

# CREDO NEWS

Issue 22

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Message from the CEO | Roy Ettlinger | [@Ettlinger\\_Credo](#)

# When should one start becoming greedy?

As China ushers in the year of the Monkey, investors will be wishing it really is out with the old and in with the new.

It has certainly been a trying start to the year. At the time of writing, we have endured the worst start on record with both the FTSE 100 and S&P 500 down over 10%, the Nikkei down 15%, and the Shanghai Composite Index down over 20%.

Away from the financial markets, the situation is much the same. The civil war in Syria is now in its fifth year; the recent entrance of Russia on the side of Bashar al-Assad adding fuel to the flames of anarchy. Together with the many regional conflicts across the Middle East, this has resulted in the displacement of many millions of innocent people, many of whom have resorted to taking extraordinary risks to try and get themselves and their families to safety in order to start a new life.

This mass migration to Europe – the largest since the Second World War – looks set to be the deciding factor in the “Brexit” referendum, which is expected to be held on June 23rd. As things stand, “Brexit” is the ultimate known unknown; what

the British people will vote for, and the consequences of that choice are the unknown unknowns.

And just to add a few more ingredients to this cauldron of uncertainty, consider the slowing of Chinese growth to only 6.5% (can the numbers be believed?), the emerging market currency crisis, the commodity bust, and negative interest rates, to name but a few of the major concerns afflicting financial markets today.

**Talk about uncertainty – no wonder markets are reacting as they are!**

At Credo, we remain of the opinion that interest rates, certainly in the developed world, will continue to remain lower for longer. This may well mean investors requiring income will be forced to look elsewhere as banks and money market funds no longer cater to their needs.

Baron Rothschild is credited with saying that **“the time to buy is when there’s blood in the streets”**. He should know – Rothschild made a fortune buying in the panic that followed the Battle of Waterloo.

But that’s not the whole story: the original quote is believed to be **“buy when there’s blood in the streets, even if the blood is your own”**.

This is contrarian investing at its heart: the strongly-held belief that the worse things seem in the market, the better the opportunities are for profit.

Contrarian investors have historically made their best investments during times of market turmoil. In the crash of 1987, the Dow dropped 22% in one day. In the 1973-74 bear market, the market lost 45% in about 22 months. The market also dropped following the attacks of September 11th, 2001. The list goes on, but these are times when contrarians found the ripest of opportunities.

The current turmoil, both geopolitically and in the financial markets, certainly makes our previous mantra of **“Keep Calm and Carry On”** extraordinarily difficult. However, Warren Buffett’s famous quote **“Be Fearful When Others Are Greedy and Greedy When Others Are Fearful”** immediately springs to mind. Perhaps the question to ask is now: **“when should one start becoming greedy?”** ■





# There is no crystal ball



Barely a month into 2016, and already it feels like a tumultuous year in global markets. In just the first five trading days of January, for example, US stock indices declined by some 6%, thereby registering their worst first week of the year since records began. Seven days later, another record: year-to-date, the market was down 8%; the worst two week start in history.

Markets across the board were affected, and none more so than China where circuit-breakers triggered a suspension in trading on two consecutive days in the first week of the year, following 7% falls in the country's main index. Soon after, the circuit-breaker system itself was suspended. Volatility continues.

Further fuel was added to the fire with strategists and analysts publishing bearish outlook pieces. In particular, the recent "Sell Everything" note by Andrew Roberts (head of European Economics at Royal Bank of Scotland) attracted a lot of attention. According to the note, the only financial asset that Roberts would buy is high quality government bonds, "*which are cheap*", according to him (even though it is hard to find any sovereign in the UK or continental Europe that yields anything at present, with the exception of longer dated bonds). Roberts ends off his overview with a warning:

*"In a crowded hall,  
exit doors are small.  
Risks are high."*

What to do in the face of this kind of scaremongering? One of the first things to bear in mind, is that no-one really knows exactly how markets will play out; there is not one investor or strategist out there who has perfect foresight.

This last point was eloquently illustrated in a recent article by Tim Harford (author of, inter alia, *The Undercover Economist*) focusing on Phil McNulty, chief football writer for the BBC. In December 2015, McNulty offered his predictions for the rest of the English Premier League season – the kind of thing that pundits do all the time.

As a starting point, Harford first reminds us of McNulty's most recent set of forecasts, a short four



months earlier (when the current season started). At the time, the BBC's man predicted that previous league champions Chelsea would come out on top again, and that Leicester would be relegated at the end of the season - an outcome which seemed totally reasonable at the time but which is now inconceivable (based on how both these teams have performed in the season to date).

Why on earth should we therefore care about McNulty's updated set of predictions, Harford rightly asks?

Harford then continues to analyse our fixation on forecasting. One of the reasons that we keep on trying to see into the future, he postulates, is that forecasts *"offer us a lazy way to understand a complex world... it's a simple way to convey a fleeting sense of understanding"*. As Harford rightly concludes: *"The forecast will probably be wrong. But at the instant it is consumed, it gratifies."*

Tim Harford's insights apply not only to sports punditry. They are valid in all walks of life, including financial markets. When considering Andrew Roberts and his *"Sell Everything"* prognosis, for example, it is perhaps worthwhile to note that the same analyst has been predicting disaster consistently for at least the past five years. In June 2010, for example, he was quoted as saying: *"We cannot stress enough how strongly we believe that a cliff-edge may be around the corner, for the global banking system (particularly in Europe) and for the global economy. Think the unthinkable."*

As pointed out in *The Spectator*, *"the unthinkable in that case turned out to be that, contrary to the Cassandras' warning of a double dip recession, it didn't happen"*. Furthermore, if one had listened to the RBS analyst in 2010 and sold out of share portfolios, you would be licking your wounds: equity markets have approximately doubled since then (even taking into account the recent sell-off).

It should be stressed that I am NOT trying to fall into the trap of making my own predictions here (by suggesting that someone like Andrew Roberts will necessarily be wrong in his bearish pronouncements). All I am saying is that there is nobody in the world who has a crystal ball, no matter how rich and famous he or she is.

It is of course true that the market has experienced a start to the year which is unprecedented, and as a consequence it is totally understandable that many people will react with apprehension if not trepidation when they look at their portfolios and try to come to grips with overall valuations that are lower than a few weeks ago. But, as Howard Marks (founder and co-chairman of Oaktree Capital) said in his most recent memo to clients (quoting Ben Graham): *"the day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment. You just can't take it too seriously."*

Who knows exactly what the market has in store for the rest of the year. As mentioned before, the 8% decline in the first two weeks is an all-time record, but it's interesting to note

that after the second worst start in history (i.e. minus 6.6% in the first two weeks of 2009), the market actually yielded a positive return amounting to no less than 32.5% over the rest of the 2009 calendar year.

Regardless of financial market conditions, there will always be opportunities for astute market participants to find quality assets at reasonable valuations. In fact, one can argue that some market weakness is of course healthy, as it leads to a number of attractive buying opportunities. Contrast this with an environment where most securities are *"priced for perfection"*... the signs of which have been around for some time now.

In his *"Sell Everything"* note, Andrew Roberts warns us that the exit doors are small. My response would be that it shouldn't matter. Speaking for myself, I'm not going anywhere in a hurry. It's been proven time and time again that the most rational approach is to stay invested with a focus on the long-term, rather than panicking at the bottom and missing out on the next upswing as a consequence.

In closing, I take heart from a line in a recent article by Morgan Housel who writes for the *Motley Fool*. I could not say it better myself:

*"The past wasn't as good as you remember, the present isn't as bad as you think, and the future will be better than you anticipate."* ■



Alan Noik - MD | [@AlanNoik\\_Credo](#)

# GLOBAL EQUITY FUND

Following the success of the Best Ideas Portfolio (BIP) and the Dividend Growth Portfolio (DGP) in providing global equity exposure to Credo clients over the past few years, we are excited to announce the imminent launch of the Credo Global Equity Fund (CGEF).

The CGEF will essentially combine the "best of both worlds" in that a substantial portion of it will overlap with existing stocks included in BIP and DGP.

## Background

In April 2011, Credo launched the BIP – a managed portfolio solution focusing on a limited number of global stocks acquired in accordance with a long term, low turnover, value orientated investment philosophy. The portfolio has owned a maximum of 20 different stocks (equally weighted, at time of purchase) at any given point in time.

In December 2012, the strategy was replicated in the DGP, with a greater focus on yield. Whilst

this portfolio has been managed with a similar 20 stock limit in place, there has always been considerable overlap with BIP, given that both portfolios are based on the same investment philosophy and approach. Accordingly, the total number of unique stocks across the two managed portfolio solutions has never been more than a total of 28 at any given point in time.

We are pleased to report that both BIP and DGP have enjoyed very satisfactory investment performance over time, in both absolute and relative terms – as reflected in the table below:

Cumulative Total Return (GBP)	12 Months to 31/01/2016	Since Inception
Best Ideas Portfolio	1.6%	58.3%
MSCI World	0.2%	47.4%
Outperformance	1.3%	10.8%

Cumulative Total Return (GBP)	12 Months to 31/01/2016	Since Inception
Dividend Growth Portfolio	11.1%	51.0%
MSCI World	0.2%	40.2%
Outperformance	10.9%	10.7%

## Going forward

Once the CGEF is launched, clients of Credo requiring equity exposure will have a choice between, on the one hand, our new mutual fund and, on the other, the existing managed portfolio solutions (BIP & DGP).

Depending on the specifics of client circumstances, the CGEF may present certain tax advantages over the managed portfolio solutions, given that capital gains will typically only incur tax liabilities upon exiting the fund (and not every time an underlying security is sold). It is recommended that clients who are uncertain

*“We have a highly experienced investment team lead by our CIO, Deon Gouws, and are confident that we can deliver long-term, above-market returns for our investors, through careful stock selection and portfolio construction”.*

of the tax consequences obtain specialist advice in this regard.

### Portfolio construction

As mentioned above, a substantial portion of the new CGEF will overlap with existing stocks included in BIP and DGP.

In addition, investors can also expect to see some of the names included in the Credo Special Opportunities Portfolio. This solution, selected over the last 18 months, consists of a limited number of stocks with a somewhat higher risk/reward profile, as compared to the BIP and DGP, which tend to focus on more “blue chip” names.

The one key difference between exposures within the fund, as compared to the managed portfolio solutions, will relate to position sizing. In BIP & DGP, we will continue to follow an equally weighted approach (with limited rebalancing), given the practicalities related to managed portfolios. In the CGEF on the

other hand, we will have the ability to express our conviction in any given stock with more accuracy; accordingly, positions will typically be “built up” incrementally over time (and “sold down”, in similar fashion, when our conviction levels eventually start to dissipate).

### Fund facts

The Fund is regulated by the Guernsey Financial Services Commission as a Class B collective investment scheme.

We have partnered with Momentum Wealth International to provide the overall Fund structure

and with Northern Trust which will act as the third party custodian and independent administrator.

Please seek advice before making a decision to invest in order to ensure that an investment in the CGEF is suitable for you.

### Key features

- Long-only equities
- No other asset class exposure
- No derivatives
- No gearing
- No hedging
- Transparent
- Diversified global equity exposure via a single investment

<b>Minimum initial investment</b>	£10,000 or \$15,000
<b>Minimum subsequent investment</b>	£1,000 or \$1,500
<b>Dealing</b>	Weekly, each Wednesday
<b>Asset management fee</b>	0.75% p.a.
<b>Number of shares</b>	30 to 40
<b>Share classes</b>	£ and \$
<b>Platforms</b>	1. Credo 2. Momentum Wealth International
<b>Auditor</b>	PWC
<b>Indicative TER</b>	1.25% (up to £25m, then reducing)





# Anatomy of the panda



Investors who are bearish on China have been given their own nickname, the Pandas. And contrary to their wildlife brethren, the population of these China bears has of late been booming. Newly minted “China experts” have been falling over themselves to explain why currency, economic and financial collapse is imminent. I am neither a Panda nor a China expert, but a simplified journey through some of the arguments might help investors avoid narratives that are based on vastly incomplete information and driven increasingly by confirmation bias.

## The impossible trinity

In 1994 the People’s Republic of China embarked on a series of fiscal and monetary reforms, following the Third Plenum from the previous year which brought focus towards a more market oriented economy.

The problem with managing a currency peg is that you run into the central bank’s trilemma – to maintain a fixed exchange rate you either have to concede control of domestic monetary policy or you have to impose capital controls. On any given day the People’s Bank of China (PBOC) must enter the market as either a buyer or seller of its currency at the targeted exchange rate. As China prospered and capital inflows put upward pressure on the yuan, the PBOC would buy USD (and accumulate USD FX reserves) with newly created currency to prevent the exchange rate from increasing – this new currency made its way into the domestic money supply, leading to a loosening of monetary conditions. Similarly when there was capital flight (via official channels,



Macau casinos, or otherwise) the PBOC would buy that exiting currency and sell USD from their reserves to relieve the downward pressure and maintain the exchange rate – removing that RMB from circulation is effectively tightening monetary conditions in the domestic economy.

The latter is what China seems to be facing today. As the dollar rises to accommodate easing from Europe, Japan and half the world (50% of countries in the MSCI AC World had rate cuts in 2015), the PBOC has had to buy RMB reserves, draining China's money supply and tightening domestic monetary conditions (onshore lending rates have remained around 4.4% whilst PPI inflation has fallen to -6%) – this all coming at a time when one could argue they should in fact be loosening: the economy is slowing due to a shift in domestic policy objectives and competitiveness is under pressure as competitors devalue (see Abenomics). China has had to shoulder the burden of the world's exported deflation. Having been dragged higher with the USD, the speculation is that the exchange rate is now significantly overvalued. And what is now mainstream belief is that the PBOC's FX reserves will be overrun by the stampede of a generation of domestic Chinese investors that were born into an era of no defaults or currency risk, now facing the prospect of both.

## Is your glass always half empty?

Today's dire global China narrative resembles the glass half empty/ glass half full quibbles we saw

when the oil price first collapsed: the same people who didn't see it coming are now banging the table either that lower oil prices are bullish through a tax cut for consumers or bearish due to pressures on commodity producers. But there is much evidence from behavioural economics that markets make opinions and not the other way around - ***the "truth" about oil or China will be determined in hindsight based on whether market prices are up or down in the interim, related or not.***

Since the end of 2014 the renminbi is down 6% versus the dollar. This compares to pound sterling and euro which are down 8.7% and 11.3% against the dollar, respectively. Is the reason investors are not equally concerned about capital flight from these countries due to careful analysis or half-truths and politically charged polemics? In the case of the Eurozone the consensus even considered a falling euro a positive ... wouldn't devaluation allow easing of monetary conditions for the Chinese consumer (as the PBOC becomes unshackled from US tightening), a more competitive export sector (as per the Eurozone consensus) and Chinese assets which will look that much cheaper for foreign investors?

Headlines extrapolating YTD trends in FX reserves put forward the scenario that at the current rate, China will have depleted its \$3 trillion war chest within 10 months. Well, if we extrapolate the performance of asset classes YTD, by the middle of December 2016 Global Equities will hit ZERO in value, and a barrel of oil will cost you -\$20.6. Sound plausible?

China's opacity and command economy has long been touted as a reason it could never succeed but now liberalisation and the introduction of market forces are viewed as a harbinger of its impending doom. But if we do see trillions in capital flight, then the flows have got to go somewhere. Not so long ago the anecdotes of Chinese money buying up London and Australian real estate were seen as bullish indicators for those assets. A wall of Chinese money looking for an international home couldn't be more of a boon for global assets.

## What is the smart money doing?

***"Paradoxically, when 'dumb' money acknowledges its limitations, it ceases to be dumb."***

Warren Buffett

Only in hindsight (if ever) will we know whether the Pandas will have their day or just become another categorisation of permabear along with the Gold Bugs and Malthusians. More likely, all of the main opinions you hear today will end up being wrong, and the outcome will involve an unknown unknown that has yet to materialise. As Buffett says, smart money knows when it doesn't know. Unless the PBOC committee and 1.3 billion Chinese savers have given you a personal guarantee of what they are going to do in the future, you have no edge on how global markets will be affected. Be the smart money - stick to what you know and can control: your risk tolerance and your portfolio diversification. ■



Ed Fincham - Investment Analyst

# The monkey and the machine

*A Chinese Parable*

According to Wu Cheng'en's classic, *Journey to the West*, the Monkey King was born from a magic stone that sat on top of a mountain. When the wind blew, the stone turned into a monkey, complete with the five senses and four limbs. As his eyes moved, two beams of golden light shot towards the Pole Star palace and startled the Jade Emperor of the Azure Vault of Heaven. In his benevolence, the Jade Emperor disregarded the disruptive monkey, saying "*creatures down below are born of the essence of heaven and earth; there is nothing remarkable about him*".

Sure enough, the Monkey King soon established himself as one of the most powerful demons in the world, usurping even the authority of Heaven. In an effort to placate him, the Jade Emperor invited the Monkey King to join the heavenly host. However, feeling slighted by his lowly task of mucking out the heavenly stables, he wrought havoc across heaven and single-handedly defeated the Jade Emperor's 100,000 strong army of celestial warriors. It was only by direct appeal to the Buddha that the mischievous Monkey King was finally subdued.

**For 2016, the disruptive monkey will no doubt prove a fitting leitmotif – especially within the financial industry – as fledgling ideas and technologies usurp the old order.** Chief among these could be the widespread adoption of machine learning models and techniques. One might be tempted to think that, given the onslaught of so-called "*robo-advisors*" over the past few years, the party is already in full swing and I'm running late. Strictly speaking, however, your average robo-advisor is little more than a rules-based process for investing and tax-loss harvesting. Machine learning is something altogether more nuanced.

For those unfamiliar with the field, the pioneer Arthur Samuel defined machine learning as the science of getting computers to act without being explicitly programmed. Though this may smack of sentience, it is nothing of the sort. For instance, when I visit Amazon and wonder how the website knew I was after a Kurt Vonnegut novel, in the background an algorithm recommended it by analysing what my most probable choice would be, given my previous searches, purchases, and those of every

other user. **It may wound our pride but, in the aggregate, our choices are quite predictable.**

The methods involved in machine learning are typically statistical in kind, and though they may match or trump human ability within a given realm, the approach to decision-making cannot be said to be the same. For instance, in 1997 when IBM'S Deep Blue famously beat Grandmaster Garry Kasparov in a game of chess, it was capable of evaluating 200 million positions per second. Though decisions may at times be made via brute force rather than shrewd understanding, **machine learning is capable of mimicking even those pursuits long deemed the preserve of the human intellect**, such as poetry. For example, in 2011 a Duke University student wrote an algorithm to generate entire poems, one of which was successfully submitted to *The Archive*, the Duke literary journal.

Within the sphere of financial services, machine learning could well run amok of the established order. Benjamin Graham wrote that "*in the short run, the market is a voting machine but in the long run it is a*

*weighing machine*". That is, although it is the real substance of a company that matters over the long-term, shorter term price movements are more due to the fickle and fleeting opinions of investors. Unfortunately, in entering a position we are at the market's whim as we have no control over the prevailing mood. But what if this could be measured?

With machine learning we can: **using a simple set of algorithms and an internet connection, we can in a moment distil a torrent of opinion, headlines, and other morsels surrounding a security into a simple metric, gauging investor sentiment.** This is no fantasy: a study by the ECB in July of last year found that a crude metric combining Twitter and Google search data containing the terms "*bullish*" and "*bearish*" can predict stock returns. However, such a rudimentary methodology would be too particular to apply to new data. Alternatively, we could use a simple machine learning classification algorithm

such as Naive Bayes (so-named since it utilises Bayes' Theorem). Conceptually, this algorithm exploits the fact that, given a known outcome, we typically know how often some particular evidence is observed. Bayes' Theorem allows us to compute the reverse: the chance of a particular outcome happening, given the present evidence. Though this may all appear rather abstract, it can be readily elucidated with a simple example.

Suppose we read 20 articles, of which we label half to be "*bullish*" and the other half "*bearish*". Given a new article the algorithm would compute, for each of these two labels, the probability that the new article is of that label. Finally, it would classify the article as the most probable label. Concretely, in identifying how likely it is that the article was "*bullish*", for each word in the new article the algorithm would multiply how often it occurs in the 10 "*bullish*" articles by the overall probability that any article is "*bullish*" (in this

case 50%, or 10 of 20 articles). **Equipped with this model, we can quickly quantify the thoughts of thousands of investors and market commentators.**

By all accounts, Naive Bayes is a very simple algorithm yet, in its various formulations, it enjoys considerable predictive power. Though a trivial example, within certain realms these tools not only usurp but obviate the need for human participation. As far as Credo is concerned, we are exploring how these tools may assist our own investment process. Like the mischievous Monkey King, machine learning may disrupt but, ultimately, it will not displace more traditional methods of securities analysis. Instead, it will augment them, providing the analyst with an unprecedented degree of clarity from the ever-increasing complexity of large scale data. Unlike the Monkey King, a foil to the disruptive power of machine learning remains to be seen. ■







Jarrod Cahn - Director

# The cure for low oil is low oil

An old trader's adage holds that "*the cure for low prices is low prices*", meaning that a weak market will clear once prices fall far enough. The sharp downward move in the price of oil over the last 8 weeks, from \$45 to under \$30, has been relentless. So what has changed?

As a major component of global oil demand, the market has grown anxious over China's slowdown; uncertainty shrouds the debate between a soft and hard landing. Accordingly, **investors are increasingly concerned as to whether the overall demand for oil will capitulate**, compounding the existing problem of an oversupplied market.

To date, we have argued that the weakness in the oil price has been driven by supply side fundamentals: shale operators in the US, a dysfunctional OPEC, Saudi overproduction, as well as continued supply by non-OPEC members such as Russia. These combined forces have led to a scramble for market share, where prices are determined by unhindered market forces.

In the wake of recent turbulence, the question is now whether the demand curve will weaken. Recent data from China, suggesting a potential slowdown in growth, has triggered widespread revisions across the market. Importantly, these are not limited to China, but are worldwide. For instance, the IMF revised global growth rates from 3.6% to 3.4%.

**In truth, it is too early to call: the data from China remains too**

**opaque, and the market remains too uncertain of the extent of the slowdown.** This time, however, no one is giving China the benefit of the doubt. Even so, the data continues to suggest that demand for oil remains intact and, as prices slide, this in itself could stimulate further demand. Net importers of oil such as Japan, China, India, Turkey, and Western Europe should be the winners. Though the net benefit of this would be mildly offset by a stronger dollar, history suggests that lower prices stimulate demand.

Turning to the supply side, oversupply has been the consistent theme of 2015 and looks set to continue well into 2016. Most surprising has been the continued resilience of shale oil in the US: although rig counts have plummeted, oil production has remained steady thanks to improved technology and falling input costs. Our belief is that these producers have remained shielded from the oil price due to hedges at viable economic rates. **Now that these hedges are expiring, it is highly unlikely that they will be able to continue producing profitably** at current oil price levels, given their marginal cost of production. In the meantime, access to capital is shrinking and cash flows will likely crumble. Accordingly, we expect to see a spike in defaults of high yield E&P debt throughout 2016. Together, these factors ought to curb production, which will likely alleviate the current oversupply suppressing the market.

Headlines have been dominated by

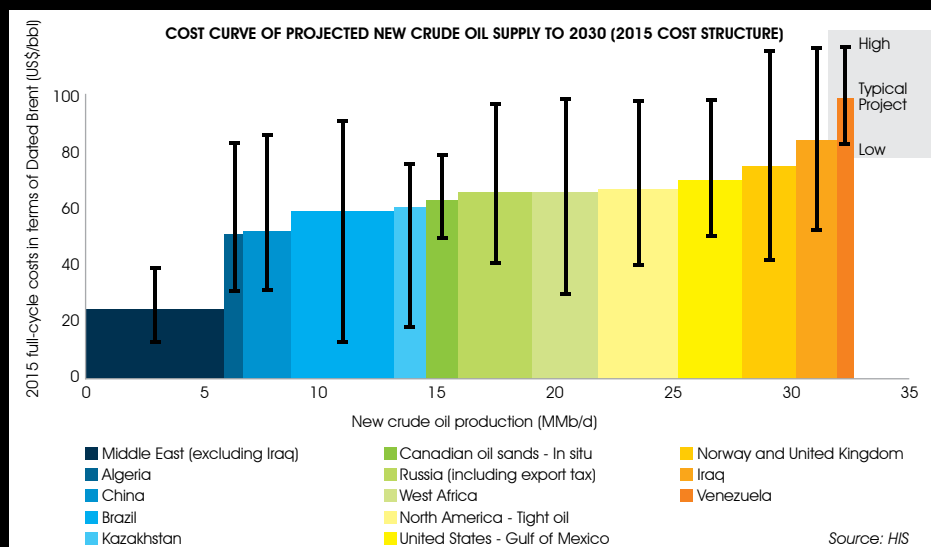
Iran's return to the fold and the effect that may have on the oil supply. At one time, Iran was the second largest producer in OPEC and the IEA forecasts they will bring 300,000 barrels per day to the market from March 2016. Iran, however, has loftier ambitions and intends to supply up to 500,000 barrels per day. Either way, this will no doubt add fuel to the flames of oversupply.

Yet with all the negative sentiment circulating in the market, my mind is drawn to a diagram I recently reviewed which depicts the global crude oil cost curve, and is reproduced below. Though estimates of this curve vary between institutions, the conclusion is inescapable. **With oil prices at \$30, over 75% of future oil projects are unprofitable.**

Even at more moderate prices of \$50, large swathes of conventional and unconventional production remain unprofitable. Accordingly, throughout 2015 we have seen most companies move towards capital preservation.

All unnecessary and high cost exploration projects have been mothballed, and the key feature has been cost reduction, cash flow generation, and necessary maintenance expenditure. There is a belief that, given the sharp cutback in capital expenditure and weak investment in future projects, the market may see a supply shock in years to come.

In the meantime, however, the oil price is driven by sentiment and momentum. Prospects look bleak, but in all likelihood we are near the floor for oil prices. There remain a number of known unknowns such as China's slowdown, the speed with which conventional and shale supply will capitulate, the extent of Iranian production and pricing rationality, supply disruptions caused by tension between Saudi Arabia and Iran, their proxy war, as well as the potential of an emergency OPEC meeting to try and rein in unbridled production quotas. Yet all that considered, I would think that over the long-term these forces shall yield to upward pricing pressures. ■





Rupert Silver - Director

# Make the Taxman your friend

It has now been just over a year since we wrote about the advantages of EIS investing for UK tax payers, so we thought we'd take the opportunity to remind investors of the investment rationale and Credo's approach to EIS investing. Before we begin, however, we must stress that such an investment is only suitable for investors who are capable of withstanding considerable risk and volatility.

## What is EIS?

The Enterprise Investment Scheme is a government scheme designed to promote investing in smaller UK companies. The scheme assists companies in raising finance by offering a range of tax incentives to UK investors.

## What are the benefits to investors?

- Tax relief of 30% of the cost of the shares will be offset against the investor's income tax liability for the tax year in which the investment was made, effectively reducing the initial price of the investment by 30% so long as it is held for three years.
- Capital gains made on disposal are tax free, assuming the investment is held for three years, while any losses can be offset (unlike investments in ISAs where losses cannot be offset).
- Ability to defer previous capital

gains through the investment in EIS shares, for the period 36 months prior to the investment or 12 months after.

- Exemption from inheritance tax after a two year holding period.

## Is EIS for everyone?

Unfortunately not. Since the main advantage is tax relief, EIS investing is only appropriate for UK tax payers. In addition, EIS companies are by definition small and usually with a very limited track record. They are at the uppermost end of the risk spectrum for listed equities, and can be very illiquid.

## Can I sell EIS stocks at any time?

If listed on the LSE, the stocks can be sold on the secondary market. However, to fully enjoy the tax benefits, they must be held for the minimum period. As with all small companies, dealing in larger size can be difficult and spreads may be wide.

## Investment process

As EIS relief only applies to young companies, quantitative analysis becomes harder than usual. Whilst we always look at valuation, our analysis is also based upon qualitative factors such as the product, opportunity, and management. On this basis we typically meet senior management before investing and keep close

contact throughout the holding period. Investing here requires fortitude; some companies will surely stumble, but those that thrive more than compensate.

While our process is at first blush fundamental, we recognise the benefits of diversification and so invest in a wide array of industries.

## Performance

It should be noted that investing in EIS poses considerable risk to the prospective investor, and the usual caveats apply. Though there have been substantial divergences between our winners and losers, on balance our historical picks have proved successful. Since inception our average holding is up 42%, and an equally weighted basket has produced an IRR of 10% via capital growth (resulting in 20% per annum if one includes the income tax relief). A detailed summary is available on request.

## Summary

We recognise that EIS investing is not suitable for everyone, and we can make no claims as to future performance. Whilst EIS remains a small percentage of our clients' portfolios, in recent years we have seen growing demand for such investments. No doubt the increase in tax relief from 20% to 30%, as well as an increasing desire to shelter assets for the purposes of inheritance have been significant drivers of this increasing demand. ■



# To whom it may concern...

Following the unprecedented volatility witnessed so far this year, many of our clients are understandably concerned about their portfolios. Rather than our usual attempts to assuage our readers' anxieties and remind them to focus on the long-term, what follows are a few excerpts from an actual conversation with one of our longest-standing clients.

*To my adviser,*

*As the old year draws to a close, my concern with our cash holdings – particularly the US dollar – mounts. My nagging worry that the US corporate debt bubble will burst remains, especially now that the Federal Reserve's quarter percent hike has added to the pressure.*

*This debt stands at almost \$2.2 trillion, with a large portion being bond loans to corporates in the fracking business and other dubious enterprises that rushed into leverage when rates were so conducive.*

*Three of the ten mutual bond funds (which together hold the bulk of this debt) are already showing the signs of strain, such as a stop on withdrawals. It is easy to see how this might trigger a panic amongst investors and, as 2008 showed us,*

*how such panic may soon spread and become systemic. It was not so long ago that everybody thought these bonds were safe, just as they did in the housing bond bubble that burst so spectacularly in 2008. But conditions for these corporates have now changed. For the frackers, crude oil has more than halved, which will put them under considerable pressure when their bonds fall due over the next three years. No doubt, a sizeable portion shall be reclassified as Junk, with all that entails.*

*You may say this is no more than my usual bearish attitude, and you may well be right, yet only a small change to our positioning could do much to mitigate these risks. The counterargument for such a move would be that now that the Federal Reserve has started its tightening cycle, the US dollar could resume*

*its upward trend. But over the last few months it would appear that the dollar has stabilised against the other currencies that took such a hit during the last dollar bull-run.*

*Given this, we can presumably diversify the portfolio further by reducing our holding of US dollar. But what currency to shift it to, that is the question? I find myself ill at ease with the pound sterling and euro, as these countries are still printing money like mad. China appears to be having its own problems at the moment.*

*For an old man who, like many of your elderly clients, thinks more about the preservation of capital than its growth in a volatile world, your thoughts will be very helpful.*

*Kind Regards  
John*

*Dear John,* 



Dear John,

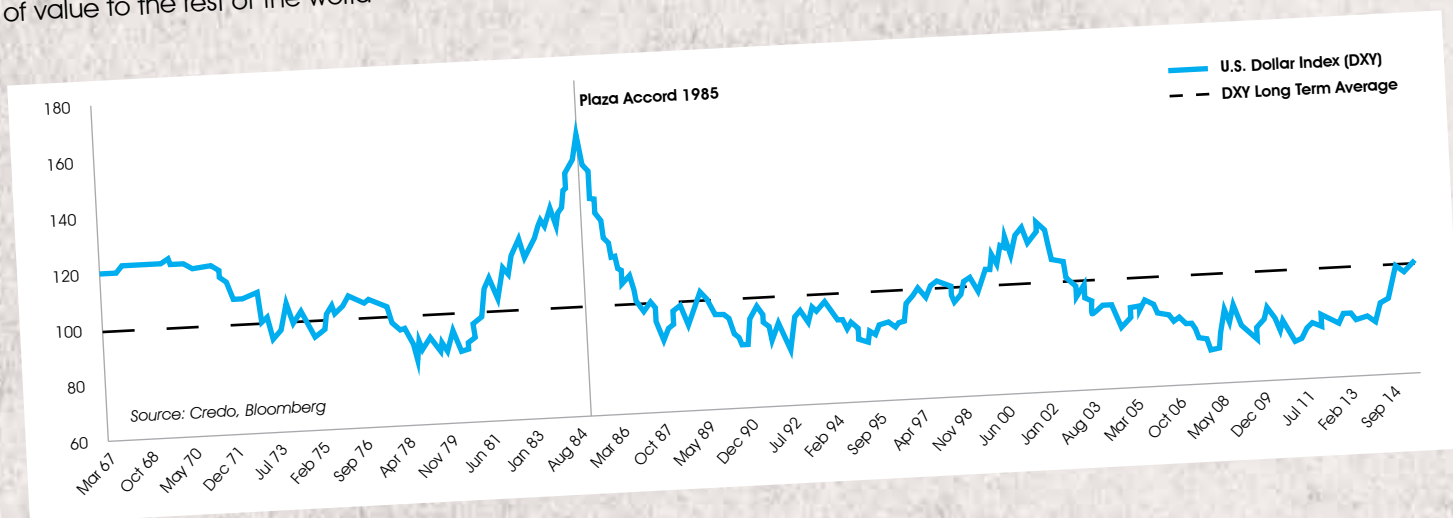
Your concerns surrounding global debt levels are duly noted, and we are certainly mindful of these trends. I'd like to offer some thoughts on how these observations relate to the US dollar. Whilst many factors determine the demand for a currency, during a crisis the ultimate factor is liquidity. What determines liquidity for a currency? It is how many individuals around the world are willing to accept it as a means of payment in the future. Rightly or wrongly, the US dollar is by some margin the most widely held currency in the world. The IMF recently reaffirmed this: the dollar was the only developed market currency whose weight in the SDR (a benchmark for central bank reserves) was not cut. Politics aside, a more fundamental reason supporting the dollar is that the US possesses a lot of things which are of value to the rest of the world

(iPhones, Microsoft Windows, and over 300 million import hungry American citizens, to name but a few), thus others will continue to hold dollars to transact with the US.

The value the market places on US dollar liquidity can be seen in the dollar's behaviour during previous crises; during the Global Financial Crisis global equity prices fell 50% between May 2008 and February 2009, while the US dollar index rose by 20%. Similarly as the US debt ceiling approached in 2011, and fears of default were widespread, global equities fell 21% between April 2011 and September 2011 while the dollar index rose 8%. This episode was testament to the importance of liquidity for global savings; investors with nowhere else to turn actually flocked to the safe haven of the US dollar despite the US government being the default risk

in question. In similar fashion, were your concerns over US corporate debt to materialise, historically, the US dollar has tended to appreciate when US corporate bonds have fallen. This has occurred because when those who borrowed in dollars want to deleverage, this generates demand for US dollar cash to pay back their debts.

However, the plural of anecdote is not evidence. The chart below plots the US dollar index (DXY) over the last 50 years, and allows one to assess US dollar currency risk from a broader perspective. Whilst the recent headline grabbing moves in the dollar have indeed been dramatic (as you can see in the bottom right of the chart), the index is currently around its average level (black dotted line) since central banks broke their link with gold in 1971, and currencies became free-floating.





The highest peak in the dollar was in the 1980s when Paul Volcker's Federal Reserve saw interest rates peak at near 18%. The trend was only halted by the Plaza Accord in 1985, when all the major central banks met in New York and agreed to intervene in the currency markets to arrest the dollar's rise. Today, however, we are witnessing the reverse of that policy: the European Central Bank, People's Bank of China, and Bank of Japan (amongst others) are all looking to devalue. It would take a drastic volte-face in their combined policies to cause a crash in the US dollar similar to that which followed the Plaza Accord.

That said, in today's markets anything is possible and it would be a useful exercise to use the Plaza Accord and ensuing drop in the US dollar as a case study for what could happen to the cash holdings of your portfolio. As the chart shows, between February 1986 and December 1987 the DXY fell

47%. However, we must remember that currencies are valued relative to each other, and the major currencies in the dollar index are euros, pound sterling, yen, Canadian dollar, Swiss francs, and Swedish krona. In such a scenario, your portfolio is well placed to weather the storm since it holds the majority of these major currencies already. Based on this fact, I would be relatively comfortable with the degree of diversification in your current cash holdings. My humble advice would be that no action is required for the time being (which is quite often the case in investing).

I understand that doing nothing and staying diversified may not be particularly exciting advice, but I would echo your point that your objective is preservation of capital as opposed to growth. I read quite a philosophical passage from Jeremy Grantham's GMO not too long ago on this point, and have included it below in case it resonates with you as it did for me:

*"We're in a canoe race to the other side of the lake. We know all of the canoes are old and a bit leaky in the best of times, and there's a storm coming. If we knew the storm were going to break now, we'd just stay in the cabin and laugh at everyone else as they were forced to turn around and trudge back to the cabin, sopping wet and half drowned. But we don't know when the storm will break or even if it might miss us altogether, so we've stuck an extra guy in the middle of our boat with a bucket instead of a paddle. We know it will slow us down, but it will go a long way to help ensure we don't sink along the way, even if we're resigned to the likelihood of a long slow paddle in the rain, sitting in water up to our ankles."*  
Ben Inker, GMO

Hopefully this has been helpful and do let me know if you have any questions on the points above.

Kind Regards  
Your Faithful Adviser ■





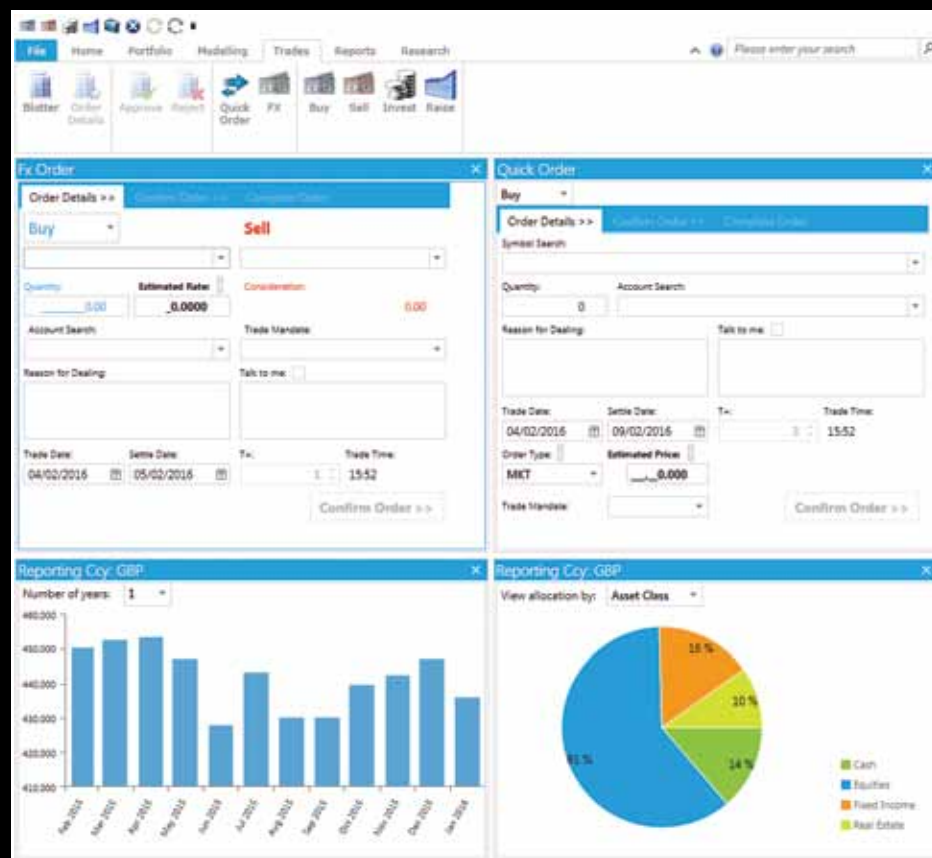
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  - o Portfolio modelling
  - o Reporting
  - o Near real time pricing and valuation
  - o Improved security with two-factor authentication
  - o The ability to export complex data
  - o White labelling



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