some of it was irrelevant, some was pure nonsense and a small amount, having done a sort of 'gold-panning' exercise on the document, proved to be useful and interesting. However, I have traded one benefit for another: electronic PDF copies of reports which were designed to be read in paper format do not work well when being read on screen. Worse still, if you do manage to overcome the 'nominee hurdles' to attend the AGM, you still need (in normal times) to get hold of a paper copy of the report to take with you. These are just some of the problems that many users of company reports currently face.

A major FRC project

In October last year the FRC issued a discussion paper on 'The Future of Corporate Reporting' (available here). A review of corporate reporting was long overdue. Much of the content, format and general approach to corporate reporting remains rooted in the mid-twentieth century – if not earlier. In its introduction the FRC questions whether the traditional concept of the annual report remains 'fit for purpose' adding:

'In recent years it has been pushed and pulled to meet increasing demands from traditional and new users. The result is a document that is confused about its intended audience and purpose'.

It is also a document that has become voluminous. Key information is scattered around in a way that makes it hard to find and even harder to assimilate. In some, information is repeated while other information that would assist understanding is omitted. What a mess!

The FRC's paper goes back to basics and considers a number of key requirements for any annual report, including:

- Its primary objective of communicating information to readers;
- The range of different users or readers and their varying interests;
- The ease with users can find their way around the report and access the information that is relevant to them.

Starting with an analysis of user needs has, surely, to be the right way forward.

A reporting network

Based on the key considerations above, the discussion paper makes suggestions for developing a new framework and principles for corporate reporting. This recognised the wide range of 'stakeholders with a legitimate interest in how a company reports, what it discloses and how it can ensure that information given is meaningful and intelligible to all stakeholders. The FRC makes an outline proposal that there should be three key reports at the heart of the reporting network:

- The financial statements and notes to the statements; these would comply with all current accounting standards.
- A business report which, as a key theme, would enable users to understand how a business generates and sustains value over the long term. The business report would also contain or provide direct links to much of the content that appears in the current 'Strategic Report'.
- A public interest report; this would aim to provide a different perspective and sufficient detail in areas in which stakeholders want to hold companies to account. This was a proposal that appeared in the Brydon review; the FRC commentary suggests that it will require further thought and development.

In addition to this there would be other reports, some of which might be periodic. These includes interim reports and preliminary statements, thus bringing these within the holistic reporting framework so that they all link together to provide comprehensive information to users.

The discussion paper goes on to make more detailed proposals on specific aspects of each of the reports such as the objective of the report, the perspective (company focused or wider or something very specific such as environmental issues), content themes (performance, value creation and so on) and a summary of 'minimum content' that each key element of the report must cover.

Some tricky issues

So far so good. The problem is the next step down – which is not discussed. It is fine to say that the business report should include the business-model report. The difficulty is that much business-model reporting is currently extremely poor. In many company reports much of it is generic and gives very little indication how a company really generates and sustains value. Without a well-articulated business-model report it becomes difficult to make judgement about risks – a problem further compounded by the fact that much risk reporting is little more than a 'washing list' of uncertainties. Many of these are generic and could apply to any company. To illustrate some of these points, UKSA included in its response a short critique of Rolls Royce's business model in its 2019 annual report. We chose Rolls Royce because it is well-regarded and yet, like so many others, its business-model reporting is demonstrably inadequate.

The FRC's discussion paper suggests, correctly, that in future corporate reporting should be 'digital by default' – that is to say that it should be designed for use in digital format and that in doing so it should seek to maximise the opportunities that this creates for users to be able to move easily from one report to another and back again to gather the information they want and need. However, we have stressed to the FRC that for many private investors access to a 'hard copy' of the report is essential when attending and asking questions at AGMs.

The discussion paper also considers issues such as ensuring better standards in non-financial reporting. The financial elements of company reports are audited. Should the non-financial elements also be audited? We believe they probably should for the simple reason that without this it is likely to be very difficult to bring about a real change in standards. Without this there is a risk that much non-financial reporting will remain a mix of obfuscation, promotional 'puff' and compliance boilerplate. A copy of the joint UKSA/ShareSoc response can be found on the UKSA website here.

Next steps

The FRC believes that this overhaul of corporate reporting is going to be a ten-year project. We think that is probably right and in our response we have said that we would like to see an outline of the key stages and milestones that will define the implementation plan.

Some readers will no doubt be thinking to themselves that corporate reporting is not just about the information that companies publish in the annual and other periodic reports. A full review of corporate reporting must include the AGM. The two are not separate; they are intrinsically linked – or at least they should be. Reassuringly, the FRC has this in hand. It has set up a working group of investors and others

(which includes representation from UKSA and ShareSoc) to look at the future of the AGM.

The 2020 round of AGMs produced a wide range of responses to the constraints that were imposed on physical meetings due to Covid. Thanks to detailed feedback on last year's AGM experiences from members such as Phil Clarke and Nick Steiner, we have been able to provide excellent feedback to both the FRC and BEIS. The aim now is to ensure that the best practices are adopted and developed in future. Hybrid AGMs are almost certainly here to stay and offer a welcome opportunity for much greater shareholder engagement in future – the current constraints of nominees notwithstanding.

The Future

Some may read all this with an air of scepticism. Technology will move on apace and some of the ideas put forward for the Future of Corporate reporting may be out of date before they get anywhere near implementation. To its credit, the FRC is one jump ahead of the game. The Reporting Lab has produced a new report, hot off the press as I write, on the use of 'Virtual and augmented reality in corporate reporting'. You can read it here. It makes fascinating reading and provides a glimpse into a possible future that would transform many areas of corporate reporting and will, more widely, change the whole communications and entertainment landscape. It may also be a good 'primer' for those who want to find out more about an area in which there might be interesting investment opportunities in future.

Letter to the Editor

From Robert Aubrey

Thank you to Mohammed Amin for his article in the December 2020 issue of "The Private Investor" giving the absolute basics for friends and family. In an effort to develop this I offer the following comments for consideration.

2. I would add that "Term insurance" should be matched to perceived liabilities and take account of other means of meeting those liabilities should they arise. To take an extreme example an older dependant child might soon earn its own living while a severely disabled child may need a lifetime of care.

4 and 6. Both points suggest the use of "exchange traded funds". I would add that these points should be preceded by point 8, since if funds are to be used then it is preferable that they are low cost funds. To minimise costs it may be desirable to invest directly in self-selected companies rather than through a fund.

5. This point suggests a requirement to "have the equivalent of several years' worth of essential expenditure, perhaps as many as five, in cash or near cash before you buy any long-term investments such as equities ...". I would add that this would mean that the vast majority of people would not purchase any equities. Cash ISAs can be used to build cash savings until they are required for equities.

Traditional "rules-of-thumb" suggest that, if possible, you:

(1) should have three months of expenditure in cash or near cash in the belief that three months will be long enough to access long term savings and investments;

(2) should not purchase equities unless you expect to keep them for more than five years.

9. If before purchasing shares in individual companies it is necessary to "obtain sufficient confidence to make judgements about company financial reports, business models and competitive environments", then I would comment that:

1). UKSA should provide information to enable these skills to be developed or point the way to providers;

2). While I would agree that the above skills are desirable, to discourage individuals without these skills

from purchasing shares in individual companies would leave them with the options of either purchasing funds or keeping out of stock markets. The first would result in imposing upon them the additional and excessive costs of owning funds while the second would deny them the very opportunity that UKSA stands for.

A short response from Mohammed Amin

I am grateful to Robert Audrey for the feedback. I have used his numbering for brevity in this short response.

2. I agree.

4 & 6. I agree. Exchange traded funds are often very cheap, but one should always look at the cost ratios.

5. My point about the five years was qualified by how confident you are of finding alternative employment. A young person who can readily find other jobs obviously does not need five years of cash savings. A retiree like me does, while taking into account any secure pension income. I strongly agree with Robert's point 5(2), which is essentially the point I was making.

9(1). I also would like UKSA to provide more financial education, either directly or by pointing towards high-quality resources. Let me start by recommending the book "Winning the Loser's Game: Timeless Strategies for Successful Investing" by Charles D. Ellis which I believe all investors should read.

9(2). Every investor has to start somewhere. However, I do believe that one who does not understand company accounts, or the business world, is flying blind, and is likely to be his or her own worst enemy as an investor. Remember, most professional investors underperform the market index. While a knowledgeable private investor has many advantages over professional investors, a non-knowledgeable one has none. In my view they should stick to a global market capitalisation weighted index tracking ETF. These are very cheap; available in London for 0.22% p.a. costs, and in New York for about 0.08% p.a. costs.

Editor's note: Readers might like to know that a review of the book by Charles Ellis can be found here on Amin's website.

Update on Northern Rock

On 26 February the UK Government announced that it had completed the final £5 billion sale of Bradford & Bingley plc and NRAM Limited (formerly Northern Rock) and their remaining loans, acquired by the taxpayer as a result of the financial crisis.

Dennis Grainger, Chairman of the UKSA Northern Rock Small Shareholders Action Group, said: "We note the Government sale of the Rock assets which were confiscated by the Labour Government in 2008 for no compensation whatsoever.

As anticipated there has been no cost to the taxpayer and a huge profit has been made by Government as we always argued, at the expense of the small shareholders, mainly pensioners in the North-East.

Our campaign fight goes on, and we remain very hopeful that Boris Johnson will yet set up an inquiry in the whole handling of the Northern Rock affair leading to a fair compensation for the little people who lost everything whilst the Government cashed in using their property."

In case you missed it

Rob McDonald's regular review of stories in the headlines

– Ordinary investors can now access a report that names and shames funds failing to offer good value. These are called Value Assessment Reports and investment companies are required to publish them by the Financial Conduct Authority – Holly Thomas, The Times, December 26th

– All the major UK Stocks and Shares platforms recorded large increases in ISA clients in 2020 vs 2019. Percentage increases were A.J. Bell +120%, Hargreaves Lansdowne +36%, Interactive Investor +130% – Holly Thomas, – The Times, December 26th

– Millions of savers face dwindling options for a return on their cash amid ultra-low interest rates. As a result, wealth managers said clients were increasingly moving their money into equity markets – Madison Darbyshire, FT, January 9th

– The market trend is in some ways a rational bubble given that expectations that sustained low interest rates will compel investors to own more equities and higher-yielding corporate bonds of lower credit quality.

– 'The European Central Banks over time will insist on banks creating holding companies inside the EU,' said a Chief Executive of a UK bank. Banks will want to locate as much of their central banks to their holding companies.

'One can imagine that in 10 years London will be a subsidiary of Paris rather than the other way round as now' - Phillip Stafford, Laurence Fletcher and Stephen Morris, FT, February 14th

– Chamath Palihapitiya, a prominent venture capitalist, recently ruefully revealed that he used Bitcoin to buy a $1.6m property on Lake Tahoe in 2016 – that same amount of Bitcoin would today be worth $128 m.

– At $48,277, the current 18.6 million Bitcoin in existence around the world is worth eight times the value of Goldman Sachs or about one-third of the entire FTSE 100 Robin Wigglesworth & Eva Szalay, FT, February 13th

– BHP has pulled ahead of Shell to become the UK's biggest group by market value, underscoring the contrasting fortunes of the mining and oil industries in the pandemic. Because it is dual-listed in London and Sydney, only 42% of its share count is listed in the UK, which makes it only number three in the FTSE 100. The top spot is held by the Anglo-Dutch group Unilever, which recently unitised its shares onto the London exchange. Neil Hume, FT, February 13th

– Mercedes Benz will by the end of this decade earn as much from electric vehicles as from its luxury combustion models., FT, February 14th

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CURRENT UKSA EVENTS

Company meetings

UKSA's programme of meetings has been suspended during the current health crisis.

Meetings of UKSA Croydon & Purley Group

Location	**Spread Eagle, High Street, Croydon CRO 1QD** **Meeting dates will appear here.** **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