Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

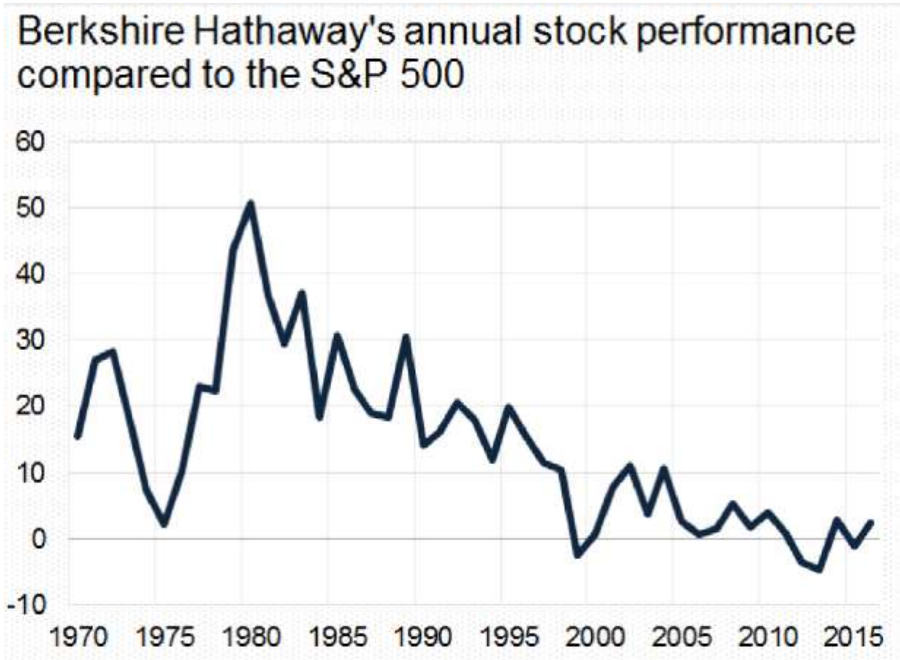
The last "forever" stock

10 August 2020

My first article for SharePad was 27 May last year when the FTSE 100 stood at 7,274. 15 months later and 18% FTSE 100 lower it is easy to feel downhearted. What we should have done is own gold (+19%) and, mainly, the NASDAQ 100 (+65%). I didn't. I rather stuck to Warren Buffet's mantra "if you see a bandwagon it's too late". Over that time period Berkshire Hathaway shares are down c.1%. Which is not a bad return for a value investor. The only call really was to buy these expensive unicorns.

Value Investing

Berkshire Hathaway made its strongest returns in its early years, illustrated in this chart



Source: Motleyfool

Value tends to outperform after a bear market. Between 11 January 1973 and 6 December 1974, the Dow Jones lost 45% of its value and Buffet's value investing style brought rich rewards after that, outperforming the S&P 500 by 50%. At the end of the bear market in 2000 Imperial Brands traded on a historic PE of 8.1X. Terry Smith's annual letter of 2018 stated it traded on a PE of 16.5X and he cited that as a good example of value investing, buying good companies when they trade below intrinsic value and waiting for an event to change the valuation.

A look at SharePad tells us that today it trades on a historic PE of 4.7X, the same absolute share price as it traded at in 2005. Value investing involves buying stocks when they are trading significantly below their intrinsic value and selling them when they trade at above intrinsic value, so by definition it is more active than the long term buy and hold investing. The example of Imperial Brands illustrates that value investing requires a sell discipline, and sell decisions are often harder than buy decisions. The debate between value, quality, momentum, and growth stocks has been long running, but it is clear that value investing requires a shorter holding period than long term buy and hold quality investing.

Growth is an input, Value an output

Terry Smith devised a screening tool while he was a broker called "Quest" which is still in use today. This system analysed stocks between the 4 aspects of growth, value, momentum and quality, and the data was sold to fund managers to assist their decision making. In his 2018 Fundsmith letter to shareholders he says that he views growth and value as joined at the hip in that growth is merely a component of value and that owning either "growth" or "value" stocks is fuzzy thinking. Though he graciously concedes that he engaged in some "fuzzy thinking" some years ago. It seems that he views growth as an input to the valuation while value is the resulting assessment.

Quality Stocks

Fundsmith invests in "quality stocks" and has an outstanding track record. As this is my last weekly for SharePad I feel it would be good to cover some "quality" situations, as I would prefer to be associated with quality rather than those deep value mistakes I have been attracted to. I would like to find a stock that in 10 years' time I can be remembered warmly for. The problem is that everybody's definition of quality differs. Words like "Moat" are used by Warren Buffett. Some look for "pricing power" or "intellectual property". But the evidence for all of these features shows through in financial performance. Fundsmith evidences the quality of the portfolio in a table in their annual letter.

	Fundsmith Equity Fund Portfolio								S&P 500	FTSE 100
Year ended	2012	2013	2014	2015	2016	2017	2018	2019	2019	2019
ROCE	29%	31%	29%	26%	27%	28%	29%	29%	17%	17%
Gross margin	58%	63%	60%	61%	62%	63%	65%	66%	45%	39%
Operating margin	23%	24%	25%	25%	26%	26%	28%	27%	15%	17%
Cash conversion	101%	108%	102%	98%	99%	102%	95%	97%	84%	86%
Leverage	44%	40%	28%	29%	38%	37%	47%	39%	53%	41%
Interest cover	18x	16x	15x	16x	17x	17x	17x	16x	7x	10x

Source: Fundsmith

The theory sold to us by Terry Smith, and to some extent by Warren Buffet is that quality outperforms over time. Buffet tells us the ideal holding period is "forever". But many of the stocks in the Fundsmith portfolio are large global companies which just don't have the small company factor described by Jim Slater as "elephants don't gallop". Fundsmith has £26bn of assets while Berkshire Hathaway has $194bn. Funds of this size need to be able to invest £200m in a stock to make a difference which is one of the key reasons we invest in small companies. They are under researched and under owned, so we hope by definition less efficiently priced. And as they grow the increased popularity should ensure more demand resulting in a valuation uplift.

Screen

A reasonable filter for quality stocks may well be to use the factors that Terry Smith provides in his annual letter to evidence the quality of his portfolio. If we use the SharePad filter for the 5 financial metrics exhibited by Fundsmith we may find a more exciting list of quality stocks. Using the lowest average numbers for the Fundsmith portfolio over the 8 years (e.g.: ROCE 26% in 2015) from the table above we get a screen that looks like this:

	Min:	Max:
ROCE	26	
Gross margin	58	
Operating margin	23	
Operating cash convers.	95	
Net gearing		47
Interest cover	15	

Applying these filters tells us that only 3 stocks on the whole of AIM would meet the average for the Fundsmith portfolio metrics, while there are also only three stocks that qualify in the FTSE All Share index.

FTSE All Share

Name	ROCE	Gross margin	Operating margin	Operating cash convers.	Net gearing	Interest cover
Ferrexpo PLC	31.1	61.4	36.1	109.1	20.8	20.8
Games Workshop Group…	65.2	67.0	27.1	173.8	0.0	150.2
Moneysupermarket.com …	49.2	68.6	30.5	114.8	5.1	59.0

AIM

Name	ROCE	Gross margin	Operating margin	Operating cash convers.	Net gearing	Interest cover
Andrews Sykes Group P…	26.9	58.3	25.0	118.8	0.0	41.0
Argentex Group PLC	50.5	98.6	37.4	311.0	0.0	210.4
EMIS Group PLC	29.2	90.3	24.6	127.5	0.0	99.3

Source: SharePad

Of course, these numbers are by definition backward looking, so as investors we need to assess the sustainability of these returns going forwards which brings words like "moat", intellectual property" and "pricing power" into the assessment. Then we also need to assess the growth prospects going forward and the valuation.

1. Valuation

This is perhaps the easiest to assess:

Name	Price	Market Cap. (intraday) (m)	PE	*fc* PE	Price to NAV	*fc* Yield
Games Workshop Group PLC	£90.475	£2956.5	41.7	44.1	22.2	1.2
Moneysupermarket.com Group PLC	308.8p	£1657.2	16.5	22.0	8.1	3.8
EMIS Group PLC	£10.15	£642.6	19.8	21.5	6.2	3.2
Argentex Group PLC	166.75p	£188.8	18.4	17.7	7.3	1.9
Ferrexpo PLC	199p	£1221.8	3.5	5.5	1.1	7.8
Andrews Sykes Group PLC	630p	£265.7	17.7		4.2	

Source: SharePad

Games Workshop is patently expensive trading on 44.1X forward earnings with a lowly yield of 1.2%. These high valuations can continue for some time, but it is valuation that would exclude me from buying it at this point.

At the other end of the extreme is Ferrexpo. The valuation of 3.5X earnings rising to 5.5X in the forecast year evidences steeply declining profits while the yield of 7.8% (if the dividend gets paid) suggests this fulfils the value criteria, where the yield is higher than the PE.

Note that Andrews Sykes has no forecasts in the market. This is by the company's insistence that they don't wish to pay a broker to forecast. I always find this an encouraging sign in that the company is focussed on running its business, rather than the share price.

2. Growth

We can see that Games Workshop has had a fantastic 5 years. If it was going to increase its EPS by another 471% in the next 5 years, we would be happy to pay the 44X PE, but I don't have enough confidence to know that. Valuations frequently reflect past event rather than the future and it is our job as investors to assess the future.

Name	Price	%	EPS 1y %chg (ann)	EPS 5y %chg
Games Workshop Group PLC	£90.375	▼-0.41	▲8.5	▲471.7
Andrews Sykes Group PLC	630p	0.0	▼-11.9	▲61.8
Ferrexpo PLC	198.6p	▲9.42	▲20.6	▲53.4
Moneysupermarket.com Group PLC	307.2p	▲2.06	▲5.2	▲49.2
EMIS Group PLC	£10.15	▲0.099	▲13.6	▲29.7
Argentex Group PLC	167.25p	▲3.56	▼-10.2	

Source: SharePad

Over 5 years all of the companies have grown their earnings usefully, between 29.7% and 471.7%, while Argentex hasn't been quoted for long enough to have a five-year track record. Over 1 year, Argentex' EPS has declined as a result of shares issued at IPO while Andrews Sykes has had an element of cyclicality in some geographies. Going forwards analysts estimate the prospects as follows:

	EPS Growth 2020/21	**EPS Growth 2021/22**
Games Workshop	-5.5%	15.6%
Andrews Sykes	n/a	n/a
Ferrexpo	-37.4%	-14.3%
Moneysupermarket.com	-24.7%	22.6%
EMIS Group	-7.6%	8.9%
Argentex	3.4%	27.5%

Source: Sharepad

- **Games Workshop** – With stores closing during lockdown the 5.5% EPS reduction may be a result, but the 15% growth is a more meaningful estimate of growth prospects, albeit considerably lower than the past 5 years.
- **Andrews Sykes** – There are no forecasts. The company has recently declared a special dividend which suggests that the hire book is generating excess cash so perhaps shrinking.
- **Ferrexpo** - This iron ore miner and pellet processor in Eastern Europe is highly cyclical, and has recently undergone management changes. The company is benefitting from lower energy prices and may be an interesting recovery play. Forecasts certainly seem gloomy.
- **Money supermarket** – 65% of revenue came from Insurance and money during the 3 months to 30 June. This is being held back by the lockdown where car sales have been impacted, and loans restricted. Forecasts assume the company doesn't fully recover until after 2021, which seems cautious.
- **EMIS Group** – The company is relatively resilient selling software licenses and services to the healthcare sector. While the company warns there may be some delays to new contracts as a result of Covid it says trading is in line. A 7.6% EPS decline looks pessimistic at this point for the current year.

- **Argentex** – Having delivered 28% profit growth last week for the full year to March 2020 3.4% EPS growth in the current year looks very conservative but the 22% growth for the following year may be more representative.

3. Sustainability

Markets change over time. I am sure we have all bought a share thinking the coast was clear only to find a competitor park their tanks on the lawn outside the head office through a co-ordinated price discounting campaign, or similar. Therefore, the strength of the franchise is hugely important to the long-term investor who wants to follow the company but not necessarily trade it.

- **Games Workshop**- No one else could produce Warhammer characters. The intellectual property owned by the company enables them to license the product which provides a very strong moat. It is conceivable there could be vagaries of fashion, but Warhammer looks likely to be an enduring brand. Lego has been going since 1934 after all.

- **Andrews Sykes** – Construction costs are high on large projects and health and safety requirements rigid. So if someone says you can use Sykes pumps that were used in the construction of the millennium dome or this cheaper one from China I suspect most project managers wouldn't choose the cheap version from China. The company has a strong brand in industrial markets which has so far endured 163 years.

- **Ferrexpo** - is the world's 3rd largest exporter of steel pellets globally. The heavy capital cost of entering the market represents a significant barrier to entry, but with relatively fixed supply and variable demand for steel the company can be very cyclical. Longer term threats perhaps come in the form of technologies that can produce replacements for steel. This looks more like a cyclical recovery stock that a long-term quality stock.

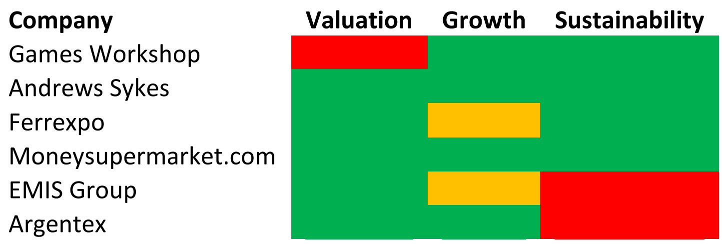
- **Moneysupermarket**- I tend to think of this rather like the Hargreaves Lansdown of personal finance. It is a brand which is enhanced by their regular advertising. It is important to keep up with the technology in terms of automating services, but as long as they keep up the technology spend this could have a long term "moat".

- **EMIS** – Personally, I tend to slightly discount software companies' intellectual property as the barriers to entry are lower. With high market ratings for software companies', capital is available at cheap prices for new entrants using the latest artificial intelligence. While EMIS' embedded customer base will not be easy to replicate someone with deep pockets and clever technology could represent a threat.

- **Argentex** – Alpha FX was the only quoted FX company in 2017 and now we have three; Alpha FX, Equals, and Argentex, which underlines the speed with which competition can increase. This is now a technology race where the FX platforms are developing into bank like offerings. There will be winners and losers in the race and while the prospects appear positive for all of them they are not yet large enough to have unassailable market positions.

Conclusion

Appraising quality requires subjective judgements so I find it can be useful to use traffic like colours to summarise, see below. I just can't buy Games Workshop at the valuation it trades at though I accept that may well be a mistake over a long-term time scale. Ferrexpo troubles me on a long-term view but actually looks like quite an interesting value stock which is well run. It could be a little early, but the PE is lower than the yield and the company is continuing to pay its dividend. At the same time, I wonder about the competitive pressure that may challenge EMIS and Argentex at some point in the future. That leaves that Andrews Sykes and Moneysupermarket would be my long-term quality holdings. I did a more comprehensive review of Andrew Sykes on 2 March which readers may care to review, or not.



Source: author

Summary

Having written for Sharepad for 15 months when the market has gone backwards, I have made the mistake of being overly attracted by value when value outperforms after a bear market, not during it. As the great investing masters will confirm. But in the interests of personal vanity I would prefer to be remembered for quality stocks. So, in a last-ditch attempt to attach my name to quality I would like to bet that both Andrews Sykes and Moneysupermarket will reward investors handsomely over the next ten years. If they do perhaps someone will offer to buy me a pint from their winnings in 10 years' time. If they don't, I will buy a pint for one person. I am afraid with SharePad's growing investor numbers I can't offer to buy everyone a pint. Thankyou for reading and I wish all of you and SharePad happy and prosperous investing.

Future Events

Company	Date	Event
Argentex	17-Aug-20	AGM
EMIS	09-Sep-20	H1 Results
Games Workshop	16-Sep-20	AGM
Andrews Sykes	25-Sep-20	H1 Results
Moneysupermarket	05-Mar-21	FY Results
Ferrexpo	18-Mar-21	FY Results

Source: SharePad