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Phil Oakley's Weekly Round-Up

Coronavirus is making investors in shares take a long overdue reality check and consider how sustainable companies' profits are

This week I am going to concentrate on the impact of coronavirus and what it might mean for company profits and share prices. I will return to my usual format of discussing company results next week.

Is coronavirus a wake-up call for complacent stock market investors?

It is very difficult to accurately predict the future when it comes to the economy and the stock market. There are always optimists and pessimists out there, but the general prevailing view tends to be that things will carry on as they are currently – at least in the short run.

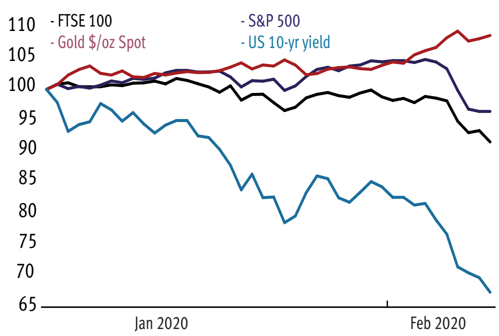
A few months ago, no one was talking about a virus that could wreak havoc with the global economy. Most of the focus was on how low interest rates would go and the fact that there was little alternative to shares for investors seeking a real return – a return above inflation – on their money.

This view holds up as long as profits do. Profits, and the sustainability of them, are now the big focus of investors across the world. Some, including me, would argue that it is long overdue.

There are two things that tend to kill bull markets: Rising interest rates and/or falling profits. The first one has not been considered to be a threat after the Federal Reserve tried increasing rates in late 2018 and the stock market fell. Since then it has been printing money to keep interest rates down and up until recently the stock market has reacted favourably.

The outlook for profits is another matter. While there have been some hawks out there that have worried about western economies going into a recession, company profits in general have held up pretty well. Returns to shareholders have also benefited from cheap borrowing costs, which have allowed companies to buy back their own shares and give a nice boost to the closely watched

Shares have fallen and US Treasury yields have tumbled (indexed from 1 Jan 2020)



Source: Bloomberg & Investors Chronicle

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earnings per share (EPS) figures. Dividend growth has also been pretty reasonable.

I've written on quite a few occasions previously on these pages that equity valuations on high quality business are very high. Valuations on most shares have not been pricing in the risk of a sharp fall in profits. In fact, they have been pricing in exactly the opposite. This is especially true in the case of the US stock market. Yet, investors have been prepared to pay high valuations for predictable and modest growth in a world of low interest rates.

Coronavirus (also known as the COVID-19 virus) and the reaction of governments and people to it has changed all this. Companies that were once seen to have bulletproof revenues and profits are now telling investors that this is not the case. How share prices and valuations absorb these developments is now a major source of worry, and rightly so.

Even in a low interest rate world, which can justify higher valuations (high PE ratios and lower yields), they still imply rosy expectations of future profit and cash flow growth. If those expectations start to be challenged then shares with lofty valuations can fall a long way.

This is where I think many equity investors have been guilty of some complacency. There has arguably been too much focus on shares due to the lack of viable alternatives, while perhaps there has not been enough attention paid to the sustainability of company profits – the most important thing when it comes to determining share prices.

Nobody knows how bad this virus will turn out to be. Optimists point out to the damage limitation in China and how the virus seems to have been reasonably well contained. After all, according to a report in *The Times* newspaper on Wednesday this week, China – a country with a population of 1.3 billion people – has seen just over 78,000 cases of coronavirus and 2,718 deaths so far. Some say that the outbreak in China has peaked. Time will tell.

Pessimists will point to the 3.5 per cent death rate of those infected. They will then say that China has a younger population and an autocratic government that was able to effectively quarantine people in Wuhan where the outbreak began. If the virus was to spread to countries with older populations and where quarantining was more difficult then the potential death rate could be very substantial. This then gets people going on to asking about how health services would cope and so on.

My concern at the moment is that the pessimists – aided by a mainstream media that has pages and airtime to fill – are gaining more attention because bad news sells.

That's not to say that coronavirus is not a serious issue.

It is, but the reaction to it may actually make things as worse as the event you are trying to prevent.

It should come as no surprise to anyone that if you stop people moving then a society and an economy will not function as well. Keeping people on ships or in hotels and telling people if they have been to Italy that they cannot come to work for 14 days are examples of this.

If people stay at home and shops and factories are closed, company revenues and profits are bound to fall and global supply chains will begin to run out of stuff.

This is now manifesting itself in profit warnings from listed companies. Both **Microsoft (US: MSFT)** and **Apple (US:AAPL)**, who rely significantly on China for their supply chains, have said that they will make and sell fewer products.

We have also seen UK-listed companies come out and tell investors how coronavirus is going to reduce their profits this year.

Spirits company Diageo said on Wednesday that its revenues and profits had suffered because bars in China were closed and banquets had been cancelled. This effect was also being seen to a lesser extent in other Asian countries.

With people taking fewer flights across Asia, sales in airport shops were also down. Diageo reckons that based on the current levels of disruption it is going to lose between £225m and £325m of revenues and £140m to £200m of operating profit. To put this into context, analysts were expecting Diageo to make £4.2bn of operating profit this year, so the maximum expected downgrade at the moment here is 4.8 per cent.

SSP (SSPG), which runs food and drink shops at train stations and airports, has also said that its Asian profits have taken a hit. Air passenger numbers at its Chinese locations are down 90 per cent year on year in February. Its Asia Pacific revenues, which account for 8 per cent of its total revenues, are expected to be down by £10m to £12m this month, with a profit hit of £4m-£5m. Current full-year operating profit forecasts are for £232m, but we can see what one month of disruption can do to a business like this and what might happen to profits if the virus continues or spreads.

The concern now must be that we are in for weeks of announcements like this and that the hits to profits may get worse. This may be the case if governments overreact to events. The reaction to the virus in Italy has been dramatic, with trains not being allowed to cross borders, big events being cancelled and towns being quarantined. Travel and tourism is more difficult and people are cancelling trips to Italy.

This just adds to the worry and it is no surprise that the shares that have a high exposure to China and travel and tourism have been badly hit during the past couple of weeks.

Big fallers: Companies with travel exposure (price changes 19-26 Feb)

Company	% change 1 week
Dart Group	-32.8
easyJet	-20.3
On The Beach Group	-19.5
Ryanair Holdings	-17.4
Carnival	-17.4
TUI	-16.2
SSP Group	-16.1
Wizz Air Holding	-15.9
International Consolidated Airlines	-13.3

Source: SharePad

These businesses need uncertainty like a hole in the head. Airlines are highly operationally-geared businesses with lots of fixed costs to cover. If people fly less, the planes are less full (they have a lower load factor) and profits get hit badly.

Cash flow is also a concern as customers usually pay for their flight holiday in advance, which in normal times gives travel companies a favourable working capital position as they get cash before they have to pay some of their bills. Any deterioration in this means that money to pay day-to-day running expenses has to be found from somewhere else – such as a bank overdraft – which is more expensive.

For me, it is the impact on cash flows and company working capital flows that poses the biggest threat to companies and the economy in general. A decline in one company's cash flow can mean a late or missed payment to one of its suppliers that could trigger a nasty domino effect across industry supply chains and push some companies into financial difficulties.

If this scenario comes about then there are bound to be questions as to whether banks have sufficient liquidity to help businesses and that central banks might have to come to the rescue. This may be taking things too far at the moment, but these thoughts are regularly on my mind at the moment.

There have been few safe havens on the UK stock market, just shares that have fallen by lesser amounts.

Along with the potential damage to the economy and company profits and cash flows, my biggest concern is the American stock market which remains very highly valued by historical standards. As I said earlier, high valuations can be sustained for a lot longer than people think, as long as company profits hold up. If they don't then share prices can and do fall a long way.

So what should investors do? This is not an easy question to answer because each investor has different personal circumstances and financial requirements. For the past few years, buy and hold investing has worked really well, as price falls have been temporary and have recovered.

You tend to find that lots of people are very comfortable with buying and holding in a bull market. Yet there can be a tendency for this strategy to drift into complacency and become something resembling buy and forget.

If there is one good thing to come out of the current coronavirus outbreak, it is that it has served as a wake-up call to some investors. It is a reminder that shares represent part-ownership in a real business that operates in the real world, selling real products and services to people and businesses. They are not numbers on a screen that move up and down just based on where interest rates might go. Profits always matter eventually and they don't always go up.

There's also nothing better than a sharp sell-off in the stock market to get investors to work out how much risk they are comfortable taking on. Portfolio diversification can sometimes seem a bit academic and has kind of gone out of the window in recent years given that bonds and cash offer measly returns, while commodities and precious metals are arguably riskier than shares in many states of the world.

If you are worried about what falling share prices might do to your personal wealth then raising your cash allocation remains the simplest and most effective course of action. It's not as if you are sacrificing the opportunity of risk free returns anywhere else.

As with everyone else, I hope that coronavirus does not become a nasty pandemic and that things soon get back to normal. I think it is also important to get things into perspective and that it is unlikely that we are facing up to the end of the world right now. This is why governments need to tread carefully, not overreact and cause panic.

My oldest and trusted former colleague from my stockbroking days often refers to the sage advice given to him by his father when things looked bleak. His father lived through the Great Depression and was wounded while a soldier in the Second World War. He had witnessed things that most people today have thankfully not had to, but it gave him a different perspective on life. His view was that it was "remarkable as to what people would get used to". By that he meant that human beings are very good at adapting to whatever is thrown at them and making the best of it. I agree.

This is the view of a rational and pragmatic optimist, not a complacent and reckless speculator. It is a view that has served long-term investors in the stock market well.

What it also probably means is that nothing really has changed when it comes to good long-term investing in stocks. Buying and holding good businesses that can survive and prosper in good times and bad remains key.

The ability of a company to grow and the price you pay for its shares do matter. This does not mean that their profits and share prices will go up every year, but that over the long haul a good business should compound in value. This was pretty much the message that Warren Buffett was giving last weekend and has been for decades. Focus on the underlying business not the share remains good advice.

Sometimes share prices and company valuations get ahead of those justified by business performance and this is arguably true for many companies in recent years. From time to time these excesses are corrected by events and this is what could be happening at the moment.

If you can't cope with falling share prices or can't afford to lose money (because you are close to a savings target) then you may need to think again about how much exposure you have to the stock market.

That said, vigilance is the order of the day and complacency needs to be avoided. The actual fall in share prices in general is not yet that big and there is a chance that events in the real economy could get worse before they get better.

If they have not already done so, investors might want to prepare themselves for a bumpy ride, but also keep one eye on opportunities that may come along.

Fantasy Sipp Portfolio

	Portfolio % returns			
	1 month	Year to date	1 year	2 years
Scottish Mortgage Investment Trust	5.55	5.18	25.4	31.7
LF Blue Whale Growth Fund	-1.02	3.61	20.9	36.8
Martin Currie Global Portfolio Trust	-2.69	2.12	22.7	30.2
Fundsmith Equity T Acc	-1.99	1.35	17.2	30.1
Phil Oakley Fantasy Sipp	**-1.2**	**1.3**	**25.3**	**38.1**
Vanguard S&P 500 ETF	-1.14	0.682	17.2	22.9
Smithson Investment Trust	-0.459	0.308	17.5	
Mid Wynd International Inv Trust	-0.331	0	19.8	23.9
Phil Oakley UK Quality Shares	**-1.7**	**-0.9**	**–**	**–**
Castlefield CFP SDL UK Buffettology	-2.86	-1.42	20.1	24.8
Lindsell Train Global Funds	-2.83	-2.27	10.6	26.9
Finsbury Growth & Income Trust	-1.71	-4.11	10.6	18.8
FTSE All-Share - Total Return	-4.34	-6.05	4.85	6.05
Vanguard FTSE 100 ETF	-4.76	-6.38	3.73	5.08
Vanguard FTSE 250 UCITS ETF	-3.32	-6.57	9.74	8.55

Source: SharePad

Unsurprisingly, the value of most portfolios have taken a bit of a beating over the past week. The UK Quality Shares Portfolio, which had got off to a very encouraging start, has now given up all its previous gains for 2020. It has performed a lot better than the UK market, but I never really see this as any consolation if a portfolio has actually lost money – although this is a very short-termist view where this portfolio is concerned.

The Fantasy Sipp has held on to a small gain for the year to date and continues to perform reasonably well when compared with some of the best quality funds out there. It is also beating the S&P 500 (in pound sterling terms) and the FTSE All-Share Index.

Just out of interest, I will show you how both portfolios have fared in the market carnage during the past week. The UK Quality Shares Portfolio fell by 5.7 per cent compared with a fall in the FTSE-All Share index of 5.4 per cent. The individual stock performances are shown on below.

UK Quality Shares last week

Company	%change 1 week
Hollywood Bowl	-12.0
InterContinental Hotels	-11.4
WH Smith	-10.9
JD Sports Fashion	-9.6
Greggs	-8.1
Diploma	-7.8
Howden Joinery	-7.1
Smith & Nephew	-7.1
James Halstead	-6.9
Ashtead	-6.8
Croda International	-6.2
Diageo	-6.1
Forterra	-5.4
Intertek	-5.2
Rightmove	-5.2
Sage	-5.1
Auto Trader	-5.1
Halma	-4.9
AJ Bell	-4.7
RELX-	4.2
London Stock Exchange	-4.0
Spirax-Sarco Engineering	-3.9
Experian	-3.6
Avon Rubber	-1.8
Bioventix	-1.3

Source: SharePad

I did add **Sage (SGE)** to the portfolio last week to replace **Games Workshop (GAW)**. I have mixed views about this company and wrote a detailed article about it in the *Investors Chronicle* recently. It is a very good business and remains highly profitable, but is lagging its peers. It needs to up its game, but if it doesn't then I see it as a very viable takeover candidate.

The Fantasy Sipp fared worse and fell in value by 6.7 per cent. The Vanguard S&P 500 fell by 5.6 per cent. The individual stock performances are shown on page 8.

www.investorschronicle.co.uk
email: icalpha.editorial@ft.com

Fantasy Sipp last week

Company	%change 1 week
Mastercard	-13.5
Walt Disney Co (The)	-12.1
Visa	-11.5
InterContinental Hotels	-11.4
WH Smith	-10.9
Paychex	-8.8
Amazon.com	-8.1
Smith & Nephew	-7.1
James Halstead	-6.9
Moody's	-6.4
Croda International	-6.2
Diageo	-6.1
Intertek Group	-5.2
Sage	-5.1
Halma	-4.9
RELX	-4.2
London Stock Exchange	-4.0
Spirax-Sarco Engineering	-3.9
McDonalds	-2.3
Pepsico	-2.2
Avon Rubber	-1.8

Source: SharePad

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email: icalpha.editorial@ft.com

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