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CSS Strategise December 2014 Review

Collins Sarri Statham Investments Ltd

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Please refer to the CSS Strategise Brochure for further details.

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CSS Strategise is our advisory service aimed at providing clients with a new approach and framework to volatile markets.

CSS Strategise now encompasses eight strategies, this is worth recapping:-

i) **Income** – UK equities offering sustainable dividends at a 20% premium to FTSE All Share dividend yield.

ii) **Value** – UK equities offering value characteristics including low P/E – discount to book values usually for temporary reasons

iii) **Special Situations** – The strategy targets M&A situations, corporate restructurings

iv) **Growth**- companies in growth industries and experiencing high EPS growth

v) **Emerging Markets**; The strategy targets investments in the “BRIC” countries, and “N11” (next 11 emerging economies)

vi) **Midcap / Small cap** – the strategy targets promising mid cap and small cap co’s.

vii) **US Balanced**; broad selection of US blue chip stocks with EPS growth

There are exacting selection criteria for inclusion into the specific strategy.

We are shifting to more normal quarterly ending dates of March, June, September and December for CSS Strategise updates.

We have introduced some changes to the colour coding – blue denotes a new addition to the strategy – red denotes a sell/ exit.

Fresh issues in 2014 for 2015 and beyond

A number of geopolitical issues have emerged over 2014 that require time to resolve.

*A new Cold War? – the Russia/ West standoff at first glance looks like a re-run of previous Cold War escapades, where both sides sought to add or respond to “client” state conflicts. The Ukraine, a country previously considered part of the Russian hegemon staggered through a decade of debate as to whether the country should focus in the direction of Europe or Russia. With the ousting of the Russian backed Yanukovych on 21 February 2014 subsequent instability, Russia annexed the Crimea and supported a “dirty war” in eastern Ukraine, with the apparent objective of acquiring further territory in the Donetsk region.

How exposed is Europe to the slow escalation in tensions between the West and Russia? In our view the Russian problem has many facets and could brake EU GDP growth.

*OPEC- the historic move on 27th November to allow the oil market to find equilibrium (where supply = demand and there is no unsold inventory) promptly caused crude oil prices and other commodities to slide. Saudi Arabia, Kuwait and the UAE appear to be part of a core group driving down oil prices to levels at which higher cost producers become loss making and withdraw supply.

To what extent can other OPEC members and non OPEC producers afford Saudi Arabia's laissez-faire approach? Our view is few OPEC members, and arguably not even Saudi can afford to keep crude oil prices this low for long.

*Strong US GDP growth is positive up to a point, but 5% growth for Q3 is likely to prompt a rise in US Fed funds around mid 2015.

Will the eventual rise in Fed funds rate destabilise the US bond market? Depends on the management of the rise and expectations post. The Federal Reserve has consistently promised only a gradual approach to the rate cycle.

CSS Strategise- The Income Strategy

The strategy is designed to deliver 20% income premium to FTSE All Share (3.41% 1st April 2014) hence a yield above 4.09%% from a selection of companies with strong track record paying dividends and a commitment to the dividend as part of shareholder returns.

TICKER	DESCRIPTION	RECOM	TARGET	ENTRY/EXIT
AML.L	AMLIN ORD	BUY	NOT HIT	08/05/2013
ANTO.L	ANTOFAGASTA	BUY	NOT HIT	13/08/2013
BKG.L	BERKELEY GROUP	BUY	NOT HIT	13/11/2014
BLT.L	BHP BILLITON	BUY	NOT HIT	07/02/2014
DLG.L	DIRECT LINE	BUY	NOT HIT	26/10/2012
HSBA.L	HSBC HLDGS	BUY	NOT HIT	08/08/2012
HSV.L	HOMESERVCE	BUY	NOT HIT	20/03/2013
IAP.L	ICAP	EXIT	HIT TARGET	30/12/2014
INVP.L	INVESTEC	BUY	NOT HIT	18/09/2013
NEX.L	NAT.EXPRESS	BUY	NOT HIT	08/11/2011
RMG.L	ROYAL MAIL	BUY	NOT HIT	11/11/2013
SGRO.L	SEGRO	BUY	NOT HIT	20/05/2013
SVT.L	SEVERN TRENT	BUY	NOT HIT	20/01/2014
SSE.L	SSE	BUY	NOT HIT	07/06/2013
STAN.L	STANDARD CHARTERED	BUY	NOT HIT	13/11/2014

***BHP Billiton;** Ahead of the H1 2015 demerger of non-core operations, BHP's board has announced it will sharply reduce new investment in Australian iron ore operations primarily due to the slump in iron ore prices to $70/MT. BHP also has significant exposure to petroleum (c 30% of operating profit) another commodity suffering from oversupply. Forward EPS for 2015 are expected at 122.4p rising to 129.5p in 2016. We remain positive that the worst in share price terms is behind. However there could be further downside risks ahead as commodity prices have yet to settle down in our view.

***ICAP;** Recent volatility in commodities has led to increased risk aversion which helps ICAP's bond platforms. The electronic platform reported total traded volumes of $694.1bn in November 2014 up 3%. In our view the stock is up with events and exceeded our revised 450p price target. Hence we have decided to exit.

***Royal Mail Group;** 2014 has been a tough year for Royal Mail impacted by increased competition in parcels and post. The stock got a brief respite with the administration of City Link a competitor in last mile services over the Christmas break. We are hoping Royal Mail's near ex growth phase will change in 2015. There is optimism over the potential for central London property disposals despite a weak trading environment and Amazon competition.

CSS Strategise- The Value Strategy

The value strategy is aimed at recommending companies that when recommended on entry trade at a discount to book value, a trailing P/E of under 11x and Beta in a range of 0.6x- 1.3x.

TICKER	DESCRIPTION	RECOM	TARGET	ENTRY/EXIT
AAL.L	ANGLO AMERICAN	BUY	NOT HIT	04/12/2012
BARC.L	BARCLAYS	BUY	NOT HIT	21/11/2011
INTU.L	INTU PROPERTIES	BUY	NOT HIT	14/11/2011
MLC.L	MILLENNIUM & COP	BUY	NOT HIT	14/11/2011
RDSB.L	RDS 'B'	BUY	NOT HIT	14/11/2011
SBD.L	SONGBIRD	BUY	HIT TARGET	17/09/2012
VOD.L	VODAFONE	BUY	NOT HIT	14/11/2011
VZC.L	VERIZIB COMMS	BUY	NOT HIT	31/03/2014

***Songbird Estates;** The board has recommended investors sit tight and not accept the revised 350p cash offer from the Qatar/ Brookfield consortium. The Qataris with 28.6% need to get to a total 50% shareholding for the 350p offer to meet its conditions. However the Qataris seem to have won the valuation argument with their comments on the recent rise in the Songbird NAV to 381p. The Qataris claim 381p values the properties on a record low yield of 4.6% and ignored the fact that Wood Wharf will require well over £1bn to develop. Franklin Advisers a 7% shareholder has given its backing to the Qataris, as have Third Avenue a 3.5% shareholder hence the Qataris are at around 39.1%. They need to convince a high proportion of the 21.1% free float or one of the large holders, China Investment Corp (15.8%), Morgan Stanley (8.5%) or Simon Glick (25.9%). China is likely to vote its shares in line with the board recommendation and is normally a long term investor. The battle remains open and will be close, we view the 350p cash offer as attractive.

CSS Strategise- The Special Situations Strategy

The Special Situations strategy focuses on corporate activity and "bid situation" companies.

TICKER	DESCRIPTION	RECOM	TARGET	ENTRY/EXIT
AFR.L	AFREN	BUY	NOT HIT	28/02/2012
CHG.L	CHEMRING	BUY	NOT HIT	16/11/2013
GLEN.L	GLENCORE XSTRA	BUY	NOT HIT	20/03/2013
HGM.L	HIGHLAND GOLD	BUY	NOT HIT	23/07/2013
LAD.L	LADBROKES	BUY	NOT HIT	21/01/2014
LIO.L	LIONTRUST	EXIT	HIT TARGET	2/12/2014
LMI.L	LONMIN	BUY	NOT HIT	15/11/2011
MAB.L	MITCHELLS&BUT	BUY	HIT TARGET	23/02/2012
PFC.L	PETROFAC	BUY	NOT HIT	18/12/2012
RBS	ROYAL BANK SCOT	BUY	NOT HIT	16/01/2014
SXX.L	SIRIUS MINERALS	BUY	NOT HIT	09/07/2013
TSCO.L	TESCO	BUY	NOT HIT	07/06/2013

***Liontrust Asset Management;** we are pleased with the tripling of the shares during the period in the strategy. Liontrust is now valued at 3.3% of its £3.8bn funds under management, which is slightly above those of peer group companies. Hence we have decided to exit.

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***Petrofac;** The board guided investors to expect i) net profit of between $580m to US$600m for 2014 ii) net profit of US$500m in 2015 – equating to around 92p EPS. This reflects the much weaker oil price environment and cuts in capital spending from oil major clients. The rating has moved down to 7.6x which is relatively high against US oil service peers many of whom are on a 5x-7x rating. The rapid slump in oil prices has been a shock for this sector and could persist for most of 2015. There is significant earnings risk in our view. We are sticking with Petrofac as its order backlog will provide a revenue cushion during this period.

***Tesco;** Ahead of the eagerly awaited strategy review, due January 8th, the new CEO Dave Lewis has not given any clues as to the next step for Tesco. Will it divest some of its Asian assets or Tesco bank? Will there be a rights issue to prop up the balance sheet? Will Tesco seek to intensify the UK price war? It seems clear Tesco must stabilise UK market share and cut capital spending but it must also buy time to do this. Our view is Tesco will seek to trim more of its Asian operations which could prevent a rights issue.

CSS Strategise- The Growth Strategy

The CSS Strategise Growth strategy targets sector related investments in renewable energy, uninterruptible power, internet, social media, emerging market property, oil exploration etc.

TICKER	DESCRIPTION	RECOM	TARGET	ENTRY/EXIT
AGK.L	AGGREKO	BUY	NOT HIT	21/3/2012
BBY.L	BALFOUR BEATTY	BUY	NOT HIT	18/11/2012
BP.L	BP	BUY	NOT HIT	21/11/2011
CCL.L	CARNIVAL	BUY	NOT HIT	09/04/2013
MPI.L	MICHAEL PAGE	BUY	NOT HIT	15/01/2013
SMDS.L	SMITH DS	BUY	NOT HIT	17/12/2013
TALK.L	TALKTALK	BUY	HIT TARGET	23/10/2012

***BP**; BP begun production at Kinnoull in the UK North Sea, a bit of good news. But the tumbling crude oil price has led to BP to review capital spending for 2015 and $1bn in restructuring charges, a move that will simplify its upstream and downstream operations. A further concern is BP's 19.75% stake in Rosneft, the heavily indebted Russian oil major. In its 2013 accounts the stake is held as an associate investment worth $13.68bn (equating to $7.62 per share) – Rosneft has since declined to $3.44 per share (30 December 2014) hence the investment is now worth c.$7.2bn. This $6.5bn loss of value will be recognised at 2014 prelims and it is quite possible that the board will guide EPS forecasts lower.

***Carnival;** new CEO Arnold has started a restructuring aimed at improving operational performance after a string of high profile crises, including the Costa Concordia grounding. However Carnival is likely to benefit from declining fuel prices over 2015, once existing hedges expire, and the Obama Administrations' move to end the Cuban trade embargo and restore diplomatic relations (assuming US Congress approval is forthcoming). Carnival is based in Miami and is home to a large Cuban population.

CSS Strategise- The Emerging Markets Strategy

The CSS Strategise Emerging Market strategy focuses on blue chip investment trusts focused on overseas investments in the BRIC (Brazil, Russia, India, China) and "N11" (next eleven large emerging market economies).

TICKER	DESCRIPTION	RECOM	TARGET	ENTRY/EXIT
HFEL.L	HEND.FAR EAST	BUY	NOT HIT	09/11/2011

ATR.L	ASIAN TOT RTN	BUY	NOT HIT	19/04/2012
JMC.L	JP MORG CHIN	BUY	NOT HIT	09/11/2011
JII.L	JPMOR. INDIAN	BUY	NOT HIT	09/11/2011
JRS.L	JPMORG RUS	BUY	NOT HIT	11/11/2011
RUS.L	RAVEN RUSSIA	BUY	NOT HIT	11/11/2011
PBR	PETROBRAS	BUY	NOT HIT	11/11/2011
TKC	TURKCELL	BUY	NOT HIT	11/11/2011
PLND	MRKT VECTORS POLAND	BUY	NOT HIT	11/11/2011
CHL	CHINA MOBILE	BUY	NOT HIT	15/03/2012
WMMVY	WAL MART MEXICO	BUY	NOT HIT	15/03/2012

The emerging markets investing environment has become considerably more complicated over 2014. The term BRIC is a bit of a misnomer as Brazil, Russia, India and China have experienced considerable divergence. But it is fair to say the proliferation of conflicts in many different parts of the world, Syria, Iraq, Israel/ Palestine, Ukraine and stories of terrible human tragedies have dimmed investor appetite for overseas investment. Russia's foray into Ukraine has come at a considerable cost, the absorption of Crimea brought billions in liabilities and EU/ USA sanctions. Furthermore the downing of MH370 and support for Russian operatives in Donetsk created an exodus. Recent government moves, to lift interest rates to 17%, and ordering exporters to repatriate US dollars look like desperation.

***Raven Russia** the warehouse owner said that 2015 will be difficult and reported a US$3.5m hit to net operating income due to the rouble's loss against the USD. However the vacancy rate remains low at 3% with tenant sectors holding up. The business is renegotiating leases in 2015 which will give a better view on operating income. There is earnings risks relating to Russian tenants which are primarily in small/ mid sized corporates.

CSS Strategise- The MidCap/ Small Cap Strategy

The MidCap/ Small Cap portfolio focuses on FTSE 250 and smaller companies with a threshold / floor valuation of £250m and a ceiling valuation of £3bn.

TICKER	DESCRIPTION	RECOM	TARGET	ENTRY/EXIT
AQP.L	AQUARIUS PLAT.	BUY	NOT HIT	29/03/2012
BAG.L	BARR (A.G.)	BUY	NOT HIT	21/11/2011
CGL.L	CATLIN GRP	HOLD	HIT TARGET	10/02/2014
CWD.L	COUNTRYWIDE	BUY	NOT HIT	7/7/2014
DEB.L	DEBENHAMS	BUY	NOT HIT	13/03/2013
DTY.L	DIGNITY	BUY	NOT HIT	18/11/2011
DGO.L	DRAGON OIL	BUY	NOT HIT	15/03/2012
MLC.L	MILLENNIUM & COP	BUY	NOT HIT	18/11/2011
PMO.L	PREMIER OIL	BUY	NOT HIT	21/11/2011
SNR.L	SENIOR	BUY	HIT TARGET	15/02/2012
SHB.L	SHAFTESBURY	BUY	NOT HIT	23/07/2013

***Catlin** The board confirmed press speculation that it had received an approach from XL Group valuing Catlin at 699p per share. The precise terms 0.13 XL shares plus 410p cash per Catlin shares. The board expect to distribute the £85m proceeds of the sale of Box Innovation Limited. We are expecting XL, which is in the midst of due diligence to reach final terms soon.

***Shaftesbury** The 2014 results released 27th November showed net property income up 8.9% to £79.7m and 29.1% diluted net asset per share growth to 679p. The business spent £107.9m this year on two purchases, 57-59 Broadwick Street and Sandringham in Chinatown.

CSS Strategise- US Balanced strategy

The US Balanced strategy selects a broad coverage of US blue chip multi-national companies with a strong track record of earnings growth, valuation above $5bn. In some cases the US strategy will include companies where we expect corporate activity.

TICKER	DESCRIPTION	RECOM	TARGET	ENTRY/EXIT
BAC	BANK OF AMERICA	BUY	NOT HIT	19/09/2012
BA	BOEING	BUY	NOT HIT	11/09/2012
CSCO	CISCO SYSTEMS	BUY	HIT TARGET	12/09/2012
EBAY	EBAY	BUY	NOT HIT	19/09/2012
XOM	EXXON MOBIL	BUY	NOT HIT	19/09/2012
GG	GOLDCORP	BUY	NOT HIT	17/09/2012
HPQ	HEWLETT PACKARD	BUY	NOT HIT	27/11/2013
INTC	INTEL CORP	BUY	HIT TARGET	12/09/2012
MCD	MCDONALD CORP	BUY	NOT HIT	12/09/2012
MSFT	MICROSOFT	BUY	HIT TARGET	19/09/2012
PEP	PEPSI CO	BUY	HIT TARGET	12/09/2012
SRCL	STERICYCLE	BUY	HIT TARGET	12/09/2012
VZ	VERIZON COMMS	BUY	NOT HIT	19/09/2012

Stericycle Inc The medical / pharmaceutical waste specialist moved up to $132 near record levels after revenues jumped 24.9% to $667.9m in Q3 2014 and EPS of $1.08 which beat consensus by 2 cents. The focus on international acquisitions continued with 13 new purchases, which are something of a drag on earnings given the lower margins on businesses outside the USA. Still the company only has a market share of around 16% globally on an addressable market that is worth $15.5bn.

Summary

Recent US GDP acceleration to 5% (Q3 2014) and the shift down in global bond yields (US 10 YR 2.2% / UK 1.82%) suggests equities will remain underpinned by the lax monetary environment. US indices appear extended in the short-term but appear to have benefited from a repatriation of funds back to the US.

High volatility has become the norm in commodity linked equities, with clear oversupply emerging in base metal commodities as new supply arrives into saturated markets. The China slowdown, whilst still officially a soft landing has been sufficient to create a glut in iron ore and increasingly metallurgical coal. Investors need to observe inventory levels in these commodities and be cognisant of pre-boom pricing of these commodities ($10-$20 MT iron ore 2000-2003) which suggests possible further downside price risks.

The CSS Strategise approach enables investors to position their portfolio according to different risk weightings in different areas, with specialisation being brought to each individual area. We believe this is a helpful approach to investing in areas that are of interest.

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