



Phil Oakley's Weekly Round-Up

The Fantasy Sipp is having a tough time in 2020, although it is still up over 12 months

Fantasy Sipp & UK Quality shares performance

	1 month	Portfolio total returns (%)		
		Year to date	1 year	2 years
Scottish Mortgage Investment Trust	17.4	16.1	27.3	39.3
LF Blue Whale Growth Fund	7.2	3.4	10.3	36.4
Smithson Investment Trust	15.0	3.2	12.1	
Fundsmith Equity T Acc	5.6	-0.2	7.3	29.6
Mid Wynd International Inv Trust	10.3	-3.2	9.5	20.0
Vanguard S&P 500 ETF	10.2	-3.7	6.8	23.8
Martin Currie Global Portfolio Trust	5.7	-4.7	5.0	21.7
Lindsell Train Global Funds	4.7	-4.9	-2.2	21.4
Phil Oakley Fantasy Sipp	5.9	-6.4	5.6	27.9
Finsbury Growth & Income Trust	4.7	-13.1	-9.5	3.8
Phil Oakley UK Quality Shares	9.3	-16.2	-	-
Castlefield CFP SDL UK Buffettology	7.3	-16.8	-9.5	2.6
Vanguard FTSE 100 ETF	5.7	-21.2	-16.2	-14.2
FTSE All-Share - Total Return	6.2	-21.9	-16.8	-15.6
Vanguard FTSE 250 UCITS ETF	8.9	-26.6	-16.0	-16.6

Source: SharePad

The Fantasy Sipp is having a tough time in 2020. Its performance has suffered mainly due to its exposure to travel-related shares such as WH Smith and InterContinental Hotels. Disney (discussed later in the report) has also done a lot of damage. Avon Rubber and Amazon have been the star performers.

The UK Quality shares portfolio has taught me just how difficult it is to put together a diversified portfolio of UK shares that are highly profitable, cash-generative, can grow and have the all important recession resilience.

I find myself very much in agreement with Keith Ashworth-Lord, manager of the Castlefield Sanford-DeLand UK Buffettology Fund, who feels that exposure to UK consumer-facing businesses are a recipe for disappointment.

On that basis, shares in the UK Quality Shares portfolio such as JD Sports, Greggs, Hollywood Bowl and WH Smith (whose travel business is badly wounded right now) should be sold. The problem is what do I replace them with?

Alpha Production Editor: Sameera Hai Baig

Unilever and Reckitt Benckiser tick a lot of boxes in terms of quality and profitability, but I am bearish about their long-term growth prospects and their competitive positioning against the rising quality of private-label alternatives. That said, their defensive characteristics and robust trading performances could see their shares perform quite well over the next couple of years.

I have therefore taken the decision to sell out of WH Smith and InterContinental Hotels in both fantasy portfolios, as I feel both businesses have sustained long-term damage to their business models. I will replace them with Unilever and Reckitt Benckiser. This is a case of investing in the least worst alternative, not something I like doing. I will also fully accept the criticism that I am selling low and buying high, but needs must right now.

The UK portfolio remains a challenge, as good quality companies are either very expensive (Halma, AJ Bell) or highly cyclical, such as is the case with companies like Renishaw. I need to do some more work, as I feel current events have taught me a very harsh lesson in how hard my approach is in the UK market.

UK investors face slim pickings

One of the things I find most troubling about the UK stock market is the quality of companies listed on it.

I don't mean to say they are terrible companies in an absolute sense. Most are run by very capable people who work very hard to serve their customers with good products and services. The bad bits I am referring to are the very challenging economics that many of them have to face up to.

This comes in several forms: Many face very unstable revenues as they are tied to a weak UK economy or volatile commodity markets. Others face limited long-term growth opportunities due to their size or mature markets, or are crippled by legacy debts or pension fund black holes.

For many big companies in the FTSE 100, the only attraction of their shares has been a chunky dividend yield. This is now disappearing rapidly with the coronavirus and the weak economy being used as a convenient excuse to slash or scrap a dividend policy that has been unsustainable for far too long.

Investing in high dividend yield shares has always been risky and many investors have chosen to ignore the big red flag that the yield was waving in their faces as a sign that the market thought the payout was unsustainable.

Shell and BT are two classic examples of this and I expect more dividends to follow the same route. The case for owning a FTSE 100 or even a FTSE All-Share tracker

fund (which is dominated by the FTSE 100) is a weak one.

This leaves people seeking income in a very difficult place right now. It's difficult to know where they are to turn to so that they can at least get some income and sleep well at night.

If you are going to invest for dividend yield and you want to sleep soundly at night then here are some simple general rules to follow:

■ Invest in shares of good companies with high profit margins, high return on capital employed (ROCE) and free cash flow. Look for companies that have shown proven recession resilience in the past. A quick and simple test is to look at what happened to its dividend in the last recession.

■ Accept a lower dividend yield in the 3-4 per cent range and stay away from very high-yielding shares. The yields are high because the market thinks the dividend will be cut. Why take the risk?

■ Make sure that the company's dividend is covered by free cash flow – free cash flow per share is higher than the dividend per share.

■ Be wary of companies with high debts and big pension fund deficits.

This leaves very little to choose from in the UK market, in my view. I have prepared a small list of shares below:

Possible sources of safe dividend yield

Company	Price	TTM DPS(p)	TTM FCFps	Dividend yield	FCF yield
Imperial Brands	1619	206.6	278.8	12.8%	17.2%
British American Tobacco	2998	203.0	282.5	6.8%	9.4%
Severn Trent	2421	96.1	-92.3	4.0%	-3.8%
Tesco	236	9.1	-11.3	3.9%	-4.8%
Pennon	1105	41.9	0.8	3.8%	0.1%
Morrison (Wm) Supermarkets	186	6.8	13.5	3.6%	7.2%
Moneysupermarket.com	323	11.7	18.1	3.6%	5.6%
Unilever	4031	142.8	207.0	3.5%	5.1%

Source: SharePad and Investors Chronicle

Sticking to my simple rules above would lead me to shares such as MoneySupermarket, Tesco, Morrisons and Unilever. Tobacco companies are understandably not to everyone's liking, but I think both Imperial Brands and British American Tobacco will generate plenty of cash to maintain and possibly grow their dividend payouts. Tesco is expected to use the proceeds from the sale of its Asian business to eliminate its pension fund deficit and pay a

special dividend of around 50p a share.

Water companies fail the free cash flow and debt tests, but are a special case. Essentially, these companies pay out all of their regulated profits in dividends. They have just had their five-year regulatory review of prices and I expect all the three quoted companies to maintain their dividends and probably increase them in line with inflation.

Pennon is the best performing water company from an operational point of view. It has just sold its waste business Viridor for a fabulous price and will be debt-free. I expect a big special dividend and plenty of room to keep up its annual payout as well.

The caveat with all of these is that we live in strange and uncertain times, which means nothing can be ruled out.

There are some wonderful companies listed in the UK, but many have already been discovered and have seen their share prices and valuations bid up to stratospheric heights.

Over the past decade we have seen a flight to quality shares, with strong balance sheets being highly profitable and offering steady growth. This trend is being strengthened in the recent turmoil in a further flight to safety.

This is making many shares very expensive and requiring a lot for future growth to make investors plenty of money, but at least you can believe that these companies have the potential to grow.

Then there remains the argument that there is no alternative. Despite governments borrowing unprecedented amounts of money, bond yields are absurdly low. I was astonished to read earlier this week that the UK government via the Debt Management Office managed to sell £3.25bn of five-year gilts with a yield to maturity of 0.017 per cent.

Who on earth is buying these? The only reason to do so is that you believe the world is going to enter a sustained period of deflation and that the buying power of cash will increase. Given the shock to the economy from coronavirus-induced lockdowns, I think this is entirely possible. That said, if you believe this you might as well just hold cash than buy government bonds.

I also think it is possible that governments will print unprecedented amounts of money, which might just find itself into the real economy rather than enriching investors and property owners. If coronavirus has taken supply capacity out of the economy – which I think it

will – then we could be left with the scenario of too much money chasing too few goods and services. The result would be inflation and perhaps lots of it.

How the current buoyancy of certain sections of the stock market stack up against these real risks is beyond me right now, but it is how bubbles are formed and that rarely ends well.

With the exception of just blindly buying an S&P 500 tracker fund which has been a great investment – although increasingly risky given its large concentration in the five biggest shares – I think trackers in the UK market are a dead product.

Careful and selective stock-picking is the order of the day, and I am quite happy about this. Stay away from bad companies, but try and pay reasonable valuations and hopefully you will see the value of your savings grow. That said, this task is far from easy and has arguably never been harder.

JD Sports

JD Sports (JD.) was dealt a blow on Wednesday morning when the Competition and Markets Authority (CMA) blocked its acquisition of Footasylum and told it to sell it.

It was no surprise that the company was not happy with the decision and went to great lengths to explain how the CMA had got it wrong.

My view is that the JD Sports management is seething because it thought it could make a quick killing from buying Footasylum and it has had it taken away.

The deal to buy the loss-making Footasylum looked like a very simple deal about buying power to me. JD, by using its far superior scale and buying power, saw an opportunity to take Footasylum's £225m of sales (long before the impact of Covid-19) and make a reasonable profit from them.

If it could have got this business to make margins of 7 per cent or more (not too unreasonable an assumption given JD's UK business in normal times – then it would be making profits of £15m compared with the implied value of £90m it is paying – a pre-tax return on investment of 16.7 per cent.

Coronavirus had put paid to achieving this any time soon before the CMA put the boot in. Yet, I can't help thinking that JD Sports may have had a lucky escape.

Footasylum is very reliant on selling from its stores and has a negligible presence online, where consumers have dramatically shifted to in recent weeks and they are likely to stay there. This and the big push into direct-to-consumer retailing by big brands such as Adidas and Nike also makes

you think that the outlook for JD Sports is not going to be as good as it was before the current crisis.

At the moment, big sports brands probably can't afford to bypass big retailers such as JD Sports, but that might change and faster than people think. The current lockdown will force many consumers to change their habits and it is very possible that they stick with them.

I have immense admiration for JD Sports' ability to sell lots of overpriced trainers to young people, but I think it's long-term competitive position is getting weaker. I think it will struggle to find anyone willing to buy Footasylum for anywhere near the price it paid for it and it might even have to close it down and take a financial hit.

Like many things, the coronavirus lockdown has exposed weaknesses in businesses and has got investors to see and think about them. I may be getting out at the lows, but I am tempted to sell the shares out of the UK Quality shares portfolio when I can come up with something better to replace it with.

ITV

ITV (ITV) is a business that I quite like, just not from an investment point of view.

I think the business has some very good assets in ITV Studios and a back catalogue of TV programmes that it is now trying to monetise through its Britbox venture with the BBC.

Sadly for ITV, the BBC is one of its biggest problems. While ITV has to fish for its supper, it has to go up against the BBC which does not and has almost complete security in knowing what its annual revenues are going to be. Without the BBC, maybe ITV would be a lot more valuable business than it is now. I say this because it might have been able to develop a subscription TV business rather than being overly reliant on advertising, which it still is.

Despite being fairly well-managed, ITV's Broadcasting business has very cyclical advertising revenues and virtually all its operating costs are fixed. When advertising revenues are rising, the business is extremely profitable. When they fall, as they are at the moment, then profits tend to collapse. This is why its shares have struggled as a long-term investment.

First-quarter trading until the end of March had only been lightly touched by the impact of coronavirus. Broadcast revenues were up by 2 per cent, with advertising revenues up by the same amount and online revenues up by 26 per cent, as businesses such as the ITV Hub online player continue to do well. Studios' revenues were down 11 per cent due to the phasing of programme deliveries

and a bit of a hit from Covid-19.

April's advertising revenues fell off a cliff and were down by a whopping 42 per cent. Lots of overheads are being cut along with capex and programming budgets. It's dangerous to say this in the current market, but I don't think the company will need to issue equity – at least not for a while – as my guess is that even if broadcasting profits collapse in 2020, and I think they will – then the more resilient profits from studios can probably still pay the interest bill on its debts with some room to spare.

The shares have halved in value so far this year and could no doubt rally hard in any economic recovery, but I sadly think that things will get worse before they get better for ITV.

National Express

Regular readers will know that I quite like **National Express (NEX)** as a business and recently added it to the UK Quality shares and Fantasy Sipp portfolio.

After last month's reasonably reassuring trading update, I was a little bit surprised – but only a little bit – to learn on Wednesday morning that the company intended to raise money by placing up to 19.99 per cent of its existing shares with investors.

Existing shareholders will now have to suffer some dilution of their shareholdings, but the company did provide some reassuring news as well – more on this shortly.

I always think that investors can learn more about what is going on in the economy and the real world by reading company news releases rather than listening to economists and financial journalists (including myself). National Express' update and planning for the future is likely to become more common in recent weeks, in my view.

The company is now planning for trading conditions to be worse than what it expected just a few weeks ago. It is running its businesses on the assumption that there will be a second spike in coronavirus infections and that further lockdowns are likely.

What this means is that it expects its revenues to start to recover a little bit from July onwards, but that they will be starting from half the expected amount before coronavirus appeared. It then expects business to gradually pick up to be 25 per cent lower than expected by the end of 2020 and throughout the whole of 2021.

This obviously means that profits will be a lot lower this year than in 2019. The company's best guess is that its efforts to cut cost will limit some of the damage from

reduced revenues at earnings before interest, tax, depreciation and amortisation (Ebitda) – not a great measure of profit, but the only one it is talking about – which was £510m in 2019 and is likely to be around £300m this year.

The good news is that with the effect of recent acquisitions and new contracts, Ebitda should have a good chance of getting back to 2019 levels in 2021, when the company intends to reinstate its dividend at the half-year stage.

Clearly, with the placing, 2021 profits are going to have to be shared out amongst a larger number of shares, so any dividend is going to be lower than it was in the past, in my opinion.

What is encouraging to read is that the company is in a very good place to pick up new business from the damage done by coronavirus.

Schools that previously ran their own school bus fleets are increasingly strapped for cash and are struggling to afford to replace ageing fleets. They are now looking to outsource to private providers for the first time.

Many businesses are looking for dedicated bus shuttle services, while cities are looking for providers of urban bus services to take over from struggling incumbent operators.

National Express will need to invest money to take advantage of these opportunities and money raised from issuing new shares will be a big help with this. The good news is that new projects can be expected to earn returns on investment of more than 15 per cent.

The ability to invest at these rates of return and generate free cash flow with it are the reasons I like this business. I don't expect the shares to make much progress for a while, but I do when things get a bit more back to normal, as it looks like the company's competitive positioning is going to be stronger than it was before.

It seems that a few professional investors might have the same view as the company was able to place 101.9m new shares at a price of 230p each, compared with Tuesday's closing price of 238p.

Based on the assumption that the company could get back to generating free cash flow for shareholders of £100m-£120m by 2021 on the increased number of shares of 613.6m, this would give an estimated free cash flow per share of between 16.3p and 19.8p and a free cash flow yield of between 7.1 per cent and 8.6 per cent, at a share price of 229p. That looks okay to me and something to hang on for.

Smith & Nephew

I think **Smith & Nephew's (SN.)** businesses are plugged into some favourable demographics and trends with its joint replacement, advanced wound care and sports medicine products.

However, the problem at the moment is that because hospitals are full of emergency coronavirus patients, not as many people are having hips and knees replaced, sports injuries treated and wounds cared for.

As with many companies, first-quarter revenues to the end of March 2020 were not too terrible. In S&N's case, they were down 7.6 per cent on an underlying basis. In April they were down by 47 per cent, as many non-urgent operations were cancelled.

There's no surprise in the company withdrawing its guidance of future profits, although it did say that trading in China was improving.

I like this company because it solves problems in long-term growth markets where barriers to competition are high. In more normal times it makes high profit margins, good returns on capital and generates plenty of free cash flow.

It does need to sort itself out, though. It looks to be very inefficient on its stock control and could generate more cash. From an operational point of view, it needs to rev up the growth rate of its core hip and knee implants.

The previous chief executive left last year possibly because he worked out he wasn't going to get paid obscene amounts of money for buying companies. The new chief executive needs to concentrate on the more mundane day-to-day stuff and make a good business better than it is now.

S&N is a scarce asset that may well attract a takeover bid over the next few years if it doesn't up its game. I like the business long term and think that a higher value will come out eventually and so it stays in both the fantasy portfolios.

Walt Disney

Walt Disney (US:DIS) has suffered terribly from the coronavirus. It has had to shut all its theme parks, while production at its TV and film studios have seen significant disruption. Cruises have also been cancelled.

The lack of sporting events in the US and the disruption to film and TV schedules has also seen advertising revenues take a big hit.

Walt Disney: Q2 revenues and profits

	Quarter Ended			Six Months Ended		
	March 28, 2020	March 30, 2019	Change	March 28, 2020	March 30, 2019	Change
Revenues:						
Media Networks	\$ 7,257	\$ 5,683	28 %	\$ 14,618	\$ 11,604	26 %
Parks, Experiences and Products	5,543	6,171	(10) %	12,939	12,995	– %
Studio Entertainment	2,539	2,157	18 %	6,303	3,981	58 %
Direct-to-Consumer & International	4,123	1,145	>100 %	8,110	2,063	>100 %
Eliminations	(1,453)	(234)	>(100) %	(3,103)	(418)	>(100) %
Total Revenues	\$ 18,009	\$ 14,922	21 %	\$ 38,867	\$ 30,225	29 %
Segment operating income:						
Media Networks	\$ 2,375	\$ 2,230	7 %	\$ 4,005	\$ 3,560	13 %
Parks, Experiences and Products	639	1,506	(58) %	2,977	3,658	(19) %
Studio Entertainment	466	506	(8) %	1,414	815	73 %
Direct-to-Consumer & International	(812)	(385)	>(100) %	(1,505)	(521)	>(100) %
Eliminations	(252)	(41)	>(100) %	(473)	(41)	>(100) %
Total Segment Operating Income	\$ 2,416	\$ 3,816	(37) %	\$ 6,418	\$ 7,471	(14) %

Source: Walt Disney

The company's media and studio entertainment businesses were cushioned somewhat by the inclusion of the Twenty First Century Fox assets that were bought last year. The real damage to profits has been done in the theme parks business where a 10 per cent fall in revenues fed through to a whopping 58 per cent fall in profits – big operational gearing in full view.

A bright spot is the good start that Disney's streaming service Disney+ has got off to, with 33.5m subscribers by the end of March. This is competitively-priced (£5.99 per month in the UK or £59.99 per year) and includes an enviable amount of content from Disney, Pixar, Marvel, Star Wars and National Geographic.

Disney subscriber numbers

	March 28, 2020	March 30, 2019	Change
Disney+	33.5	–	nm
ESPN+	7.9	2.2	>100 %
Hulu			
SVOD Only	28.8	23.2	24 %
Live TV + SVOD	3.3	2.0	65 %
Total Hulu	32.1	25.2	27 %

Source: Walt Disney

It's important not to forget that Disney+ and the Hulu streaming service have a high amount of defensiveness about them, as lots of consumers give up their cable and satellite subscriptions. Disney has a big cable TV business in the US and so any gains in streaming will be cannibalising its cable business at the same time.

The big positive for Disney is that unlike Netflix and Amazon, it owns its entire content library and has some pretty good stuff to boot. The combination of Disney, ESPN, Hulu and the acquired film and TV libraries from Twenty First Century Fox means that the company has a very good platform to succeed in the streaming wars, in my opinion. The approach to bundling ESPN, Disney+ and Hulu also seems to be going down well with consumers.

The drawback is that this is costing a lot of money as losses are going up.

The short-term outlook for the company is not great. The third and fourth quarters are the most popular times for visiting its theme parks which are currently closed. If they remain closed and tourism is subdued, then profits are likely to get a real hammering.

Looking further out, I still think this is a company with plenty of brand strength and broad popular appeal that will serve it well.

I will grit my teeth and suck up the pain in the Fantasy Sipp for the time being.

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