UKSA

UK Shareholders' Association

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Shareholder engagement

Unilever was in the news in the last couple of weeks with its plan to enable shareholders to vote on its Climate Transition Action Plan. The vote will be non-binding and advisory, but it still represents an advance in shareholder engagement. A BBC interview with Unilever's Chief Supply Chain Officer Marc Engel can be heard here. The company aims to achieve zero emissions from operations by 2030 and net zero across the value chain by 2039. Unilever believes the plan will strengthen engagement and dialogue with investors.

In other areas of shareholder engagement the news is less good.

Despite Brexit, the second version of the European Shareholder Rights Directive went into UK law last year but ultimately did nothing to resolve the nominee problem whereby investors buying shares through electronic platforms are not the legal owners of the shares they buy. When transposing the Directive the UK government sidestepped the issue on the grounds that it was clear who the shareholder was (the nominee) and there was no need to change anything. So we are no further forward. The nominee receives all notifications from the companies in which the shareholders have invested and is under no obligation to pass on the information. This issue is being addressed by the Law Commission in its review Intermediated Securities: Who Owns Your Shares? How the Government will respond is another question.

For more than a year now AGMs have taken place virtually. There is still scope for individual shareholders to attend by video and to ask questions and vote, but there is no scope for repeated close questioning of specific board members. Nor is there any way to judge the demeanour and body language of the board. A clear step backwards for shareholder engagement. And how willing will companies be to revert to full physical meetings after the end of the pandemic?

Jonathan Hill, the former EU commissioner, has completed his review of the UK listings market and the UK government has responded. Possible results include the introduction of dual-class share ownership to let company founders keep greater voting power, at the expense of other shareholders' rights.

When it comes to shareholder engagement, the issues we need to campaign on are, if anything, multiplying. *Helen Gibbons*

In this edition

Save the Date

UKSA's AGM will take place by Zoom at 2pm on Thursday 10 June.

The impact of capital gains tax on investment decisions

by Mohammed Amin
MBE FRSA MA FCA AMCT CTA (Fellow)

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

Like many people, I hold apparently inconsistent views. On the one hand, I agree with Supreme Court Justice Oliver Wendell Holmes Jr who said in 1927: “Taxes are what we pay for civilized society.” On the other hand, while paying all the taxes that the law requires, I hate paying taxes, and consider the tax implications of every decision. (An occupational hazard of being a tax adviser!)

Accordingly, I am acutely conscious of how tax law affects my investment decisions. In the late 1990s, most of my own and my wife's individual shares were held outside tax-favoured wrappers (ISAs and SIPPs). I still have painful memories of owning shares that had soared during the dot-com boom which I didn't sell because I didn't want to pay the capital gains tax (“CGT”), and which then plummeted in value.

Since then, with gradually increasing consistency, I have changed the shape of our portfolio. The goal is, wherever possible, to have individual shares held in tax-favoured wrappers while our non-tax-favoured holdings consist of collective investment schemes (“CISs”) such as OEICs, investment trusts and exchange traded funds, rather than individual shares. We are almost there, and should achieve this goal in the next five years.

The rationale is that paying CGT currently is a drain on your portfolio. You decide for investment reasons to sell share A. If share A stands at a gain, part of your sales proceeds disappear in a CGT payment, thereby reducing the amount that you can reinvest in share B.

Conversely, a CIS suffers no such drain. When the scheme sells a share, as no CGT is payable, the full sale proceeds can be reinvested. Instead, CGT is only payable at the very end when you sell your holding in the CIS.

Indeed, it is perfectly possible that CGT will never be paid. You might die while you still own that CIS holding. If so, your heirs will inherit it at market value for tax purposes and can sell it without suffering any CGT. I have a former client who has never let me forget a comment I made to him in the 1980s: “Dying is a great form of tax planning!”

There are several differences between investing in a CIS and investing in directly held shares outside a tax-favoured wrapper:

1. As explained above, the scheme can change its portfolio holdings without any CGT cost. Unless all your gains are below the CGT annual allowance, you cannot.
2. The scheme inevitably involves an additional cost. This may be tiny for very low-cost exchange traded funds (as low as 0.08% per year for one in the USA which I recently recommended to my younger son) to as high as say 2%, or more, if you pick something expensive.
3. The scheme may make better or worse investment decisions than you would personally.

I decided to do some modelling to look at the effects of (1) and (2). Many years as a tax professional taught me two key things about models:

A. The purpose of the model is not to predict the future. It is to help you to think about a problem as part of your decision-making.

B. Many problems are so complicated that “first principles” thinking in your head is insufficient to grapple with the complexities. Creating a model forces you to clarify your thinking. Very often quantifying the effects of a particular factor (such as paying CGT now or later) can be very illuminating.

Accordingly, I built a model looking at the effects of equity investment over a 30-year period. I kept the assumptions relatively simple to avoid over-engineering the model:

Assumptions	
£ 100,000	Initial investment
8.0%	Total return per year
2.0%	Dividend yield, retained and spent
6.0%	Capital growth = difference
20.0%	CGT rate

Obviously, in real life we hold individual shares for differing periods. I made the simple assumption that all of the capital return is subject to CGT, with the tax paid in the following year, except in final period, when, for simplicity, I assumed the tax to be paid in the same year.

I am currently running a quantitative portfolio of individual shares (held in my SIPPs) where the average holding period is around one year. Accordingly, the assumption of having all of the capital return subject to CGT (if it was not in my SIPP) is realistic, particularly since my annual CGT exemption is already otherwise utilised.

I compared the 30-year outcome with the 30-year outcome of investing in a CIS where CGT is paid only at the end. In my modelling, I assume that the scheme earns the same underlying returns that you can achieve as a direct investor.

I ran the model three times for different levels of CIS annual cost:

1. With the CIS annual cost set at zero. This brings out the impact of paying CGT annually compared with paying it only once at the end. The difference of £64,991 is very marked (16% more in your hands than direct investment) because paying CGT at the end means that money that would otherwise have been paid to HMRC is invested to earn returns for you. This model version is not unrealistic. Essentially it is what happens if you invest in a very low-cost ETF. For example, putting in an annual cost of 0.08% p.a. to match the ETF my son will invest in shows a 30-year benefit of £63,951. See PDF1 here.

2. With the annual CIS cost set at 1% per year. In this case, the costs of the scheme outweigh the benefit of the tax deferral. You are £48,732 worse off. Accordingly, direct investment is better. See PDF2 here.

3. I wanted to know the “break-even” annual CIS cost. Excel makes that very easy to calculate using the “goal seek” function. It works out as an annual cost of about 0.54% per year. If the scheme costs you less than this, then the benefit of the tax deferral

outweighs the scheme charges. See PDF3 here.

Even more important than CGT, my main reason for investing in CISs is to provide an insurance policy against my own potential incompetence as an investor. Accordingly, a few years ago I set a policy of holding not less than 40% of our portfolio in CISs, but also not more than 55%, with the rest of the portfolio being in individual shares chosen by me.

For the CGT reasons explained above, eventually everything my wife and I own outside tax favoured wrappers will be a CIS holding with the intention of that holding never being sold, except for small sales to utilise the annual CGT exemption.

AGM and a social gathering

UKSA's AGM will take place by Zoom at 2pm on Thursday 10 June.

Later in the summer, given the success of the vaccine rollout, we plan to hold a social event at the Royal Air Force Club, 128 Piccadilly, London. We are looking at dates in August. For most of us this will be the first opportunity to meet physically and enjoy a glass of wine since the start of the pandemic.

Full details will be announced as soon as possible.

Letter to the Editor

From Malcolm Howard

I joined UKSA several years ago as it gave me the chance to access information that would help me make better investments. Now I find UKSA along with ShareSoc are trying to diminish my wealth.

In the current edition of the Private Investor, I have just read the 'Capital Gains Tax proposal'. As an accountant, I support Roy Colbran all the way; the proposal has not been thought through. It would be a disaster.

Imagine I have a portfolio of ten shares. Nine are doing well and a few are doing exceptionally well, but one is languishing and going nowhere. So I sell this investment to provide funds for better opportunities. Obviously I pay no capital gains tax. But under this proposal, I would now pay tax on my unrealised gains as all calculations would be based on the overall portfolio. In addition I would be reliant on a third party to complete the calculation, thereby incurring administration costs. This is complete and utter nonsense.

Malcolm Howard, FCMA

Editor's note: the Policy Team has looked at Malcolm's letter with interest and will be discussing it in the next TPI.

The Greensill saga - a purchasing manager's perspective

by Peter Parry

Factoring, reverse factoring and supply chain finance

Call me a backwoodsman, but, despite over twenty-five years in purchasing and supply chain management, I only became aware of the term 'reverse factoring' early in 2020. The FRC had published a Reporting Lab paper in late 2019 titled 'Disclosures on the sources and uses of cash'. One of the sources of cash mentioned in the paper was the use of factoring. It contained a reference to figures released by the European Factoring Association (EFA) which estimated that the total of factoring and reverse factoring combined was €350bn for the UK and Ireland in 2017. There was no breakdown in the EFA's figures of how much of this related to reverse factoring, or 'supply chain finance' as it is also euphemistically known. However, recent estimates published by the Financial Times suggest it to be $26.6bn globally and growing rapidly.

The sheer concept of 'reverse factoring,' whereby the customer borrows money specifically to pay suppliers on time, struck me as being risky from an investor point of view. Wasn't this what Carillion had been doing – borrowing money from Lloyds Bank under the government-sponsored Early Payment Facility, ostensibly to pay suppliers on time....? Except that by all accounts by the time Carillion imploded in early 2018 it had borrowed almost £0.5 billion under the EPF scheme and its suppliers were still being paid late – in some cases very late. Added to this, because this money was treated as 'trade finance', it didn't have to be shown as debt on the balance sheet.

Who cares whether it is factoring or reverse-factoring?

Some might ask, what is the problem? Factoring has been widely used for decades. Surely, reverse factoring is just a variation on this theme – and a good one. It avoids the situation under conventional factoring whereby suppliers have to sell their invoices at a discount (often 10% or more) to a factoring agent to get paid promptly. The supplier, if lucky, gets, say, 90% of its money now and the factoring agent, often a bank, takes on all the risk, time and resource of collecting the full amount from the customer. Surely, a system whereby the customer borrows money to pay its suppliers on time has to be better.

But wait a minute... If a customer needs money to pay supplier invoices on time, isn't that just a short-term working capital requirement? Wouldn't this normally be obtained by the customer getting its bank to increase its overdraft for an agreed period of time? The fact that a company wouldn't opt for this is presumably because it can't. The bank has called time and has refused to increase the overdraft – possibly because there are no assets left over which it can take a charge as security. That should set alarm bells ringing with investors.

Something else that should set alarm bells ringing is that the company is almost certainly coming under pressure from its suppliers to settle invoices which in some cases are long overdue. In this situation suppliers threaten to put the customer 'on stop', refusing further supplies until invoices have been paid. If critical suppliers withhold supply, this can jeopardise a company's ability to continue supplying its own markets and hence pose an existential threat to the business.

Add to this the fact that, perversely, finance acquired through reverse factoring often isn't shown as debt on the balance sheet. So a company that is already under financial stress can use this form of finance to dress up the appearance of the balance sheet. Seen in this light it becomes very clear why Sanjeev Gupta and his GFG steel empire should have found reverse factoring, or supply chain finance, so attractive. All you need to complete the circle of deception is a creative counterparty, a secondary banking institution, for example, which has found a convenient way of passing the risks associated with this financing model on to other unsuspecting parties. Enter Lex Greensill.

Did anyone spot the obvious flaw in the proposition?

We now know that as long ago as 2012 Lex Greensill had managed to work his way into government and persuade, amongst others, the then Prime Minister, David Cameron and Cabinet Secretary, Jeremy Heywood, that his reverse-factoring service would be of benefit to government departments. Some senior civil servants with more questioning minds were less convinced. Why, they asked, would the government want to pay a third party private-sector organisation to provide an early-payment service? Governments can always borrow more cheaply than the private sector; so why not fix the problem at source and ensure that government departments and agencies have sufficient funds to settle supplier invoices on time themselves? This was an obvious question which never seems to have received a proper answer. This fact notwithstanding, it has to be admitted that the UK government has form with this sort of sleight of hand. The Private Finance Initiative (PFI) makes no sense as a cost-effective, value-for-money way of funding public infrastructure projects. It is just a rather costly way of keeping debt off the government's balance sheet.

What of the private sector?

Interestingly, the Financial Times has noted that reverse factoring has become popular in recent years with large companies, such as supermarkets. They have been able to set up arrangements with their own banks to secure funds specifically to enable prompt payment to their smaller suppliers, such as dairy farmers. The justification for this was that the credit rating of the supermarket was likely to be better than that of the small suppliers and the customer could therefore borrow more cheaply than the supplier. Even this appears to make little commercial sense. Most supermarkets can work on negative working capital; they operate rapid turnover businesses in which the goods are sold to the consumer and payment is collected long before the supplier invoices fall due. Why would they pay a premium to a bank just to do something they could do themselves (i.e. pay promptly) if they chose? Maybe – perish the thought – the opaque reporting requirements surrounding supply chain finance have had something to do with it.

Turbocharging reverse factoring

With conventional factoring there is little scope for developing clever wheezes. All you can do as the supplier is sell your invoices to someone else to collect the debt and accept that you are going to receive less than the face value of the invoice. With reverse factoring there is more scope for creativity – particularly if you are in serious need of cash. If rumours are to be believed, Sanjeev Gupta's GFG Alliance and Greensill Capital have been active in exploring the possibilities.

One novel approach seems to have been for GFG to raise money under the guise of 'supply chain finance' to pay invoices that the company had not yet received but which it believed it might receive in future. That might be plausible if GFG had sent its supplier(s) a purchase order for goods or services and there was therefore a firm purchase commitment in place. However, reports in newspapers such as the Sunday Times suggest that supply chain finance was being put in place to fund supplies for which, not only had GFG not yet raised any purchase order on a supplier, but for which the company itself had received no firm order from its own customers. In other words, money was being raised to fund what can only be described as a phantom supply chain based on non-existent customer orders.

Another interesting wheeze in the case of GFG, with its opaque and labyrinthine structure, appears to have been the practice of companies within the Group using supply chain finance to pay for goods purchased from other companies within the Group. It doesn't take much imagination to realise that there are endless possibilities here to play an elaborate internal-supply-chain game of 'pass-the-parcel'. Each time the goods change hands, the customer organisation within the Group can raise further supply chain finance. The system also offers plenty of scope to enhance the funding by taking a liberal approach with transfer pricing. Furthermore, the beauty of it all for the borrower is that none of this money readily shows up as debt on the balance sheet.

Where next....?

The unfolding story of Greensill Capital, GFG Alliance and other parties involved in providing the funds has further to run. Now that Greensill has collapsed, who is 'on the hook' for what? Will GFG be able to struggle on? If not, will British politicians feel compelled to step in to try to save jobs in sensitive constituencies? What about the way in which Greensill Capital was able to package up much of its own funding for supply chain finance into bonds that were sold to unsuspecting third parties with a 'low-risk' label attached? This is reminiscent of the sub-prime mortgage scandal of 2007/ 8. Added to all this is the spice of potential political scandal.

And finally....

Firstly, reverse factoring and supply chain finance are nothing more than a way of funding additional working capital. A tightening of the rules is overdue. At the very least, the debt it creates should be clearly shown as debt on the balance sheet, regardless of what it is used for. Secondly, when companies or public sector organisations enter into any purchase and supply arrangement they enter into a legally binding contract. This will stipulate, amongst other things, the payment terms. Whatever the payment terms agreed between the parties, these should be adhered to.

Cross-border voting

Better Finance, the pan-European body of which we are a member, is conducting a survey on cross-border voting. The Shareholder Rights Directive II, which, depite Brexit, has been transposed into UK law as the Companies (Shareholders' Rights to Voting Confirmations) Regulations 2020, was intended in part to facilitate cross-border voting, but shareholders are finding that many barriers remain.

If you have cross-border holdings in Europe and would like to express a view, please complete the Better Finance survey here.

A reminder why our Northern Rock Campaign continues to claim back shareholder rights

by Bill Brown

Editor's note: It's a pleasure to welcome Bill Brown as a writer for TPI. After a lifetime career in international banking and trustee business, including senior management positions in London, Bermuda, Toronto, Jersey and Guernsey, Bill completed his career in Gibraltar, where he was appointed by the Foreign Office as the first Financial Services Commissioner, charged with introducing the regulation of banks and other financial and investment firms.

Bill was a founder member of several financial services associations in Jersey and Guernsey, President of the local centres of The Chartered Institute of Bankers in both Islands, a Fellow and Member of the Council of the CIOB and for several years Chief Examiner of the Associateship Examination "Offshore Practice and Administration", which he created and about which he wrote a handbook for interested professionals.

Did the lack of liquidity mean Northern Rock was insolvent in 2008?

The fact that Northern Rock (NR) experienced liquidity problems is a complicated one. The Report, by UKSA's Northern Rock sub-committee on behalf of the Northern Rock Shareholder Action Group, looked into the full circumstances and runs to 43 pages. A summary such as this article can only deal with a limited number of factors. The sub-committee has concentrated on the fact that shareholders were not compensated when the Bank was nationalised.

Just as a reminder of the regulatory structure at the time, we had one financial regulator, the Financial Services Authority (FSA), responsible for prudential and conduct regulation and supervision. But the full scope of financial supervision was split across the "Triumvirate", the Bank of England (BofE), HM Treasury and the FSA.

And there was an important gap in UK legislation. In 2003, the G8 countries, with the exception of the UK, passed banking laws that made provision for the rescue of banks with liquidity problems. Those laws included provisions aimed at "resolving" liquidity problems. The UK did not pass such a law as it was believed that because of the size and expertise of the London financial markets there was no need for such a law.

The main facts that created NR's problems were as follows:

It became apparent to the BofE in August 2007 that NR was finding it increasingly difficult to renew its loans from other banks, loans which enabled it to increase the volume of mortgages granted. At the same time the market for one of its other main sources of funds, "securitized bond issues" (copied from the USA) ceased to operate and it became apparent that it could develop liquidity problems but in overall terms would remain solvent.

That situation was only known to the Triumvirate but a leaked "scoop" by a media reporter on the evening of 13th September 2007 brought it to public attention before an official announcement had been made. This leaked "scoop" included a statement that "Northern Rock has asked for and been granted emergency financial support from the Bank of England, in the latter's role as lender of last resort". That caused a run on the Bank by depositors, the first in Britain in over 120 years. It followed that none of the Board of Directors of NR, Parliament, BofE or the FSA was prepared for, or had experience of, such a "run".

When the financial crisis started with NR in 2007, reliance had to be placed on the only law available, The Insolvency Act 1986. That presented a problem for Government in the case of

NR. As the Bank was not insolvent it was necessary to "assume" that it was, therefore, the NR Compensation Order 2008 contained two "assumptions": that a) it was unable to continue as a going concern and b) it was in administration. Those assumptions, contained in this Ministerial Order, turned the "assumptions" into legal requirements that had to be observed by a valuer and which determined his final conclusion.

It took five months, until September 2008, before a valuer could be appointed, as there were no applicants. A valuer then took until December 2009 before he issued a "preliminary" conclusion that the shares had no value, and 1st October 2010 before he confirmed the same final conclusion. He had described the circumstances as being "unreal" but law, in the shape of the Ministerial Order, forced him to reach that conclusion.

The Financial Times at the time printed an article by Professor Tim Congdon, an economist who had been an adviser to the Conservative Party. It was a lengthy article which started with the headline, quoting the Professor, "Treasury cannot be allowed to rob bank investors".

Now in 2021, thirteen years after the temporary nationalisation of the Bank, it has only just been released from Government ownership. The Government, in addition to having earned interest and fees and paid all expenses incurred throughout that period, has pocketed a final amount of over £7.8 billion in profit (coming from an interim dividend declared in favour of Government in 2018 of £2.7 billion, plus the balance shown in the 2020 UKAR Accounts of £5.1 billion).

It is apparent that there was never a Conservative Government intention to return NR to the ownership of its shareholders.

Editor's note: Thousands of small shareholders lost their life savings when NR was nationalised in 2008. They deserve a share of the hidden value that has now been recognised.

Achieving egalitarian capitalism through revolution or evolution?

The Centre for the Study of Financial Innovation (CSFI), an independent think tank, invited UKSA to debate the subject of 'Egalitarian Capitalism' with Gavin Oldham, founder of The Share Centre.

Gavin, the lead speaker, advocated radical action to eradicate poverty. This would be done by combining financial education with empowering the disadvantaged young to achieve individual ownership, participation and responsibility. UKSA, represented by our chairman, Malcolm Hurlston, and two directors, John Hunter and Sue Milton, responded by explaining how much could be achieved if government addressed the current and well-known weaknesses in retail shareholding and savings, such as the lack of nominee account holder rights and high opaque charges for financial services.

These approaches are very different. Gavin's ideals cannot be disputed, just the approach – revolution or evolution.

You can view a recording of the debate on the CSFI YouTube channel here. While visiting, why not browse the full range of excellent videos the CSFI has to offer?

Lifetime ISAs – free money from the Government

by Mohammed Amin
MBE FRSA MA FCA AMCT CTA (Fellow)

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

Firstly, what is free money?

For money to be free, somebody has to give it to you, and not take it away later. For example, the tax refund on paying into a SIPP is not free money because when you take money out of the SIPP (apart from the 25% tax-free lump sum) you pay tax, possibly at higher rates than your original tax refund.

However, with a Lifetime ISA ("LISA"), the government gives you a bonus which it never takes back, provided you comply with the rules. That bonus is free money.

The basic LISA rules

These are set out on the Government website page. I have summarised them below:

Contributing to a LISA:

• You must be aged 18 or over, but under 40, to open a LISA;

• Once a LISA is opened you can keep contributing until you reach 50;

• The maximum annual contribution is £4,000. This counts towards your annual ISA limit of £20,000;

• The government will add a 25% bonus to your savings, so the maximum bonus is £1,000 per year;

You can take money out of a LISA without any penalties in three circumstances, namely if you are:

1. Aged 60 or over;

2. Terminally ill, with less than 12 months to live;

3. Buying your first home (subject to certain conditions, which I ignore to save space).

Accordingly, if you pay the maximum of £4,000 into your LISA every year from age 18 to 50, which is 32 years, you will have received £32,000 of government bonus, all of which you keep, plus keeping all of the growth in the LISA, all entirely tax-free.

If you take money out in any other circumstance, you are charged a penalty of 25% of the money withdrawn.

Since the government bonus only represents 20% of the LISA fund, the 25% includes a real penalty since you are paying back more than a government's notional share of your LISA. However, if you follow the rules, the penalty will never arise.

What I did for my children

LISAs started in the 2017-2018 income tax year. I was a bit slow getting organised but in January 2018 persuaded both of my UK-resident adult children (then aged under 40) to open a LISA and contribute £4000 each. I also gave them £4000 each.

I have given them £4,000 each in every subsequent tax year, just after 6 April, which they have chosen to contribute to their LISA.

They invest entirely in equities and have just made their April 2021 investment. Their LISAs are worth about £31,000 each, derived from personal contributions totalling £20,000 each. (Neither child's LISA has yet received the 2021-2022 government bonus, so that £1,000 each should be added on to the value.)

National take-up statistics

HMRC publishes statistics annually, but the most recent figures only go up to 2018-2019. In that year, £604,000,000 was contributed to 223,000 LISA accounts, so the average amount contributed was £2,708. The average figure makes sense since there is a £4,000 maximum.

While 154,000 LISA accounts received a contribution in the previous year, 2017-2018, I would expect most people once they had an account open to keep contributing to it. Accordingly, 223,000 is a reasonable estimate for the total number of individuals who had a LISA by 5 April 2019. I would expect the number to have grown since then, but not dramatically.

This contrasts with the figure of 18,576,083 UK resident people in the age range 18-39 shown in the national census. The take-up is microscopic; approximately 1.2%.

I refuse to believe that the low take-up is entirely due to lack of ability to save. The top 5% say of the income distribution would certainly have the resources to save, and probably a much larger proportion of the income distribution would. Accordingly, the microscopic take-up must derive from lack of awareness.

In my view the LISA is the most generous individual savings product available in the UK, and the low take-up demonstrates appalling widespread ignorance.

UKSA members?

I suspect that most UKSA members, like me, are rather too old to open a LISA! However, I would be interested to learn the percentage take-up by eligible adult children of UKSA members. I would hope that it was significantly greater than 1.2%.

The availability of free money is why I put LISAs number 6 in the decision hierarchy in my article "Personal Finance 101" in TPI issue 209 for those young enough to be eligible to invest in a LISA.

A chocolate teapot...?

Any prospect of the UK's financial sector being deemed 'equivalent' in a way that would allow mutual access between the UK and EU financial sectors has now evaporated, as Investment Week reports. Instead we have a memorandum of understanding providing for twice-yearly meetings between the UK Chancellor and the EU commissioner for financial services. But that falls far short of legally binding cooperation arrangements.

Reactions in the City vary, of course. One of the more colourful came from Jake Green, Global Co-Head of Financial Regulations at the Law Firm Ashurst: "This doesn't move the dial forward and it's likely to be as much use as a chocolate teapot."

So what was all the fuss about the US 10-year Treasury Bond yield?

A key tenet of the Savers Take Control initiative is the notion of savers/investors sharing their knowledge and experience of investing, as an embodiment of the principle of savers helping each other. It is in that spirit that this article is proffered, in the hope that some members may be enlightened, whilst simultaneously recognising that for some other members it is stating the obvious and may even be over-simplified.

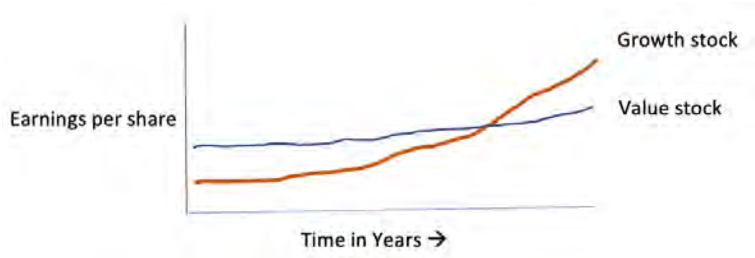
I would expect and indeed encourage those members who may be more familiar than I with the financial wizardry of stock valuations to submit their own thoughts. Note that this article is mainly about US shares and is my interpretation of the turbulence witnessed in the US market in February and March. (I say 'my', but more correctly it is the distillation of many professional views across the financial media.)

In early January, the redemption yield on the US 10-year Treasury bond was 0.7%. From the beginning of February, for a period of six weeks, the yield climbed rapidly and relentlessly to 1.7%. According to the Financial Times, this was the fastest quarterly increase in the US 10-year yield since 1970. It spooked investors and US growth stocks in the S&P 500 and the Nasdaq fell approximately 11% within two weeks, but why?

Growth vs value stocks

Some stocks are classed as 'value stocks' because the market has priced the stock at a relatively low price compared to the stock's own fundamentals. This will be reflected in the stock's low price to earnings (P/E) ratio. They tend to be quite mature companies in well-established markets and examples of such stocks are Bank of America, Johnson & Johnson and Chevron. Now, there may be more than one reason why a stock should be priced at a low level, but a frequent feature of these types of stocks is a relatively modest future projected growth of earnings per share (EPS).

'Growth stocks', on the other hand, will typically have a much higher P/E ratio and will usually have a more rapid projected growth in earnings. Examples of such, in the large-cap space, are Apple, Amazon, Facebook and Google et al., which dominate large and rapidly growing markets.



Members may own these stocks through UK investment trusts, such as Scottish Mortgage, Foreign and Colonial, Monks etc. or through ETFs (exchange-traded funds) or indeed may own them directly. In the simple graphic depicted here the projected EPS for the growth stock is on a steeper trajectory than the value stock.

The differential in initial EPS diminishes with time and at some point the EPS values cross and continue with the growth stock earnings exceeding the value stock. Like all forecasts, of course, there can be surprises on the way. (I am omitting matters such as share buybacks, stock splits, etc. here.)

Most members, I suspect, will be familiar with the concept of the time-value of money, i.e. the concept that £100 received today is worth more than a £100 received at some point in the distant future. When considering alternative investments, therefore, to make the comparison meaningful, future earnings flows need to be discounted back to today's value using appropriate discount rates.

The further into the future one goes, the greater the level of discounting applied and of course the more important the magnitude of that discount rate becomes. It is the shape of the yearly earnings profile of the two categories of stock that matters and how changes in the discount rate affect each type of stock differently. (Note: in reality, the discounting factors used are far more complex than may be implied here. Valuing future earnings flows from financial securities is highly technical and there is more than one mathematical model. Suffice to say an increasing yield will result in larger discounting factors.)

The impact may be seen by inspecting the recent trends of two exchange-traded funds that specifically track stocks identified as value or growth.

iShares S&P 500 Value ETF (Ticker = IVE) (See here). This ETF tracks the performance of 434 large US companies that are considered undervalued compared to the rest of the market and its top five constituents are as follows:

Berkshire Hathaway, JP Morgan Chase, Walt Disney, Bank of America, Johnson & Johnson

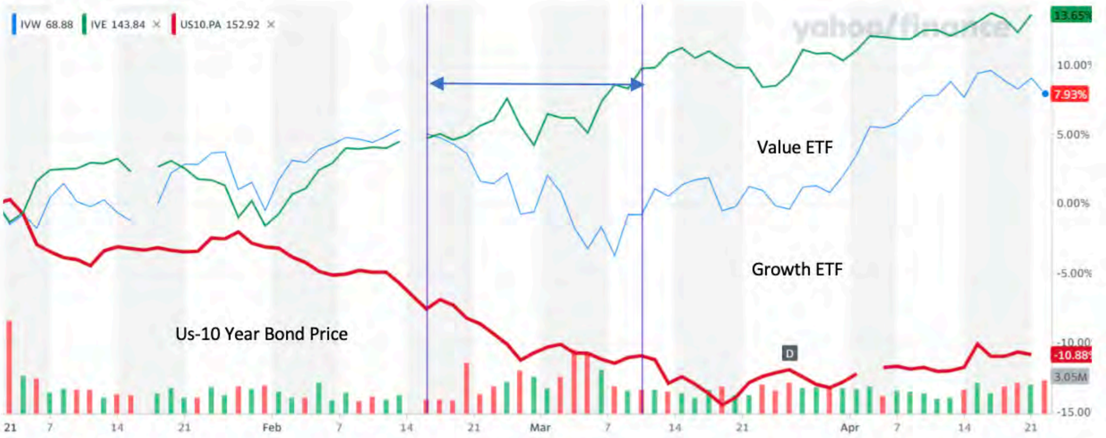
At the time of writing it had a P/E ratio of 24.63 or alternatively an earnings yield of 4.06%.

iShares S&P 500 Growth ETF (Ticker= IVW) (See here). This ETF tracks 237 large US companies whose earnings are expected to grow at above the average market rate. Its top five constituents are as follows:

Apple, Microsoft, Amazon, Facebook, Alphabet (Google)

At the time of writing, it had a P/E ratio of 41.41 or alternatively an earnings yield of 2.4%.

The following chart compares the performance for the year to date of the two ETFs above, together with the US 10-year price. (Recall: as the price of the bond drops the yield must increase.)



Growth vs Value ETF year to date (courtesy of Yahoo Finance, part of Verizon Media)

The most interesting aspect of this chart is what happens during the period between 16 February and 10 March. Prior to that period both ETFs rise and fall almost in unison, but during the period the downward trajectory of the bond price appears to be established and at that point the performance of the ETFs begin to bifurcate. At the end of that period the growth ETF has given up all its gains for the year to date, whilst the value ETF continues to rise, making a gain of 10% for the year to date.

Market commentary at the time suggested that bond investors were fearful that inflation was a significant threat on the horizon, despite reassurances to the contrary by the Federal Reserve chair Jay Powell. The fear was that inflation may have to be constrained by increases in interest rates which would disproportionately impact growth stocks. Note that as the bond price begins to plateau out and inflationary fears are allayed, the growth ETF plays catch-up with the value ETF.

So, what if anything can be concluded from this little episode?

The key points here are:

- The equity markets take notice of what is happening in the bond markets.
- Changes in the discount rate of future annual earnings affect growth and value stocks differently.
- The differential in yield between the US 2-year and 10-year Treasuries is used by market pundits across a broad section of the financial media, as a rough and ready proxy for the steepness of the yield curve (with implications for interest and discount rates in general).
- The rapid move in the US 10-year Treasury yield in a matter of weeks from 0.7% to 1.7% was seen by the market as highly significant for growth stocks, as the market feared that long-term interest rates may rise rapidly.
- That investors should be aware of the degree of value vs growth biases inherent within their investment portfolio.
- That diversification between value and growth is likely to reduce portfolio volatility.

In case you missed it...

Rob McDonald's regular round-up of stories in the headlines

James Anderson, the investment manager of the £17.6 bn Scottish Mortgage investment trust who has managed the trust since 2000, is to step down in April next year. From 2000 to today investors have enjoyed a 1500% total return. *Madison Derbyshire, Financial Times, 20 March*

Since the start of the year, long-dated treasuries which mature in 10 years have dropped almost 15% on a total return basis, according to Bloomberg Barclay index. If sustained, this will be the worst quarterly drop since the 1970s. The Fed continues its $120 billion monthly bond buying programme. *Colby Smith, Financial Times, 20 March*

Large companies with insufficient cash reserves ought to be barred from paying shareholder dividends and executive bonuses in a major overhaul of UK's audit and corporate governance regime.

BlackRock has opened a new front in the price war among ETF providers by slashing fees across nine US equity-style ETFs. The fee reduction ranges from 17 basis points to 24 basis points. The US 'style box' will carry annual fees of 3-6 basis points. *Best of Business, Financial Times, 28 March*

Nearly 80% of commercial rents in the UK in the latest quarter have remained unpaid, raising concerns about whether businesses will be able to pay arrears built up during the pandemic. *George Hammond, Oliver Barnes and Alice Hancock, Financial Times, 29 March*

Fund managers now think inflation is the single biggest danger to markets, according to Bank of America's latest survey of investors, the first time it has topped the fear table. *The Long View, Robin Wigglesworth, Financial Times, 3 April*

Volkswagen was forced to apologise for misleading consumers and investors over an early April Fool's joke on Monday that rebranded its US arm to 'Voltswagen' and led to its US-listed ADR price rising 16%. *Best of Business, Financial Times, 3 April*

High-profile Rio Tinto shareholders, including the Norwegian $1.3 trillion oil fund and the UK local authority pension fund forum which manages £300 billion in assets, voted against the miner's remuneration report which gave former chief executive Jean-Sébastian Jacques a pay rise despite the destruction of a sacred Aboriginal site on his watch. *Henry Sanderson and Neil Hume, Financial Times, 10 April*

Shipping companies ordered 72 vessels with a capacity of about 866,000 20-foot containers last month, a record volume and a sign of the industry's confidence in trade following the pandemic.

The UK Government rejected requests to help bail out Eurostar. The struggling train operator has £400 million in loans due by June. *Best of Business, Financial Times, 10 April*

Shares in GlaxoSmithKline rose after it was revealed that activist hedge fund Elliott management had built a multibillion pound stake. The company has underperformed peers and lagged behind in the race to develop a Covid-19 vaccine. *Best of Business, Financial Times, 17 April*

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CURRENT UKSA EVENTS

Company meetings

UKSA's programme of physical meetings has been suspended during the current health crisis, but we are holding a wide range of online meetings. Details of each event are e-mailed to members.

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