



Phil Oakley's Weekly Round-Up

One of the clear takeaways from the recent stock market rout is that cheap shares don't protect you. What matters is the quality of a company's profits

High valuations don't matter at times like this, but they will eventually

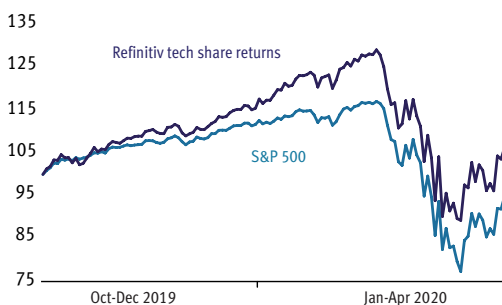
I have always believed that the price you pay for a share matters. Over a period of several years it will have a big say on the returns you will get from owning it. In the short run, it often doesn't matter as shares that look expensive can get more expensive, especially if the profits of the companies behind them are rising rapidly.

One of the clear takeaways from the recent stock market rout is that cheap shares don't protect you. Shares with high dividend yields have been hammered as the businesses behind them were always vulnerable to a recession, never mind an economic shutdown on an unprecedented scale.

What always matters above all else is the quality of a company's profits and, in particular, their stability. Companies that have been chased for their earnings predictability were not only main beneficiaries of the long bull market, but many of them gave the best protection in the recent market fall.

These shares make the best long-term investments, in my opinion. However, I have long held the view that the price for such quality and relative safety is very high indeed. Probably the best example of this is in US technology stocks, which have driven the S&P 500 and Nasdaq in recent years (see table on page 2).

US tech has outperformed and fallen less in the sell-off



Source: Thomson Reuters Eikon & Investors Chronicle

Alpha Production Editor: Sameera Hai Baig

US tech valuations and share price changes

Company	Close	PE 19/2/20	PE 23/3/20	PE 7/4/20	TTM PE	fc PE	% chg 19/2/20	% chg 23/3/20	% chg 31/12/19
Adobe Inc	30893	64.4	51.6	51.9	46.7	31.7	-18.2	2.1	-4.9
Apple Inc	25943	27.2	18.9	21.8	20.4	20.5	-18.1	18.2	-9.7
Cisco Systems Inc	4064	17.3	13	15.2	15.6	13	-10.0	20.4	-13.2
Intel Corp	5840	13.8	10.2	12	12	12.1	-12.1	18.9	-1.46
Mastercard Inc	25923	44.3	26.2	33.4	33.4	32.8	-21.5	33.1	-9.35
Microsoft Corp	16349	39.4	28.6	34.4	30.2	29.1	-11.7	21.6	4.85
NVIDIA Corp	25903	69.6	47.1	57.3	57.3	34.7	-15.2	25.4	13.4
PayPal Holdings Inc	10028	62.7	43.2	50.8	50.8	29.8	-15.8	22.4	-3.54
Visa Inc	16854	39.2	25	31	24.4	29.9	-18.2	28.4	-7.12
S&P 500	2659.41	-	-	-	-	-	-19.5	21.9	-15.6

Source: SharePad

I've looked at the trailing PE (based on last annual reported EPS) at the market's peak on 19 February this year and compared it with the low on 23 March and what it is now. I've also included the trailing 12-month (TTM) PE and for what it's worth, the forecast PE.

We can see that many tech shares had a meaningful fall in PE between the market peak and trough and have bounced back strongly to the close on 7 April. Many of them fell less than the S&P 500 to the trough and some of them rallied more than it since. All of the shares listed above are outperforming the S&P 500 year to date.

Yet, with the exception of Cisco and Intel, none of these shares can be considered cheap on a TTM PE basis. Forecasting in this market is nigh on impossible, but on a forecast PE basis the price of quality and relative safety continues to be very high.

Investors who have held tech shares have outperformed in recent years and that outperformance has continued in the downturn and subsequent rally. How sustainable this rally will be remains to be seen and regular readers will know my thoughts on this from my recent newsletters.

As I have written in this week's Investors Chronicle, I believe these high valuations offer little margin of safety to long-term investors from here. The stability of earnings may mean they hold up better than most, but that is no guarantee of long-term positive returns.

The prospective earnings yield on the shares of Microsoft, PayPal, Visa, Mastercard and Adobe is around 3 per cent if you think the EPS forecasts are realistic. That is a very low starting rate of return. The only way to make significant positive returns from here is for the companies to deliver very high rates of earnings growth and for the earnings yield to stay low and even move lower.

This is where things begin to get difficult. Low earnings yields on shares have long been seen as reasonable due to low interest rates on bonds. No one seems to think that the interest rates on US government bonds are going up

any time soon, even though the government will have to borrow a lot of money in the years to come. The assumption is that the Federal Reserve will lend the government money by buying any bonds it issues rather than face the prospect of interest rates having to go up.

The Federal Reserve has shown that it has so far been able to manipulate interest rates, but can it manipulate inflation?

Inflation can come from many sources. The main fear since the Federal Reserve and Bank of England started printing money to buy bonds is that the increase in the money supply would cause inflation. It has caused significant inflation in asset prices, but not in the general prices that households and businesses pay.

The disruption caused by coronavirus brings significant inflation risk, in my view. This time printed money is going to end up in people's pockets and will be spent. Whether this will offset the massive deflationary forces that are ongoing remains to be seen. But if that money stays in general circulation and starts changing hands quickly when the economy starts up again then there is scope for inflation to rise, especially if an economy that has been shut down cannot ramp up supply to meet demand.

The other possibility is that production that has been outsourced to the Far East comes back home and reverses globalisation. In many ways I would heartily welcome this as it could see the resurrection of higher paid jobs and address the huge inequalities in society caused by globalisation over the years. It may also lead to higher prices, at least for a while.

If inflation shows itself, will central banks raise interest rates to see it off and inflict huge pain on over-borrowed households, businesses and governments? Or will it let inflation take off? The risk is that once it does, history shows it can be very difficult to bring back under control.

Higher interest rates should lead to higher earnings yields and lower PE on stocks. Higher inflation should do the same. Investors have shown that they have been happy to own bonds that yield less than inflation. I'm not so sure they will necessarily tolerate this for long, leaving highly-valued shares looking very exposed even if they have the ability to raise their prices in such an environment.

I spend a lot of time thinking about risk when it comes to investing. Some might say I think about it too much. However, there can be no doubt in my mind that the risk-return trade-off in many highly-priced stocks does not look compelling right now. It hasn't for some time, but I

feel we are in a different world now and it is why I think share prices may need to fall again before investors can safely return to the markets.

Fantasy Sipp

Portfolio returns as of 12:00 on 8 Apr 2020

	Portfolio total returns (%)			
	1 month	Year to date	1 year	2 years
Scottish Mortgage Investment Trust	4.4	2.6	13.0	39.2
LF Blue Whale Growth Fund	-0.2	-3.6	6.3	31.2
Fundsmith Equity T Acc	-2.5	-5.6	1.5	24.8
Mid Wynd International Inv Trust	-1.1	-7.6	4.6	19.1
Smithson Investment Trust	-1.1	-7.8	1.4	
Martin Currie Global Portfolio Trust	-7.4	-8.8	2.1	22.6
Lindsell Train Global Funds	1.0	-9.1	-3.3	18.9
Phil Oakley Fantasy Sipp	-5.1	-10.7	3.6	23.3
Vanguard S&P 500 ETF	-5.2	-11.7	-2.7	15.3
Finsbury Growth & Income Trust	-5.0	-15.8	-8.9	4.1
Phil Oakley UK Quality Shares	-13.0	-20.7	-	-
Castlefield CFP SDL UK Buffettology	-12.5	-22.5	-8.9	-1.8
Vanguard FTSE 100 ETF	-12.9	-24.5	-20.1	-12.7
FTSE All-Share - Total Return	-13.7	-25.2	-20.5	-14.8
Vanguard FTSE 250 UCITS ETF	-17.2	-29.4	-18.2	-15.4

Source: SharePad

I have raised some cash in the Fantasy Sipp by top-slicing my positions in Avon Rubber and the London Stock Exchange, which have delivered stellar returns. The portfolio now has a 4.8 per cent cash position, which I intend to use to buy an additional holding when the price is right.

Tesco

Supermarkets have been one of the few beneficiaries of coronavirus and the subsequent lockdown. We all need food and so they have had their doors open, while other businesses have closed theirs. The unfortunate stockpiling of staple foodstuff seen in recent weeks has given them a boost, but to say that they will reap windfall profits is far from the truth.

The UK supermarket industry is fiercely competitive. The big four supermarket chains – Tesco, Sainsbury's, Asda and Morrisons – have found their large stores, large product ranges and big cost bases ill-equipped to compete with more nimble discounters such as Aldi and Lidl.

Tesco (TSCO) has worked hard to improve its competitiveness and the way it does business with its suppliers, and has lost much of the arrogance of a decade ago. Its acquisition of food wholesaler Booker is working well and has brought it over £200m of benefits (synergies) from combining it with the main Tesco business, with the expectation of more to come.

However, Tesco's full-year results to the end of February 2020 clearly show the harsh realities of the world the company has to work in, even before the impact of coronavirus is taken into account.

On the face of it, last year was good for Tesco. Operating profits increased 13.5 per cent to £2.96bn and retail free cash flow more than doubled to just over £2bn. The dividend per share has been increased by nearly 60 per cent to 9.15p.

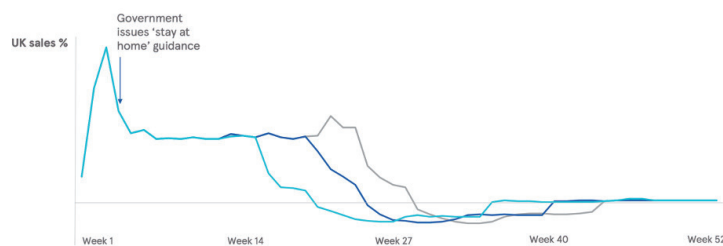
But all this came from cost-cutting, as there was no revenue growth from the business as a whole. This may not be a disaster from an income-seeking investor's viewpoint as a competent retailer, generating plenty of free cash flow can pay out most of its profits to shareholders, and Tesco's dividend looks like one of the safest out there right now.

It is good to see that the company has taken a simplified approach to its banking business. Its mortgage loan book has been sold and current accounts are no longer being offered to new customers. The business is now based on credit cards, personal loans and insurance products.

The bank made £193m of operating profit last year – a fall of 3 per cent – but has plenty of protection against losses with a tier 1 capital ratio (equity and other capital as a proportion of its loans) of 20 per cent. It is going to need it, as Tesco has said it is likely to see a spike in bad debts this year which could send the bank into a loss.

Despite a benefit from stockpiling, this is unlikely to continue. The company has given a range of scenarios on its business depending on how long the current lockdown will last. As you will also see, it has significant costs to pay, which means that profits are likely to take a hit.

Scenarios – sales shape



Source: Tesco

It is possible that UK sales could stay elevated until the early summer (week one is the beginning of March) before levelling off.

Tesco is also expected to have significant increases in costs. It has given its staff a well-deserved pay rise, but still has plenty of fixed costs such as property, store

expenses and distribution to pay and these are expected to increase and generally get bigger the longer the government's restrictions on movements last.

The range of scenarios is from a £650m increase to £925m increase. This will be offset by not having to pay business rates, which will save it around £585m.

Scenarios – UK costs

	Base case	Further restrictions	Longer-term restrictions
Payroll	£(280)m	£(335)m	£(405)m
Distribution	£(135)m	£(155)m	£(175)m
Store expenses	£(105)m	£(110)m	£(200)m
Property	£(65)m	£(75)m	£(80)m
Other (technology, communication)	£(65)m	£(65)m	£(65)m
Total incremental costs	£(650)m	£(740)m	£(925)m

Source: Tesco

Tesco, like many other companies, has not given any profit guidance for the coming year. The ultimate outcome will depend on sales volumes. The bigger these are, the more profit contribution it will have to pay its fixed overheads. It is very possible that people will eat in more rather than go to restaurants for a while after any movement restrictions are lifted, while cancelled holidays will also give volumes a short-term boost.

With a bit of luck, it is possible that Tesco's profits could actually hold up quite well.

Tesco's finances are in pretty good shape. Its total debt – borrowings, leases and pension fund deficit – of £14.7bn equates to just over three times its current annual earnings before interest, tax, depreciation and amortisation (Ebitda). The sale of its Asian business for just over \$10bn was agreed in March and is expected to complete in the second half of 2020. As much as £2.5bn of the proceeds will be used to pay off the pension fund deficit, while £5bn (around 51p per share) will be paid to shareholders (subject to approval) in a special dividend.

With £3bn of undrawn banking facilities and the continued generation of free cash flow, shareholders can sleep soundly and not worry about being asked for more money.

I've liked Tesco as a defensive income share for some time and I still like it on this basis. At 213p, at the time of writing, the current annual dividend of 9.15p per share gives a dividend yield of 4.3 per cent, which looks attractive with the likely bonus of a chunky special dividend to come. Don't expect to get rich owning Tesco shares, but it looks to be one of the best sources of decent income on the UK stock market at the moment.

AG Barr

AG Barr (BAG) is a very well run business and has been held in high regard by investors for many years. At the moment, it is going through a bit of a rough patch.

2019 was not as kind as 2018, as the hot summer was not repeated. That said, Barr also created some self-inflicted wounds of its own. It put up prices of its flagship IRN BRU drink and also botched new recipes on its Rubicon juice drinks and suffered from severe price competition to its licensed Rockstar energy drinks. Its Funkin cocktails business had a good year, while its Barr branded fizzy drinks also benefited from new business wins.

Both its carbonated and still drinks brands saw a major hit to sales volumes and revenues. The damage is shown in the table below:

AG Barr: Changes to sales volumes and revenues

Drink	Volume change (%)	Revenue change (%)
IRN BRU	-9	-4
Rockstar	-27	-29
Total Carbonates	-9.2	-8.4
Rubicon	-21	-21
Strathmore Water	-	-17
Funkin Cocktails	-	>20
Total Stills & Water	-16.8	-18.2

Source: AG Barr

IRN BRU began to recover in the fourth quarter of the year and started growing its sales volume again. The dominance of this brand meant that overall revenues for the year fell by 8.4 per cent, but the high fixed cost base of the business and its significant operational gearing saw operating profits fall by 17.3 per cent to £37.4m, which fed through to EPS of 26.5p.

The coronavirus is having a significant impact on Barr's sales volumes in 2020. Forty per cent of its sales volumes come from pubs, bars and restaurants which are closed, whereas take-home sales from supermarkets and convenience stores have been more resilient but very volatile. Unsurprisingly, no final dividend will be paid and no profit guidance has been given.

The company's factories are still working and the company has plenty of financial strength to see it through a long period of disruption. It has no borrowing, very little lease debt and a small pension fund deficit. Its £60m credit facility has been drawn down in full. Money is being saved by cutting capex and also marketing spending.

I used to quite like this business and it still has many admirable qualities, but I think it has a long-term growth problem when things get back to normal.

It is still too reliant on IRN BRU and attempts to build new brands either through acquisition or licencing are not

moving the dial much in terms of sales and profits. Rubicon has hit a rough patch and is selling into a declining juice market, although Funkin has been a success.

The company has been very vocal in recent weeks about its contract to make and distribute Rockstar Energy drinks in the UK, Ireland and parts of Europe. The contract has several years to run (the company has not specified how long), but Pepsi has just bought Rockstar which may bring this relationship into question, as Pepsi has a long standing relationship in the UK with Brtivic (which has the licence to make and sell Pepsi and 7UP drinks). Rockstar accounts for 8 per cent of Barr's annual sales volumes and its loss – while not currently expected – is now a potential risk, albeit presumably with some compensation.

The opportunity to resurrect a merger with Britvic has possibly gone, which leaves questions about where it gets its future growth from. At 502p, the shares trade on 19 times last year's EPS. That valuation used to be seen as reasonable given the company's track record and dependability. I'm not sure it is now.

Two weeks ago, I listed Barr as a potential quality share that might be worthy of a place on an investor's watchlist. On digging deeper into its operational issues, I've become more lukewarm, which shows that even if a business passes a screen and has attractive financial performance, on measures such as profit margins and return on capital employed (ROCE), you should always take the time to understand the business that produces those numbers and where its operational performance might take them in the future. I've said many times that investing should not be seen as a painting by numbers exercise and I think Barr is possibly a good example of this.

WH Smith

Last week I suggested that I would not be surprised if **WH Smith (SMWH)** came to the stock market and raised new money via a placing. This was not a particularly bold prediction following SSP's placing a couple of weeks ago.

On Tuesday morning, the company announced it had raised just under £166m (before fees) by issuing 15.8m new shares at a share price of 1,050p. This was a 4 per cent discount to the closing price on Monday evening and represents 13.7 per cent of the issued share capital before the placing.

Taken into account with fresh loans announced last week, the company should have enough money to see it through this unprecedented disruption to its business. Its revenues in many airports and railway stations (rail travel

in the UK is currently running at around 5 per cent of normal levels) will be zero as they are closed, but suppliers, debt interest, staff and rent costs still have to be paid. Hospital stores in the UK are open as are its high street stores with post offices.

The rents in airports are very expensive as they are highly sought after. The amount paid is linked to revenues, but most contracts also include a minimum amount regardless, and I assume that landlords quite reasonably expect these minimums to be paid.

That said, the company reckons it can save around £200m of costs, but expects its revenues between April and August to be down by 80-85 per cent. In April alone, it expects its revenues to be down by 90 per cent (£114m) with a reduction in operating profit of £39m. Even with cost savings, it expects a 45 per cent drop through in terms of profit reduction from the fall in sales between April and August. Even with expected first-half profits to February 2020 of around £80m, I think we are looking at a significant loss for the business as a whole for the year to August.

When things get back to normal there is a very good travel retail business here. That said, unless the virus is tackled with a vaccine the risk for it – and virtually every other business for that matter – is that it will come back and revenues and profits will take another hit.

Valuing the shares at the moment is not easy, as there's no way of knowing when lockdowns will end and how long it will take for airline and rail traffic to return to previous levels. But let's say for argument's sake that the company can get back to making £125m for shareholders in 2021 as it did last year. A full-year's profit contribution from Marshall's Retail Group in the US is assumed to cover the interest costs on the extra debt taken on. Taking into account the new number of shares in issue, this would give an EPS estimate of around 95p. At 1,176p per share, at the time of writing, this would put the shares on a PE of 12.4 times. While it may not return to the 20 times plus it was on before the crisis, the shares would look undervalued on that basis, albeit with a higher level of risk attached.

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