investors CHRONICLE alpha

27 March 2020



Phil Oakley's Weekly Round-Up

It may fly in the face of conventional wisdom, but right now I think a very good case can be made for selective stock-picking

Fantasy Sipp and UK Quality Shares performance

	Portfolio total returns (%)			
	1 month	Year to date	1 year	2 years
Scottish Mortgage Investment Trust	-5.9	-2.7	16.6	30.4
LF Blue Whale Growth Fund	-10.2	-9.2	3.8	28.8
Fundsmith Equity T Acc	-10.7	-10.5	-1.3	21.3
Mid Wynd International Inv Trust	-13.7	-12.0	4.7	12.2
Lindsell Train Global Funds	-8.4	-12.2	-3.9	19.0
Phil Oakley Fantasy Sipp	**-16.3**	**-14.9**	**3.4**	**19.1**
Martin Currie Global Portfolio Trust	-18.2	-15.7	0.1	15.6
Vanguard S&P 500 ETF	-16.9	-16.4	-4.1	9.8
Smithson Investment Trust	-19.4	-19.0	-5.7	
Finsbury Growth & Income Trust	-16.5	-19.4	-8.2	3.3
Phil Oakley UK Quality Shares	**-26.0**	**-25.5**		
Vanguard FTSE 100 ETF	-21.2	-26.4	-18.6	-11.4
FTSE All-Share - Total Return	-22.7	-27.5	-19.8	-14.6
Castlefield CFP SDL UK Buffettology	-28.5	-29.5	-14.0	-9.2
Vanguard FTSE 250 ETF	-30.2	-34.5	-20.6	-20.0

Source: SharePad

Why do you invest?

There are many different reasons why we invest our savings. For me, the reason is to grow the buying power of my money. By that I mean that I want the £100 that I invest today to buy more goods and services in the future than it does now. The only way it can do this is by it growing in value faster than the change in cost of living. In short, it needs to grow faster than inflation.

For years we have had it drummed into us that the best way to grow the buying power of your money is to invest in the shares of businesses. These are real assets that sell goods and services and by increasing the amount they sell they can become more profitable and more valuable. If they then reinvest their profits into more productive assets then they can keep on compounding in value. Shareholders get a share of the profits in the form of growing dividends and a rising share price.

That's the theory anyway.

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For some individual UK shares this has proven to be the case, with some generating spectacular returns. For anyone buying the UK stock market as a whole, the returns have been much more modest.

In recent years we have been told not to bother with stock-picking and timing the market. Both are difficult. Buy and hold is supposedly the way to go. Don't worry when the stock market falls, it always bounces back. Stocks for the long run and all that kind of stuff.

It's amazing how many times in the past few weeks some of the quotes attributed to the famous economist John Maynard Keynes have really struck a chord with me: "Pushing on a piece of string" to describe the futility of printing money and cutting interest rates to get an economy moving again. "The market can stay irrational longer than you can stay solvent" is particularly relevant in current markets. The other is "in the long run we are all dead" to describe how irrelevant that term can be to many investors.

During the ongoing market turmoil, I've also seen and heard so many commentators say those with a long-term perspective should not be afraid to buy shares now. Their argument has often been backed up with a chart of the UK or US stock market for the past 10 years or quoting the total returns over that period.

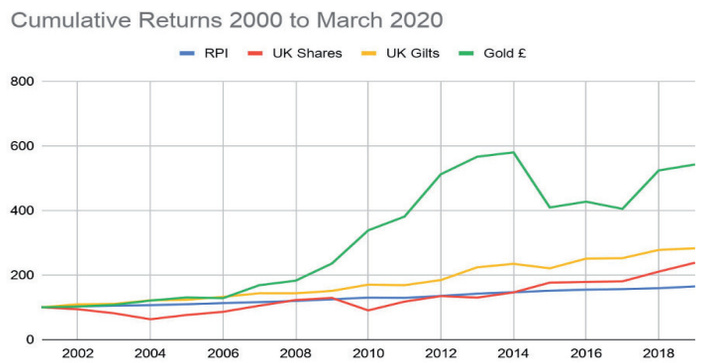
I'm fully aware that you can make any argument you want if you pick the right starting date. But if I look at the returns from UK shares over the past 20 years, I come away thinking that long-term investing has not been as good as it's cracked up to be.

It seems to me that a UK stock market investor just buying and holding the FTSE All-Share Index has put up with a lot of ups and downs and a lot of stress for pretty meagre returns on their money.

To have a look at how good or bad it has been I've compiled the returns from £100 invested in UK shares, UK gilts and gold (priced in pounds) and compared this with how much you would need to earn just to maintain the buying power of £100, by keeping pace with inflation.

The reason I have done this is just to show what a long-term investing horizon can look like. The past 20 years includes the bursting of the dot-com bubble, the global financial crisis, the long bull market that came from it and the current setback.

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Source: Barclays Equity Gilt Study, IShares, FTSE-Russell, SharePad,Investors Chronicle

The chart above shows the results.

An amount of £100 in 1999 would need to be £173 today to maintain its buying power based on the cumulative inflation over the period. A basket of UK stocks as represented by the FTSE All-Share Total Return index has turned £100 into £222, but it took until 2014 to climb meaningfully higher than inflation. A basket of UK gilts have turned into £321.60 and £100 of gold has turned into £778.70, helped by a rising gold price and devaluation of the pound against the US dollar.

So much for stocks as a long-term investment. I haven't crunched the numbers on the US stock market, but based on some reputable sources on Twitter, the compound average annual total return on US stocks over the past 20 years has been a little under 5 per cent. This compares with the FTSE All-Share's 4 per cent. These are not great returns considering the risks that shareholders are exposed to – risks that are being hammered home right now and have been periodically over the years.

This is all very interesting, but most of us are trying to work out how to invest our money going forward. The interest rates on cash savings and government bonds are so low that I think it's very safe to say they are not going to offer very good long-term returns unless we experience a severe deflation, which still means that governments can honour their debts.

So what's the UK investor to do?

Let's start with the outlook for inflation. Looking at the yields on the UK conventional and index-linked gilt (where bond returns are linked to inflation), the market is one way of working out what rate of inflation is currently priced into government bonds.

You calculate something called the breakeven inflation rate. This is done by taking the yield on a conventional gilt and then subtracting the yield on an index-linked gilt with a similar maturity.

At the time of writing, the 10-year gilt offers a redemp-

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tion yield of around 0.5 per cent. The 10-year index-linked gilt yields offer minus 2.4 per cent. Because the yield on the index-linked gilt is negative the maths of the break-even inflation calculation mean that we add (a minus minus another minus makes a plus) it to the conventional yield to get 2.9 per cent. Let's round it up to 3 per cent to make things simpler.

What this means in practice is that it would take around 24 years for inflation to destroy the buying power of your money today.

Of course, the big fear at the moment is that inflation could end up being a lot higher. There are good reasons for this. I'm not going to get into why now because I fear it would become too depressing. Needless to say, It may be wishful thinking to believe that central banks can keep on creating money out of fresh air without eventually creating inflation and I'll leave it at that, until another time.

I think it's fair to say that the need for an inflation hedge for your investments is still very strong.

Can UK shares do the job?

My answer to this is a qualified yes.

One of the most brutal lessons of the current downturn is how bad the performance of UK stock market indices have been. Both the FTSE 100 and FTSE 250 have taken a real beating and have fared worse than the S&P 500 in the US. The FTSE 250, as of 25 March, had fallen by 35.5 per cent since the start of the year, compared with 26.5 per cent for the FTSE 100 and 23.5 per cent for the S&P 500.

Granted, finding a safe place to hide has not been easy, but buying and holding a UK tracker fund or ETF has not been a great place to be.

It's not a nice thing to say, but the real problem with UK indices is that the good companies get diluted by all the bad ones – and there are a lot of bad ones. By bad I do not mean to be disrespectful to the managers and employees of these companies who are undoubtedly doing their best. It is my view that they are working with businesses and industries where it is hard to make good profits and that any profits they do make can get wiped away in a recession.

I know this flies in the face of current conventional wisdom, but what I think we have seen in both the upturn and now in the downturn is a good case for selective stock-picking. It's no guarantee of not suffering periods of painful performance, but buying good companies that have the capability to grow their profits at fair prices is an approach that is likely to deliver the best returns going forward.

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Trying to find opportunities in the economic fog

This is a horrible time for investors, but it is also one where opportunities present themselves and can be taken by those that have the nerve to do so.

The big problem that all investors are facing at the moment is that they have little or no visibility on the future profits of companies. We have been inundated with companies announcing that they are closing their businesses and suspending their dividend payments to preserve their cash resources. It has become very difficult, if not impossible, to value businesses.

In a situation like this, forget forecasts. Focus on recent profitability and try to learn from a company's history. Then try and work out what its share price is implying about the future.

Last week, I looked at potential sources of safe income in utility shares and very adventurous opportunities in the travel and leisure sector.

This week, I am going to talk about businesses with debt-free balance sheets (I will ignore pension fund deficits and lease debts for this discussion, but these should be taken into consideration).

Debt is lethal in an economic downturn and companies with pristine, debt-free balance sheets offer an extra buffer of safety against a period of falling – or non-existent – revenues and profits. This is all about looking for businesses with the potential to survive the current business conditions and come out the other side. Having no debt is a good start in achieving this, but is no guarantee of survival.

I've selected a few companies that had debt-free balance sheets at their last year-end and looked at what value they might offer in the current market mayhem.

Companies with debt-free balance sheets

Company	Price	Mkt cap	Debt	Cash	EBIT margin	EPS	PE	EPV ps (8%)	EPV prem/disc	1 -yr low	1-yr high
Games Workshop	4209	1375	0	29	31.7	200.8	21.0	2600	-43.6	2970	7350
Persimmon	1927	6145	0	844	28.8	266.3	7.2	3648	87.1	1534.5	3298
AB Dynamics	1045	235	0	36	21.3	45.2	23.1	779	-28.5	882	2850
James Halstead	418	937	0	69	19.3	18.2	23.0	253	-40.6	365	570
Thorpe (F W)	257	299	0	31	16.8	13.1	19.6	189	-22.6	231	359
MJ Gleeson	694	384	0	30	16.4	60	11.6	806	33.4	544	990
Howden Joinery	498	2971	0	267	16.4	34.8	14.3	470	-5.6	400	732.6
Barr (AG)	489	548	0	22	16.3	32	15.3	410	-21.2	426	975
Castings	305	133	0	26	9.2	25.2	12.1	371	30.1	281	449
Bloomsbury Publishing	225	170	0	28	7.8	12.9	17.4	200	-8.6	184.5	302

Source: SharePad

In situations like this, there's a lot of value to keeping things simple when looking for possible opportunities. The other thing you must not forget to acknowledge is the limitations in what you can know as an outsider.

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Balance sheets are a classic example of this. They are a snapshot of a company's financial position at the end of one particular day. It most certainly will be different to how it looks at other times of the year and after a period of the business essentially being closed down, as we have for many companies right now. But it is at least something to go on.

In addition to companies that had no debt, I am also considering the following things:

- Cash balances – Does the company have a big cash balance that can help it pay some bills when there's no or little income coming into the business?

- Profit (Ebit) margin – margins tell you how big a buffer a company has between its revenues and costs. The bigger the margin, the bigger a buffer a company has before profits turn to losses. A low-margin business can become a no-margin business very quickly and is therefore much more risky.

- The company's latest EPS. We will use this to run some downside valuation scenarios shortly.

- The PE ratio based on the last annual results.

- The earnings power value (EPV) per share – This is the value of a company if its last annual profits continue forever and do not change. I have discounted profits at an interest rate of 8 per cent. This tells you how much growth is being factored into the current share price.

- EPV premium or discount – A premium says that the share price is implying future long-term profits will be lower than the last annual profit. A discount says the opposite.

- The one-year share price high and low.

Housebuilders such as Persimmon and MJ Gleeson often look cheap because they have historically offered periods of boom followed by bust. The fact that both Persimmon and MJ Gleeson have come out this week and said that their dividends have been scrapped tells you that these businesses are perhaps not as robust as their balance sheets suggest. Builders often have land creditors which are not counted as debt on a balance sheet, but they can be big numbers and cash is required to pay them.

Persimmon's share price does look as if it is pricing in a very big fall in sustainable profits, though. This might

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turn out to be true, but if the economy can bounce back fairly quickly it's a share that might offer some upside over the medium term.

Bloomsbury's and Castings' margins are a bit too low for my liking and don't offer enough protection against trouble.

Games Workshop and James Halstead are both excellent businesses, but I have more faith in the latter than the former from a safety and predictability point of view, while acknowledging Games Workshops' recent stellar growth.

Games Workshop is one of the most operationally-geared businesses I have come across and one where there is limited long-term visibility on revenues. The closure of its shops and factory this week will show investors how operational gearing, which has worked so well for it on the upside, can inflict a lot of pain on the downside. When things return to normal – and hopefully sooner rather than later – the operational gearing will hopefully start working in shareholders' favour again.

I was given a little bit of friendly flak on Twitter recently by a Games Workshop shareholder for pointing out in our weekly podcast that the recent lofty share price (over 29 times forecast earnings) offered no margin of safety for a business that had historically volatile revenues, limited revenue visibility and huge operational gearing. As shareholders often do when they hear something that challenges their bullish stance, they disagreed with my analysis.

The fact that the chief executive and finance director had taken the opportunity offered by the share price to offload a large chunk of their shareholding was not lost on me either. No one could have predicted the current situation we were in, but the point I was trying to make is that high valuations imply high future growth and lots of downside risk if that growth is not delivered.

I very much like Games Workshop as a business, but I don't see its current valuation as a great buying opportunity right now.

Investors can use the current share prices being offered to do the same thing and work out whether expectations of future profits are realistic or too pessimistic. The share price and what it implies is one of the most powerful tools an investor has at their disposal. Too often it is ignored. The recent bull market has seen many investors essentially gambling on share prices continue to go up in what is known as momentum investing. Momentum investing can deliver fantastic short-term results, but like operational gearing it can work both ways.

I see Howden Joinery in a similar predicament to James

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Halstead and Games Workshop. It is operationally geared through its manufacturing plants and stores, but it has a very strong balance sheet with a very large cash balance and a much cheaper valuation. Whether there is the same appetite amongst households for a new kitchen when all this is over remains to be seen, but this is a good business that could be a good investment in the weeks ahead.

If I were to pick one business from this list that seems to tick a lot of boxes from the point of view of safety and business quality, it would be AG Barr. This is a well-managed business that had been doing well before the current shock appeared. I see it as a very good watchlist candidate at the very least.

Profits going down before they go up again

It is likely that many EPS forecasts will be slashed and that companies will make less money than they did last year. This will push their PE ratios up based on current trailing EPS numbers. You should not get too spooked by this and think that the shares have necessarily become more expensive. In a downturn when earnings are depressed, shares will always look expensive on a PE basis, but if they can recover then this is often a buying signal.

It is the permanent change to a company's profitability that matters here. Has the current massive economic shock permanently reduced its earnings power?

My view at the moment is that valuations – with the exception of a few sectors – are not currently signalling that there is blood on the streets. They may not even get to that situation before moving up again.

What I do think is that some valuations need to come down. We are all getting a thorough lesson in investment risk at the moment, which is something that has been perhaps ignored in recent years.

The risks and uncertainties have not been swept away by governments promising to get their cheque books out and central banks printing money. In many ways, this has created new risks that may come to a head down the road.

I think we will continue to see extreme levels of volatility on the back of what is happening with coronavirus and death rates. Only when this has safely turned in the right direction will investing in shares become less nerve-racking again. This and the bottom of the stock market probably won't happen at the same time.

This is why the exercise I have gone through just now is so powerful and useful. Understand the business behind the share price, try and get a feel for how operationally geared it is and whether there has been a permanent change in its earnings power for better or worse. Then

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try and work out what its share price is implying. This is good practice at all times, not just now. Valuations do matter and not overpaying is a key part of controlling your investment risk.

Is Pennon just waiting to be taken over?



There are only three quoted water companies left on the London market and for me. **Pennon (PNN)**, the owner of South West Water (SWW), is the best of them.

It has not only managed SWW very well, to earn sector-leading returns on equity, but it has also made a great success of Viridor, its waste management business. It has successfully diversified away from landfill and recycling to energy for waste by investing heavily in plants which burn household waste and turn it into heat and electricity.

Last week Pennon announced that it had sold Viridor to private equity firm KKR for £4.2bn. This equated to a very punchy EV/Ebitda (earnings before interest, tax, depreciation and amortisation) multiple of 18.5 times. Management deserves a lot of credit for getting such a great price.

This is very good news for Pennon shareholders. The £3.7bn of cash to be received could be used to completely wipe out its debts. What's more likely is that a decent chunk of cash will be coming back to shareholders, hopefully in the form of a special dividend rather than a buyback.

I think that it will not be long before Pennon is on the end of a takeover approach itself. Private equity and sovereign wealth funds will be attracted to its stable and predictable cash flows, which has seen them buy other UK water companies. After the Viridor deal, it is likely that Pennon will be seen as being under-geared compared with other water companies. It can either gear up itself by buying another business or paying bigger dividends, or perhaps a financial buyer will come along and gear it up for themselves.

Either way, I think there's a lot to like about Pennon right now.

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It has been the best dividend payer in the sector over the past five years by growing its annual payouts by 4 per cent more than inflation. The sale of Viridor will see a new dividend policy announced on 6 June.

It is possible that the dividend could be cut, but the strong performance of SWW and a very strong balance sheet, suggests it could also have a policy that is at least as good as Severn Trent's and United Utilities', who are expected to increase dividends in line with inflation for the next five years.

Pennon forecasts

	Year (£m) 2020	2021	2022
Turnover	1,431.10	1,437.30	1,498.80
Ebitda	570	558.5	596.9
Ebit	358.2	340	368.1
Pre-tax profit	276.8	271.6	289.2
Post-tax profit	237.2	224	248.8
EPS (p)	57	54	59.6
Dividend (p)	44	45.7	47.6
Capex	313.2	268.9	250.4
Free cash flow	159.5	199	216
Net borrowing	3,213.30	3,384.40	3,383.20

Source: SharePad

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ISSN 0261-3115.

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