BY JOHN KINGHAM

DIVIDEND HUNTER

HOW TO AVOID YIELD TRAPS – PART 2

In last month's Master Investor magazine I outlined six questions designed to uncover potential yield traps. These are relatively qualitative questions which I ask of every investment candidate, but only after I've already crunched the financial numbers looking positive features such as long-term growth, good profitability and low debt levels.

The questions focused on a range of features which are often found in potential yield traps, such as bad management, high costs and dangerously large or risky projects. Although it can be difficult to define exactly what "bad management" is, for example, investigating these issues and drawing conclusions is still a very worthwhile activity, because it builds up a nicely rounded picture of a company, far beyond what you'll get from just looking at financial statements.

In this second and final part I'll cover four more questions, this time looking at other factors which can lead to corporate and dividend declines, such as excessive acquisitions, highly cyclical markets and markets that are likely to decline over the next decade.

Avoiding highly acquisitive companies

7. Has the company avoided large acquisitions that have little to do with its existing core business?

In many ways a large acquisition is like a large meal. It can take a lot of work to digest and absorb, which in turn can lead to a long period of sluggishness. Even worse, it can take a very long time for negative side-effects to become apparent, and by that stage they're as unavoidable as they are unpleasant. Even worse than a meal which is too large is one which is both too large and

unfamiliar. A large and unfamiliar meal (or acquisition) is a potentially catastrophic combination.

On the other hand, acquisitions can be a legitimate use of shareholder capital, so I don't automatically avoid companies just because they've made large acquisitions in recent years. Instead I'm just more careful with them, especially when the acquired businesses have little in common with the acquirer's core business.

So what exactly is a large acquisition? For me, large acquisitions occur when a company spends more on acquisitions in a single year than it made in profit that year (or more than average recent profits if profits in that particular year were unusually low or negative). When I'm analysing a company, if I see a large acquisition in the last ten years then I'll look at what was acquired and how the acquisition panned out.

I don't have any hard rules about how to treat companies that have made large acquisitions, but in general the larger the acquisition, and the further it is from the acquirer's core business, the more risk averse I'll be. In extreme cases I might insist on the company having smaller financial obligations than I would otherwise accept, or higher profitability or a more defensive core business, or I might simply avoid investing in the company altogether.

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However, one thing I will automatically avoid is a company where the total spent on acquisitions over the last ten years is greater than the total profits generated over those ten years. In my experience this sort of prolonged acquisition spree is a very risky strategy. It can produce a debt-laden company made up of dozens of unrelated businesses – which are difficult to manage and of unknown quality – and which is dependent on ever more acquisitions to drive future growth.

A good example of this situation was Chemring, a leading supplier of missiles, bullets and other military consumables. I was a Chemring shareholder between 2011 and 2016, during which time the share price fell by 73%, so this was obviously a very bad investment. There were many problems with this company, but one that stood out (in hindsight) was its record of aggressive expansion through debt-fuelled acquisitions.

In the ten years leading up to 2011, Chemring spent 40% more in total on acquisitions than it made in profits. As a result, Chemring transformed itself into a collection of largely separate businesses. This approach worked fine when the economic environment was supportive, and in fact Chemring's share price went from 50p to over 700p during this intensely acquisitive period. But from 2011 onwards, Governments began to cut their defence budgets. In this less benign environment, Chemring's sprawling mass of businesses soon turned out to be a delicately balanced house of cards, rather than the robust business its track record of spectacular growth suggested.

Of course, it was that track record of success that drew me in, but it's a mistake I only intend to make once, so for the last few years I have been deeply interested in the acquisition history of any company I'm thinking of investing in.

Avoiding companies that operate in volatile markets

8. Does the company operate in defensive markets?

Investing in companies that operate in defensive markets is not a guaranteed way to avoid dividend cuts, but it can help. These companies are, in theory, less affected by the ups and downs of the economy, which means they're less likely to cut their dividends than companies which operate in more cyclical markets.

There are various ways to define companies or sectors as defensive or cyclical, and personally I use the definitions given in the Capita Dividend Monitor. The quarterly Dividend Monitor is well worth a read, and it lists all of the FTSE Industry Classification Benchmark (ICB) sub-sectors and defines them as either defensive or cyclical.

Although I prefer defensive companies, I'm also happy to invest in cyclical companies because they can sometimes generate much higher returns than defensives. However, the more cyclical a company is, the more cautious I'll be with other factors such as its debts, profitability or dividend cover. For example, I would invest in a housebuilder (a very cyclical business), but only if it had much lower levels of debt and a higher degree of dividend cover than a company selling soap and toothpaste (a very defensive business).

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What I definitely don't want to do is fill my portfolio with cyclical companies, so I have a rule which limits my exposure to them. I want my portfolio to be less cyclical and more defensive than the FTSE 100, and about one third of the FTSE 100 is made up of defensive sector stocks. So my rule is to have at least a third of my portfolio in defensives, although currently the actual percentage is much closer to 50%.

9. Is the company relatively immune from commodity price movements?

Commodity prices are notoriously volatile, and companies that operate in commodity-related sectors are prone to massive booms and busts.

The most commodity-related sectors are: 1) Industrial Metals & Mining; 2) Mining; 3) Oil & Gas Producers and 4) Oil Equipment, Services & Distribution. These are all defined as cyclical sectors in the Capital Dividend Monitor and – as with other cyclical sectors – I will invest in them, but with an even higher degree of caution.

As before, this caution mostly shows up as a demand for lower debt levels and higher dividend cover, perhaps insisting on debts of less than three-times the company's average recent profits and a ten-year capex to depreciation ratio of considerably less than two (excessive investment in supply – capex – is often a big problem for these companies).

For many dividend investors it may be easier to just ignore these sectors because reliable and progressive dividends are few and far between. Perhaps the only exception is the oil majors, whose diverse businesses have so far enabled their dividends to withstand the recent oil price collapse.

Another option could be to limit exposure to these super-cyclical companies, perhaps limiting their weighting in a portfolio to no more than 10% of the total. I don't use this rule at present, but it's something I'm thinking about.

Avoiding companies that operate in declining markets

10. Is demand for the company's core products or services expected to grow over the next decade?

As we've just seen, the dividends of companies operating in commodity-related markets or other cyclical markets are at risk from short-term factors which reduce demand (such as recessions) or reduce margins (such as excessive investment in oil exploration and production, which increases supply and reduces prices). However, another risk to dividends is the risk of operating in markets which are likely to decline either permanently, or for at least the next ten years.

There are lots of different ways in which market demand can decline over the longer-term. It can happen quickly or slowly, and it can lead to corporate death or just a permanently smaller company in the future than in the past.

One example of a rapid but non-terminal decline in demand occurred quite

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recently, when millions of middle class shoppers switched from Tesco, Sainsbury's and ASDA to the discounters, Aldi and Lidl. Before the Great Recession, I doubt Tesco's management seriously thought Aldi and Lidl could pull off the seemingly impossible trick of convincing middle class shoppers that shopping at discount food stores was not only economically rational, but socially acceptable (and even fashionable) as well. I also doubt many Tesco shareholders considered the discounters a serious threat either (I know I didn't). But they were wrong, and that risk blindness turned out to be a serious mistake with serious consequences for Tesco, its dividend and its share price.

Sometimes though, these rapid declines in demand are terminal, and these are the situations that dividend investors should really try to avoid. Technology is often the driving force of terminal decline, and examples of companies whose existing business models were rendered obsolete include Kodak, Blockbuster and HMV. Unfortunately for these companies, their management failed to sufficiently realise that photos (Kodak), videos (Blockbuster) and music (HMV) are essentially immaterial products, which can be beamed through a wire or through the air using modern technology, negating the need for customers to buy photo film from Kodak, or visit a Blockbuster video store or a HMV music store. As with climate change, it is often necessary to begin the task of avoiding an impending threat many years before that threat begins to have any significant impact. This sort of proactive behaviour is difficult to pull off however, especially if it means reducing profits today in order to boost profits ten or twenty years from now. It is far easier for most people to tell themselves that the threat is not real, and that no dramatic action is required.

For an example of a very slow and non-terminal decline in demand, I would choose the oil market. I think it is likely that demand for oil will be in permanent decline by the second half of this century, thanks to climate-related government policy and dramatic declines in the cost of renewable energy. With permanently declining demand for oil, companies focused primarily on selling oil (such as BP and Shell) would be fighting over a slowly shrinking market characterised by excess supply and very low prices. In that scenario the oil majors would be forced to either transform their businesses to sell something other than oil, or switch into run-off mode, where the emphasis would be on returning as much cash as possible to investors, rather than reinvesting it in the search for yet more oil, which almost nobody would need.

In terms of how I apply this future demand analysis to investment decisions, it mostly depends on the time horizon. For example, although I think BP and Shell are likely to be in decline by the middle of this century, my investment time horizon is short enough so that I'm still happy to invest in them today (in fact I do currently own shares in BP). On the other hand, I can remember looking at HMV towards the end of its life and deciding that I wouldn't touch it with a bargepole, no matter how low the share price. I thought it was obvious that the future market for high street music stores was going to be tiny compared to the heady days of the 80s and 90s. And even if your opinion about a company's longer-term future doesn't change your investment decision, creating some plausible future scenarios is still a very worthwhile activity.

So there you have it; ten questions (six last month, four this month) designed to uncover some of the major causes of corporate and dividend decline. They might not be perfect and they might not spot every single yield trap, but I find them incredibly useful and hopefully you'll find some value in them too.

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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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