7 Strategies for Investment (II)

Introduction

The theoretical relationship between dividend and earnings equity valuations explains why a few select statistics published in the press provide a disciplined framework for analysing corporate performance as a guide to future investment. However, as we shall now explain, there is more to buying and selling shares than the interpretation of stock exchange listings.

7.1 Corporate Information

With time to scrutinise company reports, press-media comment and financial websites, anyone can identify market forces (other than yield, growth, EPS and the P/E ratio) which are believed to drive equity prices and market sentiment, that are commonly used by professional analysts, particularly in the short term.

(a) Takeover Activity

Companies grow organically or by acquisition. Speculation that predators are about to pounce on a takeover target can provide investors with instant gains if its share price rises. So, how do you spot a takeover?

If a firm has exhausted its investment potential it may be a target. If it has met the demand for its products or services but is profitable and cash rich, it may be a predator seeking to diversify away from its core technology to maintain growth. Alternatively, consolidation between equal partners (currently in competition) may be the key issue, creating future opportunities for economies of scale.

If we ignore profitable going-concern activities, target companies can also be worth more "dead than alive", particularly if they are sitting on copyrights (which prompted the Chinese takeover of Britain's last major carmaker, the loss making MG-Rover). Another way of identifying vulnerability is to look at a company's *net asset value per share* (NAV). This is measured by the assets owned by the firm, less its liabilities, divided by the number of shares in issue. If the NAV per share is higher than the current share price, asset strippers may be ready to pounce. One of the major attractions for predators is an undervalued property portfolio that can be sold off, or redeveloped. Venture capitalists particularly, seek companies whose shares are infrequently traded with corporate assets they regard as undervalued. So, if consortia or financial institutions start to increase their holdings in such companies, particularly if they take a seat on the Board, it may signal a takeover.

Irrespective of whether markets are volatile or stable, riding on the back of any takeover is a risky strategy that is only advisable for the speculative, short-term investor. As we shall discover in Part Four, even if two companies are a "perfect fit", you may need to buy immediately before a bid and sell quickly before the takeover occurs, because thereafter price invariably falls back. History also tells us that post-takeover, holding shares for the long haul is unwise. Very few acquisitions succeed, usually because of a lack of strategic pre-planning by the predator company.

(b) Profit Warnings

Companies issue profit warnings when their results are likely to be below expectations. Shares in firms that issue warnings usually fall by an average of 20 percent on the day of publication but 30 percent is not unusual. So, should you hold stocks that have plummeted after a warning in the hope of revival?

Part of stock market law is that *profit warnings come in threes*. If investors adhere to the "golden rule" of selling high and buying low, they should therefore sell on the first and buy on the third, particularly if new management is parachuted in to aid recovery.

But there are exceptions to these rules that also defy logic. During the the1990s, many technology firms issued more than three warnings, but their prices continued to rise spectacularly. Some also recovered spectacularly after the bubble burst, notably Marconi (the UK defence contractor) from an all time low of 6 ¾ pence. Although the stock was well below its peak of £12.00 in 2002, the trading high for the twelve months to June 2005 was still a creditable £6.30 when the company became a takeover target. The question to ask (and seek out in your research of press and media comment) is whether profit warnings relate to short-term factors that can be overcome, or fundamental strategic problems that may be insurmountable.

(c) Director's Dealings

Legally, directors in many developed Western economies have to disclose when they buy or sell shares in their companies to avoid accusations of insider trading. Their deals are also published regularly in the financial press drawn from commercial websites such as *digitallook.com* and *hemscott.com*. Because directors have in-depth knowledge of their companies, it therefore pays to track their every move. Dealings are a useful source of information, good as well as bad, particularly if a new product innovation or investment has been announced, or a share issue is in the offering, notably a take-over or management buy-out. A high level of buying often coincides with the start of a rally. In the past, market upswings have been prefaced by as many as fifteen director purchases for one sale.

(d) Employee Ownership Schemes

Firms with wider employee-share ownership tend to be top performers, particularly in bullish markets. Staff that possesses shares obviously has a vested interest in generating new ideas to maintain long-term growth and overcome the competition. Data reported periodically in the financial press reveals that investing in companies where employees hold at least three percent of the equity and 25 percent of the workforce own shares seems to be the key.

(e) Research and Development Expenditure

Companies that continually spend on profitable research and development (R and D) should grow the fastest, even in rising global markets fuelled by irrational expectations. For example, during the dot.com boom, £1,000 invested each year in a fund that tracked the FT-SE 100 over the five years leading up to the millennium would have generated a creditable £6,400. However, if your investment strategy was restricted to the 40 Footsie companies with the highest R and D record, you would have made nearly £26,000.

(f) Analysts Upgrades and Downgrades

In their quest to beat the market, financial services worldwide continually analyse corporate data and produce research reports for their investment fund managers and clients. These expert reports contain profit forecasts for companies and *upgrade* or *downgrade* them when the market changes, typically with a one-word conclusion, *buy, sell* or *hold*.

Those of you with time to dig out past data from websites such as *reuters.com* and *digitallook.com* will often find that professional analysts change their minds, usually when a company's results have exceeded their predictions. Upgraded profit forecasts are termed an *outperform recommendation*. But because many of the original results leave the professionals baffled, their revised forecasts (say from "sell" to "hold") often understate how much they expect the company's future performance to *improve* or *revive*. When the next results emerge, the former is termed an *earnings surprise*, the latter is a *dead cat bounce*. Both often produce a rise in share price.

Thus, investors can profit by acquiring shares in firms that have been upgraded on numerous occasions, say over a twelve-month period. A downgrade can also have a significant, detrimental impact on share price, even from "buy" to "hold". But remember that like profit warnings, downgrades, may be due to short-term factors, rather than trading fundamentals.

7.2 "Beating" the Market

So far, our analysis suggests that you should study short-term price movements and stock market ratios (over a twelve-month period, say) complemented by *qualitative* information in the public domain. Without giving too much away, a successful strategy adopted by the author is to invest in stocks that have exhibited the highest growth rate in the last six months. Hold for a year, and then sell. As always, the key is to time your trade, buying when prices are low and selling high. However, even in a reasonably efficient market this is easier said than done, particularly when stocks rise very little, since all trades entail a cost that can wipe out your dividend or capital gain.

(a) Dealing Fees

In the UK, a typical one-off dealing fee is £25.00 over the phone, although this can drop by as much as 50 percent if you conduct more than 100 trades in a three-month period. It is also cheaper if you deal on-line. A typical internet fee of £18.00 falls to £7.50 if you trade more than 100 times. But beware the administrative costs. Many stockbrokers impose annual standing charges of £60.00, although these may be waived for frequent trades. Brokers also levy a range of extra charges on top of dealing and administration fees. For example, they often charge about £10.00 a stock if you want to close your account.

(b) Buy Everything

Of course, if you want to avoid the costs of managing your own share portfolio, the alternative is to let the professionals do it for you. The simplest and least risky strategy for playing the market and minimising management fees is not to build up a portfolio of *individual* shareholdings, but to diversify across the entire spectrum through *unit trust* funds. One type of fund is termed an *index tracker*, which represents a proportionate investment in every company that comprises the fund's chosen market index. All trackers (global, USA, UK or Japan, say) assume that no combination of shares (or their derivatives), other than the weighted *market portfolio*, can provide a higher return for the same risk. The fund is also *passive*, rather than *active*, based on a policy of "buy and hold" for all the shares in the index, rather than "trading" its constituents at the whim of management. The fund manager is essentially a computer program fed with data to allow for new entrants, or sales when a share is dropped from the index.

Advocates of trackers claim superior performance over any three to five year period than the most actively managed funds because the portfolio is independent of human ingenuity and judgement when selecting which stocks to buy, hold or sell. Long-term you should also turn a profit (the period from the early Eighties until the 2007 banking crisis is usually cited). The rationale is that tracker funds perform well when their chosen market rises. Moreover, if the market collapses, as it did in 1987 and 2000, the fund can only fall as far as its index. Proponents of actively traded portfolios may cite impressive gains, based on the fund manager's perception of rising world markets, but an actively traded portfolio can also plumb the depths. During periods of uncertainty, for example since 2007 with markets repeatedly forecast to maintain little momentum or fall significantly (so the argument goes) an index tracker fund offers downside protection, whilst also retaining exposure to any potential recovery.

However, recalling our observation from the previous Chapter that markets always revert to their long-run average price (valued by CAPE) trackers attract legitimate criticism. Unlike their active competitors, they aspire to an impossible goal, since the only way "to beat the market" is by short-term speculation or access to "insider "information, neither of which represents a realistic basis for long term risk-return management.

In theory, a portfolio strategy of "buy and hold" should work best on the few occasions when markets are *stable* and values are determined by *rational* behaviour, leaving little room for manoeuvre. Between times, in the presence of bull and bear markets or volatility, it cannot predict what proportion of traders operates on fundamental news, as opposed to rumour or speculation. In contrast, funds that actively trade their portfolios based on qualitative judgements can respond quickly to market sentiment fuelled by adaptive expectations, as well as changing intrinsic values in response to fundamental news.

Unfortunately, in a market interspersed by volatile peaks and troughs, historical support for active fund management does not stack up either, unless you select the time period carefully. One explanation is that with so much information floating around it is difficult for a fund manager to spot trends that many others have not already seen. Moreover, aggressive trading not only presupposes that the fund knows what to buy and when, but also which portfolio constituents to sell before events rapidly unfold. For example, if you had bought and held the "best" stocks cheaply in the early Nineties you would have still made money after the techno-bubble burst. But if an active fund had bought in late 1999 it would have made huge losses. Active funds also tend to be caught out when markets rally, trailing a market index following its upswing. On the other hand, tracker funds capture all of the market's returns, *minus* any charges.

So, what does all this conflicting evidence mean for investors?

(c) Fund Fees

Ask financial advisors and there is no definitive answer. You pay your money and take your choice. Like your local stockbroker, active funds justify higher fees compared to trackers because portfolio constituents are frequently researched and traded, which both entail significant costs. This is why shares in companies with a low market capitalisation experience "institutional neglect". They do not interest large active funds because research still needs to be undertaken but the rewards may be minimal. Active funds with the highest share turnover can rack up charges of at least 1.5 per cent per annum, in addition to a typical management fee of 1.5 percent.

Although trackers simply buy the shares (or derivatives) that make up an index, the author's UK analysis reveals that cost-wise, passive funds should also be selected with care. Many schemes have low charges, because they use computer software, rather than employ expensive fund managers. However, not all are cheap and like their actively managed counterparts, high charges can offset returns. Discrepancies between passive funds can also arise due to different management styles. Some managers might buy every share in an index, but many are less sophisticated and only factor in the top 80 or 60 per cent and just sample the remainder to save time and money.

The cheapest have no initial fee and an annual management charge of 0.3 percent. Others have a competitive initial charge of 0.5 percent and an annual fee of 0.5 percent. The most expensive demand a 5 percent initial charge and a one per cent annual fee.

(d) Choosing a fund manager

To rise above all the conflicting evidence for and against different approaches to fund management, the myriad of fees and their variable performance, an alternative investment strategy (whether you require income or growth) is to seek out active fund *manager*s with a successful track record, rather than a *fund* itself. Then stick with them, even if they move on. Successful managers who consistently outperform the market over a five year period are regularly reported in the financial press.

If markets take a turn for the worse, consistent management is important because it reveals how individual fund managers have coped relative to their peer group under stress. Even the best managers will have periods when they trail the market, whilst others may have much greater freedom to invest whenever they see value. Most successful managers who outperform the market over a five-year period also remain with their fund.

To track an individual fund manager's performance, rather than a share, go to a research group that assesses managers, rather than funds, such as Citywire (*citywire.co.uk*) or an independent financial advisor like Bestinvest, (*bestinvest.co.uk*). But remember that consistency does not tell you all you need to know before you invest. Active funds that performed well in the past might have done so because the economic climate suited their managerial style. For example, active funds that invested in undervalued companies since the millennium have done well. Like individual shares, however, there is no guarantee that past portfolio performance is a guide to the future. All we know is that poorly performing individual shares and portfolios usually continue to perform badly.

Summary and Conclusions

The theoretical relationship between dividend and earnings valuation models based on the market price of equity explains why a few select statistics published in the financial press encapsulate a company's current stock market performance and provide a guide to future investment. However, we have observed that there is more to buying and selling shares than assimilating price data. Even the most inexperienced investor can sift through press, media and internet information at little cost to validate their decisions. And in the short run they will "win some and lose some". However, without access to insider information, the academic and analytical consensus is that in the very long-term, playing the stock market is a *zero-sum* game, since one person's loss is another's gain. As the author explains in his *bookboon* series on the subject, no combination of shares (or their derivatives) can provide a higher return for the same risk as the weighted, *global market portfolio*.

So, does all this conflicting evidence mean that investors (institutional, corporate or otherwise) should abandon stock market analyses based on conventional financial models that explain changing share prices and their returns? On the contrary, as we shall discover in Part Four:

At even the most strategic level of financial decision-making, there is no complete hypothesis to replace the distillation of corporate performance in the form of dividend yields, cover, P/E ratios and the market capitalisation of equity, or its disciplined framework for analysing the signals sent out by the capital market.

Selected References

1. Hill, R. A., *Portfolio Theory and Financial* Analyses, bookboon.com (2010).
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Selected Websites (www.)

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