N&V

News & Views
Q4 | 2014

INSIDE

Global Investment Review and Outlook: The Ageing Bull Ploughs On

Eye of the Tiger

Divergence in Monetary Policy

The Importance of Protection

CANACCORD Genuity
Wealth Management

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David Esfandi
Chief Executive Officer
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Welcome

And so we enter the final quarter of the year with markets still ploughing on in this now, maturing bull market. Over the summer markets have been nervously anticipating the outcome of two major events, namely the Scottish referendum and the beginning of policy normalisation in the US. The former of which, we have now had an answer to. The latter, continues to remain a subject of critical debate.

Over the last year or two, we have been working on a project to upgrade our systems in order to provide a more efficient and effective service to all of our clients. Known internally as 'Project Dragonfly', this has largely been centred around the installation of new software called Avaloq which is a leading industry infrastructure provider and we are very excited about the advantages it will bring to our business and ultimately, to you, our clients.

The most visible aspect of change that this programme will bring for our clients, will be the production of much improved valuation reports – and the first of these will be available in December. In addition, the new 'Wealth Online' service will be significantly upgraded from its current functionality and we look forward to increasing the number of our clients who are able to take full advantage of digital reporting going forward.

Meanwhile, we hope you enjoy our Q4 edition of News & Views. Our CIO, Nigel Cuming, comments on the wash up that we can expect following the result of the Scottish referendum, (pages 4-9), and goes on to explain that Europe remains an area of concern with many of the Eurozone nations still in recession and the time has surely now come for the ECB to behave in a more proactive manner. On the back of this Nigel and his team have reduced their exposure to Europe whilst elsewhere their market views remain broadly unchanged. They continue to ensure that their portfolios are well diversified in low or non-correlated asset classes in order to provide a degree of protection should the market suffer an unforeseen set back.

Ryan Harrison, Chairman of the Stock Selection Committee, provides a review of the UK equity market (pages 10-13), where we have seen further merger and acquisition activity, a trend that has fuelled expectation that the London Stock Exchange could see a post-recession record of flotations this year.

Paul Philp, Senior Investment Manager in Guernsey, reviews the widening spread in government bond market returns caused by the differing monetary policies put in place by the Fed and the ECB in his article "Divergence in Monetary Policy" on pages 16-17.

Since markets bottomed in 2009, the Alpha generated by hedge fund managers has been at record lows, causing us to question the justification of the high fees typically associated with these funds; Nicolas Maunder explores this further on pages 18-19.

Protection by way of a life insurance policy is a precautionary measure that will offer you peace of mind that sufficient funds would be available to take care of your family and any debts in the event of your death. Nero Patel, Senior Wealth Adviser, discusses the "Importance of Protection" on pages 20-21.

In this edition, we have also included our Global Strategy note, written by Robert Jukes, Global Strategist, and an article about the newly coined "Smart Beta", penned by Nicolas Maunder. Our featured stocks this quarter include ITV, AMEC, Barratt Developments, GlaxoSmithKline and Harley-Davidson. These can be found on pages 24-28.

If you have any questions or require any further information on the investment themes discussed in this edition's articles, please contact your CGWM adviser.

The Ageing Bull Ploughs On

N22°41'26"
E103°25'28"

CHINA
YUNNAN PROVINCE

The mature bull market ploughs on, albeit with a less attractive risk and return profile given the current geopolitical back drop and expected changes in monetary policy.

Nigel Cuming
Chief Investment Officer

> “There are no obvious signs that this somewhat aged bull market that we have been enjoying for the last five years is about to roll over; we wish to have some insurance should it do so.”

It has been a long hot summer with market participants nervously waiting for two major developments, namely the result of the Scottish referendum which went from a likely “No” vote to a too close to call nail-biting conclusion and secondly the beginning of policy normalisation by the Federal Reserve. Concerning the Scottish result, whilst the markets responded favourably to the “No” vote, it is likely that permanent damage has been done to the perceived stability of the United Kingdom which will have adverse long-term implications for both the economy and the currency as international investors may become reluctant to invest into the UK. The further promised Scottish devolution may be the beginning of a move to a more Federalist approach as other countries, and possibly regions within the UK, may also seek increased local powers.

Global equity markets began the third quarter positively but lost ground at the end of July when developments in the Ukraine, the Middle East and Argentina’s latest debt default combined to sour sentiment. In Europe the economic repercussions of further sanctions against Russia contributed to a growing sense of nervousness following a mixed corporate earnings season and the collapse of Portugal’s Banco Espirito Santo. Asia was an exception and most markets here progressed over the course of the month exceeding expectation. China’s manufacturing Purchasing Manager Index data suggested that the economy is strengthening. A highly stimulative package of measures was announced in Korea, whilst in India the new Modi led government’s first budget was well received.

Confidence returned across the board in August and the S&P 500 pushed through the 2000 level for the first time, rising 4% on the month (Figure 1). In the UK the FTSE 100 rallied modestly in a rather lacklustre manner (Figure 2), with trading volumes and volatility very low (Figure 3). Improvements in the United States included an on-going recovery in the labour market. Whilst the unemployment rate rose to 6.2% from 6.1% in July, (Figure 4) this was primarily due to discouraged workers returning to the labour force following six consecutive months of more than 200,000 jobs being created. Claims for unemployment benefits also fell to low levels and the number of job openings rose to the highest level since 2001. In addition consumer confidence rose in tandem with the improving job situation, although retail sales disappointed during the month. Finally, surveys of manufacturers and the service sector showed increased activity and business investment spending was robust.

> “Confidence returned across the board in August and the S&P 500 pushed through the 2000 level for the first time, rising 4% on the month.”

Fig 1: S&P 500 Index return year to date

Fig 2: FTSE 100 Index return year to date

In China exports gathered steam in August reflecting improving external demand and revealing more signs that the world’s second-largest economy is stabilising. This stability is reflected in inflation data, with consumer price inflation little changed in August while producer price deflation continued to ease.

One area of the world that remains problematic is Europe. Whilst growth is picking up elsewhere, conditions remain very subdued here. Italy is back in recession and is still 9% below its pre-crisis peak. In fact its economy is the same size as it was in 2000 so effectively Italy has had no growth since the days of the Italian Lira. The French situation is at least as bad, if not worse, with flat industrial production, virtually no inflation or growth and with unemployment standing at in excess of 10%. Recent talk of the need for more austerity makes no sense at all. Even Germany which accounts for almost 30% of Eurozone GDP appears to be struggling, posting negative growth in Q2.

Although there has been some improvement in the peripheral countries, such as Spain and Ireland, the immediate growth outlook was looking extremely uncertain, especially as the sanctions against Russia, as a result of the military conflict in the Ukraine, will exact a strong deflationary force on an economy where there is virtually no inflation at present. The ECB has recently revised down its inflation forecasts and it now seems likely that the inflation rate will continue to be below the 2% target for at least another couple of years. This will make it close to four years below target, a highly unsatisfactory state of affairs.

It is generally accepted that the ECB has done so much less than the Fed, Bank of England and even the Bank of Japan to rejuvenate its economy and has not entertained the idea of fully fledged quantitative easing. However there are now signs that this could be changing. ECB President, Mario Draghi, has once again made another significant statement. His earlier

Fig 3: VIX Index (implied US equity volatility) over 10 years

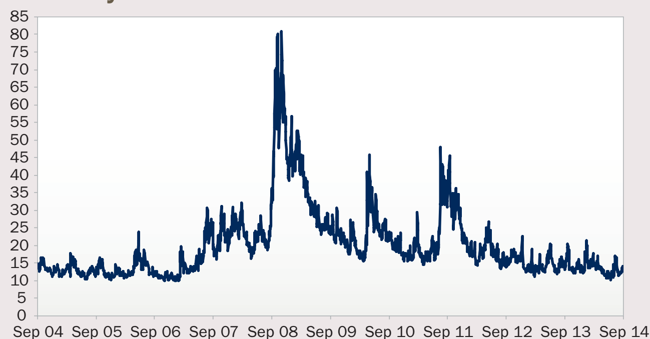


Fig 5: Euro vs US$ over 1 year

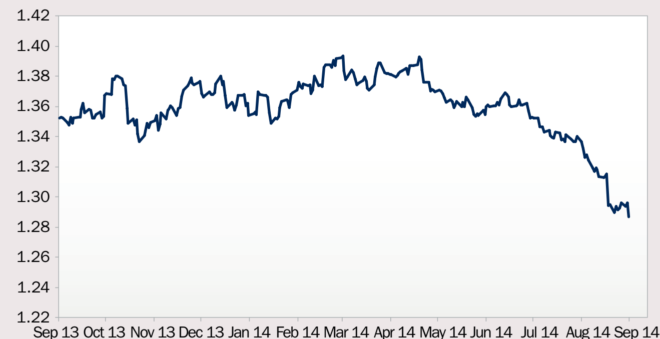
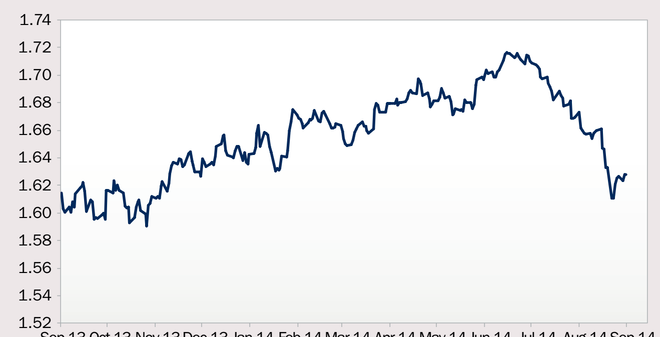


Fig 4: US unemployment

Fig 6: Sterling vs US$ over 1 year



Source: Bloomberg

promise to do “whatever it takes” to stabilise the Eurozone in August 2012 immediately improved sentiment. This time a statement at a Central Bankers’ Conference in Jackson State, Wyoming that he would use “all the available instruments needed to ensure price stability” was greeted very favourably by financial markets as it hinted at the likelihood of quantitative easing at some stage in the future.

It was generally accepted that the ECB was unlikely to implement any new measures at this time as it would wait to see what the beneficial effects of the Targeted Long-Term Refinancing Operation were, a strategy only implemented back in July. However, the deterioration in the economy has forced them to move early and the extent of the measure went much further than was expected. Interest rates were cut further although this was more a symbolic gesture, as President Draghi stated “they are now as low as they will be allowed to go”. The important innovation was that the ECB will now start buying Asset Backed Securities (ABS). This is not in itself of huge significance as the size of this market in Europe is relatively modest but it does suggest that at some future stage fully fledged quantitative easing will be embarked on in the form of purchases of sovereign bonds. This would be a total change of policy.

In addition to the ABS purchases, the ECB will also buy covered bonds which are a safer form of ABS as they are backed by other assets and remain on the issuer’s balance sheet. These measures should make it easier and cheaper for riskier borrowers to obtain loans and will help the ECB achieve its aim of rebuilding its balance sheet to its 2012 size, which implies a €1 trillion expansion. These measures are a significant change of policy for the ECB and have been described as “QE-lite”. Obviously there is speculation as to what has prompted this move. The answer is clearly the ECB’s concern at the increasingly

FRANKFURT, GERMANY
EUROPEAN CENTRAL BANK

One area of the world that remains problematic is Europe, which has seen little or no growth since 2008. The ECB must now take affirmative action. On the back of these concerns we have reduced our exposure here.

“

What is still required in Europe is for all European governments to support the much needed structural reforms without which no significant sustainable progress can be made.

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deflationary environment and growing comparisons with Japan's last decade. However, there is no guarantee that these new measures will be effective in kick-starting the European economy. The Euro has weakened significantly recently (Figure 5) which is helpful and the authorities are now hoping that a combination of cheap loans, negative interest rates and these new measures will be enough to encourage investment, home buying and construction. This is by no means definite. The new measures will be deeply unpopular in Germany so the prospect of political rift is growing. What is still required in Europe is for all European governments to support the much needed structural reforms without which no significant sustainable progress can be made. France and Italy have to eventually accept this and act accordingly. The Bundesbank is unlikely to be happy if the ECB is eventually forced to buy up the sovereign bonds of countries whose credit ratings are declining due to their failure to implement necessary reform. President Draghi has again pulled a rabbit out of a hat but against a backdrop of sluggish growth, a lack of structural reform, political disunity and geopolitical uncertainty, not to mention the worrying longer-term demographic issues of a rapidly ageing population. It would appear he will continue to have his work cut out to engineer faster European growth.

There was speculation towards the end of the quarter that the Federal Reserve would hint at an imminent interest rate hike at the September meeting. This proved not to be the case. In addition to revising down growth forecasts for the next few years, the Fed commented that despite recent improvements "there remains significant under-utilisation of labour resources" and therefore interest rates will remain near zero for a "considerable time" after its bond buying programme ceases in October. This was a less hawkish stance than had been expected and it allowed US equities to finish the quarter on a positive stance.

We have made no major changes to our investment positioning over the quarter although our concerns regarding Europe prompted a reduction of exposure here. We are persisting with a modest underweight to equities because, although there are no obvious signs that this somewhat aged bull market that we have been enjoying for the last five years is about to roll over, we wish to have some insurance should it do so. We have taken some profits in our thematic plays such as healthcare and infrastructure and are looking to introduce exposure to energy stocks and also to aerospace and defence stocks which will be obvious beneficiaries of a deteriorating geopolitical backdrop. Finally, we retain a bullish view on the US Dollar and remain nervous of both Sterling (Figure 6) and the Euro (Figure 5).

Our market views remain broadly unchanged. Against a highly accommodative backdrop and, with interest rate rises still some way off, the path of least resistance for equities remains upwards. Corporate profitability has improved and we are in something of a "goldilocks" situation. This is because, whilst the global economy is recovering, the recovery is not sufficiently strong enough to lead to an increase in inflation and force central bankers to normalise policy. However, we will continue to ensure that our portfolios are well diversified with exposure to non-correlated assets which will provide a degree of protection in the event of an unforeseen market setback.

N51°29'55"
W0°7'29"

LONDON
HOUSES OF PARLIAMENT

While the "Yes" campaign gathered momentum, it would appear that voters have been persuaded by the promise of devolution and fears that the economic viability of independence was questionable.

Ryan Harrison
Chairman of Stock Selection Committee

UK Equity Market Review and Outlook

The Scottish referendum further dampened investors' enthusiasm over the summer months when the UK equity markets saw the usual mid-summer malaise, with trading volumes falling sharply as a result of the holiday season. This dull trading period left the FTSE 100 Index in marginal positive territory at the time of writing.

In recent weeks much attention has been lavished on the outcome of the Scottish referendum regarding independence. Whilst this has been the subject of huge debate and the outcome has been to maintain the status quo, it should be remembered that there were a limited number of companies within the FTSE 100 that could have been directly affected by the vote.

The Scottish vote to remain within the union, with 55% voting "No" removes much uncertainty for the market going forward. While the "Yes" campaign clearly gathered momentum as decision day loomed, and the referendum galvanized the electorate with a turnout of 84.5%, it would appear that voters have been persuaded that the economic viability of independence was questionable. In turn, the Scottish Parliament will, however, enjoy greater powers in the future as a result of concessions agreed by David Cameron's Government.

Sterling, as widely predicted, bounced sharply as a result of the vote posting strong gains against both the US Dollar and the Euro. The FTSE also moved ahead on the news with Scottish-based businesses moving sharply upward, led by Royal Bank of Scotland up by 3.5% in the first hour of trading. The market was exhibiting signs of relief as a divorce would likely have been bitter and acrimonious.

In last quarter's review I wrote that we had been particularly encouraged by the renewed interest in merger and acquisition activity. This positive mood continues, with brewer SABMiller confirming that it had recently made a bid for Dutch competitor, Heineken. Whilst this bid was rejected, SABMiller has itself now become a speculative takeover target, with Anheuser-Busch Inbev the likely predator and certainly its portfolio of premium brands make it look attractive. As a result of this speculation the shares have moved sharply upward by some 10% in recent days and, on the back of this bid, sector competitor, Diageo, best known for brewing Guinness, has also moved higher. Importantly this takeover trend looks set to continue and the London Stock Exchange is expected to enjoy a post-recession record of flotations this year.

Continuing with the merger and acquisition theme, multinational mining company, Rio Tinto, has also been attracting attention from commodities giant, Glencore. Rio's share price moved modestly upward as the market took the view that this might be a viable deal. The combination of these two businesses would create a market leader in coal, copper, iron ore, nickel and zinc, effectively creating the largest global mining business.

Food retailers have continued to suffer as a result of the discount stores picking up a greater market share. In our last review we remarked that Tesco Chief Executive, Philip Clarke, was feeling some pressure. Since that time Mr Clarke has parted company with the business and the share price has fallen in excess of 20% on a year to date basis. Rival WM Morrison has also endured a miserable year, with half-year profits well below expectations. The business did however, raise its interim dividend and continues with its push for a greater share of the online retail business. However, we continue to have reservations regarding this sector and remain underweight.

More positively, investors in ITV have been rewarded with a handsome outperformance over the summer months. Hopes that the broadcaster will receive a boost from retransmission fees have been well founded, with Chief Executive, Adam Crozier, calling on the Government to force such payments to be made. A number of brokers are on record as expecting the share price to move sharply higher, should this deal conclude positively.

In the Telecoms sector Vodafone continues to struggle, having underperformed the market by some margin on a year to date basis. Rumours surrounding the potential purchase of media group, Liberty Global, have been seen as negative by those who had expected Vodafone itself to be a potential takeover target. On a positive note, British Telecom has outperformed the index this year and appears to be making ground with its interests in sports broadcasting.

Oil & Gas stocks have had a mixed year thus far, with a slowdown in global demand pushing brent crude prices lower. In particular, BP Group, has suffered, seeing increasing fallout from the Deepwater Horizon oil spill, that has had a negative effect on the share price. In addition there are further worries over the impact that Russian sanctions might have on BP's joint venture with Rosneft. Industry rival, Royal Dutch Shell, has however, comfortably outperformed the index this year. In related sectors, BG Group and Petrofac have both failed to deliver for investors, reflecting negative returns at the time of writing, though we remain positive on both these companies, in expectation of an improvement in performance.

Ultimately, the "No" vote will allow the market to settle down to focus on economic fundamentals once again. With government monetary policy likely to remain unchanged, and with much of the uncertainty removed by the outcome of the referendum, we continue to believe that equities remain the asset class of choice.

> "The Scottish vote to remain within the union, with 55% voting "No" removes much uncertainty for the market going forward."

N55°56'54"
W3°11'56"

EDINBURGH
EDINBURGH CASTLE

The Scottish Parliament will enjoy greater powers in the future, as a result of concessions agreed by David Cameron's government.

Robert Jukes
Global Strategist

Eye of the Tiger

China has been attracting the attention of analysts recently with the very real prospect of growth falling below the 7.5% target this year. The latest batch of monetary stimulus from the Chinese central bank is unlikely to completely arrest the likely growth shortfall – even if it is rolled out in three months time – and is certainly insufficient to deal with the many growing pains ailing this emerging giant. Chief amongst these problems is the shortfall in demand for imports from developed nations. Indeed, supranational agencies have been busy revising down developed nation economic growth forecasts this year, as has the "street". The IMF have been one of the latest to downgrade, with their new lower forecasts being coupled with warnings from Christine Lagarde about "depressed" levels of investment. The IMF's projections in April were for 3.7% global growth this year; the latest numbers are 3.4%. In part that's due to the US which has clearly had a difficult end to last year and a similarly weak start to this one. Compared to potential growth, the US economy is likely to disappoint.

Therein lays the problem. Academics and policy makers have been talking a great deal about potential economic growth recently, linking policy guidance in many countries to central bank estimates of spare capacity (the degree to which economic output is below potential). The idea being that so long as sufficient spare capacity remains in the economy, the likelihood of further growth generating inflation is relatively low, and therefore policy should remain accommodative in order to use up that wasted spare capacity – to create jobs. Interesting then that Professor Lawrence Ball at Johns Hopkins University has recently published a paper where he estimates that potential growth has fallen in most OECD countries as a result of the last recession, and in the US, he estimates the rate of potential growth to be 2.2%, down from 2.6%.

If true, that's bad news for a number of reasons. First, it may be a sign of economic hysteresis as a result of the relatively deep recession (lower levels of investment, and labour participation) meaning inflation is generated earlier in the economic recovery and at lower rates of economic expansion. Second the effects of this hysteresis may bring forward the timing of policy normalisation, possibly "baking in" the lower level of potential growth. Finally, permanently lower levels of economic expansion will lower corporate earnings potential and, therefore, equity valuations on most discount models. Assuming everything else is equal, the US equity market should be 10% lower on our models. Of course everything else isn't equal, and we cannot be certain about these estimates of slower potential growth – so markets shouldn't fully discount the change. That said, if there is something in this line of thought, it will likely provide considerable head winds for equity markets from here on in.

Perhaps that's why markets have so far shrugged off these risks, even though the warning signs of hysteresis are visible to many. That won't always be the case, and Governments need to address the growth shortfall with more imaginative policy, central

banks simply cannot provide the medicine. As the World Economic Forum demonstrated a few weeks ago, European countries need structural reform; many are just not competitive enough to generate growth, and more importantly – employment. Governments are good at talking about it, just not at delivering – as can be seen from Figure 9 – the best get better at the expense of the least competitive. A de-valued Euro may help somewhat, which seems to be the likely endgame of belated action from the ECB, but it's not clear that it is the solution.

For example, in the UK, the Sterling/US$ exchange rate has recovered some of its pre-referendum nerves at 1.63 roughly towards the middle of the relatively tight trading range that was established in 2009 following the credit crunch. The quantitative easing designed to lift the economy out of the recession was at least in part targeting the exchange rate. Aiming for a weaker currency, it was thought, was one way to stimulate economic demand by restoring international competitiveness – remember that Sterling was trading at above US$2 in 2007. That made the post credit crunch currency adjustment comparable to the devaluation following the UK's exit from the European Exchange Rate Mechanism (ERM) in 1992. While the latter contributed to a significant boost in the UK terms of trade forming the foundations for a significant growth boost, the more recent currency adjustment really hasn't helped much at all. Following the ERM exit, the UK current account position steadily improved towards balance, following the credit crunch, the deficit has steadily increased towards 4.5% of GDP.

Improving the competitiveness through currency devaluation during a co-ordinated global slow-down was not the best idea. Likewise, extraordinary monetary policy measures from the ECB are unlikely to help much either in a low growth world. The global economy has clearly changed since the credit crunch, and some would argue that the structural damage inflicted by the sharp downturn has permanently reduced growth potential. Governments need to explore more imaginative forms of economic stimulus, particularly in the Eurozone, and investors need to beware of the risk posed by government inaction. While economies continue their slow recoveries, many will struggle to reach escape velocity, and from what we've seen of policy makers so far in Europe we can't help but question their will to survive.

Fig 7: Developed market GDP recovery

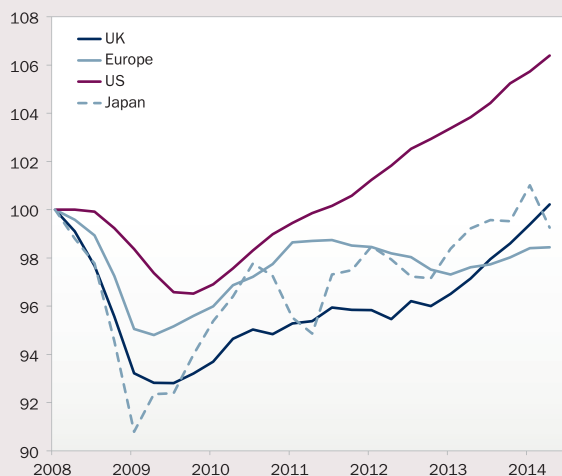
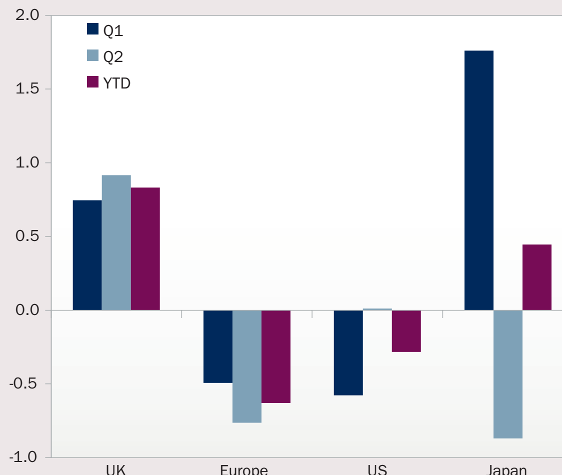
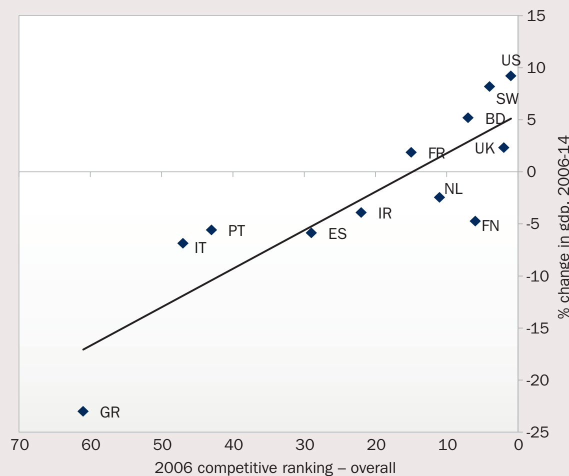


Fig 8: GDP growth relative to trend: below trend this year (except UK)



Source: Datastream and Canaccord Genuity Wealth Management.

Fig 9: Changes in competitiveness since 2006 (the best get better)



Source: World Economic Forum, Datastream and Canaccord Genuity Wealth Management.

Paul Philp
Senior Investment Manager

Divergence in Monetary Policy

Over the course of the year we have seen a widening spread in the differing levels of return that one can expect to receive from investing in US and European government bonds, the primary cause of this being divergence in monetary policy.

US Treasuries have been the worst performing government bond market during the third quarter of 2014. The US Treasury 10 year yield currently stands at 2.52% the highest since 5 August. US Treasuries have returned just 0.4% since the end of the second quarter which is the lowest across 26 sovereign bond markets. However, Eurozone government bonds have returned 2.4% during the same period. Investors appear to have underestimated the Federal Reserve in that they will begin to raise borrowing costs earlier in 2015 than was previously expected. Added to the case for the Fed to raise rates has been a slew of more positive data and therefore the appeal of US government securities is waning amidst signs that the economy is improving. Although recent employment data was somewhat below expectations the 3 month average of monthly payroll gains remains above 200,000. Looking ahead currently the market sees a 79% chance the Fed will increase interest rates to at least 0.50% by September 2015 which compares with a 73% probability seen on 29 August.

European government bonds however, have outperformed US Treasuries this year on speculation that the European Central Bank would ease policy in order to boost the economy. A subsequent divergence of monetary policy is beginning to take shape (Figure 10). The ECB is cutting rates whilst their US counterparts are continuing to taper quantitative easing operations, at the same time Fed rhetoric has been more focused on subsequent interest rate rises.

European Central Bank (ECB) president Mario Draghi pledged to do “whatever it takes” to save the area’s common currency and dovish comments at the recent Jackson Hole conference, signalled the ECB’s willingness to experiment with monetary policy with a further easing. Subsequently ECB officials have said that more stimulus is needed to prevent a slide into deflation, or a spiral of falling prices that could derail the recovery. The bank cut its deposit rate to -0.1% from zero on 5 June, then again to -0.2% on 4 September whilst at the same time reducing the benchmark interest rate to a record-low of 0.05%.

“

The ECB is cutting rates whilst their US counterparts are continuing to taper quantitative easing operations, at the same time Fed rhetoric has been more focused on subsequent interest rate rises.

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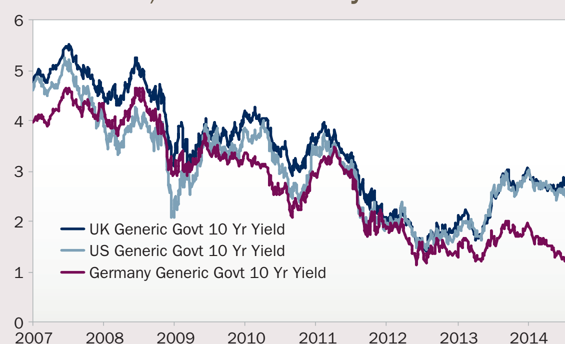
A deposit rate below zero effectively punishes banks that have extra cash but are reluctant to extend loans to weaker lenders. The economy is grappling with a shortage of credit and unemployment is nearing its highest level since the currency bloc was formed in 1999. The ECB has particular reason to use negative interest rates whilst the Fed and the Bank of Japan have turned to large-scale asset purchases, known as quantitative easing, that create new money to fuel the recovery. European Union rules make it politically difficult for the ECB to buy large volumes of government bonds, though it is offering more liquidity to banks and plans to begin purchasing Asset Backed Securities (ABS). As a result, short-dated government bond yields have moved back into negative territory with German 2-year yields at -0.7%, French 2-year yields at -0.3% and even the Emerald Isle’s 2-year yields at less than zero (Irish government 2-year yields -0.01%).

Within our fixed interest strategy we have been planning for this divergence in monetary policy since the latter part of 2013. We are employing an actively managed highly diversified approach where we continue to use core government bonds to provide capital preservation in times of heightened volatility. Fundamentally we remain long term value investors, gaining exposure to undervalued areas of the market, for example in December last year we added financials which have provided attractive returns and a solid income. Furthermore this strategy is positioned for rate normalisation in the US and UK, as c. 45% is invested in variable and floating rate notes, which will rise in value as rates slowly edge upwards.

We maintain our strategy of investing in those stable nations our global macro analysis identifies, such as hard currency debt from Singapore, wealthy Middle Eastern and Scandinavian nations. These provide our investors with excellent long term value. We employ a pragmatic and flexible approach to managing funds entrusted to us, generally maintaining a short duration strategy favouring sensible credit risk over interest rate risk in the current environment.

Fig 10: 10 Year Government Bond Benchmark Yields – UK, US and Germany



Source: Datastream

For details of the Canaccord Fixed Interest Committee’s current views and outlook and portfolio positioning in our fixed interest models, please get in touch at cgwmjfi@canaccord.com

Nicolas Maunder
Hedge Fund Analyst

Absolute Return Sector – Where's the Alpha?

Alpha can be broadly explained as performance generated through manager skill – it is the return achieved beyond what otherwise would be expected based on the risk taken.

Investors allocate to absolute return or hedge funds for a number of reasons, with the potential to deliver superior risk-adjusted returns when compared to traditional asset classes, and portfolio diversification, usually coming high on the list. We have noticed that, since markets bottomed in March 2009, the Alpha generated by hedge funds when measured over a five-year rolling period is at record lows. Meanwhile, five-year rolling R-squared (the percentage of return that can be explained by movements in the benchmark) is at record highs.

We have analysed hedge fund returns since 1990 using the HFRI Fund Weighted Composite Index; an equal weighted index of 2,000 hedge funds and compared these returns to the S&P 500 Index. We reviewed four distinct periods – January 1990 to October 2007 (pre Lehman Brothers bankruptcy), April 2009 to June 2014 (the current bull market) as well as two prior bull markets for equities (June 1994 to March 2000, and March 2003 to October 2007). The results are shown in Figure 11 opposite.

What is interesting is that Beta, a measure of risk compared to the benchmark, is relatively stable throughout all periods. It is also interesting to note the similarities between the S&P 500's performance and risk statistics for the periods April 2009 to June 2014, and from January 1994 to March 2000. During these periods the S&P 500 Index generated a similar annualised return (22.78% versus 22.86%) with similar volatility (13.89% versus 14.00%). In contrast the performance and risk statistics of hedge funds over these periods is vastly different. While risk-adjusted returns, as measured by the Sharpe Ratio, are attractive for both periods, it is the lack of Alpha (skill) and high R-squared (movement which can be explained by the benchmark) from April 2009 to June 2014, which drew our attention. After all, we are seeking managers who can produce Alpha and provide diversification in order to justify the high fees they typically charge. The natural questions one should ask as a result of this analysis are why is Alpha negative and are the causes temporary or structural?

With central banks anchoring short term interest rates near zero and providing vast amounts of monetary stimulus through quantitative easing, the period since 2009 cannot be considered normal. Since March 2009 the S&P 500 Index has generated risk-adjusted returns rarely seen in the last 25 years. High risk-adjusted returns from the market, along with the uncertainties generated by quantitative easing, could explain the lower Alpha. However, it does not fully explain why Alpha has turned negative.

For this we can look at how the hedge fund industry has changed over the years. To begin with, the number of funds and assets managed by the industry has grown significantly since 1990, with c.8,200 funds now managing c.US$2.7 trillion as at March 2014 according to Hedge Fund Research. In addition the industry has borne increased regulation, greater competition from long only products employing similar techniques, a move towards more liquid assets and advancements in technology. All of this has reduced the hedge fund industry's previous information advantage; the internet has allowed all investors access to the same information and effectively levelled the playing field.

While it is hard to quantify specifically how the changes mentioned above may have impacted the hedge fund industry, the decline in Alpha and increase in R-squared is likely due to both temporary and structural forces. However, what we can say is that zero Alpha and a high R-squared are not a good combination for any absolute return fund.

Fig 11: Hedge Fund Research Index vs S&P 500 Index

	Jan 90 to Oct 07		Apr 09 to Jun 14		Jan 94 to Mar 00		Mar 03 to Oct 07	
	HFRI	S&P 500	HFRI	S&P 500	HFRI	S&P 500	HFRI	S&P 500
Annualised Return %	14.56	11.98	8.17	22.78	16.98	22.86	13.00	15.39
Annualised Standard Deviation %	6.55	13.41	5.71	13.89	7.77	14.00	4.39	8.26
Sharpe Ratio	1.57	0.58	1.41	1.63	1.52	1.26	2.27	1.49
Best Monthly Return	7.65	11.44	5.15	10.93	7.65	9.78	3.58	8.24
Worst Monthly Return	-8.70	-14.46	-3.89	-7.99	-8.70	-14.46	-1.56	-3.31
Max Drawdown Return	-11.42	-44.73	-8.97	-16.26	-11.42	-15.37	-2.35	-4.71
Alpha %	7.74	0.00	**-0.05**	0.00	5.51	0.00	5.19	0.00
Beta	0.33	1.00	0.36	1.00	0.36	1.00	0.39	1.00
R-Squared %	46.51	100.00	**75.73**	100.00	41.31	100.00	51.88	100.00
Up Market Capture Ratio %	59.45	100.00	34.42	100.00	50.50	100.00	62.71	100.00
Down Market Capture Ratio %	13.93	100.00	39.01	100.00	16.84	100.00	15.06	100.00

Source: Hedge Fund Research and Standard & Poors

Glossary

Absolute return: The return that an asset achieves over a certain period of time. This measure looks at the appreciation or depreciation (expressed as a percentage) that an asset – usually a stock or a mutual fund – achieves over a given period of time. Absolute return differs from relative return because it is concerned with the return of a particular asset and does not compare it to any other measure or benchmark.

Beta: A measure of the volatility, or systematic risk, of a security in comparison to the market as a whole.

Up market capture ratio: The up market capture ratio is used to evaluate how well an investment manager performed relative to an index during periods when that index has risen.

Down market capture ratio: The down market capture ratio is used to evaluate how well or poorly an investment manager performed relative to an index during periods when that index has dropped.

Nero Patel
Senior Wealth Adviser

The Importance of Protection

Research shows that only 33% of families have some form of life cover to protect them in the event of premature death.

The reasons cited for not having sufficient cover are mainly affordability issues but also that there is a shortage of constructive advice in this area. Others are simply too busy to think about what might happen to their family as people fall into the monotony of routines, stress at work and financial battles.

According to one life insurance provider, a typical family could survive financially for just 18 days if it lost its normal sources of income and had to live on savings.

Protection by way of a life insurance policy is a precautionary measure that will offer you peace of mind that sufficient funds would be available to take care of your family and debts in the event of your death.

There are different types of cover available that cater for different needs, such as the repayment of a mortgage, settling an Inheritance Tax (IHT) liability or providing regular income to a surviving spouse to pay for their lifestyle.

Further information on these methods of protection are detailed as follows:

Term Assurance
This type of policy is often used to pay off the mortgage in a lump sum and is especially important if your children or partner depend on your income to cover the mortgage. The term of the cover usually coincides with the length of the mortgage. It is possible to reduce the cover each year in line with the outstanding mortgage if this has been structured on a repayment basis, this is known as decreasing term assurance. Decreasing term assurance costs less due to the reducing level of cover payable over the selected term.

Whole of Life Insurance
Whole of life insurance is designed to provide cover for an individual's life and pay out a lump sum on death. Whole of life differs from term assurance as term assurance is only taken out over a certain amount of years, whereas with whole of life insurance your beneficiaries are guaranteed a cash sum regardless of when death occurs.

This type of policy is often used to cover a potential Inheritance Tax (IHT) liability. The policy is written in trust for the beneficiaries of the estate. Many insurance companies offer a policy where both the level of cover and the premium are guaranteed, which offers peace of mind that the amount of the insurance will not decrease, or premiums increase, due to changing market circumstances.

Whilst whole of life insurance is naturally more expensive than a term assurance, it does offer significant value over the long term.

The below figures illustrate the monthly cost for guaranteed cover:

Amount	£250,000	£500,000	£750,000	£1,000,000
Age				
40	£128.67	£249.79	£373.44	£497.09
45	£163.01	£317.10	£474.41	£631.71
50	£206.43	£402.20	£602.04	£801.89
55	£269.89	£526.58	£788.63	£1,050.67
60	£347.18	£678.08	£1,015.87	£1,353.66
65	£498.13	£973.94	£1,459.66	£1,945.39

*male, non-smoker in normal good health (source Pru Protect). For illustrative purposes only.

A male aged 55 who is accepted for standard cover would expect to pay £526pm for £500,000 of cover. This cover would pay out immediately on death at any time. If death occurred at age 95, it would have cost £252,480 in premiums in return for £500,000 of cover.

Where producing a fund for covering an IHT liability is concerned, typically the policy is set up on a joint life basis, where the policy pays out on the death of the survivor of a married couple, i.e. when the IHT liability arises. It is important to ensure the policy is written into a suitable trust. An example of cover for a premium of £3,000 per annum has been selected as it is the equivalent to one person's annual gift exemption allowance, many clients use this structure as part of their 'giving strategy'.

The below table demonstrates the amount paid out to dependents upon second death assuming a £3,000 per annum premium has been paid and candidates accepted at ordinary rates as non-smokers.

Age	Sum Assured
40	£476,033
45	£390,666
50	£339,234
55	£286,945
60	£227,758
65	£166,536

Source: IRESS

Family Income Benefit

This type of cover is becoming increasingly popular for those looking to protect their families in the event of the breadwinner's demise, as the cost of living continues to increase. The policy is set out over a term which will normally finish when the youngest child is 18-25 when they may no longer be financially dependent. This benefit is paid as a tax-free monthly benefit, rather than a lump sum, and this typically covers school fees and general lifestyle expenses.

The costs for family income benefit are quite reasonable as the cover is another form of temporary assurance. For example, a couple aged 40 with two young children could secure cover of £7,500 per month tax-free over the next 15 years when the youngest child would be aged 23, at a fixed premium of £80pm. The policy would pay out the tax-free income, in the event of first death, to the surviving spouse for the remainder of the term.

With all protection arrangements it is important to seek advice for the best rate and to secure cover as early as possible. The cost increases with age and is based on an individual's health at the time of application. Some providers offer the ability to reduce the monthly premiums by leading a healthy lifestyle.

Canaccord Genuity Wealth Management's Financial Planning Service can offer an assessment service, subject to the acceptance of our Terms of Business, to ensure that clients are sufficiently insured. To find out more about this service please contact your wealth adviser.

> “A typical family could survive financially for just 18 days if it lost its normal sources of income and had to live on savings.”

Nicolas Maunder
Hedge Fund Analyst

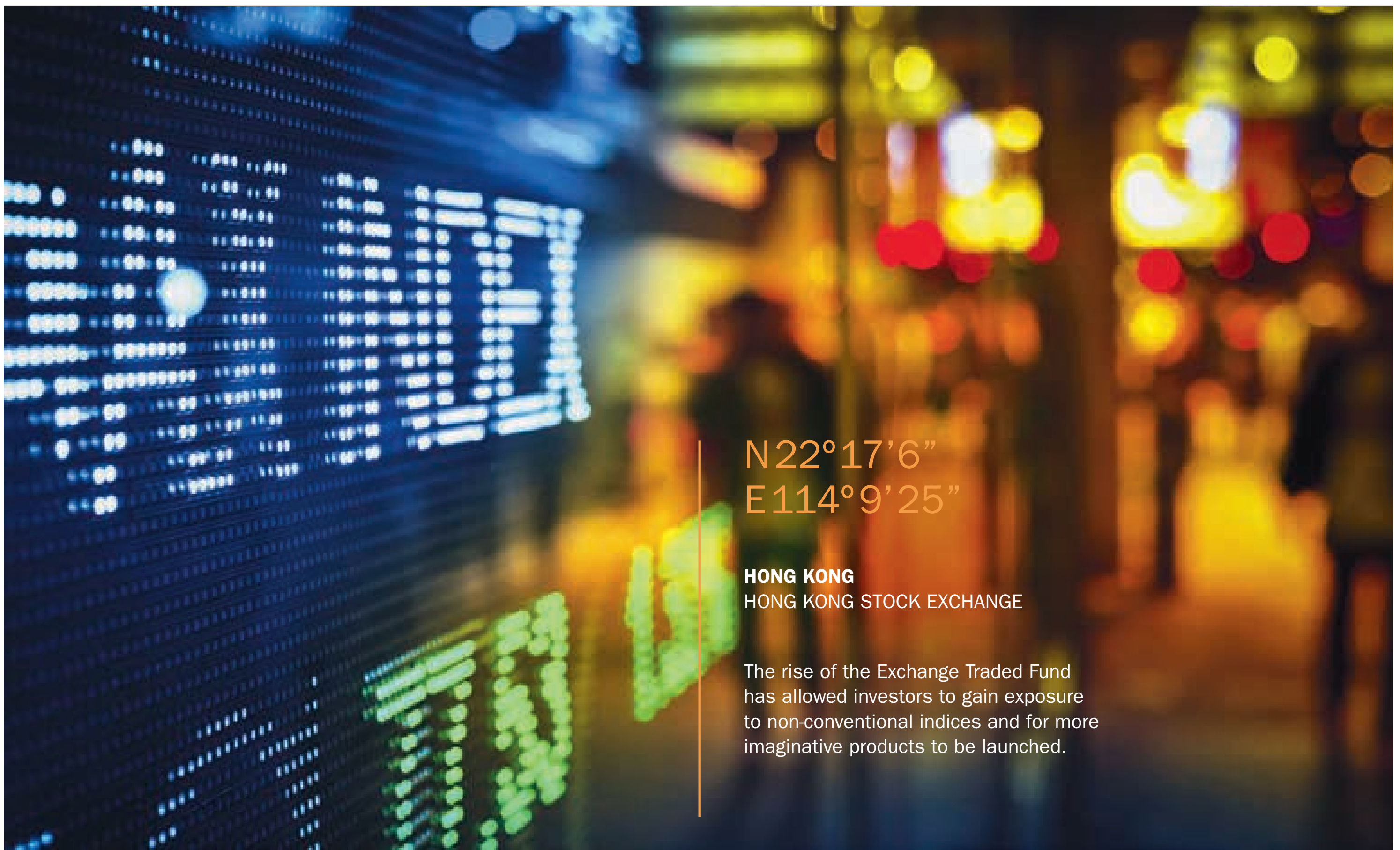
Smart Beta, What Does it Mean, and is it That Smart?

"Smart Beta" is a relatively new term generally used to describe any product which tracks a non-market capitalisation weighted index, such as an ETF.

What constitutes a Smart Beta product is still being debated and the only thing people within the industry can agree on is that no-one is fond of the name. Like the term "Newcits", which was initially coined for absolute return funds using a UCITS structure, it will probably survive for a while however.

Constructing indices using methods other than market capitalisation has been around for many years, but it is the rise of Exchange Traded Funds (ETFs) which has allowed investors to gain exposure to non-conventional indices and for more imaginative products to be launched. With many industry participants seeing this as a growth area for ETFs, a whole host of new products may well appear in the months and years to come.

The problem with the term "Smart Beta", is that it implies the traditional indices which use market capitalisation are inferior. This is simply not the case; they simply provide different exposure. The Guggenheim S&P 500 Equal Weight ETF, launched in 2003, has attracted assets of $8.7billion and has outperformed the S&P 500 Index since launch.



However, it simply replaces one bias with another; the Guggenheim ETF has a bias towards mid-cap, rather than mega-cap stocks, and this size bias has proven rewarding since launch. This does not necessarily mean it will do so in the future.

Smart Beta has moved far beyond equal weighted and dividend focused indices to now include fundamentally weighted factors, risk measures, indices that exploit market anomalies and more. Fundamentally, weighted indices select and weight constituents according to a number of metrics such as price to book, sales growth, price to cash flow and return on assets. There has also been growth in products which group stocks based on particular equity characteristics such as low beta, size, value, momentum and quality. A recent ETF launch seeks to benefit from the "month-end effect"; a theory that equity markets are stronger near month-end. In order to exploit this anomaly the product uses leverage to increase its exposure going into month-end with the aim of generating higher returns.

While Smart Beta ETFs will not be for everyone and "Smart" is not in our view the correct word to describe them, they can provide easy access to opportunities which were not so accessible, or allow an investor to tilt their portfolio in a desired direction. Not all of these innovative products will succeed and therefore investors should only incorporate those whose selection and weighting criteria makes sense and provides the desired exposure. Undoubtedly most Smart Beta products will demonstrate good performance track records when tested historically; you will rarely see a bad back test as these ideas do not make it to market. Therefore investors should remember the golden rule – past performance is not necessarily indicative of future results.

Robert Pickford
Senior Investment Manager

ITV

ITV is an integrated producer broadcaster, operating the largest commercial family of channels in the UK. Alongside the main ITV channel they operate numerous digital channels (e.g. ITV2, 3 and 4). The company will shortly launch a new free to air lifestyle and reality channel, ITVBe. In addition to traditional broadcasting, the company delivers content on demand through various platforms, both directly and via ITV player. Through ITV Studios, the Group's international content business, the company produces programmes for both their own channels and third parties in the UK and overseas.

When Adam Crozier became CEO in 2010, ITV was an incumbent struggling to deal with a rapidly changing environment. He quickly introduced a 5 year plan to deal with the structural pressures on its advertising dependent model. He wanted to create a lean, creatively dynamic and fit for purpose organisation that could maximise audience share, drive new revenue streams and build a strong international content business.

The company is in a much better position now than it was in 2010. Leaner certainly, with headcount cuts, margin expansion and material cost reduction. The balance sheet has been rebuilt and is unrecognisable compared to the horror it was in 2009. "Creatively dynamic" and "fit for purpose" are subjective metrics, although ITV Studios revenue is certainly higher. New revenue streams are also gaining traction, albeit still a relatively small part of the business.

ITV Studios is growing in importance but advertising momentum is still the key driver for the company in the short term. The outlook is bright with forecasters predicting another strong year for advertising growth. As ever there are risks, with advertising being driven by the UK economy and indeed the consumer sector, which can be volatile and unpredictable.

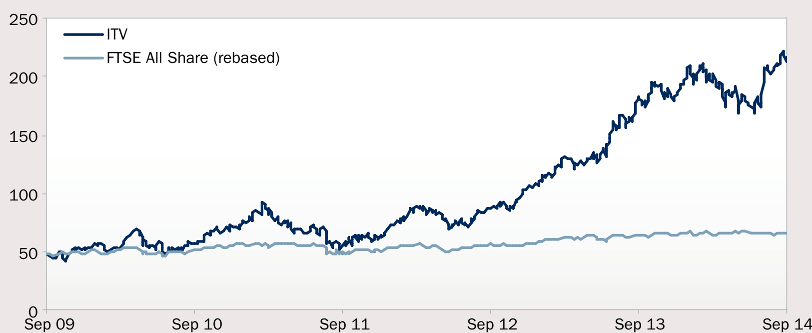
Despite advertising's importance, to ignore the value of the growing content side of the business would be foolish. Industry dynamics are shifting power to the producers and owners of quality content, a trend that should continue. The production business will not only diversify revenue streams (30% revenues in 2013) but also help protect and grow market share.

Recent corporate activity at ITV has seen Liberty Global, owner of Virgin Media, acquire BSkyB's 6.4% stake in the company. Liberty's future plan will become apparent over time but the appeal of a full takeover offer of ITV is clear with tax, cost and revenue synergies as well as strategic benefits. Add in retransmission fees and there are two additional catalysts to an already strong fundamental case.

Capital discipline remains strong and the guidance to grow the dividend by more than 20% per annum over the next 3 years is a clear positive and leaves room for more special dividends and bolt on acquisitions. Despite recent share price performance the superb and steadily improving returns profile along with commitment to value creation, suggests further upside.

ITV	
Price	209.2p
12 month high/low	222p/169.5p
Market capitalisation	£8421m
P/E (prospective)	16.0x
Dividend yield (historic)*	3.17%
Dividend cover	2.3x
XD date	30 Oct 14
Net debt	£-164m
EPIC code	ITV

All data as at 17 September 2014. *Net of the 10%, non-reclaimable, dividend tax credit.
Past performance is not a necessarily guide to future returns.



Source: Datastream, Bloomberg

William Lamond
Senior Investment Manager

AMEC

AMEC is a geographically diversified supplier of consultancy, engineering and project management services to the world's natural resources, nuclear, clean energy, water and environmental sectors. The business is divided into 4 divisions; Oil & Gas (50% of revenues), Clean Energy (24% of revenues), Environmental & Infrastructure (14% of revenues) and Mining (12% of revenues).

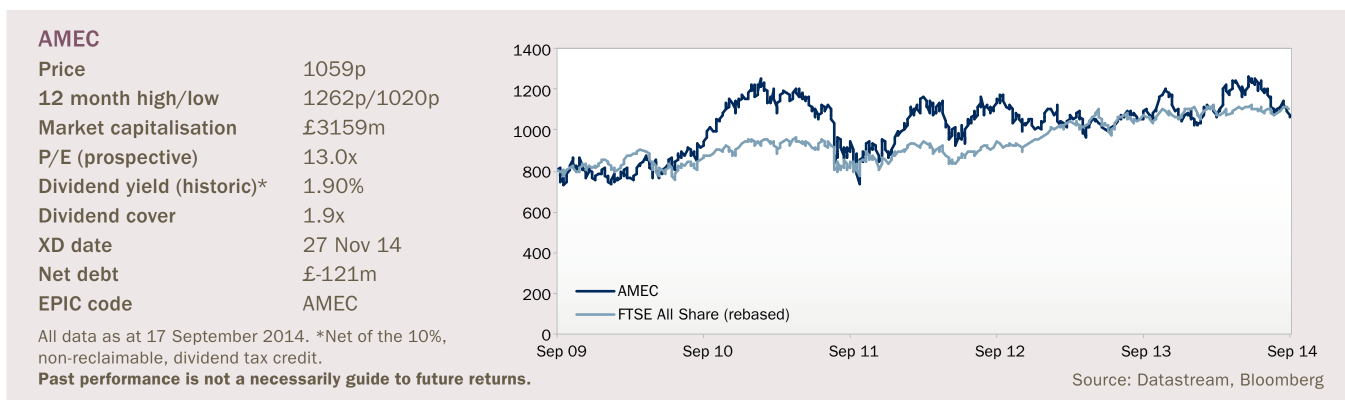
The company operates in sectors with high barriers to entry and exposure to long term growth markets. The business is well diversified both geographically and divisionally with increasing income derived from services provided to utilities. Management has a strong record of managing the business which has been reflected in significant earnings per share growth (28% Compound Annual Growth Rate) over the last 7 years. This has also led to strong cash generation, which in part has been returned to shareholders through dividends and share buy backs.

AMEC is on the cusp of acquiring Foster Wheeler (with completion expected in early Q4 2014). Foster Wheeler is a leading US engineering and construction firm. It focuses its offering to downstream oil and gas engineering, as well as possessing extensive upstream capabilities. It also has a steam generator business. This acquisition will transform the company in terms of earnings as well as further diversify AMEC's revenue stream. When complete, AMEC will be able to leverage Foster Wheeler's scale in certain growth markets, particularly the Middle East, where AMEC is currently lacking, which should enable it to increase profit margins. AMEC will also gain exposure to the fast growing US downstream market, producers of petrol, fibres, plastics etc, as well as adding LNG (Liquefied Natural Gas) capabilities. This should lead to significant generation of revenue synergies in the medium term.

Management has prepared for cost synergies from the acquisition of US$75m by 2017, with an upfront cost of US$60m. The market has viewed this target as conservative, with many analysts believing the total cost savings to be more than double this figure. These cost savings, however small, will lead to further expansion in the joint entities operating margin which should significantly improve the bottom line.

AMEC is currently trading on 13x 2014 and 10x 2015 expected earnings* as a standalone business, which is not a demanding multiple for such a quality business. With the acquisition of Foster Wheeler and the potential cost and revenue synergies that this will bring, it is easy to see significant earnings growth in the medium term, which should lead to strong appreciation in the company's share price.

*Source: Canaccord Quest™ our proprietary valuation and analytical tool which combines consensus market figures with the Quest™ Discounted Cash Flow (DCF) valuation model.



AMEC	
Price	1059p
12 month high/low	1262p/1020p
Market capitalisation	£3159m
P/E (prospective)	13.0x
Dividend yield (historic)*	1.90%
Dividend cover	1.9x
XD date	27 Nov 14
Net debt	£-121m
EPIC code	AMEC

All data as at 17 September 2014. *Net of the 10%, non-reclaimable, dividend tax credit.
Past performance is not a necessarily guide to future returns.

Source: Datastream, Bloomberg

Barratt Developments

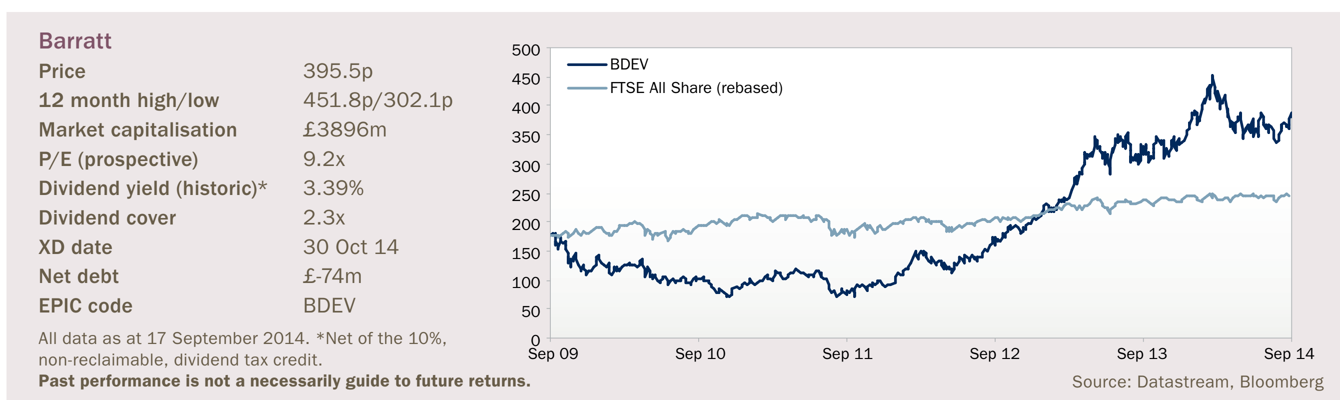
Simon McGarry
Senior Equity Analyst

Barratt Developments is one of the largest UK house builders and specialises in traditional housing, apartments, urban regeneration as well as commercial property development. The company has come a long way from the depths of the financial crisis when it wrote down £500m in land and was forced into a £720m rights issue to reduce the net debt which stood at £1.3bn. Fast forward four years and UK house builders are a far cry from the leveraged horrors that nearly went bust in the financial crisis with year-end net cash of £70m compared to net debt of £26m a year earlier.

Today, the UK house building industry appears in good health. Customer credit continues to improve as mortgage lending becomes increasingly diversified. Since the start of this year NatWest, Santander, Woolwich and Leeds Building Society have increased lending and taken substantial market share from Lloyds and Nationwide. Savills suggests that by 2019 there could be a 160,000 shortfall in new homes in the south of England alone. Analysis from the Bank of England indicates that housing is more affordable now than in the run-up to the crisis. Add to this that the UK house building industry has become increasingly difficult for small private builders to compete against companies like Barratt given their high reliance on structured finance which isn't as readily available as in the past.

In September, Barratt delivered an upbeat annual report. They expect to build over 15,000 homes this year up from 12,500 last year. Quality land remains in good supply having acquired over 21,000 plots last year bringing their total land bank to 4.5 years of supply. This land should help drive a significant increase in profitability and returns well into the future. They have already achieved a number of their 2016 targets including an 18% return on capital employed, minimal year end net debt and 3x dividend cover. As a result they have revised upwards a number of their targets for 2017. By 2017 they expect a gross margin of 20%, return on capital employed of 25% and zero year-end net debt. They also announced a special capital return plan whereby they will return £950m to shareholders by November 2017. This equates to 96p per share or 25% of the current share price.

Despite attempts to moderate excessive lending with the introduction of the mortgage market review in April coupled with higher capital requirements the market remains resilient. In 2015 management expect strong performance across all regions to continue with a modest increase in build costs and for the land market to remain positive. Given the current environment we find it puzzling at how cheap the shares trade on a variety of valuation metrics most notably the 12-month forward price earnings ratio of just 9x. House building is undoubtedly an extremely cyclical market with forecasts beyond 2017 difficult to predict. However, we believe that this recovery in UK house building is sustainable in the medium term and that they are extremely well placed to benefit. Consequently Barratt appears to offer an attractive investment proposition.



Barratt	
Price	395.5p
12 month high/low	451.8p/302.1p
Market capitalisation	£3896m
P/E (prospective)	9.2x
Dividend yield (historic)*	3.39%
Dividend cover	2.3x
XD date	30 Oct 14
Net debt	£-74m
EPIC code	BDEV

All data as at 17 September 2014. *Net of the 10%, non-reclaimable, dividend tax credit.
Past performance is not a necessarily guide to future returns.

Source: Datastream, Bloomberg

Harley-Davidson

Marc Pullen
Senior Equity Analyst

Harley-Davidson manufactures the iconic heavyweight (651cc and above) Harley-Davidson motorcycles.

In July Harley's Q2 results surprised the market with a worse than expected downward revision of its sales forecasts for this year, although motorcycle sales are still expected to be above last year's level. The company blamed the poor weather in the early part of the year and timing issues with the launch of new models, nevertheless the market was clearly spooked with the shares falling 5% on the day.

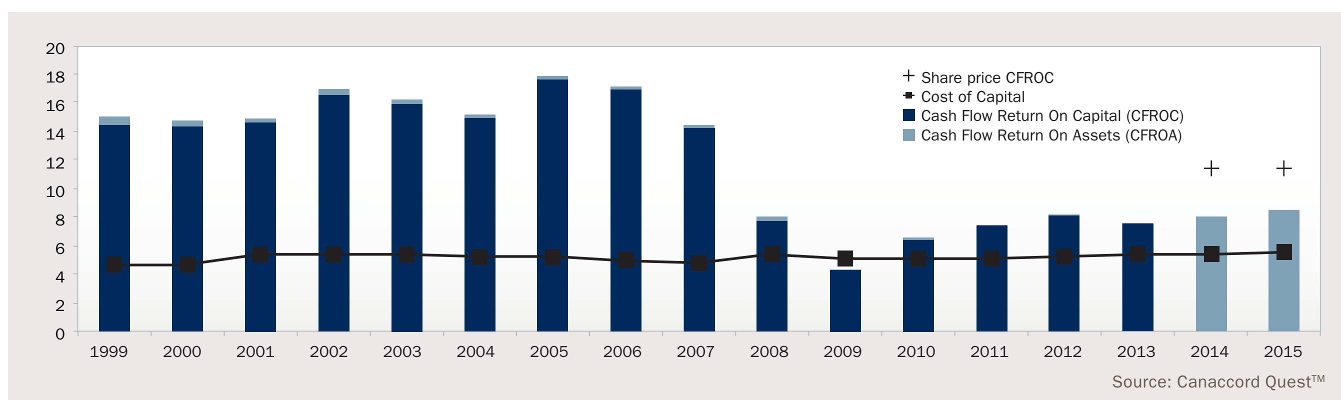
Like many companies, Harley saw both sales growth and profit margins collapse during the 2008 crisis, however, whilst profit margins have largely recovered, sales (in spite of decent growth over the last 5 years) still remain significantly below pre-crisis levels. The company's Cash Flow Return on Capital (CFROC) profile provides a great overview of these events. During the 5 years leading up to the crisis Harley's CFROC averaged 16.4%, but by 2009 this had collapsed to 4.3%, and whilst the rate of CFROC had recovered to 7.5% by 2013, this is still nearly 9 percentage points below the pre-crisis average.

In many ways Harley has done the easy bit in terms of increasing its CFROC from the crisis lows, in as much as the process has been within its control. Between 2009-2013, the company implemented a successful restructuring program that saw the fixed cost portion of total motorcycle manufacturing costs drop from around 20-25% to 15-20%. Going forward, any further improvement in returns will have to come from top-line growth and whilst the company does have opportunities to exploit this, it is nevertheless dependent on the wider economic environment.

On the plus side the US economy, which is Harley's most important region (generating 65% of sales) and where the company is by a long way the market leader (with a 55% market share) is clearly – if albeit slowly – recovering. Furthermore Harley has implemented an outreach program in order to engage with new younger customers. In Europe, which accounts for around half of Harley's international sales, the company has seen a steady increase in its market share over the last 5 years and it is now the number two player in the region. With a market share of just 13%, Europe remains a significant opportunity.

On the minus side, Harley's core target market – middle aged white males – is on the decline, as the baby boom generation heads off into the sunset. Furthermore there is the perennial Japanese competition that brought the company to its knees in the 80's, although this time around there is the additional threat from the resurgent Indian and Triumph brands.

On balance we remain positive on the company, believing that a leaner and meaner Harley should be able to benefit from the benign macro outlook in the US and its growing market share in Europe.



Source: Canaccord Quest™

Dean Whitty
Portfolio Manager

GlaxoSmithKline

GlaxoSmithKline (GSK) is a British multinational research-based pharmaceutical company. It develops, manufactures, and markets vaccines, prescriptions, and over-the-counter medicines, as well as health-related consumer products.

GSK manufactures drugs and vaccines for major disease areas such as asthma, cancer, infections, diabetes, digestive and mental health conditions.

The business is focused around the delivery of three strategic priorities which aim to increase growth, reduce risk and improve long-term financial performance. These priorities are: grow a diversified global business, deliver more products of value, and simplify the operating model.

GSK's share price has been as high as 1690p this year but fell to below 1380p in early August following on from disappointing second quarter results reported at the end of July.

The fall was mostly due to the figures reported by CEO Andrew Witty. He talked shareholders through the numbers which included a 4% shortfall in the topline growth and 14% decline in revenue and sales in respiratory (including new and old drugs). In addition, GSK lowered share buyback expectations from previous guidance of between £1-2bn of repurchases. They also attributed a 5% sales decline in the consumer division due to manufacturing interruptions in both Wellness and Oral health divisions which they now see as ending the year broadly flat. Overall, expectations for 2014 were dampened with Witty stating – "it is unlikely we will deliver sales growth this year".

The negative sentiment surrounding GSK following these results was not helped by the on-going bribery allegations from China and a general concern over the sustainability of the dividend.

The biggest disappointment in the results was the reduction in market share and pricing of their most profitable asset, Advair, which treats asthma. Whilst there is not yet an available generic replacement, the 20% reduction in sales was not anticipated.

So what's next for GSK and Andrew Witty?

Diversification has to be a key driver for GSK and Mr Witty has already begun to address that. He has been successful in agreeing a 3-part

transaction deal with Novartis which should complete in 2015 in which GSK will:

- With Novartis, create a new consumer healthcare business with 2013 pro-forma revenues of £6.5bn. GSK will have majority control with a 63.5% equity stake.
- Sell its oncology portfolio to Novartis for an aggregate cash consideration of £9.8bn.
- Acquire Novartis' global vaccine business excluding influenza vaccines for an initial cash consideration of £3.1bn.

The swapping of assets has also allowed GSK to announce a £4bn capital return funded by net cash transaction proceeds, expected to be delivered via a B-share scheme.

Upon completion of this deal, we expect future growth to be more stable and predictable due to the diversification of revenues (70% will be derived from respiratory, consumer, vaccines and HIV collaboration).

Respiratory still accounts for 25% of total revenues and there is uncertainty lingering over the stability of GSK's respiratory franchise as well as limited visibility on the outlook for markets especially as competition is heating up. However, following completion of the Novartis deal, we would expect this reliance to be somewhat reduced. The decline in Advair could be offset by the recent news that it has been restored to Express Scripts' covered list for 2015, the largest pharmacy benefit management company in the US.

Many investors are attracted to GSK due to its healthy dividend of just under 6% which is the biggest of the large-cap pharmaceutical companies. As mentioned, there is some concern around a reduction of the dividend, however, management has committed to prioritising this. With a free cash flow yield of 5.8% forecast over the next 12 months (vs a sector average of 5.4%*) we believe that the risk of a reduction is limited.

With regards to cash flow, GSK has put a portfolio of mature drugs up for sale that is now in the second stage of bidding. This portfolio has been valued at approximately £2.0bn and they could use this cash for buybacks or to support the dividend cover.

From a valuation stance GSK is trading on a forward P/E ratio of 15.0x and therefore at a discount to its peers who are on an average of 17.5x.

We believe that the discount to the sector does not account for the new drug pipeline, which includes 15 products entering or exiting phase III testing, reduced reliance on respiratory following the Novartis deal and a potential to increase share buy-backs with the sale of a portfolio of mature drugs.

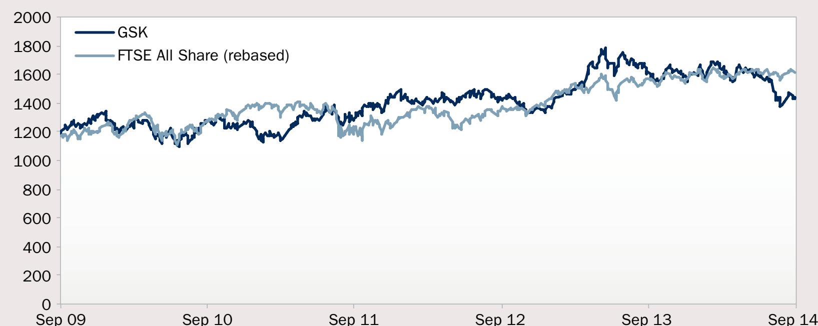
We therefore currently hold GlaxoSmithKline within portfolios as we believe it to be a good company with solid financials which the market has discounted due to short-term issues.

*Source: Canaccord Quest™ our proprietary valuation and analytical tool which combines consensus market figures with the Quest™ Discounted Cash Flow (DCF) valuation model.

GlaxoSmithKline (GSK)

Price	1422.0p
12 month high/low	1690.5p/1377p
Market capitalisation	£68961m
P/E (prospective)	15.0x
Dividend yield (historic)*	5.07%
Dividend cover	1.2x
XD date	06 Nov 14
Net debt	£12645m
EPIC code	GSK

All data as at 17 September 2014. *Net of the 10%, non-reclaimable, dividend tax credit.
Past performance is not a necessarily guide to future returns.



Source: Datastream, Bloomberg

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