



BY JOHN KINGHAM

DIVIDEND HUNTER

HOW TO AVOID YIELD TRAPS – PART 1

As a dividend-focused investor I'm always on the lookout for high yield shares, whether that yield is high relative to the market average or high relative to the company's peers. However, as most yield-seeking investors soon discover, high yield stocks do not always deliver the yield you were hoping for. That's because dividends can be cut or even completely suspended, and the higher the historic or forecast yield the more likely that is to happen. This is the dreaded yield trap, where investors are lured in by an attractive yield and then stung with a capital loss when the dividend is cut.

Like you, I want to avoid this fate wherever possible and so over the years I've built up a series of tests which every potential investment must pass before I'll invest so much as a penny. These tests do not have any magical power to spot yield traps with 100% accuracy, but I do think companies that can pass these tests are far less likely to cut or suspend their dividends than those that fail to pass them.

A two phase approach: First quantitative, then qualitative

My approach to weeding out yield traps is twofold. First, I focus on a

company's financial numbers, looking for a range of features including: 1) a ten-year unbroken record of dividend payments; 2) a long history of relatively consistent revenue, earnings and dividend growth; 3) high

rates of profitability (return on capital employed); and 4) small debt and pension obligations. These are simple quantitative measures that I can use to rule a company out if, for example, its total borrowings are more



than five times its five-year average profits. You can find out more about these quantitative tests in previous Dividend Hunter articles.

Personally though, I wouldn't want to invest on a purely quantitative basis, so the second phase of my yield trap filter is to analyse each investment candidate using a series of mostly qualitative questions. These questions focus on what the company actually does to produce its revenues, earnings and dividends.

To give credit where credit's due, the bulk of these questions have been adapted from *Corporate Turnaround*, a book by Stuart Slatter and David Lovett. Their book contains a chapter on the symptoms and causes of corporate decline and it describes in detail a list of principle causes of decline. The list includes destabilising factors such as large acquisitions, excessive expansion and changing patterns of market demand.

I've found this list to be useful for two main reasons: First and most obviously, it helps me to avoid yield traps, which are often companies that are about to go into serious decline. Second, looking for these various causes of decline is a good way to build up a fairly detailed picture of what a company actually does and how it does it. For me it's important to have a fairly detailed understanding of what a company does because

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it helps me to avoid panicking if a company's shares fall by say 30% or even 50%. If I don't have a good idea of what the company does then a big chunk of my information will be coming from the share price, which is a volatile and nerve-wracking thing to focus on. But if I have a decent understanding of the company then I can much more easily ignore the share price and focus on the company, and companies tend to be much less volatile and much less stress-inducing than their share prices would suggest.

I've written the questions so that a positive answer is good and a negative answer is bad. In terms of ruling companies in or out, the only hard rule I have is that if a company has more negative answers than positive ones then I would put it into the "too risky" pile. However, such a bad score would be unusual and in most cases the decision to invest or not is more subjective than that. In other words, I gather the facts from the company's website and annual reports, answer the questions, look at the overall score, see what my gut tells me and then include or exclude the company as a potential investment.

Avoiding bad management

The first couple of questions relate to whether or not the company has good management, or perhaps more accurately, whether it doesn't have obviously bad management. As a numbers man this sort of qualita-

tive statement (what is "good management"?) is about as far outside my comfort zone as it's possible to get. However, there are a couple of things the *Corporate Turnaround* book focuses on which I also think correlate quite well with good management, namely 1) a focus on the core business and 2) strategic consistency.

1. Does the company have an obvious and dominant core business?

In most cases when I've invested in a company and it's all gone wrong, the new CEO (replacing the existing CEO is almost mandatory in turnaround situations) will invariably look to re-focus the company around its core business.

That's because a common cause of decline is excessive expansion into "exciting" new markets with great "synergistic" opportunities for growth. Or to put it another way, the core business has stalled and so the CEO launches or acquires new businesses in new markets in which the company has little or no experience. This can keep earnings per share growth on target when growth in the core business is no longer forthcoming.

Sadly, these new ventures often add complexity to the organisation and take management's focus off the company's core "cash cow" business. In many cases the core business will start to decline, although for a while this may be offset by growth in the new ventures. Eventually though,



the new ventures plateau or begin to decline (or never make a profit in the first place), and the folly of this strategy becomes obvious to everyone. After a profit warning or two the CEO "resigns" and a new CEO begins the process of selling off those non-core businesses while investing in and focusing on the company's core business and core competencies.

Not all companies have a single core business though. For example, Marks & Spencer has its largely separate Food and Clothing businesses, while GlaxoSmithKline has three core businesses of Pharmaceuticals, Vaccines and Consumer Healthcare. But these are still significant core businesses and different to the situation I'm trying to avoid, which is either a) a company that makes significant attempts to enter new markets in order to offset a stagnant core business, or b) a jack-of-all-trades company that has no obvious core competency.

I won't necessarily avoid a company just because its core business is weak or non-existent, but if that appears to be the case then I'll definitely mark it down as a potential risk.

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2. Does the company have a clear and consistent goal and strategy?

There is mounting evidence that companies with a clear overall goal or purpose have a definite advantage over those that don't. The default goal of corporations in the 1990s was to maximise shareholder value, but that doesn't exactly inspire customers or employees. I know that when I used to work in the corporate world I didn't exactly do backflips every morning saying "Wow, today I get to maximise returns for shareholders - lucky me!"



Personally I much prefer to see companies where the goal or purpose is to make the world a better place in some way or other, and that maximising shareholder value is a powerful way to efficiently achieve that goal, but it is not the goal in and of itself.

Just as important as a clear and consistent goal is a clear and consistent strategy. As China has shown, the ability to develop and then stick to a long-term strategic plan is critical if you want to achieve long-term goals, especially if those goals are difficult, as most corporate goals should be. On the other hand, as some democratic nations have shown, bringing in new management, new goals and new strategies every four or five years can lead to lots of time wasted going around in circles, allowing those who can focus consistently on a single strategy to pull further and further ahead.

Avoiding high cost companies

Companies that cannot compete on price are likely to run into serious trouble at some point. Yes, Unilever can sell Ben & Jerry's ice cream or Flora margarine at slightly higher prices than unbranded competitors, but most companies do not have that luxury and so an ability to compete on price is critical. And even if a company doesn't have to compete on price, keeping costs low is still important if returns (to sharehold-

ers, stakeholders and society) are to be maximised. Here I'll focus on two drivers of cost competitiveness: size and experience.

3. Size: Is the company one of the largest players in its markets?

I'm not obsessed about investing in companies that are number one or two in their markets (although it's nice if they are), but if a company is outside the top five or so I would definitely mark that down as a negative point. Being a small player may give a company more room to grow, but it also means headwinds in terms of economies of scale and the relative unfamiliarity of the company to its potential customers.

Looking back at Unilever, Marks & Spencer and GlaxoSmithKline again, these are all companies that have many market-leading products, ranging from ice cream to painkillers and underpants.

4. Experience: Has the company been operating in its current markets for many years?

Learning how to do something efficiently takes time, especially when that something is as complex as organising many thousands of people into a profitable enterprise producing goods and services that customers really want. Of

course, there is the potential for new companies to enter a market with completely new and more efficient ways of doing business. However, I have no idea how to pick winners from new entrants, so I'll stick to my current approach, which is to look for companies that have been running the same core business for decades, and in some cases centuries.

Again, using Unilever, Marks & Spencer and GlaxoSmithKline as examples, these are all companies with histories in most of their relevant markets stretching back more than a century.

Avoiding large and risky "one-off" projects

Large "one-off" projects are a common cause of decline. These typically fall into two categories: 1) large projects to reinvent or radically change a significant part of the company, or 2) large revenue-generating projects which are a normal part of the company's core business.

5. Is the company free of bet-the-company projects which could push it into a crisis?

The classic example of a bet-the-company project was Bill Gates' decision in 1995 to focus a huge amount of Microsoft's resources towards developing a free web browser to kill off the threat from Netscape's Navigator. In Microsoft's case this massive about-turn worked out well, but that was because it could rely on a tsunami of cash from its near-monopoly position within the PC operating system market. Such dramatic shifts in less dominant companies are massively risky, and it's a risk which is easily avoided (unless of course the shift begins after you've become a shareholder).

6. Does the company generate revenues through the sale of millions of low-cost items rather than relying on large one-off projects?

These days everybody knows about bond proxies, also known as "the inevitables". These are companies that can generate relatively smooth revenue, earnings and dividend growth year after year, decade after decade. Most of these companies generate reve-

nues from brand-name low-cost items that people or businesses need every day. Toothpaste, soap, washing up liquid: these are all classic bond proxy products.

But not all companies sell powerfully branded toothpaste, and few of the bond proxies are available with yields that are even remotely interesting to income investors. So dividend hunters will often find themselves looking at companies that generate revenues and profits from multi-million pound, multi-year projects (typically in the form of a large contract).

Unfortunately, this can be a very risky way to earn a living. What often happens is that these contracts, perhaps to build a bridge or manage a prison, are won through a process of competitive tendering, where the lowest cost bid will frequently win. This pricing pressure leads to "suicide bidding", where very optimistic estimates of the cost of fulfilling the contract are used to justify a very low price to the client, whilst still (theoretically) generating a profit for the company. The suicide bidder then wins the contract, congratulates themselves on their "success", and then has massive cost overruns for the lifetime of the contract, leading to predictable and unavoidable losses over many years.

Another type of large one-off project is the blockbuster patent, most commonly used in the pharmaceutical industry. In that case a company like GlaxoSmithKline develops a new drug and patents it, which gives it a 20-year or so monopoly on that particular drug. Thanks to its monopoly position, profit margins and profits will be

reliably fat for many years. However, at the end of the patent's lifespan, those profits will vanish as generic manufacturers begin to manufacture the once-patented drug, driving profit margins down to wafer thin levels. If the company fails to replace expiring patents with equally impressive new patents then its profits and share price will be toast.

“LARGE ‘ONE-OFF’ PROJECTS ARE A COMMON CAUSE OF DECLINE.”

Of course, this is not ideal and so I am especially wary of companies that depend on – and therefore must regularly replace – large contracts or patents. I have been bitten twice with this type of company, having had bad experiences with both Balfour Beatty (which depends on large one-off building contracts) and Serco (which depends on large one-off service contracts). It's an experience I'd rather not repeat, so although I won't necessarily rule these companies out (I still own GlaxoSmithKline and AstraZeneca, for example) I am especially careful about their other risk factors, such as the size of their debts, pension schemes or capital investment requirements.

Alas, I seem to have run out of space this month, so I'll finish off this list of yield trap questions in next month's issue. The remaining questions will cover a range of risk factors including capital intensity, acquisitions and sensitivity to commodity prices.

About John

John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John's approach to high yield, low risk investing is based on the Benjamin Graham tradition of being systematic and fact-based, rather than speculative.

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