“Innovation is the market introduction of a technical or organisational novelty, not just its invention.”

Joseph Schumpeter, 1911

OVERVIEW

With less than 90 days to go to the UK General Election in May, the phrase we hear banded about most often is that the markets and UK economy will experience ‘unprecedented levels of uncertainty’, both before and after the Election.

Ironically, it seems to be a near certainty that we will experience another coalition government, although who the coalition will comprise of is uncertain, but there is a finite list of probabilities by which to calculate an expected outcome. It is also clear that a less stable form of government could exist – a minority government. Uncertainty usually arises when there appears to be multiple outcomes. We would see this as distinct from complete unknowns, where we experience a complete left-field event that, with the knowledge we have available to us today, we could not have predicted. Indeed, for this election there are so many permutations of the type and colour of government that could be formed, it seems totally apt to speak of uncertainty. But we certainly cannot speak of unknowns, rather we can speak of known unknowns.

It seems intuitively obvious that “uncertainty” can influence the economy and impede our ongoing economic recovery. The private sector will tend to stave off any productive investment decisions and business activity will invariably stall whilst the political landscape unfolds.

However, once the private sector knows which policymakers will be running the asylum, whether they are business friendly or not, they can begin to implement their gameplans, made on their original assessment of probable outcomes. Risks are always quantifiable and if uncertainty equals risk then surely we can measure uncertainty?

It was the global economic crisis of the 1920s which saw the first attempts at defining and then measuring economic uncertainty. Frank Knight’s ‘Risk, Uncertainty and Profit’ is the seminal treatment of the subject matter. He actually distinguishes between risk and uncertainty. A Knightian uncertainty is a risk that is immeasurable. Risk is measurable, uncertainty isn’t. That was his conclusion.

As Knight saw it, an ever-changing world brings new opportunities for businesses to make profits, but it also brings with it an imperfect knowledge of future events. Therefore, according to Knight, risk applies to situations where we do not know the outcome of a given situation, but can accurately measure the odds. Uncertainty, on the other hand, applies to situations where we cannot know all the information we need in order to set accurate odds in the first place.
Many economists since Knight have sought to blend epistemology, physics, mathematics and behavioural science to try to measure uncertainty. They aim to try to predict when we might have an economic collapse, for instance, but no model has been created that manages this with much confidence, if any at all. How do you measure a risk that is unmeasurable?

No, there is nothing certain about economic predictions. Donald Rumsfeld, the former U.S. defence secretary, un-wittingly declared it so at a NATO press conference in 2002, when he responded to a question on intelligence gathering by saying:

“It’s not the certainties that make life interesting; it’s the uncertainties. There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things we know we don’t know. But there are also unknown unknowns – the things we don’t know we don’t know.”

“Unknown unknowns” was ridiculed at the time as a piece of delib-erate and meaningless obfuscation. Rumsfeld even won an award from the British Plain English Campaign for the most nonsensical remark made by a public figure.

We would add that he narrow-ly pipped California Gov. Arnold Schwarzenegger, who commented: “I think that gay mar-rriage is something that should be between a man and a woman.” Another stunning revelation. It’s OK; we are clearly in safe hands with illustrious leaders like this.

We digress. We would contend there is a more sophis-ticated definition of ‘uncertainty’ measurement, which can help us to ‘operationalise’ it and turn it into quantifiable risk. This definition can help business leaders in their for-ward planning by providing the following categorises:

- Rumsfeld Risk: Known Unknowns, where events belong to a known historical distribution

- Ellsberg Ambiguity: where the distribution is unknown

- Knightian Uncertainty: where the range of possible events is entirely unknown

(We’ve also seen a profusion of swans, including Nic Taleb’s Black Swan and the WPP boss’ more predicta-ble Grey Swans, plus of course our very own David Ste-venson’s White Swan with a few grey and black spots (largely predictable, but occasionally volatile in an un-predictable way).

It is clear the UK Elections fall under Rumsfeld Risk. So Ben will highlight what the differing government possible outcomes are in the Economic Elections Insights section, in a follow up to his UK election primer last month. He illustrates the various scenarios, from a Labour or Con-servative majority to the likelihood of a Labour-SNP coal-ition, and then explores the impact of these on econom-ic policy, markets and individual stock sectors. He also touches on Higgs’ work, not Peter Higgs of the Boson fame, but Robert Higgs, an Austrian economist who may have found the ‘god particle’ of understanding uncertain-ty, at least economically speaking – that of private fixed investment trends.

Indeed, private fixed investment is another theme in Views, where Ben explores the role of financial and productive capital in the new techno-economic paradigm that has developed over the past two dec-ades. The double bubble of finan-cial and technological innovation – which has been inextricably linked and self-reinforcing – has created an exponential growth in these sec-tors that has undoubtedly left econ-omists with severe ‘uncertainty’ about a measurable outcome. In-terestingly though, Carlota Perez, a British-Venezuelan London School of Economics professor, like Rob-ert Higgs, believes if we observe private fixed investment trends, we perhaps begin to see certainty in real productive economic growth. We, on the other hand, are far less sanguine about this viewpoint as you will see.

In this month’s stock selections, Mark introduces two stocks that are based on our stock-screening criteria, which by happenstance observe our election narrative. What were the odds of that?! We also look at the ‘Master of Posts’, who benefited from the public sector assuming its own fiscal pension liabilities, and an engineering group that has benefited from public government contracts. We believe election politics have already impacted on these companies, causing them to trade at a discount to their earnings and peers. Possibly, we may be guilty of a little poetic licence, as we can argue many sectors have underperformed because of fear of Miliband’s socialist and populist rhetoric.

Finally, please do not miss the charts in WHAT HAPP-ENED? Market & Sector Analysis, where it is clear we are at a critical juncture in the UK equity markets.
Our three main investment ideas this month are:
1. Royal Mail Plc
2. Babcock International Group Plc
3. Surprise Miss

CONTENTS
In this edition of the UK Dividend Letter, you'll find:

VIEWS ‘Double Bubble, Technological and Financial Innovation I’ by Ben Davies 4

ROYAL MAIL PLC ‘Master of Posts’ by Mark Mahaffey 10

BABCOCK INTL. GROUP PLC ‘An Election Play’ by Mark Mahaffey 15

ECONOMIC ELECTION INSIGHTS, ‘Higgs’ Certainty’ 19

WHAT HAPPENED? Market & Sector Analysis 25

SURPRISE MISS ‘Stock Selection Re-cap’ by Mark Mahaffey 29

HINDESIGHT DIVIDEND UK Portfolio #1 32

HALF.L ETN 33

APPENDIX I The Way We Think / Our System 34

APPENDIX II How We Think 35
On November 9, 2009, Berlin celebrated the 20th Anniversary of the Fall of the Berlin Wall with a ‘Festival of Freedom’. The Fall of the Wall ushered in an era of globalisation as international borders were opened up to free trade across the Eastern-bloc, and in other former Communist countries in SE Asia and Latin America. We could argue that this really enabled us to harness capital productively and help drive world economic growth, but November 2009 was also the anniversary of the worst global financial crisis since the Great Depression of the late 1920s. So what happened?

1. Globalisation
2. Financial Innovation (Financialisation)
3. Digital Age

These three factors collided and reinforced each other’s growth all at the same time, growth that would be exponential in nature. Globalisation allowed borders to open up to create extraordinary productive capital creation. Production capital can be thought of as the agent for accumulating wealth-making capacity. Austrian economists refer to such capital as the physical production structure of the economy, including machinery, buildings, raw materials and human capital, i.e. skills. It is represented by entrepreneurs and managers who are engaged in the production and distribution of goods and non-financial services.

Technology and in particular the internet, computers and telecommunications facilitated the opening up of these borders at a faster rate. This productive capital itself could be transported across borders via fibre optics, whilst at the same time technology, computer miniaturisation and speed of processing power helped facilitate financial engineering and new forms of credit creation that make up financial capital. By contrast to productive capital, financial capital can be thought of as the agent for reallocation and redistribution of productive wealth, through investors and financial intermediaries, either in shadow or traditional banking system. This financial capital in turn could also be transported in nanoseconds, even picoseconds, around the world with the advent of technological revolution. In short, all capital had now become highly mobile.

THE 1990s & 2000s: A SWITCH IN DIFFERENTIAL ASSET INFLATION

Source: Carlota Perez, 2012
Double Bubble
Globalisation also encouraged financial capital growth because it allowed goods and services inflation (CPI and inflation) to remain low, despite the fact that rising commodity and asset prices, largely wages, were falling. In fact, if there were any wage demands, they were not being met as globalisation allowed the developing world to grow their trade outside their regions and they were highly competitive because they had a surplus of workers. This surplus forced the global marginal labour cost down by over 90%. Think about it, over one billion workers entered the global market. This neutralised any input costs that could have caused push-cost inflation.

The two decades prior to the financial crisis of 2008 was known by economists as ‘the Great Moderation’, an acknowledgement of a period of low inflation and relatively stable growth, with only two relatively mild recessions. Furthermore, this stable period was attributed to the success of the Federal Reserve Bank (and many of the other world’s central banks) adopting an inflation target. They decided on a preferred inflation rate and steered the economy towards it. This adjusted interest rates, making them lower when inflation fell below target and higher when inflation exceeded the target. Of course, with falling inflation rates from globalisation, the Federal Reserve Bank lowered rates, fearing wrongfully deflationary outcomes. If anything such lower pricing was disinflationary and became a positive input, whereby we had more disposable income in our pockets. So rates should have actually risen earlier and never been cut. Instead of which, lower and lower rates fuelled several bubbles: the Technological Bubble of 2000 and then the Housing (Financial Bubble) of 2008.

The low rate environment encouraged creative ‘financial engineers’ to produce higher yielding assets, and in a world with highly mobile capital, due to technology, newly opened countries saw capital flood into them. I would add that two restraints on money and credit creation helped reinforce this feedback mechanism, which led to the exponential trajectory associated with bubbles and their busts.

Financial Capital Restraints Removed
1968 marked the beginning of our current monetary regime, a fiat currency system, no longer derived from an asset (gold) with intrinsic value. Money could be created with no restraint. It is now into its 5th decade. The other restraint on credit growth centred on the removal of liquidity provisions. Since 1945, reserve requirements had ensured that banks had sufficient liquidity to repay customer deposits on demand fell. This was further exaggerated by the revocation of the Glass-Staegall Act, which in 1933 had separated commercial banking from investment banking. Once commercial and investment banking was reunited under one roof a host of financial innovation arrived that enabled credit creation, both inside and outside the banking system. Banks relied more heavily on wholesale funding borrowed from other banks in the overnight markets, as well as euro-deposits and the commercial paper market. These gave them more access to funding at low rates by which they could lend out multiple times. Likewise, they encouraged the growth of time deposits, where fewer reserves had to be allocated for.

Over the last few decades reserve requirements have fallen to a level that is meaningless with regard to providing any provisions for depositors or lenders. This we refer to as ‘inside’ credit.

Another, and perhaps just as significant, development was the loosening of financial regulation which enabled non-bank entities to engage in credit creation; what we call ‘outside’ credit or the shadow banking system. It is probably fair to say that the loosening of financial regulation in the US, as we will depict in a moment, would not have been facilitated on such a magnitude had it not been for the global vendor-financing relationship.

Principle amongst these new credit entities in the US were the government sponsored entities (GSEs) Fannie Mae and Freddie Mac. These were the main two units that aggressively supplied credit (they also borrowed it to provide themselves with leverage). They were initially they were set up to make housing more affordable, borrowing funds at a cheaper rate than other borrowers due to their implicit government credit status; however, in time they merely became a casino, using excessive leverage relative to their asset base to boost profits for their reckless and immoral executives’ personal gratification.

Other suppliers of credit were issuers of asset-backed securities (ABS). These issuers acquired funding by selling bonds. They then used the proceeds from this funding to make purchases of various assets – namely mortgages, credit card and student loans – and then they bundled these together in varying means and vehicles by which to provide different levels of credit risk for investors who bought them.

This industry mushroomed into the CDO and CLO businesses which were underwritten by ‘financial guaranty’ insurers – monolines. These monoline insurers were so-called as they tended to assure a sole line of insurance. All this served to reduce the cost of borrowing, but the monoline business migrated into insuring residential mortgage-backed securities (RMBS) that comprised many CDOs and CLOs and left them woefully undercapitalised to meet a collapse in the real estate market.

Ultimately, this lack of reserves was held by both banks and these new financial companies meant there was more money than ever before entering financial markets and the global economy. The inverse of the reserve requirement is the money multiplier; a vivid explanation if ever there was one. For multiply credit in the economy it did, producing the mother of all super credit cycles. Except this one was global.
Just as in the decade after the 1929 crash, we are now living in the aftermath of a shattered illusion of stability. We now reside again in an age of financial and geopolitical insecurity, which tends to manifest itself after the social fabric of society is upended by question marks over its economic sanctity and each individual’s participation in the economic order. For it exposes the excesses or ugly periods in capitalism, whereby cronyism and inequality of wealth occur as productive entrepreneurial wealth is transformed into financial capital.

So, while there is no doubt that the fall of the ‘Soviet bloc’, symbolised by the collapse of a physical wall, had a major psychological bearing on a new world cooperation, I think it would be hard to refute that it’s been the Digital Revolution that has done most to break down national barriers in goods and services trade. By circumventing physical borders, cyberspace has opened up free corridors and channels of communication, which has organically facilitated co-operation and trade that would have taken decades to break through because of government red tape. Of course, it’s not without complete friction. There are government controls that seek to restrict capital flows.

Just as in the decade after the 1929 crash, we are now living in the aftermath of a shattered illusion of stability. We now reside again in an age of financial and geopolitical insecurity, which tends to manifest itself after the social fabric of society is upended by question marks over its economic sanctity and each individual’s participation in the economic order. For it exposes the excesses or ugly periods in capitalism, whereby cronyism and inequality of wealth occur as productive entrepreneurial wealth is transformed into financial capital.
Here’s Perez on this transformation:

“The world is now at the turning point. The crash of 2007-08 has plunged the real economy into a recessive mode and has revealed the decoupling of finance from real wealth creation as well as the polarisation of income and the illusory growth that was hidden behind the frenzied bubble years. The time has come to move from the gilded prosperity at the end of the installation period to the truly golden prosperity of the deployment period. This will require a very substantial shift in the market context to orient the behaviour of the investment agents.”

Perez illustrates the deployment period of the previous surge: from 1947 to 1974 fixed investment consistently outpaced financial credit flows; whereas during the “installation” phase of the surge of 1970s to 2000s finance increasingly decoupled from investment in the real economy.

I contend we are still intractably caught in the Financial Bubble aftermath and the financialisation of the economy is ongoing. We have learned nothing and implemented no institutional change that would foster productive capital to drive growth. Take the corporate sector. We have seen the fastest growth in corporate debt since 2008, leading to record highs. Rarely used for capital expenditure, these businesses have fortified their financial positions by buying back stock, which is also at an all time high. The casino-economy still reigns – but am I missing something?

**Dynamics of Bubbles and Golden Ages**

I want a sanity check on my viewpoint. A few years ago, I read a book by Carlota Perez, a Venezuelan-British born national. She holds the Centennial Professorship of International Development at the London School of Economics, amongst other academic seats. In her thoughtful book, ‘Technological Revolutions and Financial Capital: The Dynamics of Bubbles and Golden Ages’, she provides an historical narrative that is based primarily on Schumpeter’s theories of the clustering of innovations over the past two centuries, but by far the most interesting component of her model relates to bubble technology busts (deployment periods). Here, prosperity is once again focused on productive capital growth in a new economy paradigm born of this new technological innovation.

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**HISTORICAL MODEL OF Techno-EconoMIC PARADIGMS – BUBBLE (INsTAllATION) AND THEN THE DEPLOYMENTS (ADOPTION OF TECHNOLOGICAL INNOVATION IN THE NEW ECONOMY)**

![Historical Model](https://example.com/historical-model.png)

Source: Perez
One could say this is very true of companies like Google that have plenty of free cashflow and can incubate new innovation. But everything has a price and value and if you read our HindeSight Investor Letter Nov. 2013, Equities: A Rarefied ‘APP’mosphere, one can see why this is important from capital formation.

So we need to watch for a rise in private fixed investment as perhaps the first signs that we can shift away from the casino-driven economy. According to Perez, we should be on the cusp of a new global golden age, as finance will become less responsible for funding innovation. I interpret her conclusion to mean that new productive organic growth will be created by cashflow from the now installed companies of the technological revolution.
Perez believes the ‘Green’ growth will see the most benefits, with the revamping of transport, energy, recycling and production systems. Although for now, I would say the ‘green revolution’ may well have just had a kick in the groin from the deleveraging of an over-financialised energy sector.

My conclusion is that we need to begin to normalise rates, reign in credit creation and allow this undoubted productive capital to flow more naturally as the “shape” of production is distorted by such financial capital or “stimulatory” spending. This is because productive resources are not free in a world of scarcity, this distortion comes at the expense of productive effort elsewhere.

The pattern of production thus gets out of sync with the pattern of consumption and eventually this must lead to a collapse. Productive sectors, like dot-com start-ups or residential housing, become “overbought” (while other sectors develop less) and eventually a “correction” must occur. Add this distortion to the fact that the original stimulus must somehow eventually be paid for and we have a predictable bust. I can’t help but feel we will experience another significant bust because it is clear that global financial capital still supersedes private fixed investment growth. I would encourage readers to take a look again at ‘A Short Note on Existential Fear’ in the November Letter to gain some perspective on market investing.
INVESTMENT IDEA #1 Royal Mail Plc – ‘Master of Posts’
by Mark Mahaffey

**Royal Mail Plc**

<table>
<thead>
<tr>
<th>ROYAL MAIL PLC</th>
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<tbody>
<tr>
<td>Price (£)</td>
<td>438.0*</td>
</tr>
<tr>
<td>Turnover (£mm)</td>
<td>9,456.0*</td>
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<tr>
<td>Net Income (£mm)</td>
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<td>Market Cap (£mm)</td>
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<tr>
<td>P/E Ratio</td>
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<td>Dividend Yield (%)</td>
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<tr>
<td>Payout Ratio (%)</td>
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<td>Total Debt to Total Equity (%)</td>
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<tr>
<td>FCF to Market Cap (%)</td>
<td>9.9%*</td>
</tr>
<tr>
<td>ROIC (%)</td>
<td>11.9%*</td>
</tr>
</tbody>
</table>

*All numbers based on FY 2013 pre IPO float. Estimated 2014 earnings are £210mm and estimated P/E in 2014 of 17.4.

Royal Mail plc has been a public limited company since October 2013. It was the UK’s largest state asset sale since British Rail in the 1990s, and the 360-year-old postal service saw its initial public offering become the subject of endless discussions. Despite the government retaining a 30% stake, with shares rising 38% on the first day of trading and as high as 87% above the IPO price within six months, accusations that the company had been undervalued warrant some merit. Although the 150,000 royal mail employees enjoyed a 10% free share allocation, business secretary Vince Cable has spent the last 18 months defending the privatisation, not least to Ed Miliband who accused the government of handing out “golden tickets” to priority investors, namely the much-hated city bankers.

So, for the casual observer, Royal Mail is saddled with an IPO legacy and a belief that emails have eliminated the need for letters, while the competition is rife in the e-commerce of parcel delivery. But what is really going on and why it is our top pick for the HindeSight Dividend portfolio this month?

A royal mail service can trace its roots all the way back to 1516, when Henry VIII created a “Master of Posts”, understanding the modern need for keeping abreast of timely events in his kingdom.

Charles the First made the service available to the public in 1635, the postage was calculated on distance and paid by the recipient. Over 200 years later in 1839, the system changed to a single rate for delivery anywhere in Great Britain and Ireland and was pre-paid by the sender. The famous ‘Penny Black’ adhesive stamp was introduced the following year. This led to a vastly increased level of communication by letter. By 1890, there were up to 12 mail deliveries a day in London, allowing multiple letters to be exchanged within a day, so much for phone text technology!!!
All British stamps have the monarch on them, often in silhouette. Britain is the only country that does not have the issuing country on its stamps.

Fast forward almost another two centuries and the Royal Mail still maintains the universal service, delivering items to any location within the UK for a fixed price, although only one delivery a day now. (Postal Services Act 2011 guaranteed that RMG would continue Universal Service Obligation (USO) until at least 2021.)

Over the past 500 years, mail has been delivered by horse-drawn carriage, rail, air and sea. The telegraph and telephone were all originally run by the Post Office. Pensions paid and children’s postal orders were sent courtesy of Royal Mail, while The Great Train Robbery in 1963 made the mail train famous.

There is no disputing the integral role that the Royal Mail has played in the development of communications over the centuries but what place does it have to play in 2015, and more importantly will it be a worthy investment.

With 700,000 individual subscriptions received for the IPO, RMG is widely held by the UK public. However, after the blow off bonanza high price of 618p, the shares have steadily drifted lower and languish around the 450p level.

This poor sentiment that has prevailed over the last 12 months stems from some obvious concerns:

- Delivered letter volumes have dropped by 25% since 2006 due to the email revolution
- Although the parcel business is growing, there is an enormous amount of competition, especially from Amazon, with people expecting drone deliveries any day now
- The USO is unprofitable and RMG remains inefficient
Although only Victor Meldrew, Britain’s grumpiest old man, might cheer from the rafters when I challenge the “technological advances” of the last 15 years in global communications, it is merely my personal observation of CHANGE.

Change, as Obama’s campaign told us, is always seen as positive by the masses and an advancement of the human race, which is strangely at odds with the urge for nostalgia. In 2002, when I was in Seville for 6 weeks learning Spanish, I can well remember having no access to emails, either business or personal, and when I returned there were no more than 10 that I had to plough through! Nowadays, on an average day I will receive over 300, sometimes double that amount. Technology has enabled me to answer work emails from the moment I wake up at 5 am, until before I go to sleep at 11pm. It’s a fantastic invention. I no longer need to spend Saturday afternoons browsing in a second-hand bookstore because I buy all my books through Amazon and have them delivered the next day, anywhere I wish. Of course, I don’t get to read them as I am too busy answering my emails, but the concept is amazing. Anyway, as a good friend of mine often says, “It is what it is”. However subtle or revolutionary one might view these changes, one of the most profound impacts is on the fortunes of the high street shops and out of town supermarkets. Internet shopping is here to stay and it is growing at up to 10% a year. If you wanted to date a revolution, you might well pick so-called Cyber Monday, December 1st 2014, when volume records were shattered far in excess of the highest estimates.

Source: Royal Mail
Royal Mail plc has only been a public company a short time, and in that period the outlook for the industry has been unclear. However, I believe the mist is lifting and the positives are going to emerge strongly in favour of an investment. My straightforward focus on the fundamentals takes account of:

- Excellent and growing cash flow from the basic business of deliveries
- Regulatory protection
- Government absorption of the pension deficit
- Major real estate assets in London

RMG has a current revenue of £9.5bn with a market capitalisation of £4.5bn. The net income in 2014 of £260mm is estimated to rise to £320mm in 2015 and will easily fund the 4.5% dividend yield.

The future revenue stream from letters and parcels is supported by:

- Ofcom, the postal regulator has essentially given regulatory approval for Royal Mail to increase their prices to maintain the Universal Service obligation (USO). The large increase from 46p to 60p for 1st class stamps in 2012 was a clear result of that. Postage rates in the UK are still generally lower than in Europe and have risen in line with inflation for the most part.

- Despite threats of severe competition in the parcel delivery arena, City Link went out of business recently and Yodel have been much maligned in the press, and Royal Mail has the most extensive network, so it should truly benefit from economies of scale. Its GLS European parcel division further diversifies revenues. With the continued growth of e-commerce, estimates of revenue might well need to be revised higher.

Against that solid revenue, costs could well fall as the focus on efficiency continues. With 60% of costs employee related, the reduction in workforce from 190,000 to 150,000 since 2008 is significant. 35% of RMG’s staff are aged over 50, so despite associated pension costs, automation and lower cost replacements will continue.
As part of the privatisation, the government had to assume RMG’s pension deficit of nearly £12bn. Although George Osborne’s put a positive spin on this, clearly the taxpayer’s contribution has added to the attractiveness of RMG to the private investor – not only a clean pension slate but also assets in real estate in prime London (Nine Elms and Mount Pleasant valued at over £850mm) with plans for disposal. The recent merger talk involving the Dutch PostNL should come as no surprise with such compelling features.

Summary
I believe RMG is an excellent addition to the portfolio this month. A robust balance sheet with strong revenue potential that is partially protected by regulation. Coupled with efficiency led cost reductions enabling margin expansion makes RMG a solid story in itself, but with a high free cash flow paying out 4.5% dividend yield it is a must.

The Hinde Dividend Value Matrix, HDVM\textsuperscript{®} usually selects shares that are priced to pay a higher than average dividend and are long term robust companies but are temporarily out of favour, hence offering an entry point with a margin of safety. The HDVM for RMG currently is 55.09.

Analysts’ Corner
In our External Analyst scoring system, Royal Mail lies at 47.76, sitting just below the halfway point within the index. The general analyst consensus is still quite negative (with 12 out of 19 analysts giving it a positive rating). Our analyst score has become more optimistic over the past month. The average 12-month target price (TP) is 460p. Analysts have mixed opinions on Royal Mail, as many are worried about the competitive environment.

Our external analyst scoring system* places Royal Mail at 47.76 (range 30-70), which is a median score.

*(Please see the Portfolio section for a description).
Babcock International (BAB) can trace its beginnings back to 1867 when an American company called Babcock & Wilcox Company formed a British Company called Babcock & Wilcox Ltd that was separately financed. Many of the board members were well-known industrialists and engineers, such as Sir William Arrol. In 1979, Babcock & Wilcox changed its name to Babcock International and later floated on the London Stock Exchange in 1982.

BAB is a UK engineering support group that has an order book of approximately £12bn and generated revenues exceeding £3.5bn in 2014. Defence, energy, telecommunications, transport and education are all sectors in which BAB plies its trade, delivering vital support to its customers. The firm has three core capabilities, which include integrating its engineering expertise, managing assets/infrastructure and delivering/consulting large projects. The business employs 26,000 workers who are involved in designing, building, managing and operating assets that are vital within the public services industry. BAB has four main divisions:

1. Marine & Technology
2. Defence & Security
3. Support Services
4. International (providing support services for the Middle-East and African regions).

The firm looks to work with customers that have large strategic assets. These customers tend to be public bodies, large government departments and private companies working within highly regulated markets. Its largest customer is the Ministry of Defence, within both the Marine and Defence divisions.

**UK DEFENCE SUPPORT PROVIDERS**

<table>
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<tr>
<th>PROVIDERS</th>
<th>ABSOLUTE PERF. (12M)</th>
<th>INDEX RELATIVE PERF. (12M)</th>
<th>DVD YIELD (%)</th>
<th>PRICE/BOOK</th>
<th>EV/EBITDA*</th>
<th>HDVM**</th>
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<tr>
<td>BABCOCK INTL GROUP PLC</td>
<td>-17.62%</td>
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<td>BAE SYSTEMS PLC</td>
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<td>4.33%</td>
<td>5.86</td>
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</tr>
</tbody>
</table>

Note
* EV / EBITDA - Enterprise Value divided by Earnings (before interest, tax, depreciation and amortisation)
** HDVM** - Hinde Dividend Value Matrix
BAB currently has a HDVM® score of 54.9 and enters the HindeSight Dividend portfolio this month. Over the last 12 months, its share price has fallen 17.6% and 20.5% in absolute and relative to index terms. This underperformance can be attributed to:

• The Scottish referendum

• The 2015 General election

• Avincis acquisition

Stocks that rely on public sector contracts generally underperform during periods of political uncertainty. Many demonstrated this behaviour in the run up to 2010 general election. Ministers have more important issues on their minds, primarily getting re-elected, leading to a slowdown in the bidding process that these businesses rely on. Nearly 60% of Babcock’s revenue exposure comes from the public sector.

The Avincis acquisition for £1.6bn in the spring of 2014, mostly funded by a rights issue was considered expensive at the time, with the share price dropping 7% on the announcement, as BAB was paying almost a third of its enterprise value for the purchase.

After the May elections this year, regardless of the outcome, the UK Ministry of Defence will continue to focus on reducing its internal costs by outsourcing. BAB will be presented with a number of these opportunities providing the main catalyst for its recovery. The firm has outlined its intentions to take its UK experience and apply it on a more international scale with more focus on the Middle East and Africa. The company’s biggest potential upside will come from the support services that it provides its clients and prospects. This could come from a number of areas that BAB has been involved in, namely bidding on projects for nuclear and mobile asset support. It has also been active in its involvement within the emergency services industry.

BAB has a strong order book, always providing good guidance and has reported that the industry environment is improving despite the austerity regime. The firm is known for tracking good opportunities that are yet to arise within the market. They are often ahead of their rivals given the strong relationships across the industry, although a surprise upset occurred recently when they lost a large UK MOD contract to a smaller Carillion led consortium. Some of the successes include the opportunity to help with the nuclear decommissioning project at Magnox and Sellafield, as well as the training contract for the London Fire Brigade. With an excellent pipeline and a historic win rate of 40% on new contracts, BAB will continue to replenish its order book, potentially leading to an earnings upgrade in the future.
Avincis developed its reputation within the mobile asset business and offered BAB good diversification within its offering. According to last year’s reporting, Avincis has performed better than many had expected, winning more contracts whilst reducing their costs. The acquisition has started to add value, providing some revenue and cost synergies. The two groups will now be able to cross-sell with Avincis, particularly aiding Babcock’s push into the public sector industry within continental Europe.
Fundamentally, the firm is trading at a discount to its industry price to book average with growing revenues and earnings per share.

**Analysts Corner**

Babcock International is a stock well covered by a wide range of analysts. Over the past month, analysts have become much more bullish about this business (with 13 out of 17 analysts giving it a buy or hold rating). Our scoring system suggests that the stock has an average 12-month target price (TP) of 1324.74p, representing a 31.29% upside from recent prices. However, in January 2015 alone, three analysts have given an average target price (TP) of 1338.00p, which actually represents an upside of 32.61% relative to recent prices. The general recent consensus is that the stock will outperform the benchmark over the next year.

Our external analyst scoring system* places Babcock International at 63.34 (range 30-70). This is a very strong score, being in the top five positions within the external analyst system.

* (Please see the Portfolio section for a description).
The current UK General Election polls indicate that another hung parliament is highly likely. It would be the third since 1974, the other being the current coalition that was elected in 2010. This introduces a very real example of ‘regime uncertainty’, quite literally speaking.

The polls show a Labour led coalition with the SNP. Can you imagine that? This type of poster probably is enough to scare those who are unsure where to cast their vote, away from Labour to UKIP or even Conservatives and Liberals. The thought of the SNP having a say in our UK parliament sends a shudder through most of us.

Regime uncertainty is a concept that was developed by Robert Higgs, an American economic historian and economist of the Austrian School. It describes a pervasive lack of confidence felt by investors when they cannot foresee the extent to which future government actions will alter their private property rights.

Higgs uses this concept to explain why the prolonged nature of both the Great Depression and the current Great Recession was, and is, so serious. He particularly focuses on investment and shows that investment spending is highly sensitive to risk, most notably uncertainty over future tax and regulatory policy.

“This uncertainty can arise from many sources, ranging from simple tax-rate increases to the imposition of new kinds of taxes to outright confiscation of private property. Threats can arise from various sorts of regulation, for instance, of securities markets, labour markets, and product markets. The security of private property rights rests not so much on the letter of the law as on the character of the government that enforces, or threatens, presumptive rights.”

(Mises Institute)
Regime uncertainty pertains to more than the government’s laws, regulations and administrative decisions. Two administrations may administer or enforce identical statutes and regulations quite differently. A business-hostile administration will provoke more apprehension among investors than a business-friendlier administration, even if the underlying “rules of the game” are identical on paper. This seems very relevant to the past decade, where politics have largely moved towards the centre. In other words, the policy ‘bites’ are the same, but the ‘bark’ is different.

The crisis of 2008 arrested this slide and the opportunity for polarisation arose once again – the proletariat versus the bourgeoisie. The old boundaries of left and right appear to be re-emerging. The outcome of this UK election will see a slide to one side or the other, depending on whether there is a majority or what type of coalition is formed.

**Economic Election Risks**
I think we would all agree that the main area of risks for economics revolves around:

- Fiscal Deficit
- Taxation Agenda
- Immigration and EU Referendum

**Fiscal Deficit and Taxation Agenda**
Whoever gets elected as the next government will have to address the fiscal deficit issue and try to eliminate the structural deficit. As I wrote last month, although the UK budget deficit rate of increase has fallen, it remains one of the largest in the world.

The Conservatives wish to achieve a budget surplus in totality over the course of the next parliament, whilst Labour wishes to achieve a current budget surplus, i.e. cyclical vs structural. The Institute of Financial Studies (IFS) claims that fiscal tightening – cutting public expenditure – is the best way to achieve these outcomes.

Fiscal Consolidation:
Conservatives: 4.3% of GDP
Labour: 3% of GDP
Liberals: 3% of GDP

Conservatives have created one of the most competitive tax regimes in the world, both for households and corporates. They will not seek to balance the books through the false economy of higher tax rates, but Labour will. We already know about their intention to ‘right’ the unfairness of income equality, having failed to comprehend why we have it. It’s the credit system, not taxation, that is the root cause. Labour will reinstate the 50p income tax rate, raise corporate tax and instigate some type of mansion tax.

You may recall from last month that the UK relies heavily on the excesses of external capital and commentators are still not really ‘eyes wide open’ to the risks associated with such an over-reliance on foreign funding. A Labour taxation agenda against the rich could help capital inflow accelerate further. It is already beginning to slow from overseas, as wealthy foreign immigrants and investors stay away. What is more concerning is any business-hostile taxation by Labour could really impact our current account deficit, as we rely on significant overseas foreign direct investment (FDI), which rose significantly after Osborne’s corporation tax cuts.

**Immigration and EU Referendum**
Cameron has promised that an in-out referendum on the UK’s membership of the European Union (EU) will be held no later than 1st January 2018. Is Cameron playing realpolitik? I believe this is a case of the means justifying the ends. He is trying to diminish the UKIP threat, which 6 months ago seemed to be impacting the Conservatives’ position more than Labour’s, although both seem vulnerable to disenfranchised voters.
I suspect Cameron believes he can renegotiate with Brussels, as he has a good relationship with Merkel, who is a powerful ally in this regard. A big sticking point is on the free movement of labour between EU member states, which was set in stone in the Treaty of Rome. The British public clearly wants to reduce the number of migrants coming into the UK. The Treaty will not be changed in my opinion, but I do see there being a cap or quota system that many countries would like to be introduced within the EU anyway.

Brexit only becomes an issue that I am concerned about under the following coalition scenarios.

12 Government Permutations, Economic Policy and Market Risks

**Conservative Majority**
- Aggressive deficit reduction
- Spending cuts, no tax rises
- Business-friendly, FDI sought
- EU Referendum guaranteed by 2017, Brexit risk low, as its time for negotiation
- FTSE 100 breaks new highs, buy underperforming utilities
- Buy Sterling

**Labour Majority**
- Slower deficit reduction
- Tax Hikes, Bank Levy increase, Mansion Tax
- Interventionist risks to business, FDI falls
- EU Referendum
- Sell homebuilders, sell banks, sell energy utilities
- Sell Sterling
- UK Bonds rally on economic risks and QE
- BoE does not tighten on slower deficit reduction

**Liberal Majority**
- 326 seats needed, let’s not discuss!

**Conservative-Lib Dem Coalition**
- Similar to Conservative Majority
- EU Referendum still possible, but not fait accompli

**Conservative-UKIP Coalition**
- Similar to Conservative Majority
- EU referendum accelerated into 2016, Brexit risk high

**Labour-Lib Dem Coalition**
- Similar to Labour
- Personal tax allowance raised, but CGT and Dividends Taxes raised

**Labour-SNP Coalition**
- SNP and Sturgeon against deficit reduction
- SNP would bargain for Devolution Referendum and Trident cut
- Risks to UK government credibility
- Sterling and UK govt bonds fall

**Labour Rainbow Coalition (liberals/SNP/Greens and Plaid Cymru)**

**Labour Minority**

**Conservative Minority**

**Conservative - Labour coalition** (Would only happen in war emergency – call for another election)

No overall control = Multi-party coalition or fresh elections
I have taken the liberty of including a Deutsche bank probability table on economic outcomes, as they fit neatly with a general consensus. They have added into the other categories Scottish succession and a ‘stability’ or rather ‘instability’ column.

![Economic Election Risks Table]

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**Minority Governments and Weak Coalitions**

*Policy is hamstrung and political stalemate is likely to result in an extension of regime uncertainty and volatile markets at lower prices than we currently have in all assets in the UK.*

The UK’s external borrowing is funding the budget deficit. Under these governments, if austerity is not undertaken (which is likely) and the budget is slashed, the burden on our external borrowing position will continue to rise.

Domestic Private Sector Financial Balance + Public Sector Balance + Current Account Balance = 0

Or put another way:

**Budget deficit = Savings + Trade Deficit - Investment**

Remember the Current account deficit = Capital account surplus

A reduction in the budget deficit thus reveals a fall in the current account deficit, but if we have a weak coalition, as seems likely, then much-needed austerity measures will be less likely to occur. However, with indebted private sector domestic and non-financial firms no longer able to borrow much more and zero growth in UK tax receipts, then who do we look for to borrow from? More QE from BoE is the likely solution.
I would finish off by saying uncertainty seems a bit of a red herring to us. Just because we experience existential feelings of uncertainty doesn’t mean there will be bad outcomes. Far from it, our worst fears are not usually realised and there is a bounce-back effect or release of pent-up ‘animal spirits’ and / or positive market behaviour.

Arguably, when all appears to be highly stable and the status quo seems certain, that is when we should be most concerned; although the temporal nature of a negative regime change is what economists and market participants continually seek solutions for. Minsky’s by now famous Financial Instability Hypothesis has provided such a quantitative and qualitative model, although it was the Austrian economists under Mises who had already articulated in their Business Cycle Model that stability breeds instability.

At the stock specific level, our biggest concern as investors is observing a margin of safety that buys us time to see if a company or sector is in danger of obsolescence from innovation or political regime shift. We believe our methodology of purchasing companies with solid balance sheets and solid cash-flow metrics gives us that margin.

In stark terms, regime uncertainty refers to the mere fact investors are no longer confident that they can continue to operate within a capitalist system, and it is this which stymies growth. Although I would actually contend we have been experiencing a socialist form of capitalism – where political and corporate interests have actually become corruptly entwined, most notably in the US. It is also clear monetary and fiscal policy work hand in hand and fiscal government dominance over monetary policy has interfered in the market process. We have no more markets, only engineered markets but we learn to adapt. Our resounding hope is that Perez’s productive capital deployment begins to take hold, despite the overhang of financial capital, and that as private fixed investment begins to trend faster than credit growth, then we may see a golden age of sustainable growth.
Maybe there is a glimmer of hope here, as fixed investment appears to be rising.

Whatever the outcome of these elections and future economic certainties, I certainly hope you enjoyed the debate thus far.
WHAT HAPPENED? Market & Sector Analysis

The polls have had the Labour party over the last year as the lead contender for a majority, however as the months run down Labour and Miliband have lost substantial ground to the Conservatives. Notwithstanding this we believe the markets have priced in a high probability of a Labour led coalition government. Markets are discounting mechanisms and it would appear they trade well in the face of a business and market unfriendly potential government.

Here are two interesting charts. One of the FTSE 100 Price returns (no dividend inclusion). It shows we are on the cusp of creating a major triple top over many decades. If we fail here then the retracement could be substantial. If we break higher it is a significant acceptance of value over time and buying agents will send prices much, much higher at least to 9,000 to 10,000.

FTSE 100 (PRICE RETURNS) MAJOR MULTI-DECADExE TRIPLE TOP?

This next chart shows the FTSE 100 with dividends included and compounded. Amazing how it changes our perspective. We are at multi-decade highs, overbought but trending with no signal of impending failure apparent.

FTSE 100 TOTAL RETURNS AT RECORD HIGHS
UK Market Valuations

If we look at valuations and the current P/E, it is at the high end of the range but the estimated forward P/E is 15.6, so analysts expect earnings to remain strong. We haven’t shown here but EPS misses have been increasing. So we don’t see earnings rising to meet price which would reduce the price multiple.

<table>
<thead>
<tr>
<th>UK INDICES</th>
<th>PRICE/EARNINGS RATIO</th>
<th>PRICE/BOOK RATIO</th>
<th>DIVIDEND YIELD (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FTSE 100 INDEX</td>
<td>21.26</td>
<td>1.92</td>
<td>4.53%</td>
</tr>
<tr>
<td>FTSE 250 INDEX</td>
<td>17.83</td>
<td>2.27</td>
<td>3.41%</td>
</tr>
</tbody>
</table>

Our main risen to believe markets could break higher is the equity markets offer too much yield relative to government and corporate rates. This alone can drive markets to higher and higher valuations. The market has been very resilient on any sell-off. Each dip has got shallower. We await a trend signal and confirmation of a break up or down.
Sector Returns

The Consumer cyclical sector is leading over the last 12 months a positive for now. It has broadly benefited from lower oil prices as airline stocks have rallied, and homebuilders have performed well, buoyed by the recent Stamp Duty announcement and lower bond yields.
Sector Returns

Smaller capitalised companies are rich relative to big capitalised stocks but in a ZIRP environment where liquidity drives yields lower, risk premia gets compressed. So we can see small caps trade tighter to big caps in the same way junk bonds trade tighter to government bond yields.
Regular readers may well have turned the page expecting to see HindeSight Dividend letter’s third monthly stock recommendation.

My apologies if I disappointed you, but there are only two additions to the portfolio this month.

The methodology for stock selection is based on the Hinde Dividend Value Matrix®. The main drivers of which are:

• Price performance, absolute and relative over preceding multiple time periods
• Level of potential dividends or return of capital expected
• Fundamental analysis, primarily based on a systematic screening process (see Appendices)

Each stock in the FTSE 350 will have a dynamic score subject to live changes. The higher the score, the better potential we believe there is for this stock to not only perform in absolute terms, but also relative to the index. While we do not recommend the % allocation each investor should make to a UK equity portfolio, we believe that any equity portfolio that targets an index outperformance is invaluable in this era of low interest rates and low volatility.

<table>
<thead>
<tr>
<th>Name</th>
<th>HDVM</th>
<th>Entry Date</th>
<th>Return (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CENTRICA PLC</td>
<td>57.43</td>
<td>02/10/2014</td>
<td>-2.78%</td>
</tr>
<tr>
<td>GLAXOSMITHKLINE PLC</td>
<td>56.50</td>
<td>02/10/2014</td>
<td>7.84%</td>
</tr>
<tr>
<td>STANDARD LIFE PLC</td>
<td>51.44</td>
<td>02/10/2014</td>
<td>-1.13%</td>
</tr>
<tr>
<td>IG GROUP HOLDINGS PLC</td>
<td>56.51</td>
<td>18/11/2014</td>
<td>11.90%</td>
</tr>
<tr>
<td>ROLLS-ROYCE HOLDINGS PLC</td>
<td>56.22</td>
<td>18/11/2014</td>
<td>7.46%</td>
</tr>
<tr>
<td>KINGFISHER PLC</td>
<td>54.41</td>
<td>18/11/2014</td>
<td>12.14%</td>
</tr>
<tr>
<td>SAINSURY (J) PLC</td>
<td>62.40</td>
<td>10/12/2014</td>
<td>17.18%</td>
</tr>
<tr>
<td>ROYAL DUTCH SHELL PLC-B SHS</td>
<td>55.73</td>
<td>10/12/2014</td>
<td>6.27%</td>
</tr>
<tr>
<td>IMI PLC</td>
<td>55.05</td>
<td>10/12/2014</td>
<td>13.02%</td>
</tr>
<tr>
<td>VODAFONE GROUP PLC</td>
<td>56.75</td>
<td>16/01/2015</td>
<td>0.66%</td>
</tr>
<tr>
<td>HSBC HOLDINGS PLC</td>
<td>56.60</td>
<td>16/01/2015</td>
<td>-0.44%</td>
</tr>
<tr>
<td>NATIONAL EXPRESS GROUP PLC</td>
<td>53.30</td>
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<tr>
<td>ROYAL MAIL PLC</td>
<td>55.09</td>
<td>10/02/2015</td>
<td>-2.80%</td>
</tr>
<tr>
<td>BABCOCK INTL GROUP PLC</td>
<td>54.90</td>
<td>10/02/2015</td>
<td>-0.66%</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>55.88</strong></td>
<td></td>
<td><strong>5.16%</strong></td>
</tr>
</tbody>
</table>

As you can see from the recommendations already made, there appears to be a threshold of around HDVM score of 54 to make the grade. Standard Life would be closer to 54 adjusted for the expected 73p of pre-announced, but no date has been yet specified for the return of capital. This is not written in stone and will be subject to the market cycles, but currently higher than 54 would mean that the 3 factors mentioned above are sufficient enough for the stock to be well within the top quartile of the FTSE 350.

Stocks with long histories and large market capitalsations have different characteristics to smaller, higher growth stocks. They tend to exhibit a tendency to operate in a sine wave motion to the index and themselves, with value fluctuating from cheap to rich, often on short-term phenomenon with a strong tendency to mean revert over time.
The typical stock that will make the grade in the portfolio is a combination of factors, but broadly speaking we would expect to see a stock have a high score when:

- It has performed poorly over the last year in absolute and relative terms and has a higher than expected average dividend, but its long-term fundamentals, which are based on valuation and earnings potential, are solid.

- OR the price has been quite static but the underlying potential to pay greater dividends from a higher earnings forecast has increased the expected value, which hasn’t been reflected yet in the price. Although this sounds very much like a growth stock, remember that all stocks are over £1bn in size and so growth, while being very important, will be single digit at best.

The portfolio rules of diversification dictate that it has to be balanced. At the moment, most supermarkets and miners score highly on HDVM® but usually only one from each sector will be permitted. Currently, Morrisons, Sainsbury’s and Tesco are higher than 54, and only Sainsbury’s has been chosen. It should be intuitive that the higher the score, the higher potential return, but from a margin of safety perspective, the importance of portfolio diversification is paramount.
Timing, as the saying goes, is everything. There is often no such thing as a bad stock, just a bad entry point. We endeavour to make sure that our stock picks not only focus on our extensive screening process, but are also very timely. Having the wind at your back can not only increase your winners but mitigates your losers as well. All our stock picks are subject to a 25% stop loss. If a large company has lost 25% of its price from our recommendation, then we would have to admit that something unknown but potentially catastrophic is in the making and an exit would be prudent portfolio wise.

Currently, while we are monitoring every stock daily, we feel there will be better entry points to add to the portfolio over the coming months, rather than choosing the 15th best one today. We will start to send out intra-month buy alerts, if necessary, with the full write up in the monthly.
Portfolio Update and Construction

<table>
<thead>
<tr>
<th>COMPANY NAME</th>
<th>INDUSTRY GROUP</th>
<th>DATE ENTERED</th>
<th>ENTRY PRICE</th>
<th>CURRENT/ CLOSE PRICE</th>
<th>INDEX ENTRY PRICE</th>
<th>DVD YIELD</th>
<th>EX-DIV DATE</th>
<th>PAYOUT DATE</th>
<th>ABSOLUTE RETURN</th>
<th>RELATIVE RETURN</th>
<th>STOP LOSS PRICE*</th>
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<tbody>
<tr>
<td>STANDARD LIFE</td>
<td>INSURANCE</td>
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<td>399.20</td>
<td>395.90</td>
<td>6,446.39</td>
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<td>07/05/15</td>
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<td>292.90</td>
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<td>5.87%</td>
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<td>-8.78%</td>
<td>226.43</td>
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<td>KINGFISHER PLC</td>
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<td>338.80</td>
<td>6,709.13</td>
<td>2.93%</td>
<td>14/05/15</td>
<td>TBA</td>
<td>12.11%</td>
<td>10.46%</td>
<td>226.65</td>
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<td>6,709.13</td>
<td>2.45%</td>
<td>23/04/15</td>
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<td>620.00</td>
<td>706.50</td>
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<td>4.37%</td>
<td>22/10/15</td>
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<td>13.95%</td>
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<td>ROYAL DUTCH SHELL</td>
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<td>10/12/14</td>
<td>2,098.50</td>
<td>2,233.50</td>
<td>6,500.04</td>
<td>5.50%</td>
<td>14/05/15</td>
<td>20/03/15</td>
<td>6.43%</td>
<td>1.51%</td>
<td>1,573.88</td>
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<td>SAISONBURY (J)</td>
<td>FOOD</td>
<td>10/12/14</td>
<td>226.40</td>
<td>265.50</td>
<td>6,500.04</td>
<td>6.52%</td>
<td>14/05/15</td>
<td>TBA</td>
<td>17.27%</td>
<td>12.35%</td>
<td>168.60</td>
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<td>IMI PLC</td>
<td>MISC MANUFAC</td>
<td>10/12/14</td>
<td>1,229.00</td>
<td>1,389.00</td>
<td>6,500.04</td>
<td>2.60%</td>
<td>09/04/15</td>
<td>TBA</td>
<td>13.02%</td>
<td>8.10%</td>
<td>921.75</td>
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<td>HSSC HOLDINGS</td>
<td>BANKS</td>
<td>16/01/15</td>
<td>594.00</td>
<td>593.10</td>
<td>6,550.27</td>
<td>5.40%</td>
<td>05/03/15</td>
<td>TBA</td>
<td>-0.15%</td>
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<td>VODAFONE</td>
<td>TELECOMMS</td>
<td>16/01/15</td>
<td>227.80</td>
<td>230.05</td>
<td>6,550.27</td>
<td>6.09%</td>
<td>11/06/15</td>
<td>TBA</td>
<td>-0.99%</td>
<td>-3.13%</td>
<td>170.85</td>
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<td>NATIONAL EXP</td>
<td>TRANSPORT</td>
<td>16/01/15</td>
<td>259.00</td>
<td>266.90</td>
<td>6,550.27</td>
<td>5.02%</td>
<td>23/04/15</td>
<td>TBA</td>
<td>3.82%</td>
<td>-0.30%</td>
<td>194.25</td>
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<td>BABCOCK INTL</td>
<td>COMM SERVICE</td>
<td>11/02/15</td>
<td>1,050.00</td>
<td>1,050.00</td>
<td>6,820.02</td>
<td>1.90%</td>
<td>02/07/15</td>
<td>TBA</td>
<td>0.00%</td>
<td>0.00%</td>
<td>787.50</td>
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<tr>
<td>ROYAL MAIL</td>
<td>TRANSPORTATION</td>
<td>11/02/15</td>
<td>438.00</td>
<td>415.50</td>
<td>6,820.02</td>
<td>3.20%</td>
<td>02/07/15</td>
<td>TBA</td>
<td>0.00%</td>
<td>0.00%</td>
<td>311.63</td>
</tr>
</tbody>
</table>

*Stop Loss Price is 25% below the entry price

Note: Standard Life dividend does not include the 73p per share special dividend that was announced on the 4th of September 2014

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**GlaxoSmithKline**

- GlaxoSmithKline has rallied 9.3% since our recommendation on the 2nd of October 2014. The pharmaceutical giant has moved strongly off the back of its plans to reduce costs through job cuts, as part of a wider restructuring programme.

The stock is due to go ex-dividend on the 19th of February 2015, expecting 23p after collecting 19p already in November. Over the past month, the company has been given good news after winning Phase III for its new shingles drug, which is the culmination of four years of research. The CEO has once again reiterated that investor’s dividends are safe.

**Centrica**

- Centrica has fallen 3.91% since being recommended, having made a strong recovery in January. Despite no real news, we suspect the US cold weather, coupled with lower oil prices, might well bring with it increased margins. It remains the cheapest utility stock.

**Rolls Royce**

- Rolls Royce has risen 8.34% since being recommended on the 18th of November 2014. Early in the New Year, the firm announced record sales for 2014. Prior to this news, Rolls Royce also reported that Air Asia had recently increased the number of Airbuses they had ordered, which are all powered by Rolls Royce engines. The deal is said to be worth approximately £4bn. Additional contracts continue to expand their long-term order book

**IG Group**

- IG Group has profited from the recent market volatility as transactional volumes would have risen over this period, although the SNB’s surprise move has been costly with an estimated loss of £30mn. The stock is up 14.19%(including 8.45p dividend on 29th January), as the firm made numerous announcements, including the fact that it will be launching a share-dealing platform.

The company has been very active lately, having opened its operations in Switzerland, established ADRs for its shares, added experience to its senior management team, hired Tal Zohar and launched a new stockbroking platform.
Kingfisher
• Kingfisher has risen 12.18% since being recommended on the 18th of November 2014.

The firm has been streamlining its global business, having announced that it has sold its B&Q China stake for £140mm. This has been a strong trend with several western retailers exiting China in the past year.

The ECB’s QE announcement is supportive of companies like KGF with extensive European networks.

Royal Dutch Shell
• Royal Dutch Shell has risen 7.55% since being recommended on the 10th of December 2014.

The firm has continued to focus on streamlining the business. In December, it signed an agreement for the sale of its retail, commercial fuels and supply distribution businesses in Norway. The sale is subject to approval and will be completed in 2015. As the oil price stabilises, we would expect RDSB to recover.

Sainsbury’s
• Sainsbury’s has risen 17.01% since being recommended on the 10th of December 2014. The grocer has now become the target of Activist investors, such as Crystal Amber who announced that they are close to acquiring shares in the firm.

The company also kick-started the New Year by announcing a price war with its larger competitors. Many others have followed suit. As last year’s negative headlines dissipate, we expect the stock to continue to improve.

IMI plc
• IMI plc has risen 12.61% since being recommended on the 10th of December 2014. It has benefited from increased ratings within the industrial sector.

SG Hinde ETN Update
In 2013 we formulated our range of equity products based on the Hinde Dividend Value Strategies and earlier this year we launched the first in a series of innovative dividend based equity strategies in an Exchange Traded Product (ETP). These are innovative by strategy and by design as we run long only, half hedged and fully hedged exposed strategies to the overall market.

Our product launched with Societe Generale is a part of the evolution in ETPs. Societe Generale has provided us the wrapper for one of our dividend strategies in a cost effective, highly accessible and liquid product. We took the Hinde Dividend Value Strategy (50% Hedge) and replicated it in the SG Hinde Dynamic UK Equity ETN (50% Hedge) listed as the HALFL on the LSE. This is an actively managed ETP which aims to accelerate the total return generated by a dynamic portfolio of relatively high yielding UK stocks, whilst providing partial protection against market falls.
APPENDIX I

THE WAY WE THINK

We passionately believe that dividends really, really matter.

William Thorndike in his fascinating book ‘The Outsiders - Eight Unconventional CEOs and Their Radically Rational Blueprint for Success’ examined one of the most important aspects of running a business a CEO must undertake: Capital Allocation. He summarised how a CEO deploys capital in order to best utilise cash flow generated from his or her business operations. Essentially, CEOs have 5 ways of deploying capital:

• Investing in existing operations
• Acquiring other businesses
• Repaying debt
• Repurchasing their own stock (buybacks)
• Paying dividends

Dividend payments are a crucial operation in creating stakeholder wealth. It is this aspect of a business that we are so fixated by – the propensity for a company to produce and continue to grow dividends so that we may accrue wealth over a generation. But as readers will know we can’t just grab stocks with the highest yield for fear that this signals some cash flow or even solvency issues for the firm. So it is with this very real threat in mind we explore only well-capitalised FTSE 350 companies.

This letter’s purpose is to help inform readers on dividend investing so that they can construct a portfolio of sound UK dividend stocks based on our recommendations.

Our prerequisite is that any stocks selected for this letter must be liquid, well-capitalised with a strong free cash flow and a progressive dividend policy.

Our System

• Every month we will provide a write up of 3 to 4 stocks until we create a portfolio of 25 UK dividend stocks. This will be the HindeSight UK Dividend Portfolio #1
• You will be alerted by subscriber email intra-month when these stocks become a buy. Timing is critical to the strategy, not only buying quality stocks but buying them at the right time
• The entry points will then be recorded in the next monthly in the HindeSight UK Dividend Portfolio section and the stock(s) written up in full
• We will run our winners but tend to rotate every 6 months depending on specific criteria which would elevate cheaper companies into the portfolio relative to stocks that had performed
• The basis for stock and portfolio selection is derived from our quantitative systematic methodology which screens these companies using the Hinde Dividend Value Matrix®, (HDVM®), a proprietary stock-rating system
• In the section on ETPs we will highlight our investment philosophy and the investment process behind our stock selections. This is the basis of our dynamic risk and money management in our portfolio construction for you. You can also read the stand-alone Hinde Dividend Value Strategy document to see the methodology behind our stock selection
APPENDIX II

HOW WE THINK

“We have met the enemy, and he is us.” Walt Kelly

Our key to long-term performance investing is premised on the following:

- Systematic rule-based strategy
- Systematic risk and money management
- Occam’s razor, aka ‘K.I.S.S.’, Keep It Simple Stupid
- Consistency
- Discipline

All our investment ideas are rule-based methodologies driven by systematic and quantitative models.

**Hinde Dividend Value Strategy**

Hinde Dividend Value Strategy seeks to generate a total return from an actively managed basket of UK dividend-paying stocks. The strategy selects 20 highly liquid, mid-to-large capitalised stocks on an equally-weighted basis, which offer the highest total return potential. The 50% Hedge version of the strategy would then be subject to a strategic Beta Hedge*, which is designed to cover 50% of the value of the UK stock basket at all times.

The 50% hedge is maintained using UK equity benchmark indices to reduce exposure to overall market volatility, but without reducing overall total returns to the market over the long run. The Hinde Dividend Value Strategy (100% Hedge) would deploy a full beta hedge at all times.

**Hinde Dividend Value Matrix®**

The strategy employs a quantitative, systematic methodology, whereby FTSE 100 and FTSE 250 constituent stocks are screened using the Hinde Dividend Value Matrix®, a proprietary stock-rating system. We use the same system to select stocks for any of our strategies, long-only, 50% Hedge or 100% Hedge. The only difference is clearly the extent of the hedge on the exposure to the overall market.

The basic premise of the strategy is to accelerate returns by selecting relatively high yielding stocks which offer the highest potential for capital revaluation. The dynamic rotation of stocks each quarter enables us to sell stocks where the capital revaluation and dividend has been captured, and use this additional capital to invest in more undervalued quality companies. If successful, this cycle of capture and re-investment offers the chance to significantly improve the total return generated by the Dynamic Portfolio.

The basis of the stock selection process is the Hinde Dividend Value Matrix®, which is a derived process that looks at 3 crucial variables:

* Beta is the stock’s sensitivity to market movements, e.g. if a share has a beta of 1.5 its price tends to move by 1.5% for each 1% move in the index

1. **Dividend Screen**

The top ranking stocks will be those offering a relatively high dividend. A composite of the following criteria comprises the Dividend Rank:

- Relative Dividend Yield
- Dividend Capture
- Payout ratios

The Relative Dividend Yield assesses if a company pays a higher dividend than the Index it derives from (the FTSE 100 or FTSE 250). The Dividend Capture criteria explain how quickly and how much of the dividend is paid at any point in time. The Payout Ratio gives a snapshot of whether a company will be able to maintain and grow its dividend. It helps us to assess how much of a company’s revenue, profit or cashflow is paid out in dividends.
The lower the amount of dividends paid out as a percentage of profits, the healthier future dividend potential will be. History is for once a good guide as to whether companies will continue to pay and grow their dividends. A stock with an excessively high yield relative to its sector or the overall market is invariably showing signs of heightened risk to its dividend sustainability and often the viability of the company itself. The screen incorporates a limit on yield dispersions from the overall market.

The strategy is emphatically not a yield chaser. It is the Performance and Value screens that are used to assess the total return potential of a stock by analysis of how undervalued it is relative to its fundamentals, sector and overall market index.

2. Performance Screen
The top ranking stocks have the poorest relative performance to their index over multiple time horizons.

A composite rank of the following criteria provides the Performance Rank:

- Stock relative performance ranked over multiple time periods
- Average of time periods taken to select rank of stocks

3. Value Screen
The top ranking stocks by key fundamental criteria show stable fundamentals and exhibit upside momentum growth potential. The following are some of the criteria that provide the Value Rank:

- **Value** - Price to Book (intangible book adjustment), Free Cash Flow metrics
- **Quality** - Return on Investment and Earnings metrics
- **Financial Stability** - Debt levels, Coverage and Payout ratios
- **Volatility** - Stock variance, Dividend variance
- **Momentum** - Sales Growth, Cashflow metrics
- **Liquidity** - Minimum market capitalisation relative to index, Shares outstanding

**Implementing the Hinde Dividend Value Matrix®**
The FTSE 100 and FTSE 250 stocks are ranked using the Dividend, Performance and Value screens. An equally-weighted composite rank is then taken of these 3 ranks, which provides a final ranking from which a selection of 20 stocks is made for the portfolio.

The stocks with the highest ranking are compiled for the FTSE 100 and the FTSE 250. The top 10 from each index are then taken, subject to diversification rules, which entail that normally only 1 stock per sector per index can be invested in. For example, if the top 10 stocks are all mining companies, the selection process would take the first of these and then move on to select the next top stock from another sector. As long as a stock has the highest score in its sector, the fact that it has appeared in the final ranking means it is already eligible for investment. In exceptional circumstances, it may be that more than one stock has to be selected from an individual sector.
External Analyst Score (EAS)
This score is derived from 3 inputs that have been obtained from all the external analysts at leading institutions who are covering the stock:

1. The 12 month target price in relation to current price
2. The number of analysts covering the stock
3. The recommendation analysis, eg STRONG SELL, SELL, UNDERPERFORM or HOLD

This score is used to observe the other analysts' view of the stock and is helpful when understanding the methodology that other analysts use to determine their 12-month target price. We ultimately get a blend of price targets that is based on different valuation metrics.

EAS Score Output:

1. The combined score will vary from 30-70
2. A stock with a lowest score of 30 shows the majority of analysts not only have a full sell/underweight recommendation, but also a low 12-month target price in relation to current price.
3. A stock with the highest score of 70 shows the majority of analysts not only have a full buy/overweight recommendation, but also a high 12-month target price in relation to current price.

Note:

- On a standalone basis, the EAS score must be viewed in the following context:
  
  • Equity analysts issue far more positive recommendations than negative
  
  • If all analysts are overwhelmingly bearish or bullish, then this can signal a contrarian position be held, but this is determinate on the where the stock is valued.

- However, in conjunction with the HDVM®, we have found the score to be useful when it is high or momentum is turning higher, as this suggests that the stock offers deep value.