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UK Individual Shareholders Society

Empowering private investors

Ten key investing lessons from an ISA Millionaire©

"The snowball effect"

by Leon Boros

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Introduction

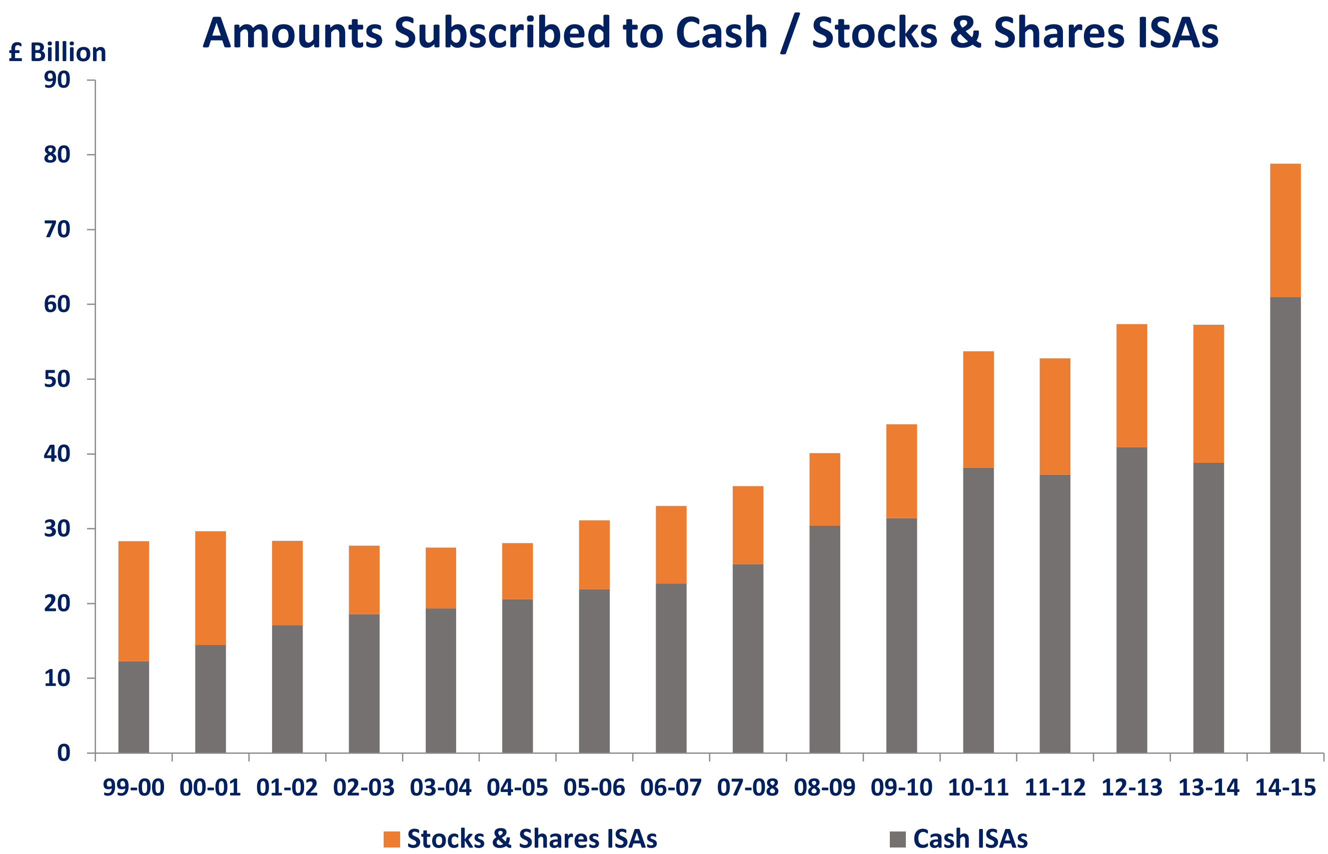
Two years ago I wrote an article for Stockopedia which described my journey to becoming an ISA Millionaire and offered some lessons learned over my then twenty-one years as an ISA investor. The article has been read over 30,000 times and I have received numerous requests from investors for an update. With continuing concerns over Chinese and global debt levels, it is with some trepidation that I update the story through to the end of December 2015.

The last two years have been fairly good for equity investors focused on smaller companies so long as they have managed to stay away from commodity and resource stocks. The FTSE Small Cap Index has risen by 10.2% during this period while the FTSE All Share Index has increased by just 2.2%, both calculated on a total return basis.

Background to ISAs

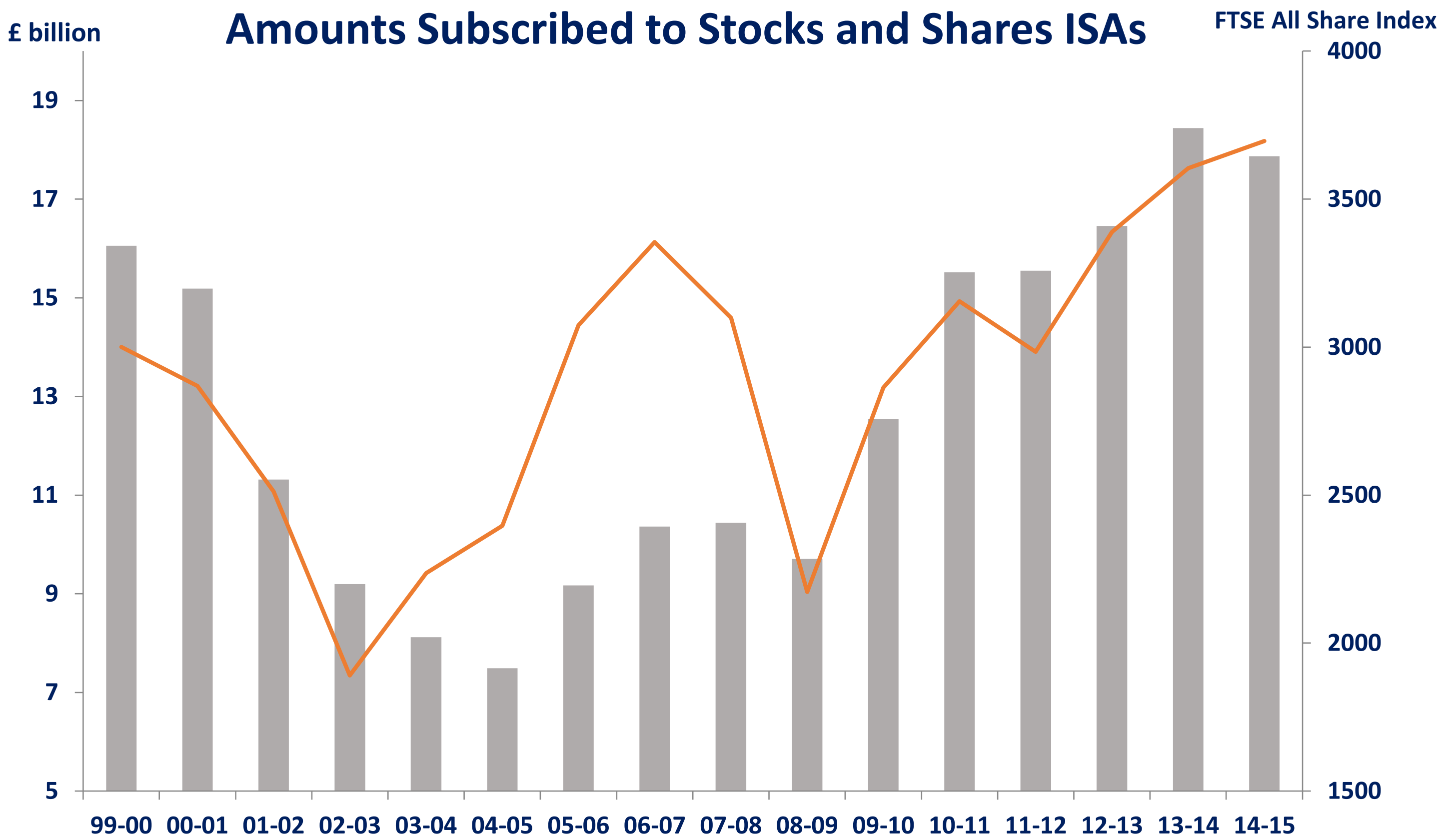
Over the same two-year period my ISA and my spouse's ISA have increased in value from £1,071,494 at the end of 2013 to £1,733,445 at the end of 2015, an increase of 54.8% after adjusting for annual contributions in the period totaling £54,240. Performance in 2015 was particularly good at 35.5%.

The Personal Equity Plan (PEP) was introduced by the then Chancellor of the Exchequer, Nigel Lawson, back in 1987 and later merged with Gordon Brown's Individual Savings Accounts (ISAs) in 2008. The scheme has been phenomenally successful with an estimated 22.7 million Adult ISAs and 510,000 Junior ISAs in existence by the end of the 2013 fiscal year.

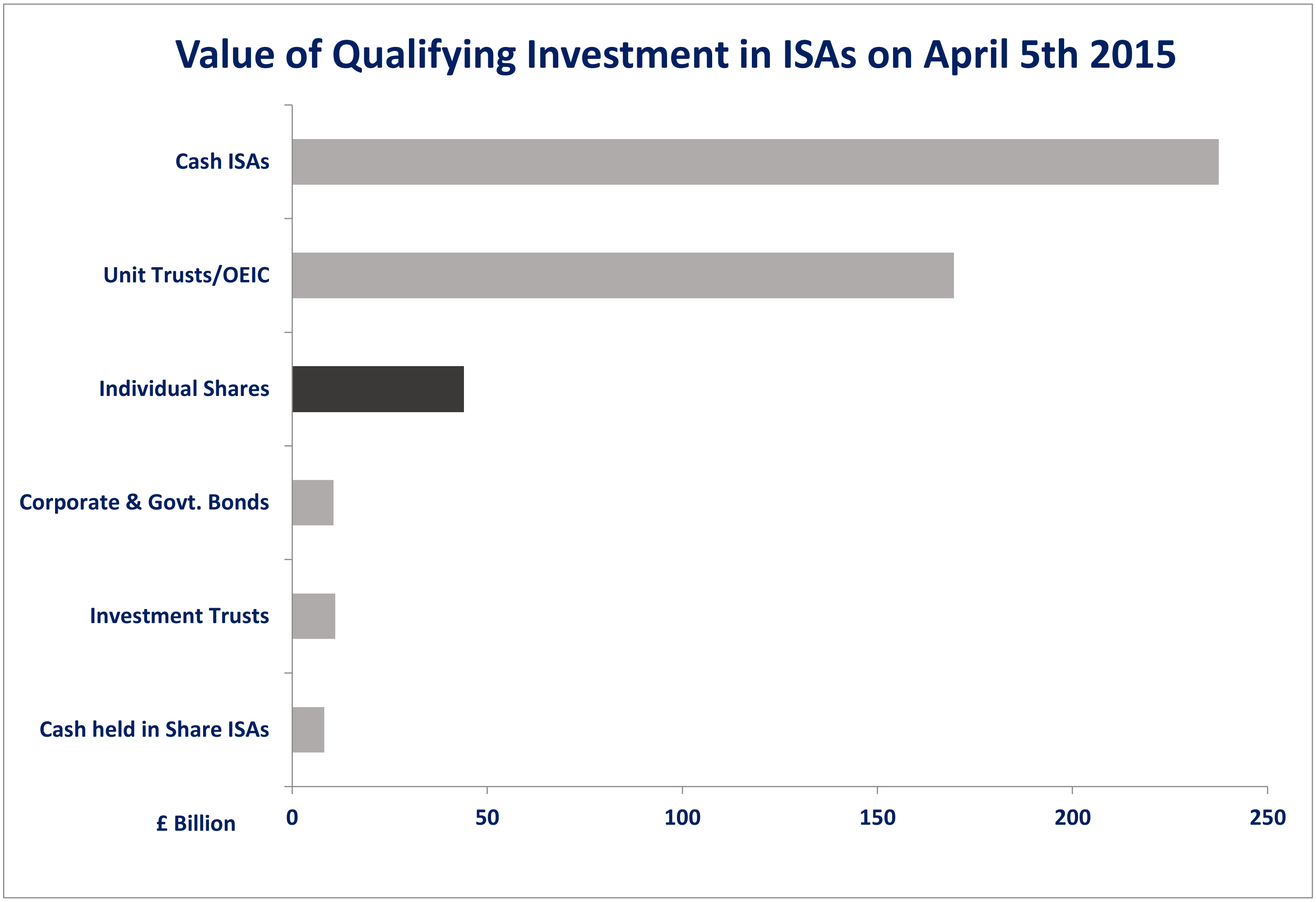


In 2014-15, a staggering £79.5 billion was subscribed to 13m Adult ISAs. This is £20 billion or 33.6% higher than in the previous year due to changes in ISA rules which saw an increase in the annual limit from £11,520 to £15,000 (£15,240 in 2015/16). Most of this new money found its way into low yielding Cash ISAs. Only 23% or £17.9 billion found its way into Stocks and Shares ISAs, a figure only slightly higher than the £16.1 billion invested at the peak of the dotcom mania in 1999/00.

Private investors appear to eschew Warren Buffett's adage "be fearful when others are greedy and greedy when others are fearful" by choosing to subscribe more to Stocks & Shares ISAs in high or rising stock markets. The following chart maps Stocks and Shares ISA contributions against the FTSE All Share Index.



Private investors also prefer to avoid investing in individual shares or securities, preferring instead OEICs and unit trusts despite the evidence showing very few ISA Millionaires have reached this milestone by investing exclusively in collective funds. In 2014/15, only £44 billion was invested in individual stocks whereas collective equity funds attracted investment of £177 billion and Investment Trusts a further £11 billion. Overwhelmingly, the preference was for Cash ISAs which at April 5th, 2015 held £237 billion.



The average value of a Cash ISA in 2012/13 was just £8,616 compared to an average of £38,824 held in Stocks and Shares ISAs. Where individuals held both types of ISA, the average value was higher at £48,311.

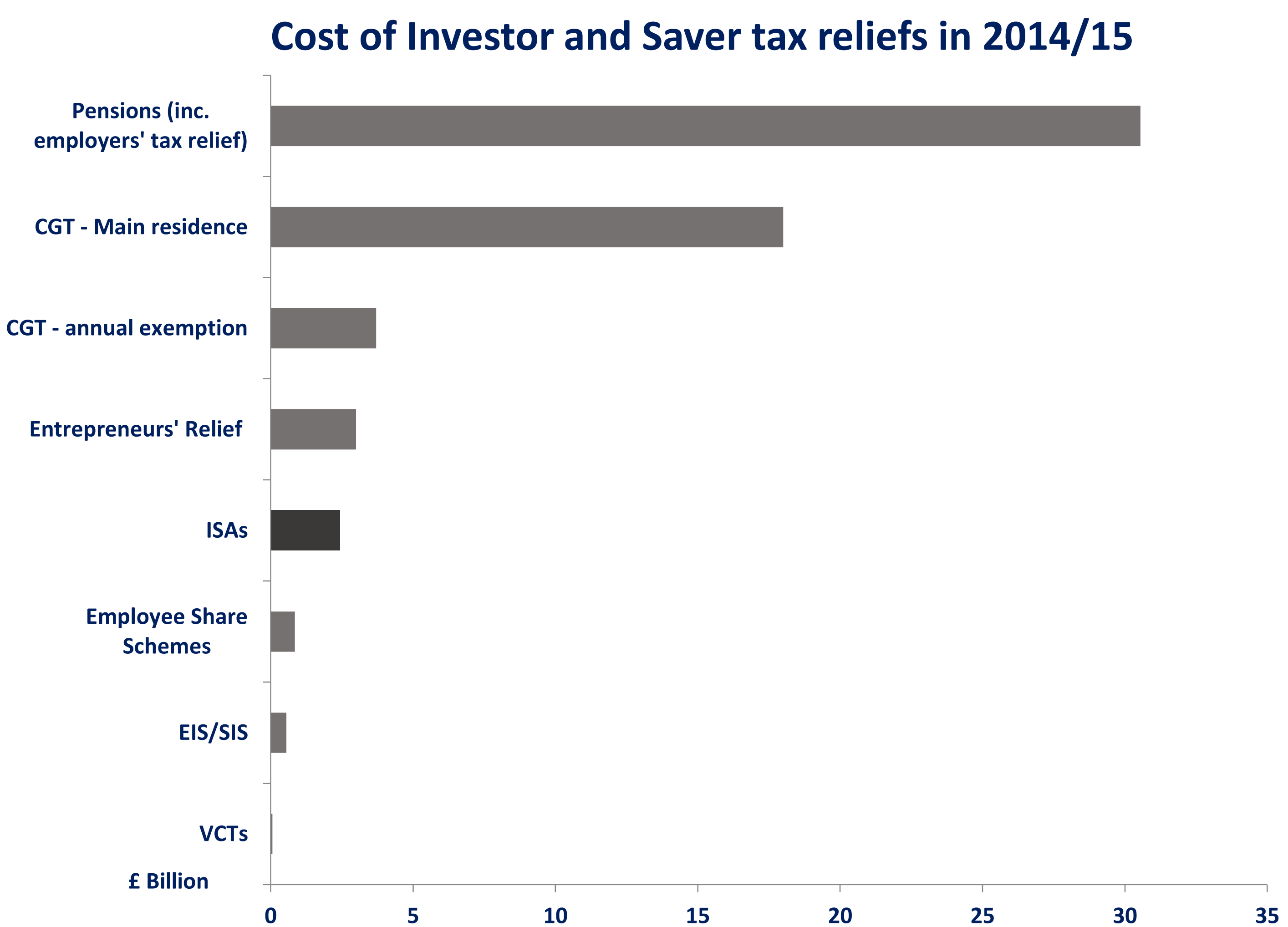
As one would expect, the average value of a Stocks and Shares ISA increases with the investor's personal income, but not dramatically so. Those earning over £150,000 had on average £77,665 invested in Stocks and Shares ISAs whilst those with an income range of £10,000 to £20,000 had investments on average worth £32,216. This contrasts sharply with those holding only Cash ISAs where higher earners had average savings of only £13,348 and those in the income range £10,000 to £20,000 average savings of £9,668[1].

[1] *All the above information on ISAs can be found at the following HMRC website.*

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/456379/ISA_Statistics_Release_August_2015.pdf

This disparity is in part due to the lower subscription limits for Cash ISAs, which was remedied in 2014 with the introduction of the NISA and a new limit of £15,000, low interest rates and a tendency for savers to use their Cash ISAs like a tax free current account with frequent subscriptions and withdrawals.

The cost to the Exchequer of ISA tax relief in 2014/15 hit £2.6 billion, up from £1.75 billion when I last reported two years ago. At face value this might seem high, but it compares favourably to the cost of other tax reliefs designed to encourage savings and investment, in particular the cost of tax relief for pensions which at £30 billion per annum is more than ten times the cost of ISA tax relief. The cost of Entrepreneurs' Relief at £3 billion per annum in 2014/15 is broadly comparable to the cost of ISA tax relief but benefits far fewer people. In fact, the ISA tax relief costs the Exchequer just £114 per ISA holder.



Source: HMRC - Main tax expenditures and structural relefs https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs

Last time I surveyed the ISA universe I estimated there were around 100 ISA millionaires. The Daily Telegraph now estimates there are around 200, with a further 1,800 or so holding assets between £500,000 and £1 million. Most appear to have achieved this by investing in individual shares rather than collective investment funds and by contributing over an extended period. Lord John Lee of Trafford, who became the UK's first reported ISA millionaire in 2003, recently disclosed that his ISA was now worth £4.5 million.[2,3]

Since 1987, anyone making the maximum contribution each year to a Stocks and Shares ISA and its predecessor the PEP could have amassed tax-free savings worth around £772,218 had he or she simply matched the performance of the FTSE All Share (on a total returns basis), at around 7.6% per annum. A couple making the maximum contribution over this period and achieving the same annual return would be worth £1,544,436. The maximum contributions would have totaled £242,520 for an individual or £485,040 for a couple.

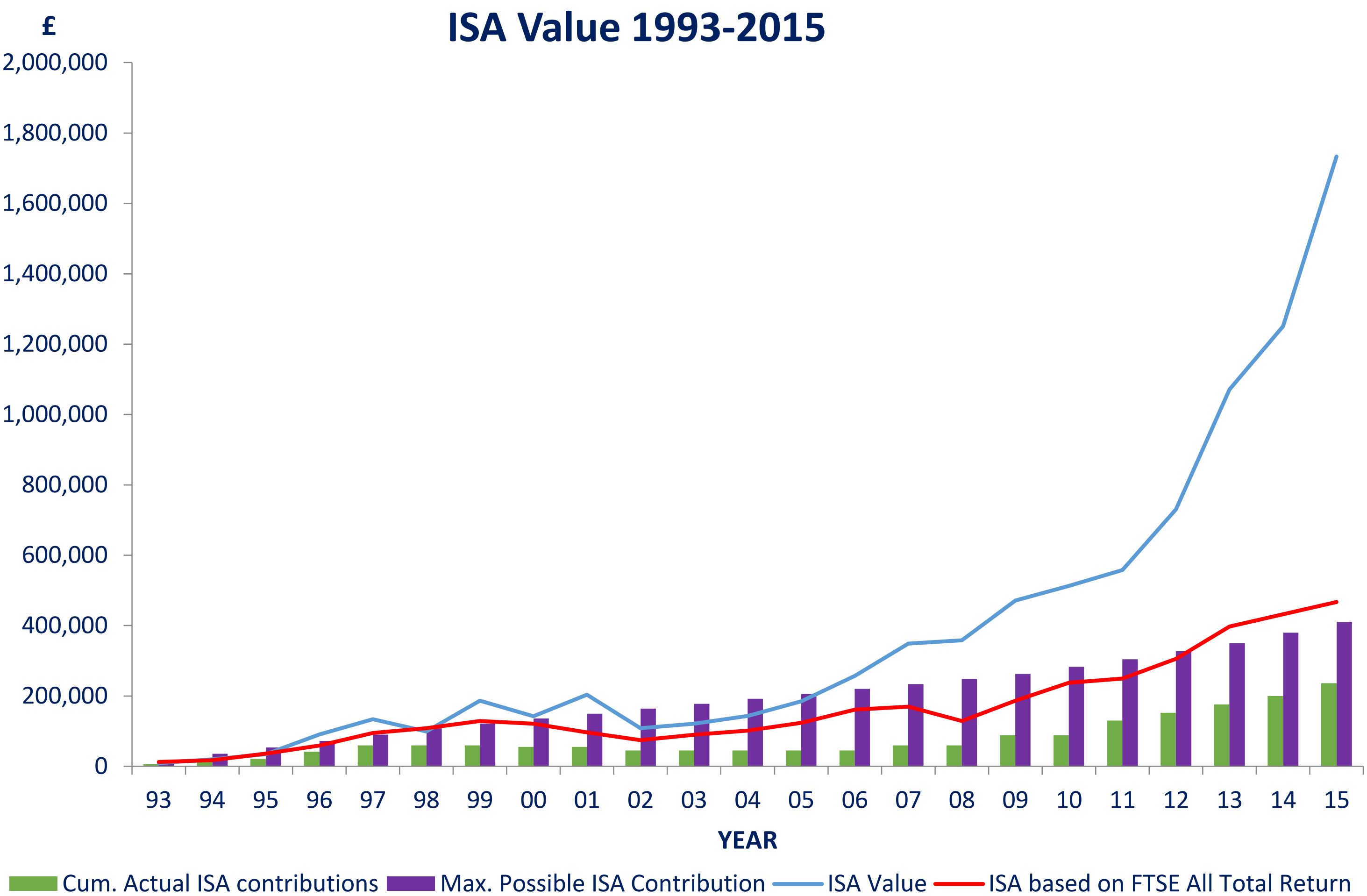
Few people are able to save regularly and save significant amounts each year. People with low or medium incomes, young families, those trying to buy a home, set up a business or pay school fees have competing demands on their resources. I know that I had some of these problems, which meant that by 2006 my spouse and I had contributed just £59,459 to our ISAs/PEPs (net of £14,575 withdrawn in the late 1990s and early 2000s), representing at that point just 22.1% of the amount we could have contributed since 1993, or 16.2% of the total we could have contributed had we started saving in 1987. Despite the paucity of our contributions, by the end of 2006 our Stocks and Shares ISAs/PEPs were worth £256,800.

[2] *http://www.telegraph.co.uk/finance/personalfinance/investing/isas/11468220/How-to-join-Britains-200-Isa-millionaires.html*

[3] *http://www.ft.com/cms/s/0/1616896a-9851-11e5-9228-87e603d47bdc.html#axzz3wqWRRTii/*

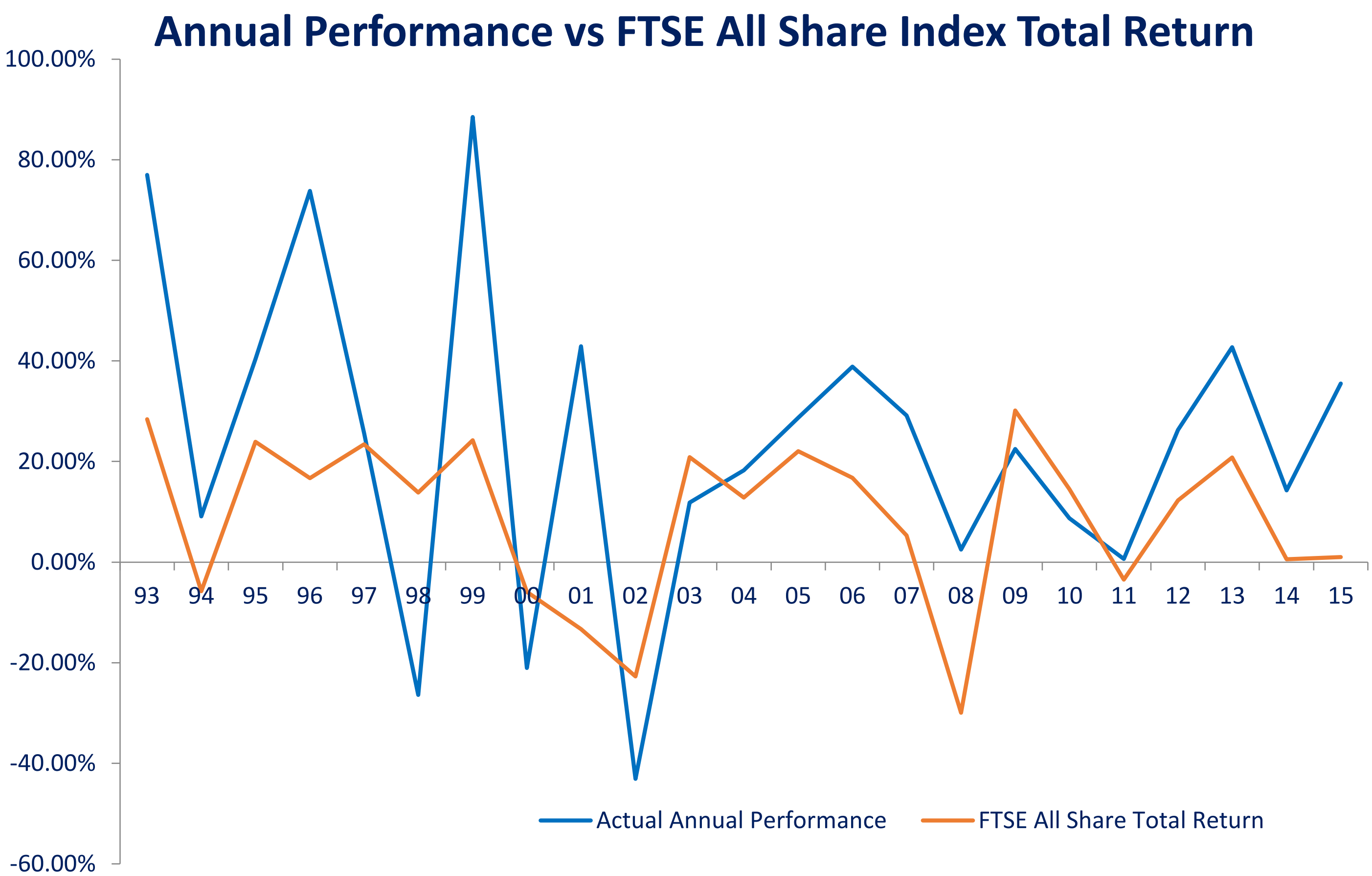
How have our ISAs performed?

At end of 2015 our ISAs had grown in value to £1,733,445 and I had become an ISA millionaire in my own right amassing a total of £1,010, 420 in my own ISA.



In recent years we have been utilising our annual contributions in full, such that we have now contributed £236,148 into our ISAs. This still only represents 48.7% of the money we could have contributed to ISAs/PEPS had we started saving in 1987 or 57.5% of the money we could have contributed since 1993. In fact, had we contributed the full amount possible since 1993, the value of our ISAs would now be worth £4.7 million, a testament to the importance of saving early and often, and giving time for compounding to work its magic.

Nonetheless, the money we invested back in 1993 has increased 61.6 times (2013: 40.0 times), representing an annual return of 19.9%. The FTSE All Share on a total return basis has increased just 5.5 times over the same period, an annual return of just 7.7%. Our internal rate of return, which factors in the timing of subsequent contributions and withdrawals, is running at around 17.6% per annum. We have beaten the FTSE All Share on a total return basis 17 times out of 23 on an annual basis, 16 times out of 19 on a five year rolling basis and over all 14 ten year rolling periods.[4]



It is a sobering thought that, had we used our actual ISA contributions since 1993 to invest in a tracker matching the performance of the FTSE All Share Index on a total return basis, our ISAs would have been worth only £467,200 at the end of 2015.

[4] *Previously my rolling investment performance was compared to the FTSE 100 on an estimated total return basis. This slightly flattered my performance. The FTSE All Share total returns data is more accurate and is sourced directly from FTSE International via* ***http://swanlowpark.co.uk/ftseannual.jsp***

Ten Key Lessons to become an ISA Millionaire

1. Compounding Capital Tax Free

The holy grail of investing is the concept of compound interest. Albert Einstein called it the "*greatest mathematical discovery of all time*". At its heart is a very simple concept, namely to earn "*interest on interest*". For an investor in equities that also applies to earning a return on re-invested dividends or capital gains. You only fully benefit from the power of compounding if you are able to leave your profits invested and to do so for an extended period. Remember, Warren Buffett generated 90% of his wealth after the age of 65.

If you need some or all of the profits to live on, or if you have to pay taxes on the capital gains and investment income, then the positive effects of compounding will be severely restricted.

The key attraction of an ISA is its ability to shelter capital gains and dividends tax free. Compounding returns and tax free investing through an ISA is a beautiful marriage. Unlike SIPPs, which also allow returns to compound tax free, there is no tax paid on money withdrawn from an ISA and no complicated rules to deal with either.

The power of compounding tax free in an ISA can be seen in the chart below. I have assumed a couple each subscribe £15,240 into an ISA and continue to invest the maximum permitted in the following years. If the money subscribed is invested in a Cash ISA, I have assumed the Tesco Fixed Rate ISA which pays 1.75% per annum gross and that interest rates and inflation do not change, it would take twenty-one years for the couple to have ISAs worth £1.06 million. The couple's total subscriptions during this period would have been around £880,000, a profit of £180,000.

Investing in a Cash ISA is rather like buying a mansion but choosing to live in the garden shed, or buying a Ferrari and never exceeding 20 mph. It is simply a waste of a powerful wealth creating engine. It fails to give the power of tax free compounding a chance to work.

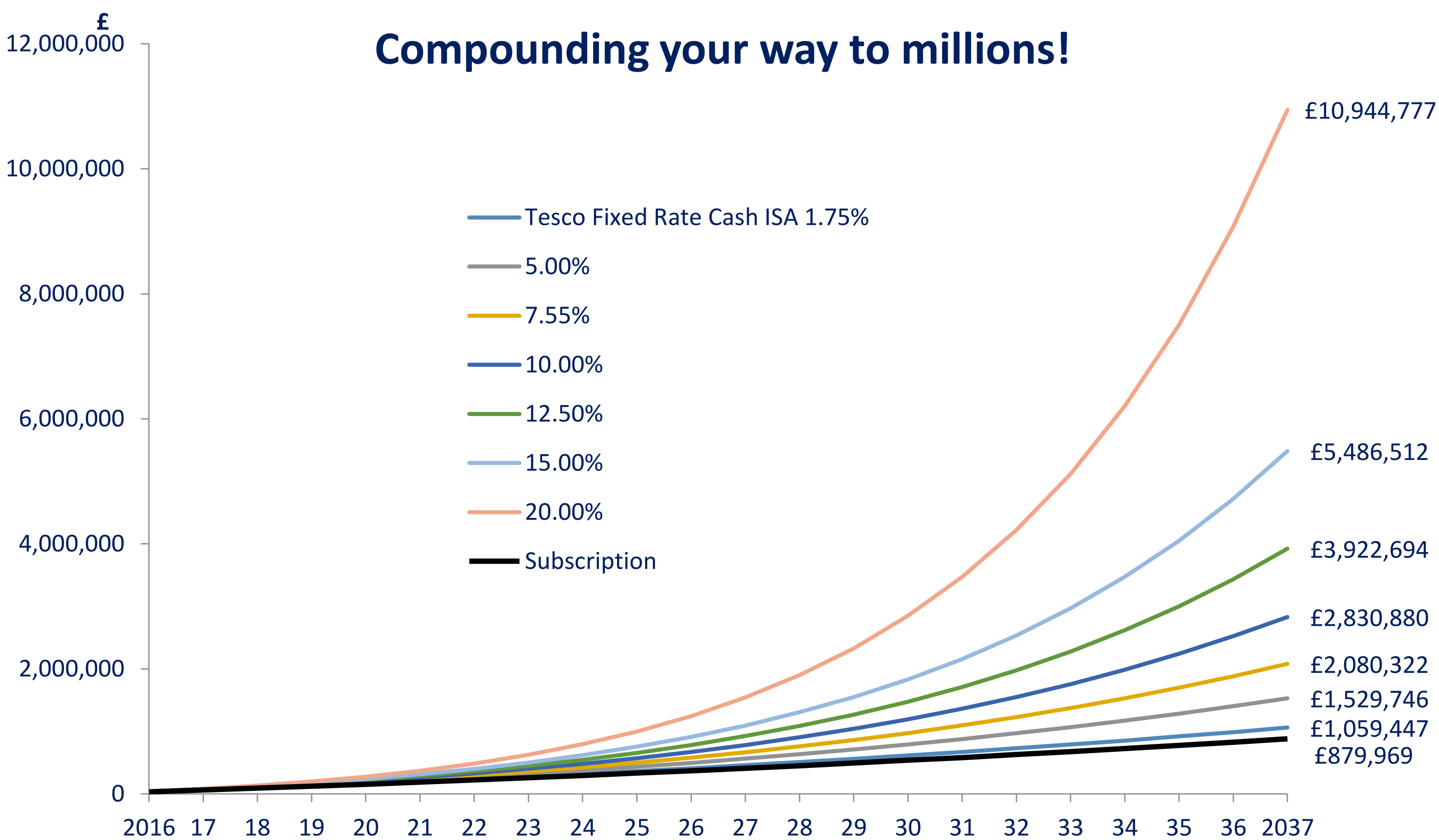
Of course investing in a Stocks & Shares ISA brings with it risks, including the potential loss of capital which many savers are not prepared to tolerate, but this caution costs them dearly in the long run. Even if our couple were only to generate a 5.0% per annum return on their ISA savings they would have an ISA worth £1.53 million after twenty-one years, a profit of £650,000 and would have achieve ISA millionaire status around 5.5 years earlier than with the Tesco Cash ISA.

The FTSE All Share has returned an average of 7.55% per annum on a total return basis since 1987. Were our couple to match this return in the future, their ISAs would be worth £2.08 million by April 2037, a profit of £1.2 million. They would have achieved ISA millionaire status around the end of 2030, seven years earlier than with a Cash ISA. Alternatively, they could have halved their total subscriptions over the period and still have achieved ISA millionaire status by 2037.

The compounding effect magnifies with time. Compounding at 15% per annum produces an ISA worth £1.09 million by 2027, 65% more than the ISA compounding at 7.55% per annum. Ten year later, the ISA compounding at 15% per annum would have grown to £5.85 million, 164% higher than the ISA compounding at 7.55% per annum.

A Stocks and Shares ISA gives compounding a chance to produce its magic. It is like a snowball rolling down the mountain gathering pace and growing in size.

"My wealth has come from a combination of living in America, some lucky genes and compound interest" Warren Buffett

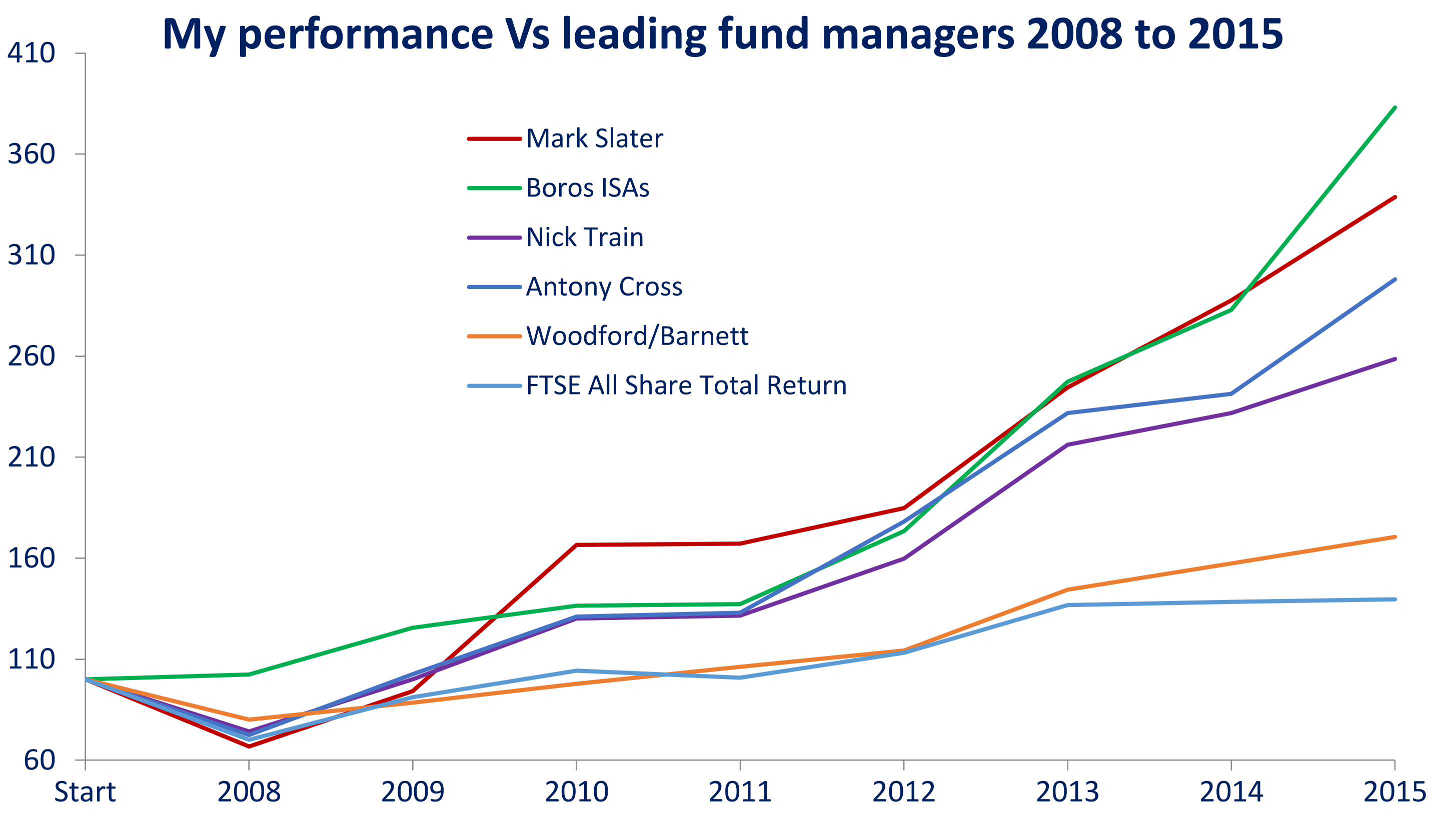


Assumptions. 1) Couple making maximum contribution from 2016/17 tax year 2) ISA limits fixed to 2019/20 then rising 3% p.a. 3) zero inflation

2. Don't assume bigger money is smarter money

As we have seen the vast majority of ISA savings are held in cash or invested in unit trusts, OEICs and other collective investment schemes.

Many investors assume professional fund managers will do a better job than them. After all fund managers are smart, have expert knowledge, extensive research capabilities and time. Despite these advantages, I still believe most private investors can beat professional fund managers. I have managed to beat some of the best in the industry since 2008: Nick Train (Lindsell Train), Anthony Cross (Liontrust), Neil Woodford (Woodford, previously Invesco) and Mark Slater (MFM Slater), as shown in the following chart.



Comparator funds: CF Lindsell Train UK Equity Acc, MFM Slater Growth A Acc, Liontrust UK Smaller Company R Inc, Invesco Perpetual Income Acc

Am I a better investor? No, probably not. So why the difference in performance?

- I am able to fully commit to my best ideas. Over the last two years my best idea and my largest position has been Bioventix which increased from £4.50 to £12.00 over the period. It is now very overweight in my portfolio at over 20%. I have not sold any stock because I believe its best days are still ahead and my second and third best stock choices are not quite as compelling. Most fund managers would not be permitted to be so heavily concentrated on one stock due to the rules which govern the operation of OEICs, the need for liquidity in the event of client redemptions and the risk to their careers of getting it wrong.

- Most fund managers are focused on achieving relative out performance rather than focusing on absolute returns. Making a big call on the market runs the risk of damaging a manager's career if he or she gets it wrong. When I sold almost all our investments in March 2008 and stayed out of the market until March 2009, I was only accountable to my conscience and my wife who fortunately pays little attention to public markets. My decision worked out well with our ISAs modestly increasing in value while the market was down by over 30% in 2008.

- Assets under management drive fund managers' fees so the incentive is to grow bigger. It gets harder to beat the market when running a large fund. A large diversified portfolio effectively removes the non-market or specific risk associated with individual investments, thereby linking performance closely to market returns. This goes some way to explain why after costs most fund managers underperform the market.[5]

- In small or micro-cap stocks, a well-informed dedicated private investor probably knows more about what is going on in a company and its markets than a fund manager holding 100 or 200 stocks in a portfolio. Small Cap fund managers with large funds to deploy find it almost impossible to run concentrated positions because they would end up owning too much of each stock. This gives the research-orientated private investor in small and micro-cap stocks a distinct advantage.

- Fund managers do not have a reliable reverse gear. It is typically easier for a private investor to get out of an investment when they make a mistake than a fund manager holding a large position. Private investors can also react quickly to bad news by selling shares when the market opens. Fund managers often take longer to make a decision and may need to write a report or get a committee or a boss to sign off before closing a position.

[5] *http://www.marketwatch.com/story/this-study-shows-stock-fund-managers-can-beat-an-index-2015-06-03*

- Fund managers often have to pay more to build up a meaningful position in a smaller company and will generally have to start selling well before the shares peak in value. Often they have to wait until a small company has become a bigger company at a higher valuation before it becomes feasible for them to invest. As respected US share blogger and successful micro-cap investor Ian Cassel says, "*Larger, smarter money can't invest in micro-caps and this creates inefficiency*"[6], an inefficiency which smart private investors can exploit. Private investors get to eat all three courses of a meal, whereas a fund manager often has to miss the starter, rush the main course and only gets to enjoy a mouthful of the dessert.

- Finally, fund managers charge fees. A typical annual total expense ratio of 1.5% represents around 20% of the annual return achieved by UK equities since 1993.

3. Meeting management and networking

Private investors often lack technical, sector or accounting knowledge and have limited access to management and limited time, but these disadvantages can be overcome. Organisations like ShareSoc, Equity Development and Mello organise meetings for private investors to meet with management of smaller, listed companies. Usually held in the late afternoon or early evening, I find these events invaluable. It is not just a chance to better understand a company's business model, products, or accounting policies, it is also a chance to hear the clarity of a management team's thinking and its ability to perform under pressure when answering questions from a knowledgeable audience.

Most important of all, these meetings provide you with an opportunity to distinguish between good, honest and straightforward managers and the fraudsters, dishonest salesmen and dreamers who sadly find their way into the leadership of some of our public companies. My best investments of 2015 Bioventix plc and Redde plc (held outside my ISA) share similar qualities. They are led by people experienced in their respective sectors, who are intelligent, have integrity, a quiet modesty and a preference for under-promising and over-delivering. I like to sleep easy at night.

Another key benefit from attending these meetings is the chance to network with fellow private investors. I have found my investing performance has improved markedly in recent years after sharing ideas with fellow private investors who I originally met at ShareSoc or Mello, many of whom have gone on to become good

[6] http://www.safalniveshak.com/ian-cassel-microcap-investing/

friends. Working together with others to analyse an investment opportunity, with people possessing different skills and different career backgrounds, has helped to improve my decision making processes and also enriched my life. So please do not be penny wise and pound foolish; join these networks and meet other private investors, particularly ShareSoc which has a wider role in championing the rights of the private investor.

4. The younger you start, the better

Start young in order to give the law of compounding the longest time to work. I set up ISAs for my two daughters a few years ago and continue to make contributions even though they are now aged 19 and 22. I had hoped it might engage their interest in investing, but they seem happy to outsource the investment management role! Both achieved returns of over 40% in 2015, in part because only four or five stocks were held during the year and all did well. For those with children under 18 years old, you can subscribe up to £4,080 per annum on their behalf to a Junior ISA (2015/16). Any help towards your children's annual ISA subscription after the age of 18 has to be made by them directly so you have to be confident that any cash you transfer to their bank account finds its way into the ISA and not elsewhere! As I tell my girls, "*you can't hope to compound your money and become an ISA Millionaire buying dresses online at ASOS.com or Boohoo.com*." An alternative approach for those parents not wholly convinced by their offspring's ability to hold onto any savings is to fund a SIPP instead, where the money is helpfully locked up until they reach the age of 55.

5. Use a quantitative led approach to filter investment opportunities

I always try and understand the numbers first before deciding on whether to spend time on understanding the business. More often than not, the numbers will tell me more about a company than the blurb in the Annual Report or RNS (LSE Regulatory News Service) or from listening to management. This approach helps me to judge whether what I am being told by management stacks up. I avoided losing money at Globo, Silverdell and Naibu in recent years because the numbers told a very different story to the bullish tale being told by their CEOs.

Most critically I want to know the following: -

- are sales growing? Top line growth drives earnings growth;

- is this a high or low profit margin business? High operating margins are usually indicative of a business with pricing power which is in turn the result of a strong brand, intellectual property, technological superiority or limited competition;

- how cash generative is the business? I look for companies able to convert a high percentage of their Earnings (post-tax profits) into Free Cash flow (FCF), typically 80-90%. I define FCF as Earnings before interest, tax, depreciation and amortisation (EBITDA), plus or minus changes in working capital, less capital expenditure and spending on internally generated intangibles, less net interest and Corporation Tax paid. Strong cash conversion allows a company to grow its earnings organically or through non-dilutive acquisitions or return surplus cash to shareholders through dividends, special dividends, tenders or buybacks. When reading an RNS or Annual Report I always opt to read the Cash Flow Statement first;

- what are the returns being generated on the capital employed in the business? There are various ways of measuring this but my preference is the Return on Tangible Assets (ROTA). This metric identifies companies which require relatively modest amounts of tangible assets (e.g. plant and machinery, stock, cash or trade debtors) to grow or preserve a business franchise. It is a great predictor of companies that should be able to generate strong Free Cash flow in the future. I typically look for companies generating a ROTA of more than 30%;

- how much debt is there and is there sufficient working capital? My approach to the balance sheet is defensive. I am not typically looking for hidden value, rather I am trying to avoid companies with stretched balance sheets which may risk the future of the business in the event of a downturn in the economy.

"***Value strategies endeavour to acquire productive capacity cheaply. Traditional value strategies do this by buying assets at bargain prices; quality strategies do this by buying uncommonly productive assets***" **Prof. Robert Novy-Marx - The Other Side of Value.**

6. Run a concentrated portfolio when you are young

"***You only need to do a very few things right in your life***." **Warren Buffett**

Typically, at this stage of your life, your portfolio value will be modest, you will have limited time for research and you still have the chance to "rebuy" from your future earnings in the event of a major loss on a share. Investing in your best ideas makes sense as it gives you the chance to outperform. Holding between five and ten stocks is perfect, but this should grow as time goes by and the value of your portfolio increases. At the end of 2015, we held only 18 stocks in our ISA and 37 overall.

7. Cut losses and run profits

"***The first cut is the deepest.***" **Rod Stewart**

Everyone should know about this rule, but few private investors have the discipline to apply it, sadly including me. Remember that when you sell a losing investment you are no worse off than you were immediately beforehand. In fact, there are big psychological benefits to be had from ridding yourself of a losing position. Between 1993 and 2013 only around 64% of my ISA investments were profitable. An embarrassingly large 36% were losing trades, but critically only a quarter of these involved losses of more than 20%. Happily, between 2014 and 2015 the win ratio increased to 68%, but I failed to be disciplined in cutting losses and two current holdings show losses of over 90%, Zanaga and Sea Energy. Thankfully, the position sizes were not large and in both cases I sold shares at various prices on the way down.

The following table shows the importance of making the first cut and making it deep!

Losses	Required return to recover loss
10%	11.1%
15%	17.6%
20%	25.0%
30%	42.8%
50%	2x bagger
80%	5x bagger
90%	10x bagger

It is worth noting that just one 2 bagger pays for five losing trades if losses are cut at 20%. So it is possible to have a win ratio of just 20% and still not lose money if you are disciplined about cutting losses.

Many private investors make the mistake of responding to a falling share price by buying more shares. This is known as averaging down. This approach is almost guaranteed to lose you money if used indiscriminately and only serves to magnify the error of not cutting losses on your original investment. I much prefer to average up, paying a higher price for the shares as the market validates my initial assumptions about the company.

Running profits can be difficult especially when a single share becomes dominant in your portfolio, but a single multi-bagging share can pay for many small mistakes. Five of our ISA investments have generated six figures in profits and dividends over the years, including Autonomy, Capita, Beazley, Lloyds Banking Group and more recently Bioventix where the gains are now substantial. A buy and hold approach keeps transaction costs to the minimum and forces you to think like an investor and not a trader.

8. Avoid blue sky stocks. Focus instead on value, reasonably priced growth and quality

"When you analyse what happened the big money's been made in the quality businesses."
Griffin, Munger: The Complete Investor

When I last reported two years ago, I described my disastrous track record with blue sky investments which had produced only one big winner in twenty years (Autonomy) and many losses! Over the last two years I invested in only two blue sky stocks, Seeing Machines and Omega Diagnostics, both of which have since been sold for a small profit. I now hold no blue sky stocks in my ISA. I have decided it is far better to hold such stocks outside of an ISA where they can do less damage and where the inevitable tax losses can be utilised.

A £100,000 loss in your ISA takes 6.6 years to replace in new subscriptions, so it must be better to pay the 20% CGT charge on the occasional blue sky winner outside of an ISA rather than wreck the performance of your ISA with one big loss. In any case, the capital gains outside of an ISA can be mitigated by CGT losses you may have generated elsewhere or avoided altogether if EIS (Enterprise Investment Scheme) relief were available at the time of the investment or the investment was made by way of a spread bet.

Resources and commodity stocks continue to be another area of disappointment for me. All three investments in this area lost money in 2014 and 2015. As previously reported, my best results continue to come from my investments in Quality at a Reasonable Price ("QARP") stocks. All seven QARP investments made money in 2014 and 2015, even better than the 90% success rate achieved between 1993 and 2013. QARP stocks delivered 78% of the gains in our ISAs since the end of 2013 and included profits on Bioventix, IG Index, Dragon Oil and Idox.

Only 65% of my Value investments made money in 2014 and 2015, slightly down from the 70% success rate experienced between 1993 and 2013, with the biggest winners being Beazley and Empresaria and the biggest loser being Panmure Gordon, the corporate broker. GARP or Growth at a Reasonable Price did well with 83% of my trades producing a profit over the last two years compared to my long term average of 67%. The biggest winners here were Tristel and Plus500.

Value and Growth are well known investing concepts. **Value** focuses on companies trading on modest multiples of earnings or at a discount to tangible asset value. The challenge here is to avoid value traps where a company's lowly valuation is fully merited because of excessive debt, poor earnings to cash conversion, dubious accounting, technical obsolescence or an exposure to cyclical markets when those markets are in free fall. I currently hold XL Media (XLM) which trades on a prospective price to earnings (P/E) multiple of 10.9x, Empresaria (EMR) on a P/E of 7.7x and STM on a P/E of 9.5x. All have scope to grow earnings rapidly but trade on low multiples for a variety of concerns including transparency of earnings (XLM), debt levels (EMR) and an over reliance on one source of revenue (STM).

Growth companies are expected to grow earnings per share rapidly. Generally, they trade on high P/E multiples that are expected to decline over time as earnings grow. Cash conversion may be low and dividends non-existent as the company focuses all of its resources on growth. Buying growth cheaply is difficult although not impossible, but do avoid the temptation to overpay for growth. Remember picking a great company is only half the battle. Paying the right price is also important as illustrated by recent developments at Tristel plc.

Tristel plc – A Study in Growth

Tristel was my third best performing share in 2015 (on a total return basis) with the shares rising by 75% from 79p to 140p by the end of the year. The rising price and further purchases (between 75p and 115p) made Tristel one of my largest shareholdings. Strong trading results in FY 2014 and FY 2015 and an expectation that top line sales would continue to grow at 15% p.a. had caused the Company's shares to re-rate and by the end of the year the Company was valued at £61m and were trading on a demanding forward P/E multiple of 26x forecast earnings for FY 2016. At these elevated levels investors only want to hear good news.

Tristel specialises in the manufacture and distribution of mainly chlorine dioxide based infection control, contamination control and hygiene products for human and animal healthcare. Tristel currently sells into 38 countries around the world through subsidiaries, JVs and independent distributors.

Until 2012/13, the largest segment of the business (approx. £3m in sales) was for products used in washing machines to clean the larger endoscopes used in gastro-intestinal endoscopy. Sales in this segment collapsed by 58% in that year after the publication of new Department of Health guidelines for endoscopy which encouraged hospitals to use the proprietary disinfectants and decontamination products of the washing machine manufactures themselves, rather than Tristel's stand-alone disinfectant products. This development and some other problems had caused the share price to collapse to just 20p by mid-June 2013.

Fortunately, these problems were quickly offset by growing sales of its patented Tristel Wipes System used on small, flexible endoscopes and ultrasound probes, and employed in a range of different hospital departments (including gynaecology, urology, ear nose & throat, cardiology and IVF), and other chlorine dioxide products. A series of positive trading updates in 2014 led to a strong share price recovery. Operating profits in FY 2015 were £2.5m on sales of £15.9m.

Overseas sales growth had been a particularly strong aspect of the Company's improving performance, growing at 20% p.a. This trend was expected to continue and even accelerate once the Company secured FDA approval for some of its products to be sold in the US market. Sales growth in the UK market had been slower at around 10% p.a. in recent year reflecting the more mature nature of the market and Tristel's already high levels of penetration in certain segments. Nonetheless, solid UK growth had helped to underpin management's belief it could grow overall sales at 15% p.a. through to 2019. Investors quickly recognised that strong sales growth combined with operational gearing would see operating profit margins exceed 20% and earnings per share race ahead as an increasing proportion of sales revenue found its way to the bottom line.

In February 2016, the Company issued an RNS which reported that sales in the six-month period to December 31st, 2015, had slowed to just 8%, principally because of weaker demand in its core UK human health market as sales reached saturation point and some of its non-chlorine dioxide products were phased out due to regulatory changes. Brokers' notes issued soon after the RNS showed the decline in the UK human health market was set to continue and that sales growth in the UK would slow to only 2%, despite the launch of a number of new products.

Investors quickly re-set their expectations for long term sales and profitability and over the following two days the share price sank from 145p into the low 90s.

Matters were made worse by the disclosure of a share based compensation charge of over a £1m, which was largely attributable to a new Performance Share Plan approved by the Board in April 2015 but only disclosed to investors on August 4th in an RNS issued at 11.57 am.

Under this plan, options were granted over 636,567 shares to two executive directors exercisable at just 1p per share. As with many "nil cost" plans the vesting of the options were subject to certain profit objectives being met over a three-year period. Controversially, an override was included which allowed all the options to vest immediately, if the share price of the Company remained at or above 134p per share for a period of 30 consecutive dealing days. This condition was fulfilled on January 6th, 2016.

The Company's AGM had been held in mid-December 2015 and as in previous years the Company issued an AGM Statement which stated its expectations on first half profits but on this occasion Tristel chose to remain silent on its sales performance.

Naturally, some investors jumped to the conclusion that Tristel's management had chosen to conceal the slowdown in sales growth knowing this would impact the share price and prevent the options from vesting. Management argued, on the contrary, that as earnings per share for 2016 and 2017 were expected to remain largely unchanged (due to cost cutting) an announcement was unnecessary.

Whatever the truth, confidence in Tristel's management has been damaged by this chain of events which is a great pity as they have always engaged enthusiastically and openly with private investors in the past.

Quality companies are those which generate high profit margins, return on capital and cash conversion. Classic quality stocks include Hargreaves Lansdown, Reckitt Benckiser and Next. Buying quality at a reasonable price is currently difficult with many trading on price to earnings multiples in excess of 20.0 times. Bioventix is no exception.

Bioventix plc – A Study in Quality

Bioventix is a specialist developer and supplier of high affinity monoclonal sheep antibodies for applications in viral clinical diagnostics, a $7bn end market. Clients include the top five global diagnostic companies, such as Abbott and Siemens.

Highlights

- Market Cap. £52.2m;
- Revenues have increased 8 fold over the last eight years to £4.3m, a CAGR of 22.5% p.a.;
- Pre-tax profits have increased to £3.1m, a CAGR of 38.3% p.a. since 2008;
- EPS has increased 192% since 2009 when the Company first came to market;
- Prospective dividend yield of 4.1%;
- Operating margins of 71% and set to go higher;
- Return on Equity of 39% and trending upwards;
- Return on Tangible Assets (excluding cash on the balance sheet) is a staggering 112%.

Sheep antibodies produce better results than the more common mice-based antibodies, allowing them to be used in the most sensitive diagnostic tests. Bioventix earns fees during the development phase, and a perpetual royalty on sales of any diagnostic that uses its antibodies. Sometimes, Bioventix is paid for the development. In other cases, it funds the development based on its own ideas and market intelligence.

There are currently around ten diagnostics assays on the market that contain a Bioventix antibody and contribute meaningful royalties, the most significant of which is a vitamin D antibody (vitD3.5H10) which has been licensed to around 16 diagnostics companies. There is also a pipeline of other assays which are expected to be launched by customers over the next few years, as well as a development pipeline of around ten new antibodies which have yet to be licensed.

The launch by one of its global customers of a high sensitive Troponin test used to detect heart attacks should be transformational although the timing is a little uncertain. House broker, finnCap, estimates this is a $1.2bn market, growing at 12% per annum and believes Bioventix will generate extra royalty sales of up to £4.1m p.a. phased in from 2017 or 2018.

At the current offer price of £10.30, Bioventix trades at around 17.2x FY 2017's EPS estimate of around 60p, which at face value may seem expensive but finnCap has a near term target price of £12.50 and has valued the business on a discounted cashflow basis at up to £16.42.

9. Never forget the importance of liquidity and knowledge

Investing in the smaller cap arena can give you the knowledge edge and the opportunity to get in on the ground floor of a great company. The downside is liquidity. As anyone who has experienced a bear market can testify, it can be almost impossible for a private investor with even a small holding to exit when there is red on the screens and blood on the streets. This need not be a problem if the small cap company has a strong balance sheet, high levels of cash conversion, good growth prospects and you do not own the shares on margin (i.e. borrowed money). In these circumstances you just hold tight. Earnings growth should compensate you for any attrition in the P/E multiple and eventually markets typically recover.

The nightmare scenario in a bear market is holding highly cyclical illiquid small cap stocks with weak balance sheets, negative FCF and funded on margin; a lobster pot or trap and everyone knows it, so magnifying the share price fall as investors try to escape.

10. Have you got what it takes?

"***Nothing is easier than self-deceit. For what each man wishes, he also believes to be true*." Demosthenes**

Many people ask me what personal qualities are required to be a good investor? I have met some of the UK's most successful private investors and know a good few of the best professional managers. It seems to me that the most important personal qualities are:

- **Fearfulness** - *Howard Marks talks of investing scared (i.e. always consider the downside risks) in his wonderful book "The Most Important Things ", but do not forget Warren Buffett's oft repeated quote, "be greedy when others are fearful"*
- **Sceptical** – *but not unduly pessimistic*
- **Contrarian** – *independence of thought is critical for investing success*
- **Open minded** - *listening to the contrary arguments and accepting when you are wrong*
- **Analytical** – *but beware that too much analysis can cause paralysis*
- **Common sense** – *probably more useful than a very high IQ but as those with common sense know it "ain't so common"!*
- **Humility** – *the greatest risks comes when you have had the greatest success. Could December 31st, 2015 have been the pinnacle of my investing success?*
- **Intelligence** – *but more critically you must be able to focus on what is important*
- **Numeracy** – *"numbers" speak louder than words*
- **Good judge of character** – *if you want to avoid promoters of frauds or follies*
- **Good temperament -** *investors need to have patience to let the snowball get bigger. If you pursue a get rich quick approach to investing, you will take too many risks and probably end up losing your money. Long standing ISA Millionaire Lord Lee of Trafford captured this sentiment perfectly in the title of his book, "How to make a million slowly."*

Conclusion

As I write, the value of our ISAs are down approximately 6.2% in 2016, a performance which is significantly worse than most of the indices. The good news is that the market sell-off has been a catalyst to top slice potentially overvalued winners, cut losers and sell out of under researched smaller positions. Our total number of holdings has been reduced by 20%.

Around 25% of our investing wealth is now in cash, the highest since 2008, reflecting my concerns about high valuations and the vulnerability of the global economy. If markets continue to recover, the heavy weighting to cash will act as a drag on performance but would be a useful hedge should markets trend downwards.

My approach this year is primarily defensive. I do not want the snowball turning into an avalanche wiping out the gains of recent years.

April 26th 2016

About Leon Boros

Leon is an Economics graduate and winner of the prestigious National Lord Kings Norton award for Economics for his ground breaking research on the financing of employee owned companies. Leon is a Fellow of the Institute of Chartered Accountants in England & Wales having trained with Ernst and Young in its tax and audit departments. He is currently managing director of Equity Strategies a corporate finance firm he founded in 2012. Equity Strategies specialises in advising and originating corporate transactions for quoted companies and private equity firms in the mid-market arena.

At the age of 29, Leon co-founded a corporate finance boutique specialising in management and employee buyouts and Employee Share Ownership Plans. The Company was sold to its management in 2001. In 2000, Leon co-founded Myshares Ltd, a software business focused on the administration of employee share schemes, raising in excess of £4m. Myshares was sold to Capita plc in 2001.

During his career, Leon has managed or originated corporate transactions with an aggregate value in excess of $1bn. His largest corporate transactions to date have been the £100m purchase by Capita plc of IRG Ltd, the £100m IPO of Benchmark Holdings plc, a leading animal health company, and most recently the reverse takeover of INVE Aquaculture by Benchmark for $342m.

Leon is a well-known private investor and was until recently a non-executive director of ShareSoc, a not-for profit organisation, which promotes the interests of private investors. Leon can be followed on Twitter @Boros10.

About ShareSoc

ShareSoc is a not-for-profit membership organisation established to support private investors by promoting their rights and by seeking to influence Government and regulatory policy. ShareSoc provides in-depth company reports, educational resources and networking opportunities with other investors and quoted companies, plus a wealth of other useful resources. The objective of ShareSoc is to empower individuals to maintain and grow their investments by protecting their interests and keeping them informed.

To find out more about ShareSoc, please visit our web site: www.sharesoc.org. To become a ShareSoc member, please go to http://www.sharesoc.org/promo.html where the differences between Associate membership (no cost) and Full membership (annual subscription) are detailed.

This e-book has been designed and its content edited by Nick Hayes at ShareSoc with help from Mike Dennis.