‘Crisis? What crisis?’  In 1979, these words helped to bring down the Labour government, even though the man who was thought to have spoken them, Prime Minister Jim Callaghan, did not actually do so.

But it mattered not, The Sun newspaper’s headline the next day caught the popular impression of a government unaware of a serious state of affairs that had sneaked up on them during the famous ‘Winter of Discontent’. There had been a run on the pound in 1975 and again in 1976 when the UK’s chancellor had to go begging to the IMF for a rescue loan. With rubbish piling up uncollected in London’s Leicester Square, inflation at 10% and almost every worker’s union on strike for higher pay, the UK was in a sorry state of affairs.
Most people would obviously argue that we have never been further from those days, economically or politically, but history has a funny way of repeating itself and there are seismic events going on. Whether they are being noticed yet by the political class or the masses, they soon will be.

---

Last Friday, the GBPUSD rate hit a 31-year low of 1.18. The last time it was near this level was 1985 when it reached an all-time low of 1.03. My future boss, Tom Newman, an expat American (being paid in USD), was planning a parity party for when the currency, seemingly imminently, would cross 1.00. Fast forward to last Saturday night when a visiting American friend of mine announced he was paying for dinner. As the bill was so cheap in USD terms, he felt obliged!!!

The phoney war we spoke of last month, post-Brexit, is over. We are now heading fully into an outbreak of hostilities and have a currency crisis of a multi-decade nature out of the chute. Depending on the currency cross, GBP is now 20-25% lower than it was six months ago. The latest ratchet down is being attributed to the announcement from the Conservative conference of the March 2017 Article 50 trigger date and the subsequent ‘Hard Brexit’ discussions and implications. Whether it is more the reactions from Merkel, Hollande et al, or the utterances of our own ‘excellent’ Brexit negotiating politicians that are at the forefront of the sterling collapse is up for discussion. Clearly, the markets aren’t liking what they are hearing.

The UK, with all the benefits of the EU single market access, coupled with enviable corporate and personal tax rates, has enjoyed an ability to potentially ‘live beyond its means’ over the last decade. We are a nation of consumers who import far more than we export and run one of the largest current account deficits in the developed world.
Fortunately, we have been able to fund this current account deficit in goods and services until now with the financial account investment inflows, so the balance of payments equates. As BOE Governor Mark Carney reminds us, we are at the mercy of the ‘kindness of strangers’ in respect to this balancing act.

Those foreign strangers currently own 50% of UK-listed equities, 30% of UK Gilts and have made sizeable investments in UK businesses and property. In their home currencies, these assets have seen serious declines in valuations in recent months, but right now the lower pound is trying to make sure they keep on buying.

UK Plc is facing a serious loss of purchasing power in respect to imported goods, which will have far-reaching implications. Not just higher priced holidays and cars for the newly impoverished consumer, but UK manufacturers or wholesalers who rely on imported produce will see their margins drop. The immediate inflationary pick up is all too obvious.
Of course, people will tell you it is good for our exporters, but we have to remember that not only do we import far more than we export, 50% of our exports are services rather than goods, which are much more subject to price negotiations.
This development, however, comes with a double-edged sword. The huge importing nation of UK Plc has just become 25% poorer. It is never good when one of your main customers gets poorer because it is clear the first thing they will do is buy fewer goods. Every exporter, EU or non-EU, that has relied on the UK for their products is in potential trouble, as well as the UK importer. The Irish Times reported last week that the Tipperary mushroom exporter Schiele and McDonald had collapsed, blaming the pound’s sharp decline. Most of their mushroom produce had headed to the UK market over the last 17 years. With UK demand faltering, forcing prices to drop, the effect on margins was catastrophic.

Our first purchase was from a fruit stand beside the main street of Kehl (in Germany, in September 1922 during hyperinflation) where an old woman was selling apples, peaches and plums. We picked out five very good-looking apples and gave the old woman a 50 mark note. She gave us back 38 marks in exchange. A very nice looking, white bearded old gentleman saw us buy the apples and raised his hat. ‘Pardon me, sir’ he said, rather timidly in German, ‘how much were the apples?’

I counted the change and told him 12 marks. He smiled and shook his head. ‘I can’t pay it. It is too much.’ He went up the street…. I wish I had offered him some. Twelve marks, on that day, amounted to a little under two cents. The old man, whose life’s savings were probably, as most of the non-profiteer classes are, invested in German pre-war and war bonds, could not afford a 12 mark expenditure.

(Ernest Hemingway, 1922/23)

Source: Monetary regimes and inflation – Peter Bernholz

Clearly, there are going to be losers when a financial rift of this magnitude erupts when a major currency devalues by 25% in less than six months, but there must be some beneficiaries. My usually thrifty American dinner guest, for one. Overseas investors and tourists will look to the UK as open for sale, one of the reasons why the FTSE 100 index is still trading very well with its non-GBP earnings. The possibility of takeovers of UK businesses and property has just risen dramatically, as long as the investor believes that the ‘cheapness’ is justified and the UK is still open for business. Hopefully, this is not a case of selling off the family silver at rock bottom prices. Strangely, the potential increase in tourism, with the UK one of the cheapest destinations, will be at odds with the number of immigrants wanting to come to the UK because their earning power has dropped substantially in their home currencies. A sharply declining economy will be one of the fastest ways to dissuade economic migrants from arriving on our shores, while the current repatriation of monies to places like Poland from the large Polish workforce here will suffer.
The ramifications of Brexit are only in their infancy but we should all be prepared for substantial changes. In the short term, UK Plc is poorer and its ability to live beyond its means is under threat. Inflation will rise, businesses will struggle and a recession is virtually guaranteed. Mervyn King, the former Bank of England governor, recently remarked that the collapse in sterling was a welcome change as it would bring a much-needed rebalancing with lower house prices and higher interest rates. Those types of remarks are much easier for a 68-year-old academic with probably a £200,000 a year index linked pension, which is fully funded by the UK taxpayer, to make than the typical worker who may feel the real brunt. Some of my friends who voted for Brexit for sovereignty and immigration reasons tell me that 5-10 years of painful readjustment will be worth it in the long run. Personally, 5-10 years is not a small timeframe and also I am not at all convinced that in 10 years we will be surely better off, rather than in even more dire straits, possibly having faced many winters of discontent in the meantime. Only time will tell.
Our main investment ideas this month are:

1. Capita PLC

CONTENTS

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INVESTMENT IDEA #1
CAPITA PLC
by Mark Mahaffey

Capita Plc (CPI: LSE) is a global outsourcing and professional services firm headquartered in London, and the largest within the United Kingdom. Capita has built a broad client base that includes central and local government, whilst also covering a vast proportion of the private sector. Capita, while primarily a UK-focused business, has considerable operations across Europe, Africa and Asia, employing over 70,000 individuals overall.

Capita first listed on the London Stock Exchange in 1991. It currently has a market capitalisation of over £4bn and the outsourcing provider is led by CEO Andy Parker and chaired by Martin Bolland who co-founded Alchemy Partners, one of the largest private equity firms in Europe. Earlier this year, Capita reported that it had generated over £4.7bn in revenues, even though they have faced significant issues over the past year.

Capita was originally founded in 1984 as a division within the CIPFA (Chartered Institute of Public Finance and Accountancy), which was then spun out as its own independent entity in 1987 through a management buy-out led by Rod Aldridge.

Many have suggested that Capita would not have formed without the existence of Margaret Thatcher and her conservative government. Rod Aldridge, who initially worked for the CIPFA, was tasked with investigating ways that the organisation could generate new avenues of revenue. At that time, Thatcher’s government was busy privatising much of the economy and introducing efficiency initiatives within the public sector.

In 1984, CIPFA formed its computer services division. Within three years this division had 33 people working for it and Aldridge launched a management buyout that was backed by 3i, the private equity group. Mr Aldridge led the group’s progression and by 1991, Capita had increased its head count 10 times over. By 1991, the company was generating £25m in turnover and five years later their turnover was over £100m with a workforce of more than 3500 individuals. In 1996, Capita cemented its growth by securing its first significant outsourcing contract, which was handed to them by the Teachers’ Pension Agency, and it started a recruitment and assessment service for the government. This momentum continued over the years and Capita was eventually able to name the Metropolitan Police, the BBC, the Criminal Records Bureau, the DVLA and many more as their clients. The five-year contract that Capita signed with the DVLA to manage vehicle tax and insurance evasion was one of the largest in their history, worth more than £100m.

Having led the group’s separation and dramatic progression, Rod Aldridge eventually left his position as executive chairman after it was claimed that several contracts which Capita had won were the result of his loan to the Labour party. He strongly denied these claims but decided to resign from his post to avoid any remaining doubt within the media. Aldridge was swiftly replaced by Paul Pindar, whose tenure at Capita saw him become the third longest serving CEO in the FTSE’s history. He resigned in 2013 after more than 13 years in charge and a career that lasted for 26 years.

Andrew Parker took the reins after Pindar’s departure and is now controlling one of the biggest outsourcing firms in Europe.
Over the years, Capita has been in the news for the manner in which it has dealt with some of its clients and specifically the contracts that were handed to them. In 2001, the London Borough of Lambeth cancelled its contract with Capita after the benefits service that it was providing deteriorated significantly. In 2000, there were more than 55,000 outstanding queries that had gone unattended, which led to a significant dispute between the two entities. In a similar situation (in 2003), the Mayor of London, Ken Livingston, suggested that he came close to sacking Capita over its handling of the London Congestion Charge Scheme. Luckily, Capita were able to renegotiate their contract. There were tighter constraints, but it was worth a significant proportion of their revenues. Overall, Capita has come under scrutiny from time to time for their lack of service, but several analysts suggest that this is due to the number of areas that they try to service.

Capita generates its revenues through eight main areas that include:

- Local government
- Central government
- Transport
- Health
- Life & Pensions
- Education
- Insurance
- Financial Services

The outsourcing industry has taken a beating in 2016 as many clients are currently struggling to grow and so suffering from budget constraints. This has led to several outsourcing proposals being put on the backburner as customers are taking their time to make decisions or ultimately deciding to sit on their hands. Given the lack of growth across the world, this situation had already appeared before Brexit. The referendum decision has surely made matters worse, at least in the short term. The lack of growth has also had a negative impact on Capita’s divisional trading across three main areas: IT Enterprise Services, Specialist Recruitment and Asset Services. Finally, Capita is also facing contractual disputes with the likes of Transport for London and the NHS, while also facing litigation risk as they try to resolve a dispute with the Co-operative Bank. This is not the first time that Capita has experienced an environment in which they face a delay in decision making, combined with tighter public sector budgets. It is a leading outsourcing group and over the years has always manoeuvered itself relative to its peer group.

Capita has demonstrated strong defensive characteristics by maintaining its revenue and cash generation throughout the business cycle, despite the issues it has faced over the years. With many investors fretting over the management’s ability to sustain its revenue generation, the company has seen its share price trade down significantly, making it one of the biggest underperformers, relative to the index over the past 12 months.

Capita Plc enters the HindeSight Dividend portfolio this month. We believe that most of the negativity surrounding the company is built into the firm’s share price. Capita Plc is a leading outsourcing giant across the globe, which currently trades with a forward P/E of 9.77x and offers a solid dividend yield of 4.80%. Over the past 12 months, the share price has fallen (45.5%) in absolute terms. There are clear negative factors, but Capita has been around for a long time and is likely to be able to recover from these problems while still continuing to generate a healthy free cash flow yield throughout the business cycle.
The underperformance in its share price can be attributed to:

- Contractual Issues & Slowdown in Pipeline conversion
- Divisional Slowdown
- Litigation Risk

**Contractual & Pipeline Conversion Issues**

Given the lack of growth around the world, many clients (prospective and existing) have held off on their decision-making process when it comes to signing or renewing a contract in 2016. Given the added factor that that the UK has decided to leave the European Union and a substantial proportion of Capita’s work comes from the public sector, they have found that several civil servants are pushing back on deciding who they should renew their contracts with, as they have 'higher priority' issues to deal with.

With the public sector accounting for 47% of Capita’s revenues and 44% of its pipeline opportunities, Brexit has been a worry for investors and management as a whole. This is not the first time that the company has faced such issues. In 2010/2011, after the UK general election, Capita was affected by the political cycle, contract attrition and the economic cycle (which affected its staffing and property administrative services). The government implemented significant public sector budget cuts and growth declined, which caused a slowdown in the management’s ability to hand new contracts that related to certain public sector outsourcing agreements because in certain cases the funding had either dried up or had to be allocated elsewhere.

The company has also come under scrutiny after it announced that it had been held up in the delivery of its TFL project and that this tardiness would have a one-off cost on its revenues as the firm was fined. Andy Parker suggested that delivery was not up to their expected standards, as the project proved more complex than anticipated. Saying that, the project has gone live and is reported to be performing well, so operationally these costs will not be incurred next year.

Capita has received criticism for the delivery of their work over the past decade, which at times has been perceived to be poor. As a result, publications such as ‘Private Eye’ have branded the outsourcer as “Crapita”.

Capita had the resolve and resources to steer through this tough period and once again the firm will see itself through this similar situation with Andy Parker – who has been on the management committee under previous circumstances – at the helm. The last time Capita saw its contract conversion rate this low was in 2010/2011. However, Capita’s management team believe they have learnt from their past experiences and will look to use their long-term relationships to help speed up the decision-making process and, in turn, improve their conversion rate. The company has recently announced some government deals that have gone through, as well as the renewal of private sector contracts with the likes of Tesco, Zurich and Three.

It is hoped that the announcement of these contract renewals will lead the charge in attaining a greater contract conversion rate and eventually lead to a rerating in their share price. With Capita’s share price at depressed levels, after being criticised for its service at times, we believe most of the negativity has been priced into its current price.

**Litigation Risk**

Investors feared the worst when Capita announced that they had a serious dispute with the Co-operative Bank, for whom they are processing mortgages. Capita feels it has delivered an element of the transformation programme and the bank has not paid them for this work. This tussle could lead to a serious legal battle and see Capita paying hefty legal bills before receiving the money it believes they it is rightfully owed. Initially, this will be a cost (that has not been accounted for in its financial statements) to Capita but it is hoped that this will all be recovered, allaying investors’ fears of further write-downs. The result of this battle will remain a high event risk, but it is hoped that a positive outcome will see the firm’s share price recover once again.

**Divisional Slowdown**

Capita has grown at an accelerated pace over the past decade. A large proportion of its growth has come from M&A activity, which now sees it servicing eight lines of business. 2016 has seen Capita’s IT Enterprise, Specialist Recruitment and Asset Services division underperform for a variety of reasons. Its recruitment division has seen a slowdown because of a structural issue within the industry as a whole that is not particularly in Capita’s control. On the other hand, its IT Enterprise business has slowed down due to company specific issues. Its Tech solutions division was expected to generate £50m in revenues but is now only reporting £30m, which has been quite disappointing from an investor’s perspective.

At its recent AGM, Andy Parker addressed this issue and suggested that its IT Enterprise and Asset Services business lines would be going through a restructuring process as the management team believes they have become too clunky and slow to react. They are also looking to restructure part of their recruitment business as the individuals leading this division have not been able to keep up with the changes in the procurement process, particularly within the educational sector.
For the time being, these divisions will remain a worry for investors, but it is hoped that this restructuring will help to create more efficient divisions within Capita, saving costs for the firm and ultimately drive both the firm’s cash generation process and its share price.

Cheap to Outside Investors
The Brexit vote has had a significant impact on the value of sterling against key currencies across the world, including the US dollar. UK companies have become markedly more attractive for foreign buyers due to the currency movements. Many experts now believe that the environment has become conducive for M&A activity within the UK. With growth slowing down across the world, corporate takeovers would help foreign businesses gain new lines of revenue and so help to both bolster their financial standing and add stability as a bigger group. With Capita trading back at its 2009 levels in dollar terms and given its experience within the outsourcing industry across Europe, it would not be a surprise to find a host of foreign entities surrounding the firm in the very near future.

Analysts’ Corner
Capita Plc is considered a veteran within the outsourcing industry that has grown significantly over the past decade. It has a strong presence within the UK and footprint across the rest of the world, with a solid dividend yield. It is well covered by the analyst community, although recent events have seen analysts sitting on the fence, with 14 out of 21 individuals giving the stock a hold rating. Our scoring system suggests that the stock has an average 12-month target price (TP) of 1027p, representing an upside of over 50%.

Summary
Capita, paired with all its peers within the outsourcing industry, is trading at the lower end of its valuation cycle. The industry has suffered with some of their business lines being inefficient and others suffering structural downturns. In the case of Capita, they have also suffered due to their own time management issues that have cost them through one-off fines. The firm is also facing a significant legal battle that has forced down its share price and kept it depressed. However, it is still a firm of significant quality and experience that generates ample cashflow throughout the economic cycle. As the management team navigate the company through its contractual disputes and restructuring process, we believe the firm will re-rate in a positive manner. The current share price level and the firm’s leading position within the outsourcing market makes it an attractive investment, especially given its defensive nature at this time.
INVESTMENT INSIGHTS

Bond market concerns?

Many people reading this letter may be surprised to know that they own investments in their portfolio that guarantee them a loss.

Anyone who has a pension that is managed by a typical manager will no doubt have bonds in their portfolio that are currently yielding a negative return. There are some $12tn sovereign bonds that are now trading in negative territory, with all the new issuance immediately trading negatively at a premium to par (100) despite no actual negative coupons being announced YET! We mentioned last month that we had reached a new point of financial insanity when we saw some non-state backed European corporates issue bonds that immediately traded with negative yields. We can't blame the corporate treasurers for taking advantage of borrowing at no cost, but when we take this to the extreme, the insanity is obvious. Personally, I am actively looking to issue 1bn, currency immaterial, 30-year bonds (roughly life expectancy) at zero rates, so that I can 'invest' the money accordingly. If the current bond mania prevails, this must eventually be possible!! The cycle of high interest rates in 1980 to negative interest rates today is in its very final stages.

Bond markets sure aren’t what they used to be. One of the last blogs I wrote over two years ago was entitled ‘Going Nowhere’ and can still be found at www.hindecapital.com - blog archive. Here is an extract:
Going Nowhere

December 9th, by Mark Mahaffey (Co-Founder and CFO)

When I started my career in the financial markets in 1985 at Daiwa Europe Ltd, market knowledge and experience were very limited. Veterans were 26 years old with 3 years experience trading Eurobonds. As raw recruits new to the industry, the 5 minute executive decision that determined whether you were to be on the sales or trading desk was farcical in today’s eyes. I was last in the queue to have my career path chosen by Kiyokawa-san. “You trade US treasuries….!!!!” Ok, great, so I got to sit over in the bond corner, splendid. Long before the days of Bloomberg and the Internet, your ONLY real reference point was Marcia Stigum’s ‘The Money Market’, still in print today.

![Federal Funds Effective Rate US](image)

Despite a full yield curve of maturities to trade, the headline issue that everyone knew was ‘the long bond’, the longest maturity US government bond.

**Treasury Bond 11.25% 02/15/2015**

In February 1985, this was the newly issued long bond, 11.25% for 30 years. The next 4 long bonds were:

T 10.625% 8/15/2015  
T 9.875% 11/15/2010  
T 9.25% 02/15/2016  
T 7.25% 05/15/2016

Arguably the 11.25% was my designated starting bond. As most US treasury traders will know, the saying is that when your long bond redeems at 100 after 30 years, your time in the market place is up too. Which means that I have about a year or so left!

In the first 15 months of my career trading US treasuries at Daiwa Europe Ltd, the long bond coupon rates dropped 400 basis points. As an aspiring primary dealer with a Japanese trade surplus to be invested in US Treasuries, Daiwa Securities were at the fore front of this raging bull market. Having no other experience to relate to, this appeared to me to be the norm. As a lovely trainee trader, one of my daily tasks was to draw the Japanese candle chart of the long bond on graph paper and maintain this on the wall in the trading floor. Over the course of the day, the Japanese traders, salesmen and managers would saunter over to view my handy work, chain smoking cigarettes where they would “analyze” the pattern and nod knowingly.

The pattern was fairly clear to the naked eye, it was a good ol’ fashioned ‘moon rocket’ pattern. During the spring of 1986, the 9.25% long bond had a period where it rallied 27 points in a month which time I was now updating my chart standing on a stepladder, borrowed from the caretaker. When the graph paper touched the ceiling I asked my Japanese boss what I should do. He said “take it down, fold it up and keep it, you will never see that again”. He was a smart man, Hibino-san. Today, Takashi Hibino is president and CEO of Daiwa Securities worldwide. Of course, I have long since lost that chart unfortunately but its memory lives on.
Global bond issuance this year is already $5tn, which doesn’t even include government bonds as the world rushes to lower their cost of capital by issuing debt. The comparisons with 2007 levels are rather ominous as corporate debt relative to GDP reaches historical, critical 45% levels.

![Graph showing US Non-Financial Corporate Debt](image)

Source: Variant Perception

Unfortunately, too many companies do not find this lowered cost of debt capital much use, preferring share buybacks to capex investment or sitting on piles of cash. Their increased leverage does not bode well for the future. When stock prices go down, leverage ratios will naturally increase and debt burdens may quickly become a major issue.

![Graph showing US median leverage ratios in the US are very high](image)

Source: SG Cross Asset Research/Equity Quant, Thomson Reuters Datastream

Everyone should be concerned that net debt has risen above companies’ earnings and these earnings are turning down, despite there being almost no debt servicing costs to speak of now.
Unfortunately, it is not the issuers of all this debt who should be worried, it is the poor investors who are being forced to invest that are going to end up holding the bag when the balloon goes up. As John Hussman quotes, debt defaults, insolvencies and pension crises are now all but unavoidable, not to mention the growing possibility of there being much higher inflation levels as the money printing presses continue to overheat.

The bond mathematics from last month’s letter are worth repeating.

Sovereign bonds at low, zero or even negative yields clearly offer nothing in terms of income but most people are unaware of the huge potential capital loss to a bond investment if for some reason interest rates went back to the 5% levels of 2007. It is generally understood that as the economy would tank if interest rates rose to that level, they are very unlikely to do so. However, if the world’s central banks are faced with a surge in inflation as a result of all their money printing (something that hasn’t happened yet), then they may be forced to do just that. A very hard rock and a very hard place indeed.

The six year UK gilt issue 1.75% September 2022 currently yields 0.40% and is priced at 107.94 while the longer 20-year issue, 4.25% July 2036 yields 1.38%, priced at 148.70. If interest rates went to 5% on these bonds, they would be priced at 83.36 and 90.73 experiencing huge capital losses of 23% and 39% respectively.

As the chart in the overview showed, UK inflation expectations are rising quickly, which is an obvious result for an importer nation that has experienced a currency collapse. The Bank of England, or at least the market place, may be forced to think that interest rates will have to rise in the face of these inflationary pressures. Homeowners, businesses or bondholders will not welcome higher interest rates.
Whether we have reached the end of the greater fool theory with regards to bond investments, especially in the longer maturities, only time will tell, but everyone needs to realise that the huge potential for losses from here on severely outweigh the possibility of short-term gains. Our recommendation would be to exit all bonds, apart from the shortest maturity Treasury Bills and take a front row seat. The bursting of the bond bubble may be one of the most spectacular financial collapses in history.
PORTFOLIO UPDATE - WHAT HAPPENED?
MARKET & SECTOR ANALYSIS

UK Market Valuations

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HINDE’SIGHT DIVIDEND UK PORTFOLIO # 1 (OCTOBER 2016)

Portfolio Update and Construction

### LIVE PORTFOLIO

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### Industry Group Proportion (%)

- Telecommunications
- Commercial Services
- Retail
- Auto Parts & Equipment
- Media
- Apparel
- Insurance
- Transportation
- Entertainment
- Home Builders
- Banks
- Food

*Note: The chart above illustrates the proportion of various industry groups within the portfolio. The data is as of October 2016. The chart is a visual representation of the distribution across different sectors.*
PORTFOLIO UPDATE

Sky PLC
Sky PLC had an ex-dividend date on 6th of October 2016 for 20.95p.

Burberry & G4S PLC
Due to good performance, we decided to sell our holdings in Burberry and G4S as they were both up over 26% and 23% (in absolute terms) respectively.
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, e.g. 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.

**Disclaimer**

This newsletter is intended to give general advice only on the importance of dividends within the equity space. The investments mentioned are not necessarily suitable for any individual, and you should use this information in conjunction with other advice and research to determine its suitability for your own circumstances and risk preferences. The value of all securities and investments, and the income from them, can fall as well as rise. Your investments may be subject to sudden and large falls in value and you may get back nothing at all. You should not buy any of the securities or other investments mentioned with money you cannot afford to lose. In some cases there may be significant charges which may reduce the value of your investment. You run an extra risk of losing money when you buy shares in certain securities where there is a big difference between the buying price and the selling price. If you have to sell them immediately, you may get back much less than you paid for them. The price may change quickly, particularly if the securities have an element of gearing. In the case of investment trusts and certain other funds, they may use or propose to use the borrowing of money to increase holdings of investments or invest in other securities with a similar strategy and as a result movements in the price of the securities may be more volatile than the movements in the price of underlying investments. Some investments may involve a high degree of ‘gearing’ or ‘leverage’. This means that a small movement in the price of the underlying asset may have a disproportionately dramatic effect on your investment. A relatively small adverse movement in the price of the underlying asset can result in the loss of the whole of your original investment. Changes in rates of exchange may have an adverse effect on the value or price of the investment in sterling terms, and you should be aware they may be additional dealing, transaction and custody charges for certain instruments traded in a currency other than sterling. Some investments may not be quoted on a recognised investment exchange and as a result you may find them to be ‘illiquid’. You may not be able to trade your illiquid investments, and in certain circumstances it may be difficult or impossible to sell or realise the investment. Investment in any of the assets mentioned may have tax consequences and on these you should consult your tax adviser. The opinions of the authors and/or interviewees of/in each article are their own, and are not necessarily those of the publisher. We have taken all reasonable care to ensure that all statements of fact and opinion contained in this publication are fair and accurate in all material respects. All data is from sources we consider reliable but its accuracy cannot be guaranteed. Investors should seek appropriate professional advice if any points are unclear. Ben Davies and Mark Mahaffey the editors of this newsletter, are responsible for the research ideas contained within. They or any of the contributors or other associates of the publisher may have a beneficial interest in any of the investments mentioned in this newsletter.

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