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# Phil Oakley's Weekly Round-Up

*It looks like the easy money printing presses are being cranked up once more. Investors may need to buckle up, but seeking quality remains worthwhile*

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The companies mentioned this week are:
- Hollywood Bowl
- London Stock Exchange
- Dunelm
- SIG
- Hargreaves Lansdown
- On The Market

**The printing presses are running again**
The Federal Reserve denies it, but it seems that quantitative easing (QE) is back with us. QE is when money is created out of fresh air with a few strokes on a keyboard and is used to buy financial assets – usually government bonds – to increase their price and push down their yields (interest rates).

A few weeks ago, the Fed had to intervene in the repo market to create liquidity for banks who appeared to have insufficient reserves of cash. On Tuesday, Fed Governor Jerome Powell said it would increase the size of its balance sheet (by creating money) by buying short-term treasuries to create the cash reserves that banks needed. But this was not a return of QE, but "reserve management".

Most people disagree, including me.

The Fed has a mandate to help the US economy achieve maximum rates of employment with stable prices. To me, the US economy seems to be doing quite well on these two issues but interest rates are expected to be cut further over the next few months – possibly all the way to zero – to keep growth from stalling as the economy looks to be weakening and trade wars with China and the EU make things worse.

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You could be forgiven for thinking that the Fed's unofficial market is to underwrite the US stock market. This view gained credence under Alan Greenspan in the 1990s when interest rates were cut when things started looking shaky to prop the market up. Investors have been relying on it ever since.

Of course, slashing interest rates after the technology bubble burst in the early 2000s has arguably created the mess we are in now. Cheap money has created too much debt that the incomes generated by economies have struggled to service. Since the financial crisis over a decade ago, which was caused by easy credit and over-valued property prices, we have even more debt and even higher property prices.

For a while now, this backdrop has given grounds to worry about what will happen to the economy, company profits and share prices.

But what is the private investor to do?

I am not complacent by any means, but I do not see what alternatives they have, apart from owning good quality blue-chip shares that have resilient business models, strong finances and preferably pay dividends. Bonds and cash yield nothing or less than nothing and have no scope to grow their income returns at today's prices. Even the Greek government is now being paid to borrow, which shows just how ridiculous parts of the bond market have become.

Bad things can and do happen when it comes to shares and if you can't accept this then you shouldn't be investing in shares in the first place.

Yet, there are pockets of the stock market that look safer than others.

As I wrote last week, I think the FTSE 100 is cheap and offers a decent stream of dividend income. Even the S&P 500, on a trailing 12-month PE of 20 times offers an earnings yield of 5 per cent and is stacked full of world leading companies. This will not stop shares going down if a recession pushes down profits, but long-term investors looking to grow the buying power of their money or provide an income to live on should stay calm and invested, but perhaps fasten their seat belts for a bumpy ride.

**Fantasy Sipp Portfolio**

I have sold the portfolio's holding of **3M shares (NYSE:MMM)** this week. This company has a lot of characteristics that I like. First and foremost, its products are intended to be problem solvers for its customers. It has a portfolio of long-standing consumer brands such as Post it Notes, Scotchbrite cleaning products and Scotch tapes and adhesives. In addition, it sells products across the industrial business spectrum on a global basis.


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The company is therefore a nice blend of a consumer staple and industrial conglomerate. It has proven to be very resilient across economic cycles and is very profitable as measured by yardsticks such as profit margins and return on capital employed (ROCE). With an ability to grow steadily over an economic cycle, the company ticked a lot of boxes for me.

Its shares have not done very well in 2019 for a number of reasons. Investors have been concerned about its cyclicality and its exposure to China and automotive markets, both of which have been slowing down. This doesn't really bother me, as I knew all about these risks when first purchasing the shares in my Sipp (note to new readers: the Fantasy Portfolio was my actual Sipp portfolio before I joined the Investors Chronicle).

What I am more concerned about, is the potential environmental liabilities for a chemical known as PFAS, which was used for stain and waterproofing in products such as carpets and paints up until the early 2000s. This chemical is now the subject of a health scare and possible causes of water contamination.

3M set aside $235m to cover its potential costs of dealing with claims, but this does not cover any new claims which seem to be coming through quite regularly. Some Wall Street analysts reckon that 3M's potential liabilities could run into billions of dollars and until there is some clarity on this, the shares are going to be under a cloud. I don't want this kind of uncertainty when I think there are better opportunities elsewhere, so the shares are no longer part of the portfolio.

They have been replaced by **Smith & Nephew (SN.)**, which is a share I liked the look of when I wrote a piece for the magazine back in July. This company is a problem solver as well, with three good businesses in orthopaedics, sports medicine and advanced wound management that are supported by long-term demographic trends.

Compared with its US peer Stryker, Smith and Nephew has been an inconsistent performer, but a new chief executive with a reputation for getting things done seems to be having a positive effect on the business. July's half-year results were better than expected and guidance for the full year was raised.

The company lacks scale in parts of its business and I expect it to buy companies. It has already started doing this and, providing it doesn't pay silly prices, this is not a bad thing to do. The business is very profitable with profit margins of more than 20 per cent and low double-digit free cash flow margins.

Arguably, one of the most attractive characteristics of


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Smith & Nephew's business from an investor's point of view is that there are substantial barriers to entry that limit competition. Regulation is high with products having to be both safe and effective. Without authorisation from government healthcare agencies, you do not have a money making product.

These kind of businesses are scarce and in the right hands have the potential to compound in value over the long term. It also has the potential to be a takeover target. The shares have been on a good run in 2019 and are not cheap. They entered the portfolio at a share price of 1,925p (fully costed for £10 broker commission and stamp duty) compared with a year high of 1,990p, which equates to a rolling one-year forecast PE of 22.2 times. Stryker, by way of comparison, trades on 23.6 times at the time of writing.

**Fantasy Sipp performance**

| | | Portfolio returns (%) | |
|---|---|---|---|
| | 1 month | Year to date | 1 year |
| LF Blue Whale Growth Fund | -0.5 | 26.7 | 18.6 |
| Fundsmith Equity T Acc | 0.0 | 26.6 | 21.2 |
| **Phil Oakley Fantasy Sipp** | **0.3** | **25.4** | **28.2** |
| Mid Wynd International Inv Trust | -3.1 | 24.7 | 16.8 |
| Lindsell Train Global Funds | -0.8 | 24.6 | 21.8 |
| Martin Currie Global Portfolio | -0.7 | 24.1 | 18 |
| Finsbury Growth & Income Trust | -1.3 | 22.3 | 21.5 |
| Smithson Investment Trust | -2.7 | 21.6 | – |
| Vanguard S&P 500 ETF | -0.8 | 21.6 | 10.7 |
| Castlefield CFP SDL UK Buffettology | -0.4 | 12.5 | 5.73 |
| FTSE All-Share – Total Return | -1.5 | 10.7 | 4.37 |
| Scottish Mortgage Investment Trust | -4.0 | 5.69 | 6.35 |

Source: SharePad

## Hollywood Bowl

I am a fan of **Hollywood Bowl (BOWL)** as a business. A trip to one of its bowling alleys costs less than a trip to the cinema and the company has been good at getting more people to visit them. Its strategy of refurbishing and rebranding its existing centres and making them nicer places to visit – things such as better lighting, better food, improved gaming experiences – is paying off.

This week's year-end trading update revealed that the business had grown its revenues by 7.7 per cent with like-for-like (LFL) sales of 5.5 per cent. Consequently, profit before tax has grown by more than analysts expected and by more than 10 per cent.

The company continues to generate very high profit margins – more than 20 per cent – and plenty of free cash flow. Given the minimal net debt position (excluding rented properties) it seems that the company is gearing up to pay another special dividend. It paid 4.33p per share earlier this year – on top of a growing annual payout (consensus dividend forecasts on page 5 clearly need revising).

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Despite the business performing well, Hollywood Bowl's shares have been rather lacklustre performers this year. At 228p, the shares trade on a one-year forecast rolling PE of 15.2 times (before any forecast upgrades) and a forecast dividend yield of 3.8 per cent.

Analysts' dividend forecasts do assume a small special dividend. The half-year dividend earlier this year was increased by 11.8 per cent to 2.27p per share. If the final dividend increases by the same amount – and there's no reason why it shouldn't given the profit performance – to 4.73p per share, then that would give a total dividend for the year of 7p per share (or a yield of 3.1 per cent which would be covered twice by profits). Throw in another 4.33p per share special dividend – it could be more – would give a total payout of 11.33p per share, a yield of 5 per cent.

Investors won't be able to rely on special dividends every year, but the valuation of the shares looks very reasonable right now for a very good business with a nice slug of income on top.

**Hollywood Bowl forecasts**

| | Year (£m) 2019 | 2020 | 2021 |
|---|---|---|---|
| Turnover | 128.9 | 135.6 | 142.7 |
| Ebitda | 37.6 | 39.7 | 41.6 |
| Ebit | 27 | 28.7 | 30.2 |
| Pre-tax profit | 26.1 | 27.8 | 29.3 |
| Post-tax profit | 20.9 | 22.3 | 24 |
| EPS (p) | 13.9 | 14.9 | 15.7 |
| Dividend (p) | 8.5 | 8.2 | 8.7 |
| Capex | 14 | 15.4 | 15.6 |
| Free cash flow | 16.2 | 19.1 | 21 |
| Net borrowing | 3.8 | -4.2 | -12.8 |

Source: SharePad

**London Stock Exchange**

The Hong Kong Stock Exchange has withdrawn its bid for **London Stock Exchange(LSE)** saying that it is no longer in the interests of its shareholders. I am quite pleased about this.

LSE is a highly profitable, high quality business. You don't tend to find too many of these on the UK market. For me, it would have been a sad loss to UK investors had the company been gobbled up. Hopefully, existing shareholders will be able to benefit from the progress of the business for many years to come.

I remain very positive on the long-term prospects for this business and am happy that it remains in the Fantasy Sipp portfolio. The main reason I like this business is not because of its stock exchange and **London Clearing House (LCH)** business – although they are good ones – but because of its FTSE Russell information business.


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The growth in passive investing has seen demand for FTSE Russell services soar. The pricing power that the business has on the exchange fees for its indices and data is immense. Good data is scarce and tightly controlled and this is what gives it substantial value. The current plan for LSE to acquire a stake in the Refinitiv data business only increases the quality of LSE's profits and cash flows, in my view.

The shares are very expensive, but LSE is a share that is worth hanging onto for the long haul in my opinion.

**LSE forecasts**

| | Year (£m) | | |
|---|---|---|---|
| | 2019 | 2020 | 2021 |
| Turnover | 2,288.60 | 2,427.30 | 2,596.80 |
| Ebitda | 1,217.30 | 1,336.80 | 1,457.40 |
| Ebit | 1,036.20 | 1,138.00 | 1,256.20 |
| Pre-tax profit | 918 | 1,024.90 | 1,122.30 |
| Post-tax profit | 700.3 | 787 | 886 |
| EPS (p) | 197.9 | 223 | 248.7 |
| Dividend (p) | 68.7 | 77.1 | 88.9 |
| Capex | 184.7 | 231.4 | 182.1 |
| Free cash flow | 705.9 | 861.9 | 978.8 |
| Net borrowing | 1,431.80 | 1,045.70 | -1,211.00 |

Source: SharePad

## Dunelm

**Dunelm's (DNLM)** homewares business had been performing very well for the past year or so. This turbocharged the performance of its shares, as it became a firm favourite with momentum investors who bought in on the expectation of further forecast upgrades and share price gains.

The problem with this approach is that sooner or later the upgrades and the share price momentum stops. This happened with the release of the company's full year results last month and has continued with this week's first-quarter trading update.

| | 13 weeks to 28 September 2019 | | |
|---|---|---|---|
| | Revenue (£m) | YoY Growth (£m) | YoY Growth (%) |
| LFL Stores[1] | 219.9 | +6.2 | +2.9% |
| Online - Dunelm.com | 35.7 | +9.2 | +34.7% |
| **Total LFL[2]** | **255.6** | **+15.4** | **+6.4%** |
| Non-LFL Stores[3] | 7.0 | +3.0 | - |
| **Total Dunelm** | **262.6** | **+18.4** | **+7.5%** |
| Closed businesses[4] | - | -4.0 | - |
| **Total Group** | **262.6** | **+14.4** | **+5.8%** |

Source: Dunelm


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The core store portfolio has continued to grow, but at a much slower rate than in the past year. The 2.9 per cent growth in LFL sales will be set against a very soft set of figures from a year ago when the business was growing at just 1.3 per cent and many shareholders will be disappointed. It also represents a sharp slowdown from the stonking 12.1 per cent growth that was seen in the last quarter of last year.

Gross margins have increased by 130 basis points due to good stock control and better buying, but these gains are not expected to last. The company is saying that currency headwinds will reduce gross margins later in the year and are consequently expected to be the same as last year.

The worry now must be that Dunelm is entering the key Christmas trading period with slowing trading momentum. The housing market looks sluggish with the Royal Institute of Chartered Surveyors (RICS) saying that the number of homes being put up for sale fell to a three-year low in September.

I think it's reasonable to assume that profit forecasts for the year to June 2020 are going to come down and possibly by quite a bit. Just over a month ago, consensus pre-tax profit forecasts were £131.2m, but were based on an expectation of 5.7 per cent LFL sales growth. Current consensus forecasts are for £129m and LFL sales growth of 3.2 per cent.

The problem that Dunelm faces is that it will start to come up against some very strong sales comparatives in the second quarter, given LFL sales were increasing by 7.8 per cent last year. Given the first-quarter performance against a weak comparative, there are grounds for thinking that the business could struggle to produce any meaningful LFL sales growth at all.

The market is clearly aware of this risk and has marked the shares down by 12 per cent as I write this.

Dunelm is a well-run business, but I'd be nervous owning its shares right now.

## Dunelm forecasts

| | | Year (£m) | |
|---|---|---|---|
| | 2020 | 2021 | 2022 |
| Turnover | 1,142.60 | 1,198.50 | 1,242.70 |
| Ebitda | 218.6 | 226.3 | 233.4 |
| Ebit | 138.4 | 141.4 | 147.7 |
| Pre-tax profit | 129 | 133.5 | 140 |
| Post-tax profit | 105.2 | 110.8 | 115.4 |
| EPS (p) | 51.8 | 54.6 | 56.7 |
| Dividend (p) | 34.1 | 38.1 | 38.9 |
| Capex | 31.9 | 34.2 | 32.8 |
| Free cash flow | 96 | 116.8 | - |
| Net borrowing | 64.2 | 18.1 | 103.4 |

Source: SharePad


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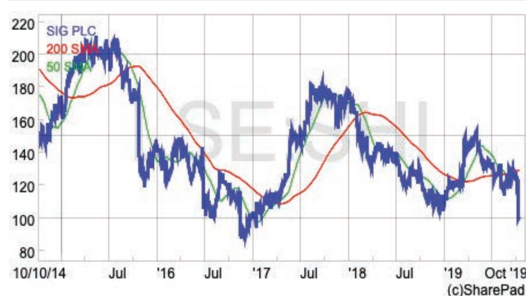


## SIG

I could never be a long-term investor in a company like **SIG (SHI)** – formerly known as Sheffield Insulations Group. I don't mean to be unkind, but this is a business that seems to lack any real path to becoming very profitable.

This is largely down to the fact that it doesn't make any of its own products but is in fact a distributor of others'. Distributors are middlemen much in the way that supermarkets are. They sell other people's products and take a small cut for themselves to cover their distribution costs. This tends to mean that profit margins are usually small, although there are some exceptions to this as we shall see shortly.

At least supermarkets have a steady and predictable demand for what they sell. This is not the case with SIG which sells insulation, roofing and ventilation products to the very cyclical construction industry. When its customers face a rough patch, so does SIG.

This week, SIG announced that demand from its construction customers in its key markets of the UK and Germany has weakened. This has come at a very bad time, as the company is just about to enter its peak trading period. Unfortunately, the profits from its specialist distribution and roofing business are now expected to be much weaker than previously expected.

The company has also announced that it is selling the building solutions and air handling divisions and will use the sales proceeds to pay down debt, which is arguably at too high a level. This is a good decision as a cyclical and operationally-geared business should arguably have as little debt – preferably no debt in my view – as possible. Shareholders might get some of the money that is leftover, but if trading stays weak for some time, the company might hold onto the cash to give itself a nice buffer to see it through a tough period.

The shares have fallen back from 119p to 101p, but they do not look compellingly cheap or offer a decent yield that could be considered safe. I feel now is not the time to own a share like this, as it seems the tide could still be going out.

### SIG forecasts

| | Year (£m) | | |
|---|---|---|---|
| | 2019 | 2020 | 2021 |
| Turnover | 2,485.80 | 2,526.60 | 2,654.70 |
| Ebitda | 176.2 | 173.40 | 195.5 |
| Ebit | 94.8 | 98.6 | 110.5 |
| Pre-tax profit | 73 | 86.4 | 95.8 |
| Post-tax profit | 52.9 | 60.3 | 65.9 |
| EPS (p) | 8.7 | 10.3 | 11.8 |
| Dividend (p) | 3.8 | 4.2 | 4.8 |
| Capex | 25.2 | 25.6 | 26.7 |
| Free cash flow | 60 | 67.1 | 61.3 |
| Net borrowing | 424.8 | 273.1 | 359 |

Source: SharePad

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### Hargreaves Lansdown

In many ways **Hargreaves Lansdown (HL.)** is very similar to SIG. It makes most of its money from selling other people's products yet it is one of the most profitable businesses listed on the London Stock Exchange.

I've been very clear in my view – including with senior people at Hargreaves Lansdown itself – that I think the company charges its customers too much to hold open ended funds (unit trusts and open ended investment companies) on its investment platform. Trail commission on these funds – money paid by fund managers to financial advisors and platforms – ended in 2016 but were replaced by platform fees, which just look like another form of commission in all but name, except that the platform customer pays it direct to the platform provider.

HL is essentially an administrator and caretaker of its customers' money. I accept that customers have to pay something to cover the cost of running the business. However, like the fund management industry in general, HL makes massive profits from scale, as it spreads more customer revenues over a large fixed cost base.

The customers do not see any benefits from increased scale. instead HL tries to get fund managers to cut their fees on their funds for its customers. In other words, the generosity comes from the fund manager and not HL.

This kind of setup has allowed HL to become extremely (almost obscenely) profitable, but the company has gone through a rocky patch and some bad publicity stemming from how it selects its recommended fund list.

However, this does not seem to have done it much harm. Despite volatile stock markets, the company added 35,000 new customers in the three months to September and now has 1,260,000. It ended with record assets under management (AUM) of more than £100bn.

**Assets under administration and net new business**

| **£ billion** | **Three months to 30 September 2019** | **Three months to 30 September 2018** |
|---|---|---|
| Opening AUA | 99.3 | 91.6 |
| Net new business | 1.7 | 1.3 |
| Market movements | 0.8 | 1.2 |
| **Closing AUA** | **101.8** | **94.1** |

Source: Hargreaves Lansdown


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More than half the AUM is in funds where HL charges its very lucrative fees. More assets means more revenue and net revenue increased by 6 per cent to £128.1m, which keeps the company on track to meet full-year forecasts for now.

| Average AUA (£billion) | 3 months to 30 September 2019 | 2 months to 30 June 2019 | 4 months to 30 April 2019 | 3 months to 31 December 2018 | 3 months to 30 September 2018 |
|---|---|---|---|---|---|
| Funds | 54.6 | 53.1 | 50.2 | 48.1 | 52.0 |
| Shares | 34.6 | 33.3 | 31.4 | 29.5 | 32.0 |
| Cash | 11.1 | 10.7 | 10.5 | 10.2 | 9.7 |
| HL Funds | 9.3 | 9.4 | 9.1 | 8.9 | 9.6 |
| Active Savings | 1.2 | 0.9 | 0.6 | 0.3 | |
| Double count[1] | (9.2) | (9.3) | (9.0) | (8.9) | (9.5) |
| Total | 101.6 | 98.1 | 92.8 | 88.1 | 93.8 |

| AUA (£billion) | As at 30 September 2019 | As at 30 June 2019 | As at 30 April 2019 | As at 31 December 2018 | As at 30 September 2018 |
|---|---|---|---|---|---|
| Funds | 54.2 | 53.8 | 52.7 | 46.6 | 52.0 |
| Shares | 34.9 | 33.7 | 33.4 | 28.5 | 32.2 |
| Cash | 11.3 | 10.8 | 10.9 | 10.4 | 9.7 |
| HL Funds | 9.2 | 9.4 | 9.4 | 8.6 | 9.6 |
| Active Savings | 1.3 | 1.0 | 0.8 | 0.4 | 0.1 |
| Double count[1] | (9.1) | (9.4) | (9.4) | (8.6) | (9.5) |
| Total | 101.8 | 99.3 | 97.8 | 85.9 | 94.1 |

Source: Hargreaves Lansdown

Positive fundamentals such as pension auto enrolment and an increasing need to save for the future suggests that investment platforms have decent long-term prospects.

My concern is that HL and other big platforms to a lesser extent such as **AJ Bell (AJB)** are making too much money because they are overcharging their customers to hold managed funds compared with other investments such as shares, investment trusts and exchange traded funds (ETFs).

Fat margins often attract competition which reduces prices, but HL doesn't feel the need to reduce charges when more customers clearly trust it with their money. That said, there is a risk in my view that one day either the regulators or competition authorities will look at the different prices that investors pay platform providers for similar investments and decide that it is not fair.

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## Hargreaves Lansdown forecasts

| | Year (£m) 2020 | 2021 | 2022 |
|---|---|---|---|
| Turnover | 535.6 | 594.4 | 651.5 |
| Ebitda | 345.3 | 383 | 413 |
| Ebit | 339 | 377.7 | 396.4 |
| Pre-tax profit | 341.8 | 382.8 | 422.9 |
| Post-tax profit | 278.3 | 310.7 | 340 |
| EPS (p) | 58.6 | 65.8 | 72.6 |
| Dividend (p) | 46.3 | 52.5 | 56.5 |
| Capex | 8.6 | 8.8 | 10.5 |
| Free cash flow | 256 | 301 | 329 |
| Net borrowing | -291.4 | -309.1 | -350 |

Source: SharePad

### On The Market

A great example of fat profit margin attracting competition is Rightmove. It charges estate agents a lot of money to advertise properties on its website, as well as providing them with data and analytical services about their markets and customers.

The costs of running Rightmove relative to its revenues are actually quite low, which is one of the reasons why it makes profit margins of 74 per cent.

The other reason is that perhaps it charges its customers too much. A quick trawl of the internet will lead you to estate agent forums where you can find a lot of grumbling about how much agents are handing over to Rightmove each month. It's not uncommon for some estate agency offices to pay more to Rightmove than they do in rent, with the average monthly payment over £1,000 per month.

A few years ago, this led to a group of agents to set up an agents' mutual to do the same job as Rightmove to see if they could succeed in getting their costs down. This business became **On The Market (OTMP)** and it listed on the stock market at the beginning of 2018.

As you can see from the chart, its shares have been a very poor investment since then.

If I was a shareholder of Rightmove, I would not be losing too much sleep from reading OTM's half-year results this week. Revenues were up by 14 per cent, but were only £8m, while operating losses increased from £5m a year ago to £6.7m.

The business had 1,2543 offices on its books at the end of September 2019, but most of these are still on trial contracts paying very little. Average revenue per agent fell from £130 per month at the end of January to just £108. As many as 2,346 agents are on new long-term contracts, paying an average of £288 per month, but OTM clearly still has a lot of work to do if it is going to hurt Rightmove.

I think this company is going to have to ask its shareholders for more money. I am not convinced that enough agents will sign up to full paying contracts to make the


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business profitable any time soon.

Estate agents are having a tough time with a sluggish property market and fewer new instructions for sale. Even though they pay a lot more money to advertise through Rightmove, it is more likely to deliver a sales lead than OTM at the moment.

I think OTM shows all the signs of being a little bit desperate for revenue, which currently covers its fixed operating costs before marketing spend and its decision to offer shorter-term contracts reflects this.

It only had £8.6m of cash left at the end of September and a good chunk of this could be gone by the time it reports its full-year results next spring.

Rightmove's competitive position – its so called economic moat – is holding up well for now.

## On The Market forecasts

| | | Year (£m) | |
|---|---|---|---|
| | 2020 | 2021 | 2022 |
| Turnover | 18.7 | 29.3 | 39.8 |
| Ebitda | -9.8 | 0.2 | 8.2 |
| Ebit | -10.5 | -1 | 8 |
| Pre-tax profit | -10.5 | -1 | 8.1 |
| Post-tax profit | -11.1 | 4.1 | 6.7 |
| EPS (p) | -12.8 | 4.1 | 6.1 |
| Dividend (p) | - | - | - |
| Capex | 2.2 | 2.3 | 2.4 |
| Free cash flow | -10.8 | 0.4 | 7 |
| Net borrowing | -5.1 | -5.5 | -12.5 |

Source: SharePad


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