Investors' Chronicle | Alpha

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Stock markets fret about government bond yields

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Volatility on rising real rates highlights fragility

World equity markets continue to fret about the rise in government bond yields. The fact that 10-year Treasuries in the US have a redemption yield of just 1.4 per cent with the UK equivalent of 0.8 per cent shows how fragile the market is.

Report by Phil Oakley

Rising government bond yields continue to hurt the share prices of expensively-valued growth stocks, while growing belief in the Covid-recovery trade is fuelling a surge in UK domestic and cyclical shares. This is causing both my fantasy portfolios to underperform badly given my exposure to the former and lack of exposure to the latter.

However, I am not going to change my approach of favouring resilient, high-quality businesses that I think can grow steadily over the long term. Investing is not easy and the main reason I set up the fantasy portfolios is to show this.

If you are investing with a portfolio of individual shares, you have to accept that it will not perform well in all weathers. At the moment, we are seeing a powerful rotation into cheaper so-called value stocks, which could have some way to run.

That said, I think we are also seeing a lot of panic-buying by professional investors who are window-dressing their portfolios to show their investors that they have backed the latest winners.

I think this may prove to be a mistake. Many of the shares that are rallying right now are doing so because they are seen to be able to recover most of their pre-Covid profits, but the essential characteristics of many of the companies behind them has not changed. Many have weak competitive positioning, poor long-term growth prospects and are highly cyclical. The long-term outlook for some have also been weakened as customer habits are likely to have changed.

As for the outlook for stock markets in general, investors were spoiled in 2020 and got bailed out by cheap money just as they have been for the past 20 years. The relationship between share prices and profits growth has perhaps been stretched too much. To expect share prices to grow faster than profits when earnings multiples are high and earnings yields are low is not realistic. I can foresee a prolonged period of time when share price growth lags profit growth.

We have to face up to the fact that equities are an extremely crowded trade given that they are seen as the least worst alternative if you want to preserve and grow the buying power of your money. But there's little undiscovered value and lots of froth.

I've talked in recent weeks about the growing threat of inflation. The movement in commodity prices certainly highlights the risk.

Commodity prices

% changes in price	Price	1 month	Year to date	1 year
Brent Oil Composite (Highest Open Interest) $	6626.2	18.7	28.1	22.2
Copper Composite (Most Traded)	430.4	18.6	22.3	66.7
Lyxor ETF Commodities CRB	1305.5	8.4	12.9	5.5
Sugar (No. 11) Composite (Nearest Tradable Month)	17.2	9.1	10.8	16.5
Wheat Hard Red elec. Composite (Most Traded)	66300.0	5.7	9.9	43.5
Soybean Composite (Most Traded)	142575.0	6.1	8.8	60.5
Palm Oil (Crude) Composite (Most Traded)	79625.0	1.0	-3.1	40.9
Coal (API2) Composite (Most Traded)	6450.0	-4.3	-6.9	34.2
Iron Ore Composite (Most Traded)	13411.0	3.5	-15.2	54.6

Source: SharePad

However, the gold price which usually rallies on higher inflation expectations is decidedly weak, which is strange.

If inflation rises then shares and bonds will do badly but where do you put your money? Commodities may do well but are notoriously volatile and not for the nervous.

As I have said before, I expect central bankers to go back to printing money to keep a lid on interest rates. They could have a big job on their hands. Governments will continue to run sizeable budget deficits which will require lots of new bonds with not enough buyers.

The huge amounts of money the Federal Reserve and the Bank of England will have to print to mop them all up has the potential to weaken the value of the currency that is being printed. Investors are right to be nervous about this.

Up until now this has not created inflation because the money printed has not ended up in the pockets of main street who are more likely to spend it. This means we have not had a situation of too much money chasing too few goods which is necessary to cause prices to rise.

What's clear is that the value of the dollar is getting weaker and this by default is pushing sterling higher, even though it arguably faces up to an equally challenging backdrop once the temporary boost of the UK's successful Covid vaccine roll-out is discounted.

As a result, we are beginning to see pressure building on the profit forecasts of UK-listed companies with lots of overseas earnings. This is also an issue for global managed funds who will see the value of their foreign holdings fall when they are translated back into sterling.

This makes for a challenging backdrop for UK investors. Domestic earning stocks are therefore likely to be the place to be for a while, but those taking a longer-term view may want to resist the temptation to jump on board the current rally.

If you are an investor rather than a trader, it is important to have a strategy that you can stick with. This may mean you have periods of discomfort from time to time. Reviewing your strategy periodically is the right thing to do, but if the long-term picture has not changed then you should take the rough periods on the chin and stick with your convictions. Unlike a professional fund manager, you can take this view without the fear of being sacked. It is one of the key advantages you have and you should maximise it to the full.

If you want to grow the value of your share portfolio over the long-haul, while minimising costs then investing in companies that can grow their profits is the best way to do this rather than trading in and out of cheaper inferior shares. You just need patience to stick with good companies.

Yes, there are plenty of statistical studies that will make the case for value strategies outperforming growth, but having the skill and temperament to do this as an individual investor is another matter. These days I believe that the stock market is a lot more efficient at pricing shares relative to their prospects. This may mean that growth shares get overvalued, but it often means that cheap shares are value traps.

Fantasy Sipp vs comparators

Portfolio % returns	1 month	Year to date	1 year	2 years	3 years
Martin Currie Global Portfolio Trust	1.3	2.7	21.1	51.4	63.9
Vanguard S&P 500 ETF	-2.1	0.7	11.3	32.9	48.0
Scottish Mortgage Investment Trust	-4.5	0.7	101.0	149.0	165.0
iShares MSCI World Acc	-2.1	0.3	11.2	27.7	36.8
iShares NASDAQ 100 UCITS ETF	-4.5	-0.9	32.6	73.3	94.0
Fundsmith Equity T Acc	-0.3	-1.4	15.6	32.9	53.4
Mid Wynd International Inv Trust	-5.5	-2.4	13.4	38.7	47.7
LF Blue Whale Growth Fund	-1.4	-2.5	19.4	42.6	67.3
Phil Oakley Fantasy Sipp	**-2.9**	**-4.9**	**2.0**	**28.9**	**44.9**
Smithson Investment Trust	-2.3	-5.0	22.2	46.4	
Lindsell Train Investment Trust	-4.5	-8.8	34.0	-3.4	58.4

Source: SharePad

UK Quality shares vs comparators

Portfolio % returns	1 month	Year to date	1 year	2 years	3 years
Vanguard FTSE 250 UCITS ETF	3.7	4.2	2.8	14.8	14.6
FTSE All-Share – Total Return	0.1	3.2	-2.7	2.9	5.6
Vanguard FTSE 100 ETF	-0.7	2.7	-5.1	-0.7	2.4
Baillie Gifford UK Growth Fund	1.3	2.2	21.1	32.6	42.1
Finsbury Growth & Income Trust	-0.4	-1.7	-0.4	10.3	21.4
Castlefield CFP SDL UK Buffettology	-2.2	-1.7	3.3	22.6	31.1
Phil Oakley UK Quality Shares	**-2.9**	**-2.1**	**-5.0**		

Source:SharePad

Companies round-up

The six companies this week are:

- Reckitt Benckiser
- InterContinental Hotels
- Intuit
- Tristel
- Howden Joinery
- Genus

Reckitt Benckiser

Reckitt Benckiser (RB.) has an enviable portfolio of consumer health and hygiene brands. Despite stiff competition from cheaper and improving own-label products, the Covid-19 pandemic has seen people across the world place their faith in trusted brands.

The problem facing companies such as Reckitt and its peers is that the boom they experienced for some of their products in 2020 is unlikely to last.

Booming sales of its Lysol and Dettol hygiene products mean that they now account for over a fifth of RB's total revenues. Its Hygiene divison's revenues increased by 19.5 per cent on a like-for-like (LFL) basis in 2020, which was virtually all volume-driven rather than relying on price increases. This included an impressive LFL growth performance of 25.7 per cent in the last quarter of the year. Operating profit increased by more than 21 per cent to £1,505m.

In stark contrast, the Health division had a much tougher 2020. Prices were cut and this did help LFL sales grow by 12 per cent, but profits did not grow and margins fell by 340 basis points. This kind of highlights the chief problem facing RB. Its products are well-known and trusted, but the price differential between them and private-label is big – possibly too big – in my opinion.

Cutting prices addresses this, but unless it leads to a big increase in the volume of products sold so that it can leverage the fixed costs in the business, profits and margins will struggle to grow.

The infant formula business has held up well in North America, but continues to perform very badly in China due to increased competition, changes in regulation and a declining birth rate. The Mead Johnson acquisition has been a disaster for RB as it paid a fortune for a business with little growth. Over £5bn of the £17bn purchase price has been written off and I was surprised not to see another big goodwill impairment in these results. The Chinese business is being reviewed and will probably be sold for a loss.

I think more brand disposals are likely to shake up the quality of the portfolio. Scholl is being sold for an undisclosed price and there have been rumours of Clearasil being sold as well.

The company announced that it is buying BioFreeze, a leading pain relief brand used by athletes which comes in gel, spray, cream and patches. RB did not say how much it is paying for it, so whilst this brand may fit well, investors have no idea whether it will produce good returns for them.

Reckitt Benckiser forecasts

Year (£m)	2020	2021	2022
Turnover	13,985.10	13,683.40	14,157.20
Ebitda	3,727.20	3,602.10	3,863.00
Ebit	3,305.80	3,163.00	3,409.80
Pre-tax profit	2,994.10	2,867.10	3,143.80
Post-tax profit	2,307.80	2,207.70	2,414.30
EPS (p)	324	312.4	341
Dividend (p)	175.1	174.9	180
Capex	499.3	599.1	577.2
Free cash flow	2,290.10	1,960.30	2,296.80
Net borrowing	10,008.60	9,529.10	8,369.90

Source: SharePad

2021 is likely to see no growth in profit and it is by no means certain whether things will get much better in the future. I can buy into the growth potential of products such as Durex condoms, and the benefits of expanding hygiene brands into new markets. However, I struggle to see the long-term organic growth potential of branded Ibuprofen tablets (Nurofen), cough medicines, cough sweets, antibacterial sprays, disinfectants and bleach.

The weak growth outlook is currently reflected in consensus forecasts and the valuation of the shares. At 5,917p, the shares trade on a 2021F PE of 18.9 times, while offering a prospective dividend yield of nearly 3 per cent. This is not expensive by any means, but I struggle to see how the shares will be rerated upwards in the absence of meaningful sustainable growth.

InterContinental Hotels

A year ago I would have used **InterContinental Hotels (IHG)** as an example of a business with very strong recession resilience. It came through the financial crisis in pretty good shape, but the current downturn has hammered its profits which fell by 75 per cent last year.

In normal times the franchising of hotel assets is very profitable. With IHG managing the booking system and marketing and pocketing royalty fees, it does not have the costs and extreme operational gearing which comes with owning hotels outright.

That said, IHG's fee profits fell by two-thirds last year and the revenue margin fell from 54 per cent to 34 per cent. US margins held up fairly well, but its business in the Middle East and Africa lost money.

The bull case for IHG is its ability to add new hotels and rooms. It currently has 886,000 rooms and 5,964 hotels on its books with 272,000 rooms in the pipeline.

The company has been growing its presence in niche upscale and luxury hotels, but the bulk of its growth is based on growing midscale hotels with the Holiday Inn and Holiday Inn Express brands in places like the US and China.

The worry for the company and its investors is that around half its business is related to business travel. This is going to take some time to recover and may not get back to previous levels, as increasing numbers of people have realised that a Zoom or Skype meeting can be a reasonable substitute to getting on a plane and staying in a hotel. There are certainly grounds for thinking that IHG's business may have been permanently weakened from this, never mind the threat of alternatives such as Airbnb.

Yet its share price seems to paint a different, more bullish picture. At £51.50, it is within 10 per cent of its all-time high, but profits are not expected to get back to 2019 levels any time soon. Then it made operating profits of $816m/$3.03 EPS.

IHG forecasts

Year ($m)	2020	2021	2022
Turnover	1,006.70	1,434.30	1,803.30
Ebitda	304.9	576.4	859.8
Ebit	159.9	478.8	730.3
Pre-tax profit	61.8	305.1	606.7
Post-tax profit	48.4	173.6	448.3
EPS (¢)	24.4	119.8	247.6
Dividend (p)	-	36.3	68.9
Capex	99.2	170	178
Free cash flow	-170.8	239.7	502.8
Net borrowing	2,639.10	2,531.10	2,236.80

Source:SharePad

Current forecasts for 2022 are for EPS of $2.48. This puts the shares on a 2022F PE of 29.4 times. That's not excessive for a high quality business which can be extremely profitable, but perhaps the loss of its previous reputation for robustness suggests that that's high enough.

Intuit

Intuit (INTU) is a business that I really like. The main reason for this is because of the way it focuses on its customers' needs and makes its products easy to use.

Its flagship Quickbooks small business accounting software is a case in point. Intuit has been brilliant at communicating the ease of use of this product across multiple devices. This is something that I think its UK-based rival Sage has failed spectacularly to do. It is therefore no surprise to me that more small businesses and self employed businesses are signing up to Quickbooks rather than Sage and why Intuit is growing strongly and Sage is not.

The same strengths apply to Intuit's Turbotax tax filing software and I expect the recently purchased Credit Karma (personal credit ratings and financial product referral service) to quickly follow suit.

The strength of Intuit's customer offer was reflected in another decent set of financial results this week.

Quickbooks' online sales increased by 22 per cent with online services (payments and payroll) up by 20 per cent and international sales up by an impressive 44 per cent. This was offset by a continued decline in desktop licences, but sales for the Small Business and Self-Employed segment were up by a healthy 11 per cent. Consumer Sales (Turbotax) fell by 79 per cent due to later IRS opening, which has shifted sales from the second quarter into the third quarter.

Credit Karma is exceeding initial expectations and has a lot of potential. The product is being integrated into Turbotax, which allows recommended products (from partners not

Intuit) such as credit cards and loans to be tailored to a customers' income and credit profile. The business is expanding into new products such as auto loans and home loans.

Intuit is an aggressive and innovative company that is developing its artificial intelligence assets to improve customer service and win new business. Some of its competitors should be worried.

It is winning the battle in shifting products that were previously used on a desktop that have been moved onto cloud based internet services. It is offering differentiated products such as live expert help with accounts and tax issues which reassure customers who may have used more expensive advisers rather than doing the bulk of the work themselves.

There still exists huge potential for this company to gain market share in its existing markets. Eighty six million tax filings are done elsewhere out of a total US market of 160m. In accounting software, the company is now targeting smaller- and medium-sized companies with up to 100 employees at a "disruptive price point".

This is a business that can leverage sales growth to great effect and deliver higher profit margins and higher returns on investment. Excluding the lower margin Credit Karma business, operating margins are expected to increase by 110 basis points this year.

The outlook for 2021 remains bullish with expected revenue growth of 15-17 per cent and operating profit growth of 12-14 per cent. Adjusted EPS is expected to be in the range of $8.20-$8.40.

Intuit forecasts

Year ($m)	2021	2022	2023
Turnover	8,922.70	10,321.40	11,577.10
Ebitda	3,201.70	3,722.40	4,328.20
Ebit	3,020.50	3,529.00	4,085.00
Pre-tax profit	2,991.50	3,513.80	4,070.00
Post-tax profit	2,278.20	2,703.80	3,152.70
EPS (¢)	837	975.6	1,151.60
Dividend (¢)	224.3	240.1	254.5
Capex	199.2	224.6	224.3
Free cash flow	2,511.00	3,060.70	3,468.50
Net borrowing	-1,988.80	-3,986.00	-7,080.50

Source:SharePad

At $413, the shares are very expensive on a 2021F PE of 49.2 times. I struggle to see the shares being rerated higher, but like the outlook for long-term profit growth which makes Intuit a share that I'd be quite happy to own for the long term.

Tristel

One of the main attractions of **Tristel (TSTL)** for investors is that its business is very easy to understand. Most of its money is made selling disinfectants for medical devices used in hospitals. It also sells surface disinfectants and has a very small business selling animal disinfectant products.

Tristel's disinfectants differentiate themselves by being based on chlorine dioxide. This was offered to hospitals to replace glutaraldehyde, which was found to be toxic and is protected by hundreds of patents.

These disinfectants are very profitable with the Tristel brand (medical devices) having gross profit margins of 84.5 per cent in the first half of 2020-21, with the Cache brand (surfaces) having margins of 63 per cent. Tristel sales continue to dominate the business and account for nearly 80 per cent of total sales.

Covid-19 has had a mixed impact on Tristel during its last half year. The cancellation of patient procedures hit the demand for Tristel (sales were still up by 12 per cent), but Cache sales have boomed by 82 per cent as hospitals rushed to deep clean their rooms and buildings.

With the UK market for its products largely mature, Tristel has been concentrating its efforts on growing overseas and benefited from increased and better distribution in countries such as India and Malaysia in this first half. Sixty per cent of revenues are outside the UK.

Overall revenue growth was still pretty good at 15 per cent, but higher costs related to share options and the entry to Malaysia saw pre-tax profit growth restricted to 10.7 per cent, while a higher tax rate saw EPS increase by 4.7 per cent to 5.62p. These figures treat share-based payments as a real cost which Tristel wants investors to ignore because they are non-cash. Regular readers will know that I strongly disagree with this point of view.

The company is sticking with its target to grow sales by 10-15 per cent a year until 2022, with earnings before interest, tax, depreciation and amortisation (Ebitda) margins (before share-based payments) of at least 25 per cent. For the remainder of its 2021 financial year to June, the outlook is more subdued as the full-year profit outlook depends on when hospital operations get back to normal. It seems realistic to assume that it will not be until the next financial year before momentum gets going again.

The shares are not cheap on a one-year rolling forecast PE of 44.3 times, but it reflects the fact that the company currently has no revenues coming from the huge US market at the moment. The company is trying to get FDA approval for its Duo foam-based disinfectant brand for medical devices. On the assumption that it eventually does so, there is considerable medium to long-term earnings growth potential which could continue to make Tristel a decent investment from here.

Tristel forecasts

Year (£m)	2021	2022	2023
Turnover	34.4	40	52.5
Ebitda	10.2	11.5	14.5
Ebit	7.5	8.7	11.7
Pre-tax profit	7	8.1	10.7
Post-tax profit	5.8	6.7	8.5
EPS (p)	11.9	13.7	17.2
Dividend (p)	6.5	7.5	9.9
Capex	1.8	1.9	1.8
Free cash flow	6.5	7.7	9
Net borrowing	-9.8	-14.2	-20.6

Source:SharePad

Howden Joinery

For me, **Howden Joinery (HWDN)** is one of the most impressive UK customer-focused businesses out there. The empowerment of its depot managers to adopt an entrepreneurial approach putting the customer first has seen Howden serve all its stakeholders well, while delivering great returns to its shareholders over the past decade.

It's in-house kitchen unit manufacturing capability when matched with slick logistics and combined with a local market strategy has given the company a strong competitive edge. This is seen again with its full-year results for 2020 released this week.

The fact that its sales were only down by 2.3 per cent is testament to the strength of this business. This was despite them falling by nearly 30 per cent during the second quarter between March and June. Howden benefited from the trend of people spending more money on their homes with second-half sales increasing by 16 per cent.

Trading improved month by month during the second half of the year and this has continued into 2021 with LFL sales in January and February up by 4.5 per cent.

Profit performance was not as good and this largely came from a hit to gross profits which came from cutting prices, lower volumes and higher costs. Operating profit fell by nearly a quarter.

Despite this, cash generation was impressive due to a £76m positive swing in working capital cash flows caused by extending creditor payment times. Net cash ended 2020 at £430m, compared with £267m at the start of the year. Given this financial strength, it wasn't really surprising to see a 9.1p final dividend declared and a further 9.1p special dividend to compensate for the absence of a final dividend last year.

Howden has long been able to defy the sceptics about its ability to grow over the long haul. The relationship between spending on new kitchens and the health of the housing market is a legitimate concern, but there still seems to be plenty of people out there with the cash – particularly retiring and downsizing baby boomers – to splash out on a new kitchen.

Howden is doing its bit to capture more of this spend by stocking attractive kitchen ranges at good prices, good stock availability, good prices and generous eight-week credit terms for installers.

It is also continuing to increase its UK market presence. Sixteen new depots were opened in the second half of 2020 and a further 35 are expected to be opened in 2021. A new depot format with lower fit out costs, but with a more efficient workplace without compromising on customer service bodes well for either margin expansion or cheaper prices to gain market share.

Having struggled to grow outside the UK and closing its depots in Belgium and Holland, it seems that the City-based depot approach in France is working quite well. Eleven new depots are expected to be added in 2021.

Howden shares have recovered their pre-Covid peak, while profits are expected to get close to doing the same in 2021. That said, the company has flagged the problem of rising commodity and freight costs on its business that may not be able to be plugged with price increases. At 723p, the shares trade on a 2021F PE of 22.1 times, which is the kind of valuation that probably needs forecast upgrades to move the shares higher. It looks like these are unlikely at the moment.

Howden Joinery forecasts

Year (£m)	2020	2021	2022
Turnover	1,541.30	1,642.10	1,746.20
Ebitda	301.2	364.2	403.4
Ebit	191.9	248.6	287.6
Pre-tax profit	183.8	240.2	280.3
Post-tax profit	148.2	188	221.1
EPS (p)	24.8	32.7	38.2
Dividend (p)	9	11.9	13.9
Capex	60	61.5	61.4
Free cash flow	86.6	171	194.9
Net borrowing	207	138.8	59.1

Source:SharePad

Genus

I did a detailed analysis of **Genus (GNS)** in the Investors' Chronicle a few weeks back. This is an attractive business with a leading position in growth markets with high barriers to entry.

Genus' genetics are all about producing better quality pork, beef and dairy products, which help its customers to make more money. The company is well exposed to the growing demand for pork meat in China, while its bovine products are adding to the value of its customers' beef and dairy herds.

This is a business which can benefit from favourable operating leverage, as was seen in this week's half-year results. Sales increased by 6 per cent to £285.7m, with adjusted operating profits increasing by 29 per cent to £51m.

The strength of the Chinese pork market continues to serve Genus well. Farmers have restocked their herds after the setback of African Swine Flu, while continued demand for meat is seeing further volume growth. Genus' products have around one-third of the Chinese market, but there is still scope to grow further as well as improving the sales mix, as royalties still account for just around 40 per cent of revenues, compared with 97 per cent in the US and 75 per cent in Europe and Latin America.

Royalty contracts are explicitly linked to the value added to the farmer and gives Genus's PIC division a better quality of revenue than a one-off sale. The royalties are linked to performance measures such as:

- Pigs born per litter
- Litters per sow
- The slaughter weight of animals born

Royalties also give a degree of resilience to PIC's revenues. When pig prices are weak and farm profits are low, the level of investment by farmers tends to fall, which can mean lower sales of animals, semen and embryos. With royalties, PIC still receives an income stream from the ongoing production at a farm.

Pig prices are still strong, but animal feed prices have increased too. Profits for pig farmers should still be reasonable and allow them to fund investment, but this is likely to be at a lower rate in the second half of Genus's financial year than the first half.

The bovine business, ABS, had a very strong first half with continued good sales of sexed semen and NuEra beef products where the medium-term outlook still looks very favourable.

As with Howden above, the very high valuation of Genus's shares needed a forecast upgrade to keep their recent momentum and they did not get one. Growth is expected to slow in the second half and exchange rates are giving rise to a significant profit headwind. As a result, full-year profit guidance was only maintained and the shares, unsurprisingly, sold off quite sharply.

That said, Genus is a unique stock market asset and is the only globally-listed share which allows investors to gain exposure to animal genetics for farming. The company has a very attractive product portfolio, which could be enhanced if its product to prevent porcine reproductive and respiratory syndrome (PRRSv) gains approval and starts generating revenues from 2024 onwards. After a very strong recent performance and a valuation of 48 times 2021F EPS, a pause for breath is not unreasonable to expect

Genus forecasts

Year (£m)	2021	2022	2023
Turnover	594.7	638.6	685.8
Ebitda	111.5	119.6	132.5
Ebit	84.1	91.5	103.3
Pre-tax profit	87.9	94	107.2
Post-tax profit	66.4	72.9	83.2
EPS (p)	101.8	109.7	123.8
Dividend (p)	31	34.2	37.1
Capex	30.6	30.3	29.5
Free cash flow	39.3	49.1	61.4
Net borrowing	82.8	65	10.7

Source:SharePad

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