UKValueInvestor.com

The Investment Lessons eBook: 2015 Edition

Real-world investment lessons for defensive value investors

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"Thank you for your insightful articles on the market and your approach, which I've found to be the best of any active UK value investment strategy on the web" – Richard L, A Happy Subscriber

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Introduction

The most efficient way to improve is to learn from the successes and failures of others

"Determine exactly what it is that you want to achieve, take off toward your goal with no guarantees of success, and then make continual course corrections until you finally succeed. If you resolve to do these things, nothing can stop you."

Brian Tracy, International best-selling author

Why you should want to learn from my failures (and successes)

One of the most difficult aspects of being a DIY investor is that it is almost invariably done in isolation. This leads to many of the same mistakes being made and the same opportunities being missed, over and over again, but by different investors.

Clearly this is not an ideal state of affairs and so my intention with this ebook is to try to fix that, at least in some small way, by publishing an entire year's worth of investment reviews for others to learn from.

These include post-sale reviews of every investment I sold in 2015 and quarterly reviews of UK Value Investor's model portfolio. The history of each investment is covered in detail, but more importantly, so are all of the lessons learned.

Hopefully this will help you to make “course corrections” without having had to go “off course” in the first place.

I hope you find this ebook useful and if you have any questions please don’t hesitate to get in touch.

John Kingham

Editor of UKValueInvestor.com

Why I've sold my shares in ICAP plc

10th February 2015

This is the story of how my investment in ICAP PLC worked out, including why I bought it, why I held it for almost 3 years and why I have now decided to sell. But before I get into the details, here are the results of that investment:

Purchase price	Sale price	Holding period
365p on 10/04/2012	467p on 06/02/2015	2 years 10 months
Capital gain	**Dividend income**	**Annualised return**
25.9%	18%	14.9%

In general I target a 10% annualised rate of return, so by that measure this investment was a success. It also taught me some useful lessons which I think are almost as important.

An overview of ICAP PLC

ICAP PLC is a FTSE 100 company with a market cap of around £3 billion. It's the world's largest interdealer broker which means that, among other things, it enables companies such as banks to carry out trades in a range of wholesale financial markets.

These markets cover financial instruments such as foreign exchange rates, interest rates, commodities, debt and equities. Trades are handled either electronically, manually (known as "voice" broking) or a mixture of both. In very simple terms, the more traders buy and sell the more profit ICAP makes.

When I bought ICAP In April 2012 the company was already facing difficulties and uncertainties. Trading volumes were beginning to fall and ICAP's revenues and earnings were expected to fall along with them.

This reduction in volume was driven partly by the Euro crisis, partly from banks

reducing their trading activities after the financial crisis and partly from uncertainty over a range of new and tighter financial market regulation.

As a consequence **investors were worried about ICAP's growth prospects to such an extent that its dividend yield was over 5%.** That was far higher than the market average, which indicated a significant degree of fear in the market that the dividend would be cut.

However, almost 3 years later those headwinds have begun to fade, the dividend hasn't been cut and the shares have seen a healthy re-rating. As a result I'm now looking to lock in recent capital gains (on top of handsome dividends already paid out) and move on to another company.

Here is the share price roller coaster I had to put up with in order to achieve those 15% annual returns:

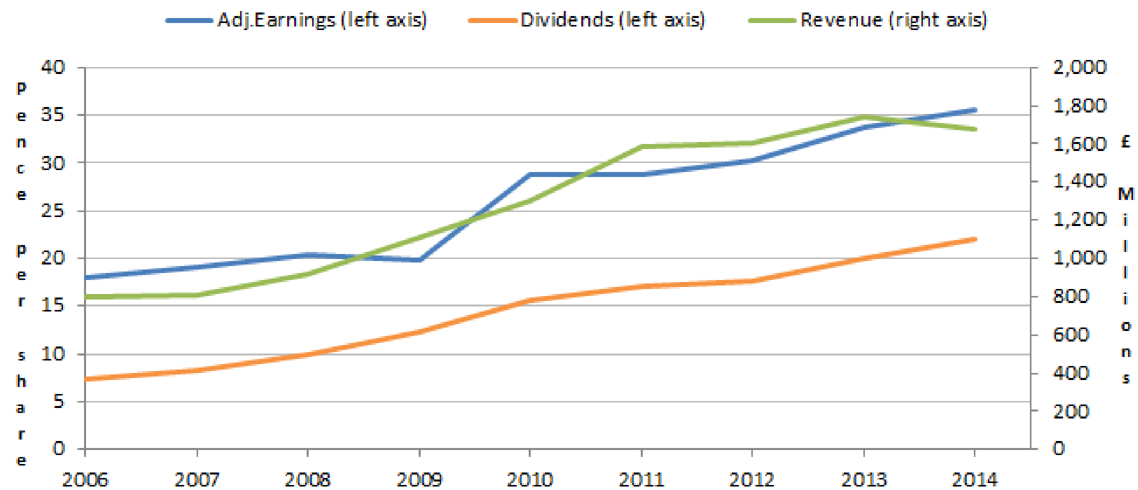
The decision to buy, even in the face of uncertainty

ICAP PLC was a potential investment for me because of all the usual reasons: it was a market-leading company with a strong balance sheet and a very strong and consistent track record of profitable dividend growth.

At the same time it was facing some problems, as I've just mentioned, where its past record of growth looked unlikely to be repeated in 2012.

Here's how the company performed in the years up to the 2011 annual results, which

were the latest available when I started looking at the company:



That's a pretty impressive chart with revenues, earnings and dividends increasing steadily over time.

With the share price at 365p ICAP's shares had the following features (using the metrics from my stock screen):

- **10-year Growth Rate** of 13.4% (measured across revenues, earnings and dividends)
- **10-year Growth Quality** (i.e. consistency) of 92% (also measured across revenues, earnings and dividends)
- **PE10 ratio** (price to 10-year average earnings) of 15.3
- **Dividend yield** of 5.5%

Taken together that was a considerably more attractive combination of growth, quality, value and dividend yield than the average UK-listed company.

The main question for me was whether or not the dividend could be sustained in the face of falling wholesale trading volumes. If ICAP's problems were short lived then the dividend looked safe, but if its problems persisted for too many years then even 365p per share may have been too much to pay.

As with any investment in the stock market the outcome was not guaranteed, but after looking at ICAP and its dominant position as the world's leading interdealer broker I thought the odds of it being a value trap were acceptably small.

On that basis I added it to my personal portfolio and the UKVI model portfolio in April 2012, with a position size of 3.2% (approximately 1/30th of the total).

The decision to hold, despite large share price declines

As usual my expectation was that I would be invested in ICAP for somewhere between one and ten years, or thereabouts, depending on how events unfolded.

The first year was nothing to write home about. ICAP's 2012 annual results were published in May 2012 and they were generally positive. The dividend was increased by more than 10% while revenues and profits were flat or slightly down.

After that initially good start the company's announcements became steadily more negative. By the 2013 half year results revenues and earnings were down more than 10% and 20% respectively.

Michael Spencer, CEO, said, *"This has been one of the toughest periods in my 36 year career in the wholesale financial markets"*, blaming a whole host of external factors. The company's focus now turned to cost cutting rather than expansion.

Unsurprisingly the market was disappointed with the way things were going and the share price fell almost 25% from where I'd bought it. Many investors would have sold at that point, concluding that ICAP was a value trap and that the original decision to buy was wrong.

However, generally I think it's a mistake to sell and lock in losses just because the share price has fallen. My preferred approach is to ignore the share price on the assumption that it merely reflects the opinions of other investors.

I prefer to focus on what the company is doing to turn things around, and also to think about where both it and its share price could be several years from now. Having done that after each quarterly announcement ICAP still looked attractive and so selling at a 25% loss was not something that crossed my mind.

As the months rolled by the company's cost cutting efforts continued and when the 2013 annual results were announced in May 2013 the dividend was maintained, despite falls in both revenues and earnings.

In May 2014 the story in the annual results was the same: Times were extremely tough, but ICAP was cutting costs, treading water and holding the dividend steady.

At that point the dividend yield relative to the purchase price was 6%, so in effect I was being paid 6% a year to wait for either the company to get going again or for other investors to push the share price up until it reached an attractive exit point.

In the end it was the second scenario which came true.

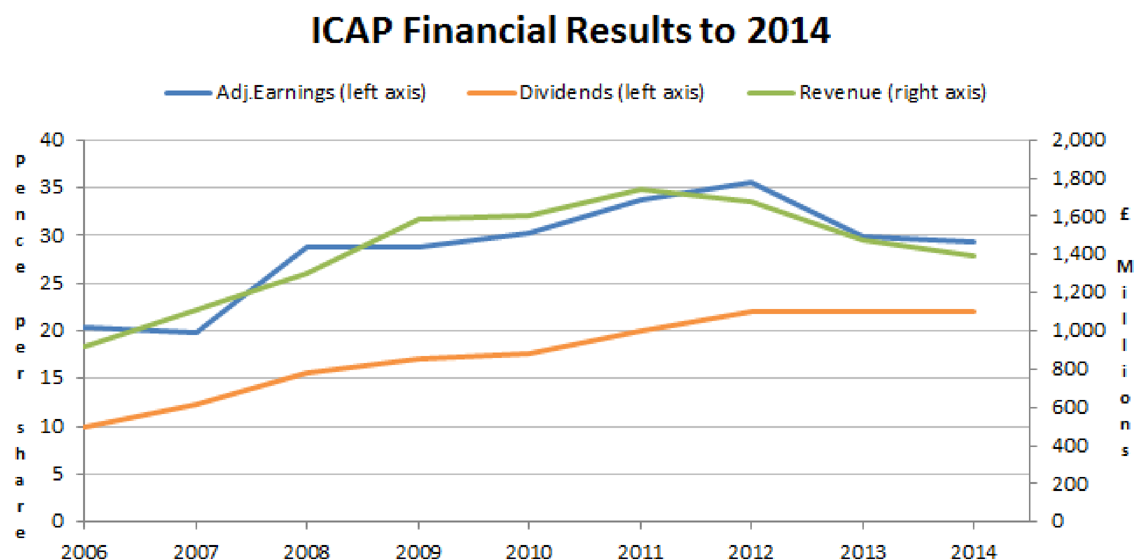
The decision to sell, just as others become more optimistic

During the second half of 2014 the share price started to climb as falling oil prices and Swiss central bankers drove fear, uncertainty and trading volumes higher. By last week the share price had reached 467p, some 70% higher than its lows of 2012 and 2013 and some 27% above the price at which I'd bought it.

So why sell now?

At one price a company (or a car, or a house) is attractively valued, at another price it is fairly valued and at yet another price it will be overvalued, or at least no longer cheap. For me ICAP now falls into the second or third category, while I only want to own investments in the first category.

This change in ICAP's attractiveness is partly due to the increasing share price, but it's also due to the company's weakening track record. Here are ICAP's financial results from the last few years, including its recent struggles:



The company no longer has an almost perfect record of consistent and rapid growth across revenues, earnings and dividends. In comparison to its track record up 2011, its:

- **10-year Growth Rate** has fallen from 13.4% to 6.8%
- **10-year Growth Quality** has fallen from 92% to 63%
- **10-year average earnings** increased from 26p to 28.5p (up 9%)

At the same time the increasing share price means that, relative to when it was bought, its:

- **PE10 ratio** has increased from 15.3 to 16.4
- **Dividend yield** has fallen from 5.5% to 4.7%

Although the dividend yield is still quite attractive and well above the market average, ICAP's stats are not as good as they were in 2012. Quite a few other companies now have a better combination of growth/quality/value/yield.

In fact ICAP now ranks at number 100 on my stock screen which makes it the weakest holding, on that basis, in my portfolio.

As for whether I should continue to hold ICAP's shares for possible future gains, my position is the same as always:

I do not know what will happen in the future. Perhaps ICAP will return to growth sooner rather than later and increase its dividend in 2015. Perhaps the share price will double from where it is today; I simply do not know.

But not knowing doesn't worry me as nobody else knows either. All I can go on are the company's past results, its current share price and how both of those compare to what else the market has to offer.

For me ICAP no longer appears to be a potentially outstanding investment, although it may still be a reasonable investment. And so, primarily for that reason, I sold it last week and will reinvest the proceeds into a new and more attractively valued company next month.

Balfour Beatty and the risks of investing in project-based businesses

9th April 2015

When I bought Balfour Beatty in 2011 the company was still performing well. This was despite some obvious headwinds in the UK and US due to recession-like conditions and government spending cuts in both countries.

I thought the company stood a reasonable chance of getting through the slowdown without major problems, and for a couple of years that was true. Eventually though Balfour became more risky and existing risks, which I hadn't spotted, began to have a serious impact.

A few days ago I sold Balfour from both my personal portfolio and the UKVI model portfolio and Balfour has become the first defensive value investment that I've sold at a capital loss. After dividends are included it still produced a positive return, but not a particularly good one, as the table below shows:

Purchase price	Sale price	Holding period
254p on 09/08/2011	232p on 07/04/2015	3 Year 8 months
Capital gain (after fees)	**Dividend income**	**Annualised return**
-9.7%	18.6%	2.6%

Those are the raw numbers, but I think the chart below does a better job of showing how "eventful" this investment has been over the last three years or so.

So the investment did not work out well which, in and of itself, isn't the end of the world. Under-performing investments are a fact of life that active stock pickers must learn to live with.

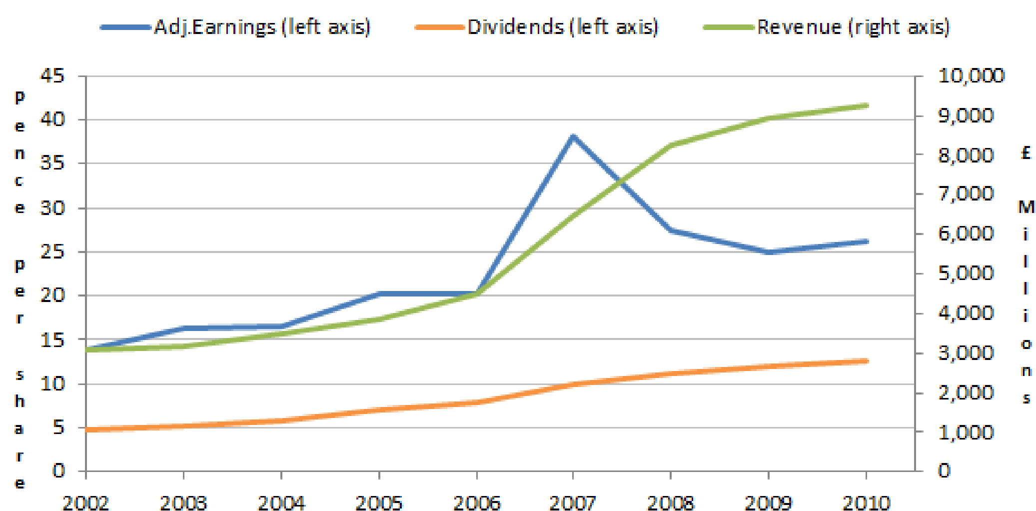
However, it is important to carry out a detailed autopsy into all past investments, especially bad investments. The idea is to extract the right lessons, improve your investment process and avoid making the same mistakes in future.

Buying an established business with a solid track record

In 2011 Balfour appeared to be having an impressive run of success. It had a long-term Growth Rate of 12.1% (for a definition of Growth Rate and the other ratios I use, see the stock screen page and scroll down) and had increased the dividend in every one of those years.

It didn't have a great deal of debt (just £44m of operational borrowings, which gave it a Debt Ratio of 0.3) and had about half of its business operating on either side of the Atlantic, which seemed to give it some degree of protection from declines in either the US or UK markets.

Here are Balfour Beatty's financial results up to the 2010 annual report, which was the latest at the time:



The impact of the financial crisis is clearly visible in the company's post-2007 earnings. However, the general upward trend was maintained with both revenues and dividends apparently unaffected by the recession.

So given that positive picture I added 950 shares to the model portfolio (and a different number to my personal portfolio) on August 9th 2011 at a price of 254p per share. That came to 5.1% of the total portfolio which is a much bigger allocation than I would use today, because in 2011 I was still targeting 20 holdings rather than the 30 I aim for today.

Holding through a bumpy and ultimately disappointing three years

For the first year or so Balfour continued to perform well against a difficult economic environment, but by the third quarter of 2012 things began to change. The company announced that profitability would be below previous expectations and that its construction services unit would face a tough 2013.

The shares dropped by about 20%, although they soon recovered most of that.

2013 continued that less positive trend. In the 2012 annual results, published in March 2013, the CEO spoke mostly of resilience in tough times and of growth when the recovery came, but revenues and profits declined. The full-year dividend was still increased by 2% despite those declines.

In April 2013 the company announced that it was launching an immediate action plan in the face of increasing weakness in UK construction, and further negative

announcements were made during the rest of the year.

In 2014 things just got worse. The 2013 annual results were very bad, with underlying profits down by around 30%. This time it was a combination of poor results from both the professional services and construction services businesses, with the key problem continuing to be the decline of the UK construction market.

As is often the case when companies run into significant problems, Balfour turned primarily to cost cutting, disposal of underperforming and non-core businesses, and internal restructuring and refocusing in order to turn the situation around.

In its 2014 Q1 statement the company announced the CEO’s departure.

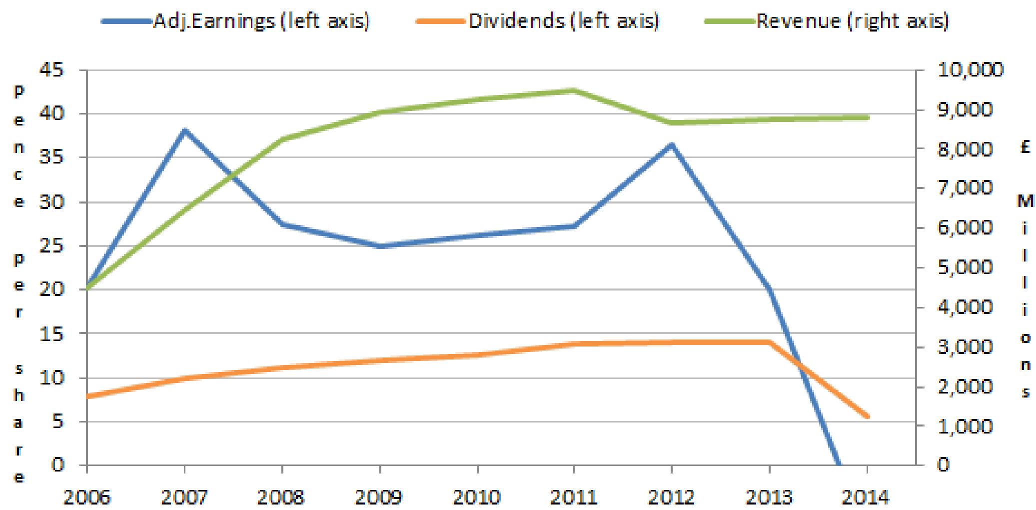
It also announced the possible sale of Parsons Brinkerhoff (a professional services consultancy focused on infrastructure), which had only recently been acquired in 2009 for £382m. Parsons was eventually sold in September 2014 for £812m and up to £200m of that was earmarked for a shareholder return.

At the half-year results the story was the same with the dividend held fast and profits down by more than 50%. By this point the construction services business was solidly loss-making, losing almost £70m at the operating level in the first 6 months of the year.

In September the dividend was put under “review” and the Chairman stated his intention to leave once a new CEO had been found. All in all 2014 was a very bad year.

In 2015 the company found a new CEO (Leo Quinn, previously at QinetiQ) who immediately launched a new transformation program with the goal of reducing costs by £100m and improving cash generation by £200m over 2 years. At that point the dividend was suspended for two payments, with the expectation that it will be reinstated in March 2016.

Here are Balfour’s most recent results including 2014's losses:



Selling because of losses, suspended dividends and a potentially difficult turnaround ahead

Generally I don't like to sell when a company is still having problems. I prefer to wait for the turnaround to turn, or at least for it to look like it might turn so that I can sell when investor sentiment, and market valuations, are higher.

However, in Balfour's case the turnaround is expected to take at least a couple of years, and the share price has remained surprisingly resilient in the face of all this bad news.

The combination of weakening fundamentals and a steady share price has reduced the company's rank on my stock screen, down to 132 out of 235, which makes it easily the weakest holding in my portfolio. The weak stock rank and potentially lengthy recovery are the main reasons I've decided to sell.

Learning the right lessons and applying them to future investments

The final step in the investment process, after buying, holding and selling a company, is to review what happened. The idea is to uncover any valuable lessons that can then be integrated into your investment strategy and applied to all future investments.

This is something I do all the time, and since I invested in Balfour in 2011 I have introduced many improvements to my investment strategy with the twin goals of increasing returns and reducing risk.

These improvements include things like:

- lowering the amount of debt that I will accept,
- looking at the size of a company's pension obligations,
- asking questions about how focused the company is,
- how cyclical it is,
- whether it depends on large contracts,
- how much it spends on capex or acquisitions
- and what sort of competitive advantages it might have.

In relation to Balfour, several of these new checks would have made me more cautious about investing, but one in particular would have ruled it out from the start.

Lesson 1. Be wary of companies that need to repeatedly replace large contracts

This was a lesson I learned a few months ago after Serco (which I also own) ran into serious trouble.

Companies that need to repeatedly replace large projects or contracts carry a lot of risk from either not replacing the contract (which of course would reduce revenues and profits, sometimes dramatically) or bidding too low in order to win a new contract.

If a contract is won at too low a price it can lock the company into wafer thin profits or even losses over a multi-year period. This has definitely effected Balfour's UK construction services business.

I'm not totally against investing in these sorts of companies but they should have very low levels of debt; perhaps a Debt Ratio (ratio of current borrowings to 5-year average earnings) of just 3 rather than my usual maximum of 4 for cyclical sector companies.

While debt wasn't initially a problem for Balfour, it did increase its operational borrowings every year to a high in 2013 of more than £600m (giving it a Debt Ratio of 3.7), which probably was too high.

Lesson 2. Be wary of companies that make lots of large acquisitions

This is another new check that I added to my company analysis checklist in January 2015 and it would have provided another warning flag against Balfour.

My rule of thumb is that if a company spends more on acquisitions in a year than it

made in post-tax profits, then that is a “large” acquisition expenditure. The more large acquisitions there are, the more cautious you should be.

In Balfour’s case it made large acquisitions in the 2007, 2008 and 2009 financial years. **In total it spent some £800m on acquisitions in those years while only making adjusted post-tax profits of £430m.**

The problem with acquisitions is that they usually have to be integrated, and the bigger they are the more disruptive they can be. The new CEO has highlighted these acquisitions as a major cause of the company’s current problems.

Although these large acquisitions wouldn’t necessarily have ruled Balfour out as an investment for me, they would have made it more likely.

Lesson 3. Be wary of companies with large defined benefit pension obligations

Oddly enough pension obligations aren't something that gets talked about much, but I think they have been instrumental in exacerbating Balfour’s other problems.

The rule of thumb which I brought in a couple of years ago was that a company should have a Pension Ratio of less than 10 (ratio of pension obligations to 5-year average earnings).

I focus on pension obligations rather than whether or not the pension fund is in surplus or deficit because a surplus today can quickly become a deficit tomorrow, so a pension surplus is not a guarantee of safety. Limiting the size of the overall obligations is a better way of limiting any potential deficit funding requirements.

In Balfour's case it had pension obligations of £2,795m as at the 2010 annual results compared to 5-year average earnings of £139m. That gave the company a Pension Ratio of 20 which is, quite frankly, massive.

How does that impact the company?

It means Balfour is at risk of running a huge pension deficit which it would have a legal obligation to reduce, by any means necessary.

In fact in 2010 Balfour’s pension plans did have a deficit of £440m, more than three times its average earnings. That year it had to pay £81m into the pension fund to close the gap, only slightly less than the £84 million paid out to shareholders as a dividend.

Over the last 10 years Balfour has paid more than £500m into the pension fund and yet it still runs a deficit and the obligations just keep growing (they currently stand at £3,518m).

With the dividend now suspended and £85m of the £200m windfall from Parsons Brinkerhoff going into the pension fund, it seems to me that Balfour is likely to be run primarily in the interests of its enormous pension scheme rather than its shareholders.

That is entirely as it should be, given the company's legal obligations to the fund's beneficiaries, but it does illustrate the importance of looking at pension obligations before investing.

Onward and upward

And so my investment in Balfour Beatty is over. It doesn't join the illustrious ranks of N Brown (50% return in 8 months) or Interserve (117% return in 28 months), but it wasn't a complete disaster and I did learn some very valuable lessons.

And anyway, it is the long-term performance of the portfolio which really matters, not the results from any one investment.

So now that I've sold Balfour I'll be looking to reinvest the proceeds next month into a better company at a better price, all in pursuit of my long-term investment goals.

Model portfolio review for Q1 2015

16th April 2015

Each quarter I review the UKVI model portfolio to make sure it's doing what it's supposed to be doing, or to give an explanation if it isn't.

But before I get into the gritty details of whether the portfolio is up or down I'd like to draw your attention to some other things that matter just as much as raw performance numbers.

Investment goals

To hit a target you first must have a target, so the first thing to review is the investment goals by which I define success. There are four basic investment goals for this model portfolio:

- **High yield** - Higher than the FTSE All-Share at all times
- **High relative return** - Higher total return than the FTSE All-Share over any 5-year period
- **High absolute return** - Total returns of more than 5% after inflation over any 5-year period
- **Low risk** – Lower than the FTSE All-Share (measured using volatility and drawdown)

Investment strategy

That's where I want to portfolio to go, and here's a quick overview of the investment strategy I'm using to take it there:

- **Buy a diversified group:**
  - Hold about 30 companies
  - Diversify the portfolio internationally and industrially
  - Hold a majority of defensive stocks

- **Of good companies:**
    - Only invest in companies that have a 10 year unbroken record of dividend payments
    - Prefer FTSE 350 companies
    - Prefer companies that have grown quickly and/or grown consistently
    - Prefer companies that are highly profitable and financially robust
- **At attractive valuations:**
    - Prefer shares where PE10, PD10 and the dividend yield are better than average
- **Hold for the long-term:**
    - Target an average holding period of 5 years
- **But sell occasionally to reduce risk and lock in capital gains:**
    - Replace the least attractive holding every other month with something better

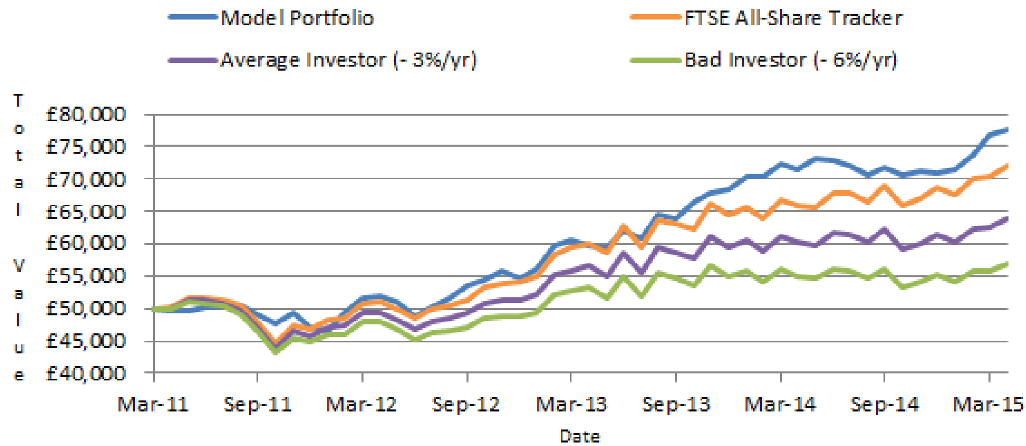
There is a bit more to it than that of course, but that's the basic picture.

Performance review

As you probably know, 2015 started with a bang. After 2014, where the UK large-cap market more or less went nowhere, 2015 has seen the FTSE All-Share increase by more than 6% in just the first quarter.

The more familiar FTSE 100 has gone from 6,500 at the start of the year to 7,100 today, blasting through both new highs and the seemingly insurmountable 7,000 barrier along the way.

However, I don't have any short-term return goals so I don't generally think about performance over such a short period of time. Instead I prefer to concentrate on how the model portfolio had done over the past few years relative to its FTSE All-Share benchmark, as shown in the chart below:



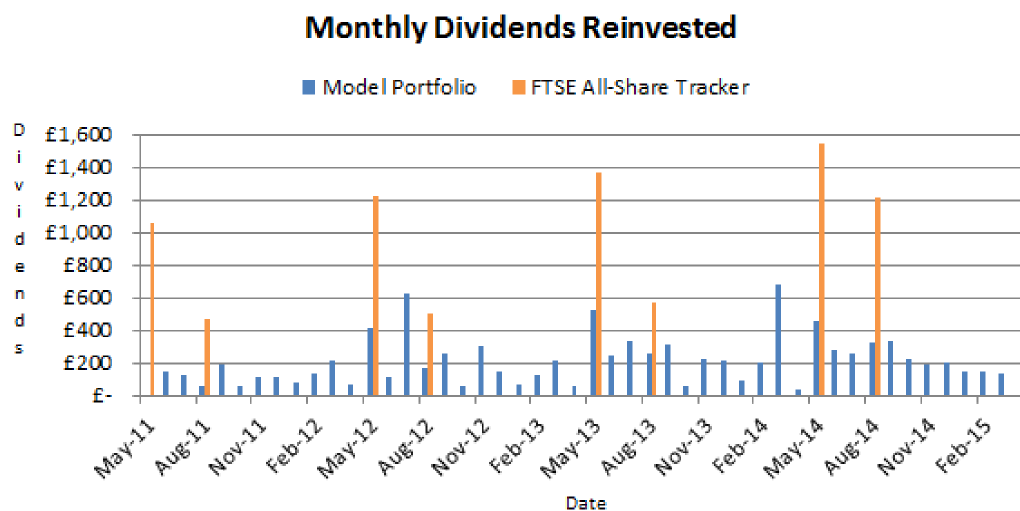
Today the model portfolio stands at £77,760, some £5,500 ahead of its FTSE All-Share benchmark, which now has a value of £72,060. Note that these results include the negative impact of broker fees and stamp duty.

So how has the portfolio done in terms of its investment goals?

- **High yield** – Its historic dividend yield is currently 3.6% compared to 3.8% for the FTSE All-Share
- **High relative return** – From inception the portfolio's rate of return has been 11.4% a year compared to 9.4% for the FTSE All-Share
- **High absolute return** – CPI inflation has run at 2.3% since March 2011, so my absolute rate of return goal is 7.3% a year. The portfolio's actual rate of return is 11.4% a year
- **Low risk** – The portfolio's monthly volatility has been 19% less than the FTSE All-Share's. The largest peak-to-trough decline for the portfolio is 8% compared to 13.5% for the FTSE All-Share

Overall then the portfolio met its high return and low risk goals, but failed to meet its high yield goal this quarter.

Looking at the details of that failure, there is no reason to panic just yet. The FTSE All-Share investment trust benchmark currently has a relatively high historic dividend yield because of the massive one-off payment from Vodafone last year. You can see how this has skewed things in the chart of reinvested dividends below:



The orange bars are the twice yearly dividends paid out by the FTSE All-Share investment trust, with a large final payment and a much smaller interim payment. However, in 2014 the interim payment was almost as large as the previous final payment.

The model portfolio holds Vodafone and so it also benefited from that company's massive special dividend (which shows up as large blue dividend in March 2014), but that dividend has now dropped out of the trailing 12-month dividend figure and no longer forms part of the portfolio's 3.6% historic yield.

The FTSE All-Share on the other hand delays dividend payments and so its Vodafone dividend was paid several months after the payment to direct shareholders (in August rather than March), and so that dividend still makes up part of the All-Share's 3.8% historic yield.

I expect that once the Vodafone payments drop completely out of the picture the model portfolio will once again have the higher yield, but only time will tell.

Biggest winner and loser during the quarter

Although not strictly necessary for a review, I always find it interesting and educational to look at just how volatile individual shares can be. It reminds me of the importance of diversification and why I hold 30 companies from a wide range of geographies and industries.

- **JD Sport up 48%** - JD Sport has been a big success for the portfolio over a long period of time. It has been a holding since the beginning in March 2011 and has returned 131% so far.
- **Serco down 64%** - Much like Balfour Beatty, Serco was an unsuccessful step into

the world of businesses that must repeatedly replace large, complex contracts.

If I focused on each individual company then I would be riding a very dangerous emotional roller coaster, with elation in one minute as JD Sport increases profits by 25% and desolation the next as Serco suspends its dividends.

But I don't focus on each company; I focus instead on the overall value of the portfolio which has, on average, gone up by almost 1% per month over the past four years (and up by 9% over the last quarter). That makes the investment process much less stressful than it would be if I focused on individual companies.

Stocks bought and sold during the quarter

As I mentioned above, part of my strategy is to make one trade each month; either one buy or one sell decision, alternating between the two.

Since the start of the year I've made the following trades:

- **January** - Bought a FTSE 100 pharmaceutical company
- **February** - Sold ICAP, the FTSE 250-listed inter-dealer broker
- **March** - Bought a small cap media company (but not that small as its market cap is almost £500m)
- **April** (not technically Q1) - Sold Balfour Beatty after an eventful but ultimately fruitless three years

Having sold Balfour in April I am now looking forward to reinvesting the proceeds into something else at the start of May.

Serco: Some lessons from a bad investment

12th June 2015

Serco is the first investment to produce a net loss for the UKVI portfolio. As inevitable as this was, selling at a loss is still an unpleasant thing to do. But rather than cry over spilt milk, my task now is to try to understand why the milk was spilt in the first place in order to avoid spilling it again in future.

First though, here are those unspectacular results:

Purchase price	Sale price	Holding period
355p on 07/05/2014	135p on 01/06/2015	1 Year 1 month
Capital gain (after fees)	**Dividend income**	**Annualised return**
-50.7%	0.9%	-48.9%

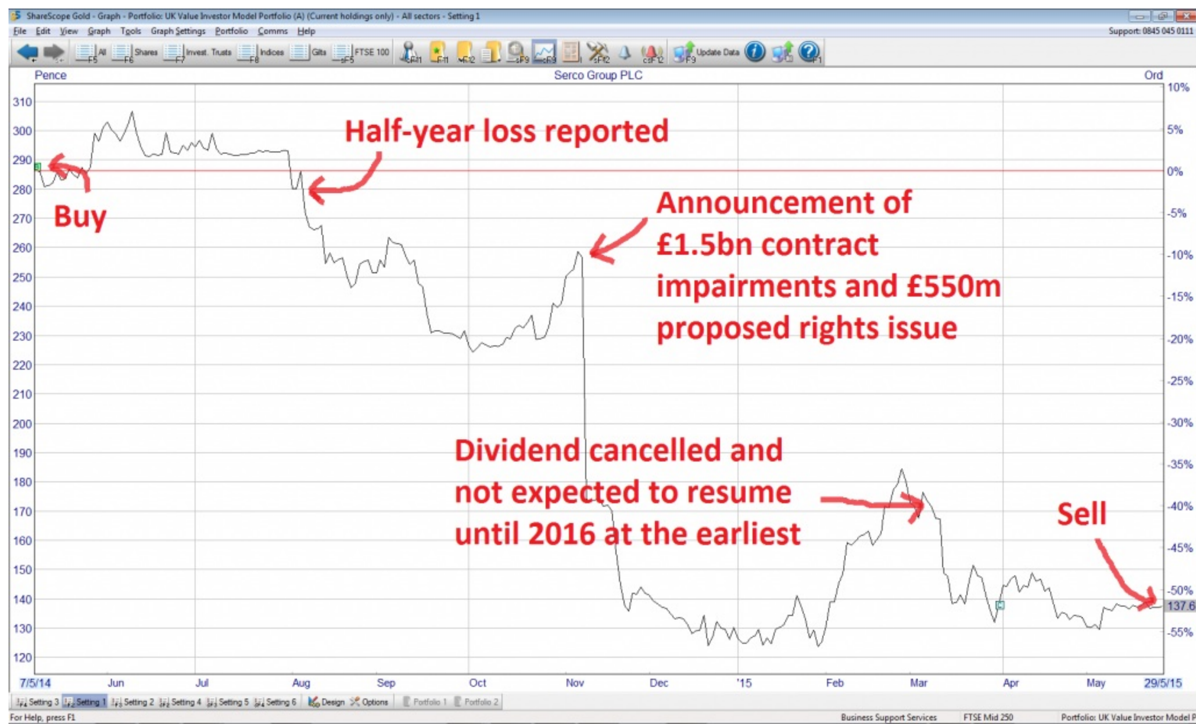
The fact that Serco has performed badly is not a complete surprise; when it joined the portfolio in May 2014 it was already in trouble.

In 2013, an independent audit by the UK Ministry of Justice found irregularities in the billing of one of its UK Government contracts. Initial findings suggested the company could have benefited by tens of millions of pounds.

As a result, Serco launched its own review as the Government expanded its investigations to include other contracts. By late 2013 Serco's CEO was gone and shortly afterwards a Serious Fraud Office investigation began.

My assumption at the time was that Serco stood a decent chance of recovering well. However, that's not what happened.

One problem followed another until the dividend was suspended, a £550m rights issue was launched and the shares fell by 50%. The only plus is that Serco has provided important lessons which will improve the stock selection process going forwards.

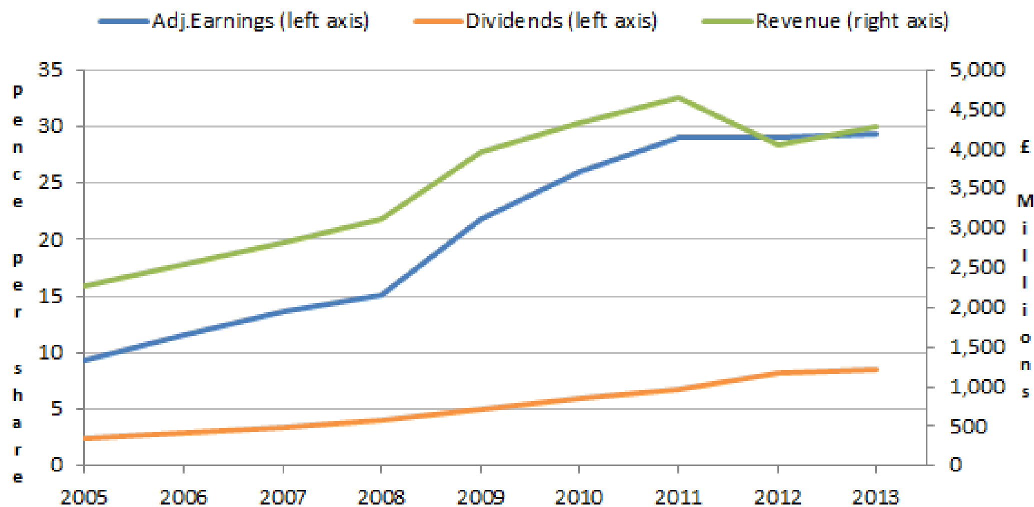


Buying: A long-established, fast-growing company with government clients

When Serco came up as a potential investment I was, as usual, after a high quality company at an attractive price. In terms of being a quality company, Serco had a long track record of consistent growth, having grown over the previous decade by almost 15% a year.

It also had financial obligations that I thought were acceptable, although not insignificant, with a Debt Ratio of 3.8 (5 is the maximum I'll allow) and a Pension Ratio of 5.8 (where 10 is the maximum I'll allow).

The chart below shows Serco's excellent financial performance up to the 2013 annual results.



As you can see, it's a picture of smooth and steady progress, which is exactly what I like to see. What made Serco really attractive was its unassuming valuation. With a PE10 ratio of just 13.4 and a dividend yield of 3.1%, its multiples were no higher than average, yet Serco's consistent growth made it appear to be a far better company than average.

Yes, Serco had problems with its UK Government contracts, but as a value investor I have to be willing to invest in difficult situations because it is usually those situations where the best value is to be found.

In fact, most of the portfolio's investments that have done exceptionally well have done so because the companies, and their share prices, have rebounded from difficult situations which other investors have avoided; so the fact that a company is having problems is not necessarily a reason to avoid it.

After analysing Serco, I thought it seemed likely that the company would face a tough year or even several. But I also thought there was a good chance its problems would turn out to be molehills rather than mountains.

As a result, I added Serco to the portfolio with a position size of just over 3% and added a similar amount to my personal portfolio.

Holding: No knee-jerk reactions, but not buy-and-hold "forever" either

Unfortunately, Serco did not recover quickly. In fact it has faired far worse than I expected, so the question now is:

Why did such a seemingly minor issue (some serious but apparently isolated problems with contracts relating to one client) balloon into a major crisis?

To answer that question, I'll quickly summarise my view of the situation.

Serco's business is built around large, long, complex service contracts. It operates prisons, immigration centres, railways and other things that require the hiring, training, organisation and management of lots of people. It takes services that are typically provided by national governments and re-engineers the component processes to provide the same service more efficiently and more cheaply.

This is a competitive market and there is a great deal of pressure to "win" contracts, which can sometimes lead to "underbidding", or my preferred term, "suicide bidding", where a company puts in a bid for a contract which is below the expected cost of providing the service.

As daft as that sounds, it isn't always a bad idea. Sometimes the contract can be made profitable through performance-related bonuses, such as completing various tasks early or to a higher standard, or through follow-on contract wins with the same client.

The practice of bidding low and underbidding is probably why Serco had been so aggressive in billing the UK Government. Having won the contract, it then needed to make it profitable somehow, and somebody thought aggressive billing was an acceptable way to do it. The UK Government thought otherwise.

Unfortunately, these practices extended into many other contracts. During Serco's internal review, it became clear that several large contracts would no longer be profitable and that other contracts would become less profitable as the level of service provided would have to be improved.

Another nail in the coffin (although not yet the final one) was the knock-on effect of bad publicity from the company's over-billing of the UK Government. Some potential and existing clients may have become wary of Serco and as a result the company won fewer new contracts, renewed fewer contracts, or had to accept even worse terms than before in order become the winning bidder.

As a consequence of losses on existing contracts, lower margins on new contracts and fewer contract wins and renewals, Serco's profits collapsed in 2014. That in turn led to the dividend suspension and major rights issue.

So that's the situation as I see it. The next step is to look for things that were visible beforehand that would have suggested that Serco was a "value trap" rather than a

good turnaround candidate.

Value trap signal 1: Weak profitability

Because contracts are won through a process of competitive tendering, the lowest bidder is often the winner. As a result companies like Serco compete largely on price, which means that profits are very thin.

Back when I looked at Serco in May 2014, I didn't look at profitability at all, so I completely missed this fact. It was the events at another holding (Tesco) and a subsequent article by Terry Smith in the Financial Times, which prompted me to look at profitability via return on capital employed (ROCE).

After some research on the subject, I added ROCE as a ranking factor to my stock screen in November 2014, using 10-year median post-tax ROCE.

As Serco had a low ROCE of 8.1%, which is only slightly above my minimum acceptable value of 7%, it would not have ranked so highly on the UKVI stock screen if ROCE had been part of the ranking calculation at the time.

A lower price would have been required for the company to look attractive enough to buy, so I wouldn't have bought in May 2014. Perhaps the stock wouldn't have looked cheap enough until late 2014, by which time it may have been more obvious that trouble was coming, but I don't know for sure.

Value trap signal 2: Highly indebted cyclical company, dependent on large, complex, long contracts

Weak profitability alone wouldn't have automatically ruled Serco out as an investment though, so I may still have invested at some point (although at a lower price). On the other hand, something that would definitely have ruled it out was its excessive levels of debt.

Debts are something I have always looked at, and Serco was no different. When I reviewed the company it had a Debt Ratio of 3.8, which was less than the maximum of 5 I was applying at the time.

However, the Debt Ratio in early 2014 was an earlier version of the one I use today. It was more lenient and didn't take into account whether the company was cyclical or defensive in nature (cyclical companies will typically be able to handle less debt than defensive companies because their earnings are usually more volatile).

In late 2014 the old Debt Ratio's shortcoming became apparent, as Serco, Tesco and

Balfour Beatty (all holdings at the time) had significant problems.

My response, as usual, was to attempt to improve the underlying investment strategy rather than sell the shares.

That meant changing the Debt Ratio to be more cautious, especially so for cyclical sector companies (like Serco, which operates in the cyclical Support Services sector), and that fix has been in place since in December 2014.

Under the new and improved Debt Ratio, Serco's debt burden looked far less sensible.

With the old approach, it had a Debt Ratio of 3.8 in 2013, which was fine, but the new Debt Ratio gave the company a score of 5.2, which is above the maximum of 4 which I'll allow for cyclical companies.

If I had been using the new Debt Ratio when I first reviewed Serco, it would never have made it into the portfolio in the first place, and I think that's the right outcome.

The main reason Serco had to launch a £550m rights issue was to reduce its debts. Under the old Debt Ratio its debts appeared to be manageable, but clearly that wasn't true. The new Debt Ratio more accurately indicates that Serco's debts were not prudent.

Another improvement to the investment strategy, introduced in January 2015 largely as a consequence of Serco and Balfour's problems, was the addition of a series of "value trap" questions.

These include a specific question on whether or not a company relies on large contracts. If it does (as Serco does) then other factors, such as debts, pension obligations and so on should be viewed with an even more cautious eye.

Value trap signal 3: Large pension obligations

When I updated the Debt Ratio to be more cautious I also changed the Pension Ratio as well, because they both work in essentially the same way by comparing a financial liability to average earnings.

Under the old approach, Serco's Pension Ratio was 5.8, but the new more cautious approach gave the company a different result.

In the 2013 annual results, its defined benefit pension obligations were quoted as being £1.4bn. At the same time, the company had earned an average of £167m in post-tax profits during the previous five years. That gave Serco a new Pension Ratio of 8.2,

which is much closer to my maximum of 10 than the old value of 5.8.

Although the pension scheme didn't have a large deficit, the company had made "special payments" into the fund totalling £80m in the previous five years, so the scheme was definitely a drag on performance and represented a significant risk.

Serco may have still passed the new Pension Ratio test, but the fact that the company had both high debts and relatively high pension obligations obviously puts it at more risk than if it had just one or the other.

Because of this, I recently added a new rule of thumb to my company analysis process. The new rule is:

- **Only invest in a company if the sum of its Debt and Pension Ratios is less than 10**

You can read more about how I came up with that rule here.

If I had used that rule during my analysis of Serco, I would have found that its combined Debt and Pension Ratio was 13.4 (i.e. 5.2 + 8.2), which is simply too high.

That would have been yet another reason to avoid it.

Value trap signal 4: Too many large acquisitions

Yet another reason to be wary of Serco was the amount it had spent on acquisitions in recent years. Looking at a company's acquisition history is a relatively new addition to my company analysis process, one I added as part of those new "value trap" questions.

One definition I use is that if a company has spent more on acquisitions than it earned in that year, then that is a "large" acquisition. Any large acquisitions should be investigated to assess their potential for disrupting the core business.

If a company has made several large acquisitions, or spent more on acquisitions over the last decade than it produced in total profits, then I would seriously consider skipping the company altogether.

Large acquisitions are often hard to integrate, are a distraction from the core business, and are often used to grow earnings per share when the core business either cannot grow or produces weak returns on investment. All of those are features I'd rather avoid.

In Serco's case, it made "large" acquisitions in 2005, 2008 and 2011. Over the 10 years to 2013 it spent £1.1bn on acquisitions compared to total post-tax normalised profits of

£1.2bn.

With hindsight, I would say that was too much spent on acquisitions, especially given that Serco is a cyclical company, dependent on large contracts (both of which make the company even risker).

Selling: Suspended dividends and a highly uncertain future

At the start of June, Serco was the lowest ranked stock in the portfolio, using the ranks assigned by my stock screen.

As part of my investment strategy, I will sell, every other month, the lowest ranked holding (i.e. the stock with the weakest combination of growth, income, value and quality) and replace it the following month with the highest ranked stock in the FTSE All-Share that I don't yet own (after a detailed and lengthy analysis, of course).

The only reason I won't sell the lowest ranked stock is if I think there is some compelling reason to hold onto it, despite its low rank. In Serco's case, I don’t think there are any compelling reasons to hold onto it.

As a result, I sold the entire Serco position at the start of this month, from both the UKVI portfolio and my personal portfolio. I'll be looking to reinvest the proceeds next month.

In summary then, Serco may not have been a financially profitable investment, but at least it has been educationally profitable. It has led to improvements in my investment process, which will hopefully lead to improved investment returns in the long-run.

You can't win them all...

Although this investment in Serco has performed poorly, the UKVI portfolio has outperformed the FTSE All-Share over the past year (and three years, and from inception), which to me is evidence that it isn't a good idea to focus on the results of a single investment.

What matters is that your portfolio does what it is supposed to do, which in the case of my portfolio is to produce a market-beating dividend yield, with higher growth and lower volatility than the FTSE All-Share.

Some holdings will do badly (such as Serco, with its 50% loss in one year) while others will do well (such as Cranswick, which has gained more than 115% in less than 2 years),

but ultimately it is the performance of the overall portfolio that counts, not the individual holdings.

> *"The result of one particular game doesn't mean a damn thing, and that's why one of my mantras has always been 'Decisions, not results.' Do the right thing enough times and the results will take care of themselves in the long-run."*
> *Amarillo Slim, Poker Legend (Quote from "The Art of Value Investing", by Heins & Tilson)*

Model portfolio review for Q2 2015

10th July 2015

How time flies. Another quarter of a year has passed and so it's time for me to review the UKVI Portfolio once again. That makes me happy because portfolio construction is one of my favourite topics (sad, I know).

Note that while this is a virtual portfolio it effectively contains my "best ideas" and so I have basically all of my net worth invested in the same stocks.

Goals

I'm a big believer in having clear goals, so here they are for the UKVI Portfolio:

- **High growth:** Generate higher capital gains and dividend growth than the FTSE All-Share (over 5 years or more)
- **High yield:** Have a higher dividend yield than the FTSE All-Share (at all times)
- **Low risk:** Be less volatile than the FTSE All-Share and have smaller drawdowns
- **Low effort:** Take just a few hours each month to maintain

Strategy

The strategy I'm using to achieve those goals is defensive value investing. The basic strategy is value investing, but the companies I buy are restricted to *relatively* defensive companies with long track records of profitable dividend growth.

Tactics

Here are some of the main tactics I'm using to implement that strategy:

- **Reduce company-specific risk:** Hold around 30 companies, approximately equally weighted (each new position starts off at around 3% to 4% of the portfolio,

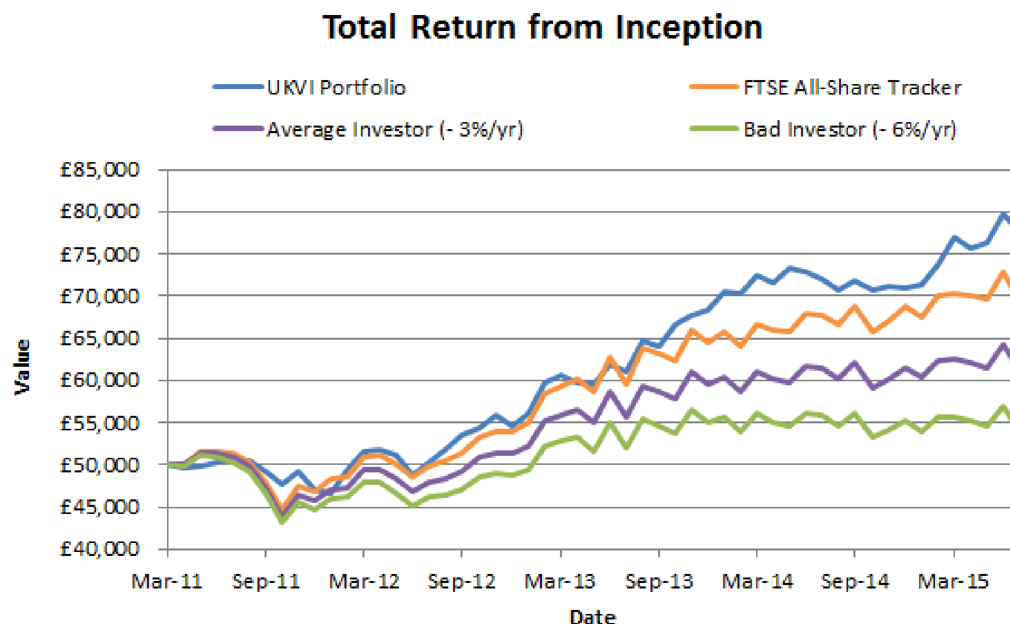
depending on available cash)

- **Reduce country-specific risk:** Have at least 50% of the portfolio's revenue coming from outside the UK
- **Reduce sector-specific risk:** Have no more than 3 holdings in any one sector
- **Be defensive:** Have at least 50% of the portfolio invested in defensive sector companies
- **Buy market-leading companies:** Invest primarily in the FTSE 350, but be willing to buy "large" small-caps
- **Buy reliable companies:** Only invest in companies that have a 10-year unbroken record of dividend payments
- **Rebalance occasionally:** Sell half of a position if it grows to more than 6% of the portfolio in order to reduce exposure to any one company
- **Reduce trading costs:** Only make one buy or sell decision each month (which gives an average holding period of 5 years for a portfolio with 30 holdings)

Performance

The UKVI Portfolio started life in March 2011 with a value of £50,000 and is benchmarked against another £50,000 portfolio which only holds a FTSE All-Share tracking investment trust (the Aberdeen UK Tracker Trust).

Their performance to date looks like this:



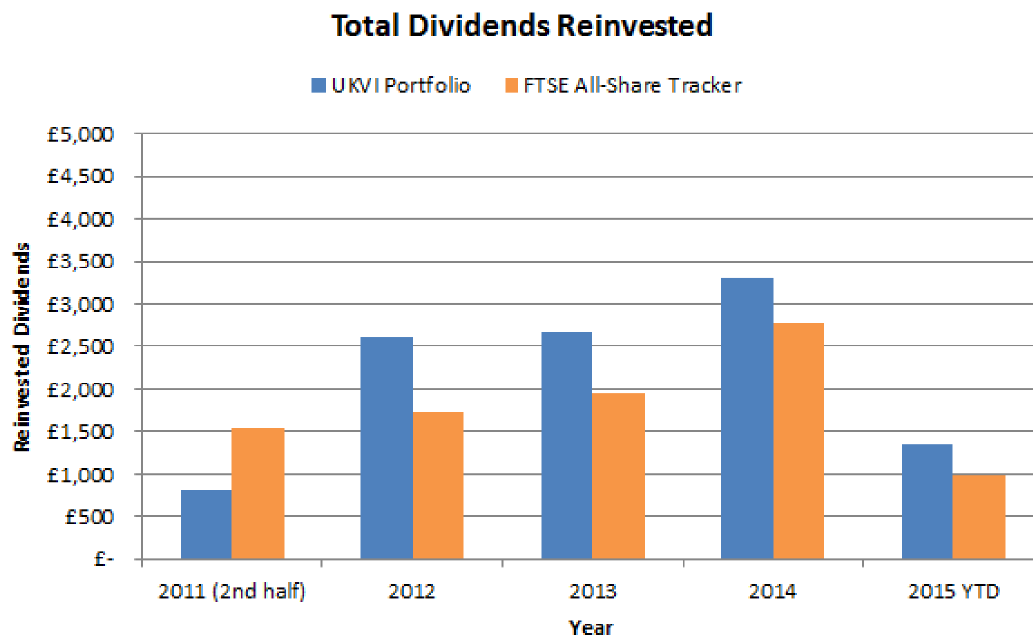
Note that the chart includes an "average" and "bad" investor, who underperform the market by 3% and 6% a year respectively, primarily because they buy what has gone up, sell what has gone down and buy and sell too often. This is based on figures

quoted by Barclays Wealth and Pete Comley's book "Monkey with a Pin".

Here is the portfolio's performance in numbers:

- **Total return from inception:** 55.3% (39.0% for the All-Share tracker)
- **Annualised return from inception:** 10.7% (7.9% for the All-Share tracker)
- **Current cash value:** £77,635 (£69,504 for the All-Share tracker)
- **Dividend yield:** 3.7% (3.2% for the All-Share tracker)
- **Maximum decline:** 8% (13.5% for the All-Share tracker)

And here's another graph, this time comparing annual dividends reinvested to date:



So far the UKVI Portfolio has met all of its performance goals of having a high yield, high total return and low risk.

At the outset I thought it should be possible to beat the market by about 3% a year, with less volatility, and so far the portfolio's annualised performance has been at about that level.

With the portfolio now more than £8,000 ahead of the All-Share tracker (not to mention £16,000 ahead of the "average" investor and £23,000 ahead of the "bad" investor), I think it's safe to say the effort has been worthwhile so far.

Assuming it takes about 100 hours per year to manage this portfolio (a couple of hours per week, with a couple of weeks off per year) then over the four and a quarter years of the portfolio's life it has taken approximately 425 hours to run.

Dividing the £8,131 outperformance by 425 hours gives a rate of £19.13 per hour, which seems fairly worthwhile to me. Of course that hourly rate will grow exponentially as the portfolio grows over the long-term, assuming its annualised outperformance remains approximately the same.

One caveat to all this is that gains over 5 years or less are highly susceptible to good and bad luck, so generally I think investors should ignore such short-term results. However, until the UKVI Portfolio is more than 5 years old I have little choice but to look at these short-term results, taking them with the appropriate pinch of salt due to their short duration.

Recent trades

In line with my one-trade-per-month rule, I made three "full" trades during the last quarter, initiating a new position or exiting an old position in full:

- **April:** Sold Balfour Beatty for a 9% return in 3 years and 8 months
- **May:** Bought a utility company with a dividend yield of almost 5% to replace Balfour
- **June:** Sold Serco for a 50% loss in 1 year and 1 month

I also made one "rebalancing" trade, which was to sell about half of the position in JD Sport (for a second time) as it had once again increased in value to more than 6% of the portfolio (the original purchase price was 228p whereas the price today is 712p).

Obviously in terms of the performance of the two companies I'd sold in full, this wasn't a good quarter. In fact Balfour and Serco have been by far the two worst performing investments to leave the UKVI Portfolio so far.

But as the rebalancing of JD Sport shows:

> *Investing is a game of averages, with winners and losers. As long as the winners significantly outnumber and outperform the losers the overall portfolio should do fine.*

As for Balfour and Serco, they have both contributed enormously to the improvement of my investment strategy, resulting in new rules on investing in defensive sectors, being more cautious about borrowings, more cautious about pension liabilities and asking questions to avoid value traps.

Diversification

As I've mentioned, I have a few rules covering diversification, e.g. how many stocks to hold, from what sectors and so on.

To give you an idea of how those diversification rules play out in the real world, here are a few of the portfolio's diversification-related features:

- **Number of holdings:** 30, up from 29 after a new purchase at the start of July
- **Average revenue source:** About 50% from the UK and 50% international
- **Defensive sector allocation:** 47% of the portfolio is in defensive sectors, which is slightly below my target minimum of 50%
- **FTSE 100 allocation:** 43%
- **FTSE 250 allocation:** 44%
- **Small-cap allocation:** 13%

Hopefully that gives you a pretty good idea of how I like to structure the UKVI Portfolio in order to keep volatility below that of the FTSE All-Share.

I'll publish another portfolio review at the end of Q3.

RSA Insurance Group: A lucky escape from a value trap

9th August 2015

RSA Insurance Group was the first insurance company to join the UKVI Portfolio back in 2012 and it has been a mostly disappointing - although not catastrophically bad - investment.

In short, it was a value trap and the most important thing to do if you're stuck in a value trap is:

1. Get out profitably and
2. Learn the right lessons so that you can hopefully avoid similar value traps in future

This review covers why RSA was added to the UKVI Portfolio, what went wrong, why it's being sold now and how it helped improve my investment strategy.

The table below summarises the results of this weak but still profitable investment:

Adjusted purchase price	Sale price	Holding period
544p on 09/01/2012	525p on 01/06/2015	3 Years 6 months
Capital gain (inc. Nil Paid Rights)	**Dividend income**	**Annualised return**
4.9%	14.3%	5.8% per year

Overview

In January 2012 RSA appeared to have turned itself around after a problematic period in the early 2000s, which included a dividend cut and rights issue to strengthen the balance sheet.

When I reviewed the company its dividend yield was 8.8%, so clearly the market was pricing the shares as if a dividend cut was inevitable. In this case the market was right because the dividend was subsequently cut, the CEO "resigned" and a rights issue was

carried out.

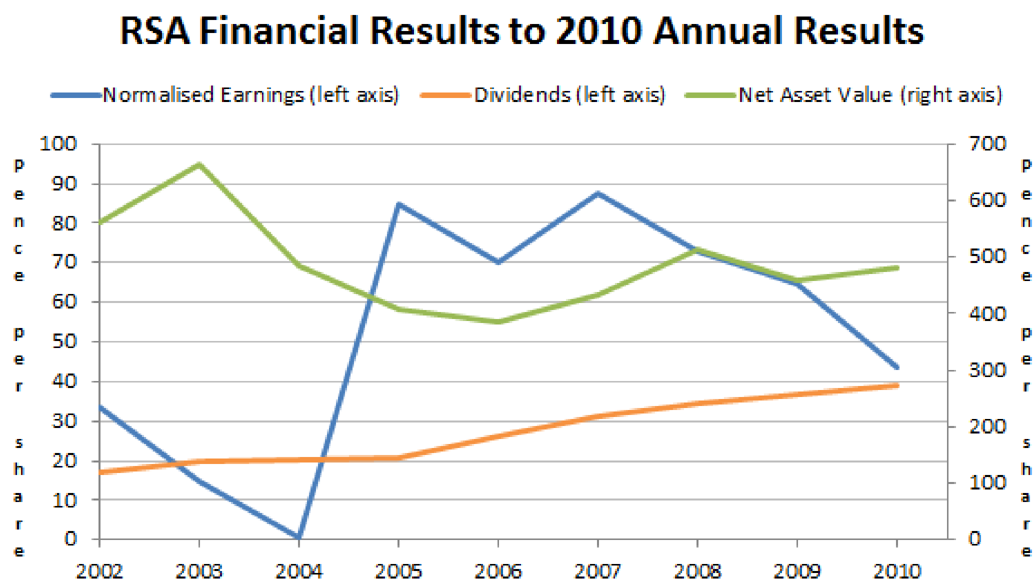
However, thanks to recent acquisition interest from Zurich Insurance RSA's share price has reached a point where this particular value trap can now be escaped profitably.

The classic value trap: A super-high dividend yield

I was well aware of the risks of investing in a company with such a high yield, but I rationalised the risks by thinking that even if the dividend was cut in half the yield would still be above the market average. In other words, I thought the risks were already accounted for in the price.

On the plus side, if the dividend wasn't cut, or was only cut very slightly, then the shares were likely to re-rate upwards, producing large and rapid capital gains.

The chart below shows RSA's latest financial results at the time of purchase in January 2012 (up to the 2010 annual results).



RSA's problems at the start of the decade are clear to see, with normalised earnings falling essentially to zero. I summarised the underlying problems in my original analysis back in January 2012:

> *"In very simple terms insurance companies can make money in two ways: one is to make money on each policy so that the premium income more than offsets any losses; the other is to invest that premium while it's held in reserve waiting to cover any losses. If this 'float' is invested well it makes money which goes on the bottom line.*

> *Unfortunately it seems that RSA had been depending too much on the stock market and when that fell for three years between 2000 and 2003 it hurt the company a lot. The dividend was cut from around 25p eventually down to less than 5p . Just as bad was the more than £900m rights issue that was used to strengthen the balance sheet."*

So the company had a history of recent failures of judgement, but it seemed that things had gotten better and none of the metrics I used in 2012 told me otherwise.

After analysing the company I was comfortable investing 3% of the UKVI Portfolio into RSA and a similar amount with my personal investments.

Holding on through dividend cuts and CEO "resignations"

Unfortunately RSA did still have underlying problems which needed sorting out, and these were pretty much the same issues it had exhibited during the 2000 - 2003 period.

These problems resulted in a bumpy ride for investors, as the share price chart below shows:

Investors were hit with wave after wave of bad news, including a major dividend cut,

a resigning CEO and a significant rights issue. I'll start with the dividend cut, which was announced in the 2012 annual results, published in February 2013, where the main reason given for the dividend cut was exceptionally low bond yields.

At the time RSA had more than £11bn of its customers' premiums invested in bonds and was clearly relying on returns from bonds and other investments to fund a portion of its dividend. This is normal for an insurance company, but it does perhaps hint at RSA's inability to generate significant cash from its underwriting (i.e. insurance) activities rather than its investment activities.

As usual I did not sell when the dividend cut was announced as in general I think there are better opportunities to sell than immediately after a dividend cut.

Dividend cuts often result in new management taking over, changes being made and companies being improved. At some point down the line some good news is likely to appear and the market will hopefully raise the share price accordingly. In RSA's case, Stephen Hester (of RBS turnaround fame) joined the company in 2014 to turn things around.

By holding on I was effectively waiting for that turnaround to come good, or at least for the market to think the turnaround would come good and therefore raise the share price to where I could sell the company for a decent profit.

However, I would have preferred to avoid this value trap altogether and, with hindsight, I think RSA's problems were visible beforehand if I'd known where to look.

Low profitability: A sign of weak competitiveness and/or a lack of capital discipline

RSA's first problem was weak profitability, which I didn't measure at all in 2012. However, for insurance companies I now use the **Combined Ratio**, which works a bit like profit margin.

It is a combination of the Loss Ratio (the ratio between claim expenses and premium income) and the Expenses Ratio (the ratio between operating expenses and premium income).

It works like this:

- If the sum of claims and expenses are less than premium income then the Combined Ratio is less than 100% and the company made a profit on its underwriting business

- If claims and expenses exceeded premiums then the Combined Ratio is above 100% and the company made a loss on its underwriting business

Today I use the following rule of thumb for insurance company profitability:

- **Only invest in an insurance company if its 5-year average Combined Ratio is below 95%**

In the 5 years to RSA's 2010 annual results (the latest results available when I reviewed the company in January 2012) it had a 5-year average Combined Ratio of 94.7%, which means it would have just about passed that test if I had been using it.

So while RSA's profitability was weak, it was not weak enough to make me avoid the company, even with hindsight.

However, when the 2011 results were published in February 2012, shortly after I'd bought RSA, its average Combined Ratio crept up to 95.1%, just fractionally outside my minimum profitability.

When the 2012 results were announced a year later (along with the dividend cut) its average Combined Ratio rose to 95.2%, which is clearly going in the wrong direction.

So the company's profitability was weak at the time of purchase, and getting weaker. It was a definite warning sign that the company lacked a meaningful competitive advantage.

Too much premium, not enough surplus

I now use a range of different metrics for measuring leverage, but for insurance companies an important measure of operating leverage is the Premium to Surplus Ratio. This is the ratio between how much premium a company writes in a given period and how much "surplus" assets the company has over its liabilities.

The idea is that an insurance company has a fiduciary duty to pay out claims and so if push came to shove all of its assets should be sold in order to fund its claim liabilities.

The size of the surplus then dictates, approximately, the maximum amount of new business the company should write, as there is only so much new insurance business a company should take on given its ability to pay existing claims.

I now use the following rule of thumb when reviewing insurance companies:

- **Only invest in an insurance company if its Premium to Surplus Ratio is below 2**

This is an old insurance industry rule of thumb which has stood the test of time as an indication of prudent underwriting activities.

In 2010 RSA wrote premiums of £7,455m and had tangible shareholder equity (tangible assets minus liabilities) of £2,557m, giving the company a Premium to Surplus Ratio of 2.9. This is clearly above my “rule of thumb” maximum of 2.

If I had looked at the Premium to Surplus Ratio in 2012 I would have seen that RSA was taking on lots of new business relative to its asset surplus. Another way of looking at it is to say that RSA's asset surplus was too thin for the amount of business it was writing.

Either way it was not running what could be described as a "conservative" operation:

> *"While the element of risk present in both the underwriting and investment portfolios affects the need for surplus, there is a rule of thumb which sets $2.00 of premiums written for each dollar of surplus as conservative"*
> *Thomas Morrill, President of State Farm Auto Insurance Company, 1970*

After the 2011 results, RSA's Premium to Surplus Ratio increased to 3.3 and in 2012 it increased to 3.7. Clearly RSA’s margin of safety was becoming ever more thin in relation to the amount of insurance it was writing.

This could not go on forever, and at some point premiums written would need to be reduced or capital would have to be raised in order to boost the surplus, or both.

Unfortunately for investors, dividend cuts and rights issues are the primary means for boosting surplus capital and that's exactly what RSA did.

Patience and a random event (a potential takeover) have produced a profitable exit price

I do not like to sell on bad news. I prefer to sell when everybody else is optimistic about the future of a company. In the case of an underperforming company like RSA, that usually means waiting for some hint that the turnaround is going well. RSA had yet to reach that point which is why it was still in the portfolio even though for a long time it had been one of the least attractive holdings.

However, Zurich Insurance is apparently now interested in buying RSA for something

in the region of 550p per share, if rumours are to be believed. This boosted the share price to 525p on Wednesday, which is higher than it had been since 2013. For me this means optimism for RSA has returned and any operational improvements from the turnaround are already largely included in that price.

After this recent price increase RSA had by far the lowest rank on the UKVI Stock Screen of any holding.

It is not a company I particularly want to keep in the portfolio and so I have taken this opportune moment to offload RSA at a point where the investment's total annualised returns are a somewhat weak but not horrendous 5.8% per year over 3 years and 6 months.

Conclusion

RSA has not been the most profitable of investments, but it has been profitable in terms of lessons learned. Thanks to RSA I expect to only invest in much better insurance companies in future.

> *"The markets are a classroom where lessons are taught everyday. The keys to investment success lie in observing and learning"*
> *Howard Marks, Chairman of Oaktree Capital*

Selling Cranswick plc for a 135% return in 3 years

7th October 2015

Cranswick plc was added to the UK Value Investor Model Portfolio back in November 2012. Over the last three years it has been a far more successful investment than I ever could have expected.

Here are the results in full:

Purchase price 769.1p on 06/11/12	Sale price 1,712.7p on 06/10/15	Holding period 2 Year 11 month
Capital gain 122.7%	**Total Dividends** 12.5%	**Annualised return** 35.3% per year

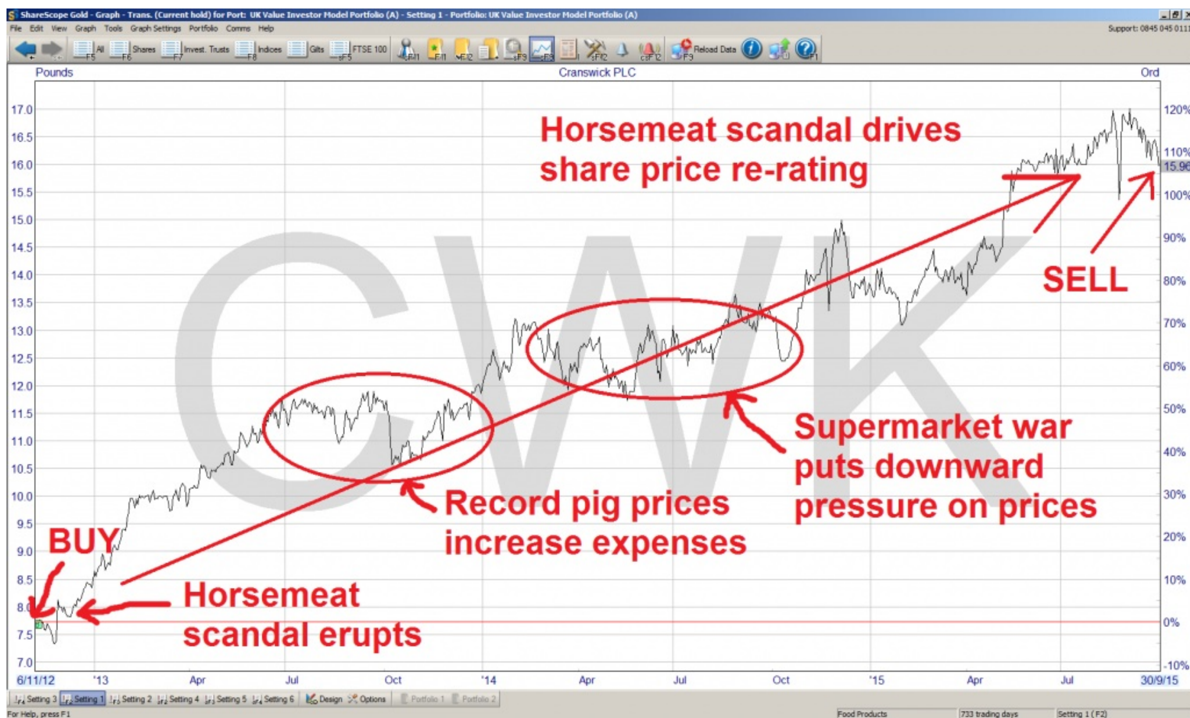
But before I congratulate myself too much, I must admit that - as is usual in these situations - the return of more than 35% a year has come from a mixture of sensible decisions and luck.

The sensible decisions were twofold:

1) Buying an above average business. When Cranswick was added to the portfolio in 2012 its dividend had increased every year since 1990 and the company had produced steady growth at more than 11% a year.

2) Buying at a below average price. Despite its high and steady record of growth, Cranswick's shares were available with a dividend yield of 3.8%, slightly above the FTSE 100's yield at the time.

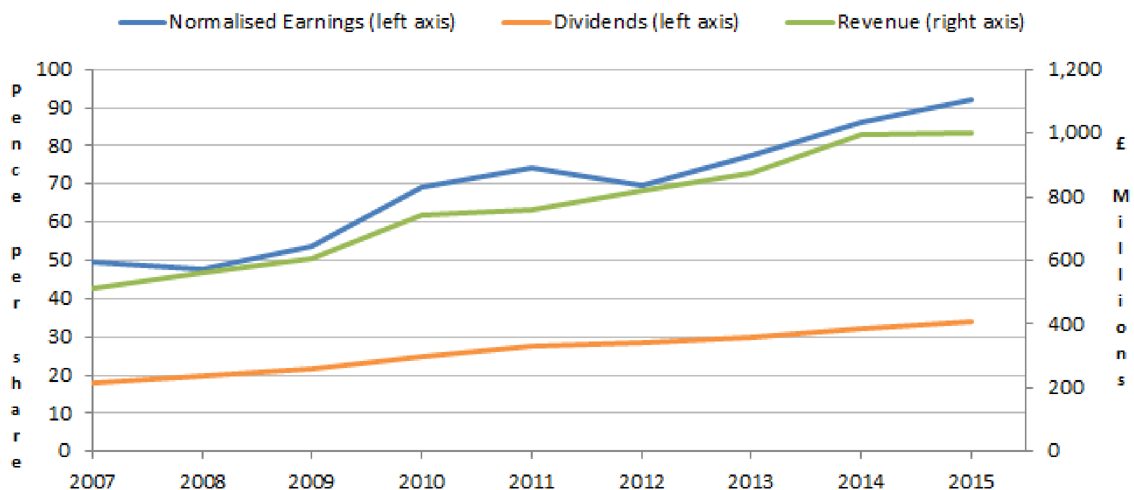
The element of luck came in the form of the 2013 horsemeat scandal.



Buying a successful, growing, relatively defensive business at an attractive price

Cranswick is exactly the sort of business I like to see in the model portfolio. It has a highly successful track record, it's the market leader in many areas and it operates in a relatively defensive sector so its less impacted by the ups and downs of the economy.

It has achieved all of this mostly by supplying commodity protein foods such as own label sausages to the major supermarkets more effectively than its competitors.



At the time of purchase in November 2012, Cranswick had the following stats:

- **10-Year Growth Rate** = 11.5% (FTSE 100 = 3.1%)
- **10-Year Growth Quality** = 95% (FTSE 100 = 82%)
- **10-Year Profitability** = 12% (FTSE 100 = 10%)

In terms of its financial track record Cranswick was clearly above average (see these worksheets and spreadsheets if you want to understand where those figures came from).

It had grown faster, more consistently and with higher profitability than the "average" company, as represented by the FTSE 100.

At the same time, because of fears about pig prices (a key input cost for Cranswick) the shares were trading at a low level:

- **Dividend yield** = 3.8% (FTSE 100 = 3.5%)
- **PE ratio** = 10.8 (FTSE 100 = 11.5)
- **PE10 ratio** (price to 10-year average earnings) = 13.9 (FTSE 100 = 13.7)

Although those valuation multiples are relatively close to the market average, they are low for a company with such a good track record as Cranswick. Typically you should expect to see above average companies trading on above average multiples and with below average yields.

However, those short-term fears about pig prices and their impact on the company were keeping investors away and depressing the share price.

This created an opportunity for long-term investors who were willing to tune out the market's short-term fears, so in early November 2012 I added 240 of Cranswick's shares to the model portfolio at 769.1p each, which gave it a position size of about 3.5% of the portfolio.

Holding on while a scandal leads to easy gains

In January 2013, newspapers led with stories about horse meat in burgers and other "beef" products. The scandal highlighted the sometimes long and complex supply chain through which meat for human consumption moves.

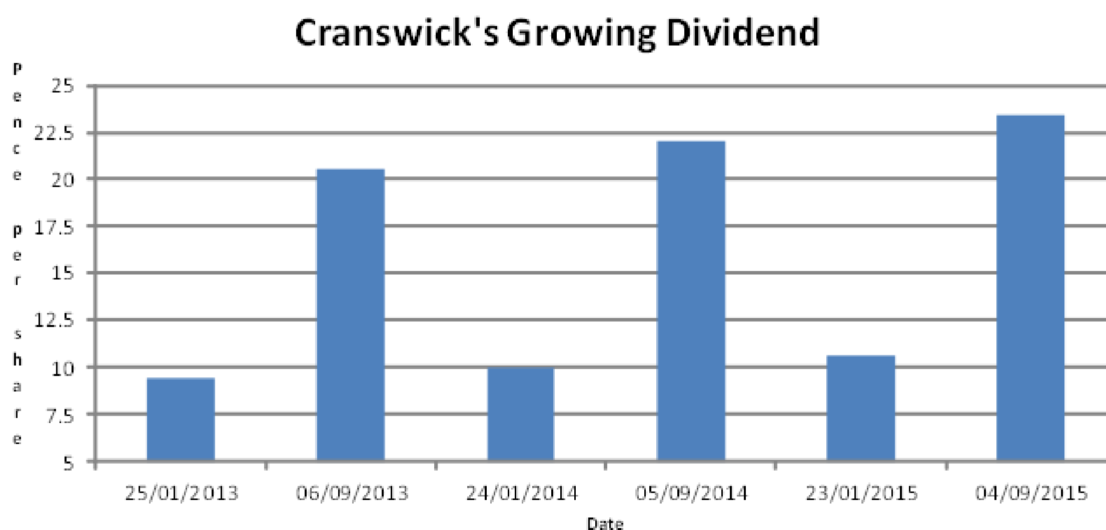
Investors assumed - correctly - that the public would shift to buying more British sourced meat products. As a result Cranswick - which gets the majority of its meat from British sources and now breeds a significant number of pigs itself - saw its share price rise by 50% over the following few months.

That share price increase was to some extent justified by the 2013 annual results in May 2013, which saw revenues, earnings and dividends increase by 5% or more.

In fact **the company continued to increase its dividend at every interim and annual result throughout its time in the portfolio**. Although each increase was only 5% or so, over a few years that starts to add up.

In calendar 2012 Cranswick paid out dividends of 28.5p. After its shares were added to the portfolio they paid out dividends of 30p in 2013, 32p in 2014 and 34p in 2015.

That's an almost 20% dividend increase in three years which - along with a healthy boost to income - provides a tangible reason for the share price to increase.



It wasn't all sunshine and rainbows though, and during the second half of 2013 the share price stagnated. This was - at least to some extent - down to resurgent fears about pig prices.

Although there are legitimate reasons to worry about pig prices if pigs are one of your main inputs, Cranswick was able to largely pass these cost increases onto its customers, or reduce their impact through improved production efficiencies.

Further problems appeared through most of 2014 as war broke out between the major supermarkets (Asda, Tesco, Sainsbury, Morrison) and the German discounters (Aldi and Lidl).

Investors were concerned that squeezed supermarkets would put pressure on suppliers to lower prices, which would of course hurt suppliers like Cranswick.

But once again Cranswick was able to raise its dividend through this difficult period.

However, profits did fall slightly, which resulted in the share price going essentially nowhere for the whole of 2014.

Selling after rapid share price gains lead to an unattractive valuation

As is so often the case, the problems of 2014 did not last forever. During the second half of 2014 the oil price collapsed, hurting several of the model portfolio's oil-related holdings. However, this was a major plus for Cranswick as oil is mostly an input cost for agriculture and food production businesses.

Subsequently, in its 2015 annual results Cranswick announced record revenues and a 10% increase in adjusted pre-tax profits, along with a 9% decline in pig prices.

This more positive mood and continued good performance from the company pushed the share price up to the 1,700p level, producing a capital gain for this investment of over 120% in three years.

This is, of course, a fantastic result, so why have I decided to sell Cranswick now?

It certainly isn't because the company is no longer attractive. I still think Cranswick is a great company and has, probably, a bright future ahead. However, now that the shares have more than doubled in such a short period of time the valuation and the dividend yield are no longer attractive.

The dividend yield today is around 2%, while the yield on offer from a FTSE 100 tracker is over 4%. Similarly, Cranswick's PE and PE10 ratios are 20 and 24 respectively, while the FTSE 100 manages 16.8 and 13.

Having said that, Cranswick's valuation is not horrendously bad; in fact I don't even think it's overvalued as its stock screen rank of 107 is still above average. But a rank of 107 out of 237 companies is not particularly impressive, and neither is a 2% dividend yield.

While Cranswick has been a great company to invest in, and one in which I would be happy to invest again, at its current price I think the best thing for the model portfolio is to sell now and reinvest the proceeds into another good company, but one with lower valuations and a higher yield.

So that's exactly what I'm going to do. I've sold the Cranswick shares and will reinvest the proceeds next month into a new holding.

Model portfolio beating the market by 14% year to date

14th October 2015

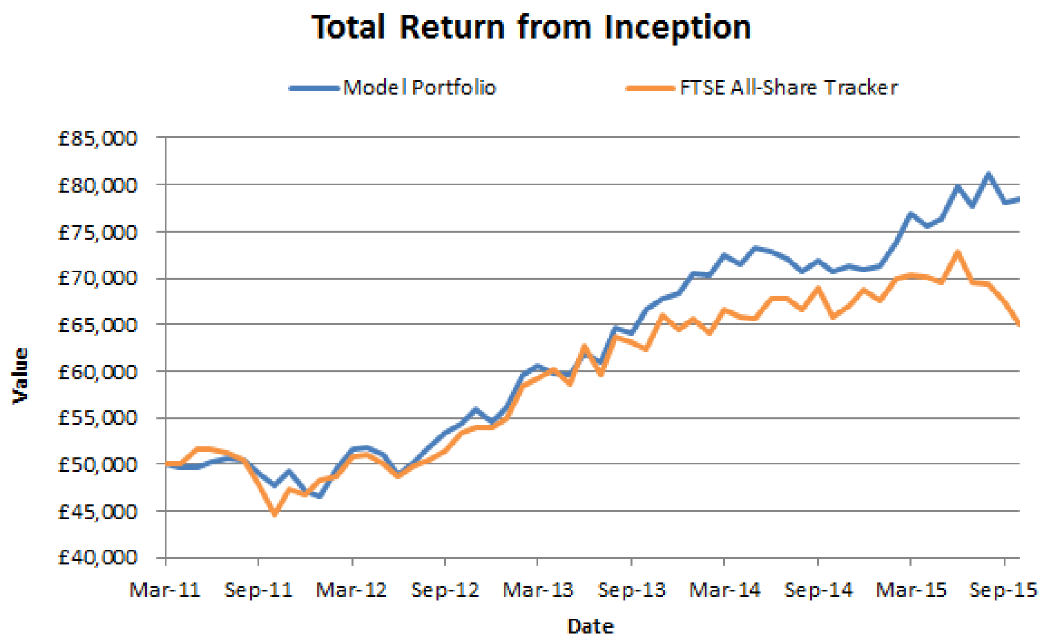
My defensive value model portfolio is ahead of the market by just under 14% so far this year. The reasons are 1) a sensible strategy and 2) some luck.

To be honest, the FTSE 100 and FTSE All-Share are not providing much in the way of competition at the moment because both of them have fallen in value this year.

However, I can't be blamed for that; all I can do is focus on the model portfolio's goals which are:

- **High yield** - A higher dividend yield than the FTSE All-Share at all times
- **High growth** - Higher total return that the FTSE All-Share over any 5-year period
- **Low risk** - Lower risk than the FTSE All-Share over any 5-year period

The chart below shows the performance from inception of the model portfolio and its FTSE All-Share benchmark, the Aberdeen UK Tracker Trust.



Both the model portfolio and the All-Share tracker are virtual portfolios which started with £50,000 in March 2011. They both reinvest all dividends and take account of broker fees and bid/ask spreads.

I have basically all of my family's long-term savings invested in the same stocks as the model portfolio.

Ahead on a total return basis

Clearly, the All-Share portfolio has not done well lately. At the start of October it was down 3.7% relative to its value in January. In contrast, the model portfolio gained 10% in the same period, producing a relative outperformance of 13.7% year to date.

The gap between the two portfolios is now £13,370, which is 27% of their original value.

In annualised terms the All-Share portfolio has generated a return of 5.9% per year (including dividends) while the model portfolio has returned 10.3%.

One of my goals for the model portfolio is to beat the market's total return by 3% per year, and that goal is still firmly on track.

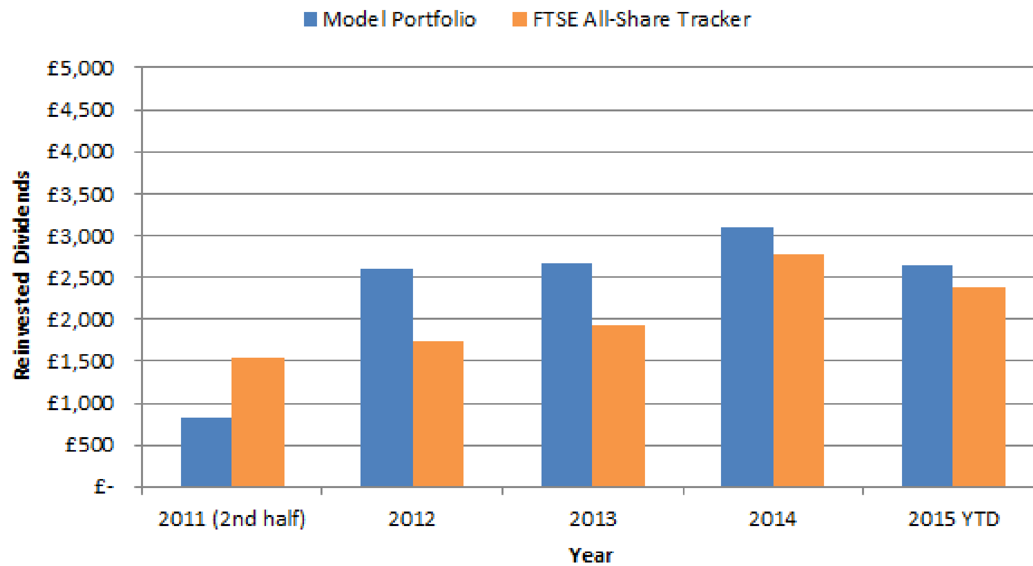
Ahead on dividend yield and (probably) dividend growth

Another of the model portfolio's goals is to have a high dividend yield at all times. This goal has always been met since 2011 and the portfolio's current yield is 4.2%, which compares well with the All-Share tracker's yield of 3.7%.

Dividend growth has also been relatively good too.

The All-Share tracker has paid out the full 2015 dividend already (of £2,384), while the model portfolio's cumulative dividend is ahead so far (at £2,650) and still has three months of dividends to go.

I fully expect its total dividend to far surpass the All-Share's by the end of 2015.



Success with Cranswick ends a bad run

In terms of individual investments, 2015 has been a bit of an up and down year.

Although I realise a sensible investor must expect some individual investments to perform badly, I was somewhat peeved after a string of underperforming holdings during the first half of the year.

As you may know I sell one holding every other month and replace it the following month. The idea is to repeatedly replace the "weakest" holding in the portfolio with a stock that has a better combination of defensiveness and/or value.

Following that approach I sold ICAP in February for an annualised return of 15% which, while not spectacular, was more than satisfactory. But after that things took a turn for the worse.

In April I sold Balfour Beatty – after three years of profit warnings – for an annualised return of 2.6%, which is obviously below par.

After that came the sale of Serco in June, which was my worst investment to date and returned a loss of 50%.

Next up was August and the sale of RSA, which returned a just-about-acceptable 6% per year. Even that result was largely down to luck and a well-timed exit during a brief share price peak, thanks to the now withdrawn Zurich takeover bid.

However, such doom and gloom ended with October's sale of Cranswick, which you

may have read about last week. It produced a record result for the model portfolio, returning 135% in just under three years, for an annual return of 35.3%.

And so it continues to be true that some you win, and some you lose. The lesson here is that it is a portfolio's overall result that matters and not the performance of any one investment.

A couple of winners drive performance

In addition to Cranswick, there have been a couple of really stand-out holdings this year whose performance has been, quite frankly, bordering on the ridiculous.

The first outstanding performer is JD Sport, which is up by about 90% from the start of the year. The second is Telecom Plus (trading as The Utility Warehouse), which is up by about 50% from where I bought it in May.

After these impressive results the share prices of both companies have reached levels that I would no longer consider attractive. In fact, I am more likely to trim their positions back a bit if their share prices keep going up as they have done recently.

Wide diversification helps reduce risk

The model portfolio is a defensive value portfolio, so risk reduction is as important to me as performance. My main weapon in the war on risk is diversification, diversification and yet more diversification.

I mention diversification three times not just for effect (although it's partly that) but also because there are three dimensions to the portfolio's diversification strategy:

- **Company diversification** – The portfolio holds 30 companies, with no more than 6% in any one holding. This protects it from problems in any one company.
- **Industry diversification** – The portfolio holds no more than three companies in any one FTSE Sector. This protects it from problems in any one industry.
- **Geographic diversification** – The portfolio generates no more than 50% of its revenues from the UK. This helps to protect it against problems in the UK economy.

One additional line of defence against risk is the portfolio's focus on defensive sectors. My rule of thumb (which it currently meets) is that the portfolio should always be at least 50% invested in defensive sectors.

This focus on defensive sectors helps me to reduce the impact of economic and industry cycles on the portfolio's capital value and dividend output.

Expectations for the future

Currently the FTSE 100 (and therefore the FTSE All-Share) is attractively valued, relative to both its own historic norms and the current valuations of international indices such as the S&P 500.

The fact that the FTSE 100 has recently had a dividend yield of over 4% is a clear indication of this, although the CAPE ratio is my preferred measure of value.

With these low valuations I think above average returns are likely from here on out, which means more than 7% a year or thereabouts. Of course that expectation is a long-term expectation, measured over the next five or ten years rather than the next five or ten months.

The model portfolio's goal over that period will be the same as it always is: To beat whatever income and growth the market produces, with less risk.

JD Sports returns 33% annualised for almost 5 years

4th December 2015

JD Sports was the third holding to join my defensive value model portfolio way back in March 2011. Little did I know then that this small-cap retailer of trainers and all things "sports fashion" would turn out to be by far the best investment over the following five years.

The table below shows a summary of just how exceptional its returns have been:

Purchase price (adjusted)	Sale price	Holding period
228.3p on 16/03/11	1,002.2p on 03/12/15	4 Year 9 month
Capital gain	**Total dividends**	**Annualised return**
221.4%	12.1%	32.7% per year

Things were not always so rosy though. The company went through a difficult period between 2002 and 2005 following a major acquisition where it purchased 209 First Sports stores for £53m. This was at a time when JD sports had just 166 stores of its own and profits of around £10m.

It was a debt-fuelled acquisition and, as if often the case, the combination of large interest payments and distracting acquisition integration efforts proved to be more difficult to cope with than was expected.

However, by the time I added the company to the model portfolio in 2011 it had successfully integrated those stores and paid down its debts.

The investment got off to a slow start in 2011 and 2012 - due to a weak UK economy and losses from another acquisition - but rapid growth eventually returned and the share price increased dramatically.

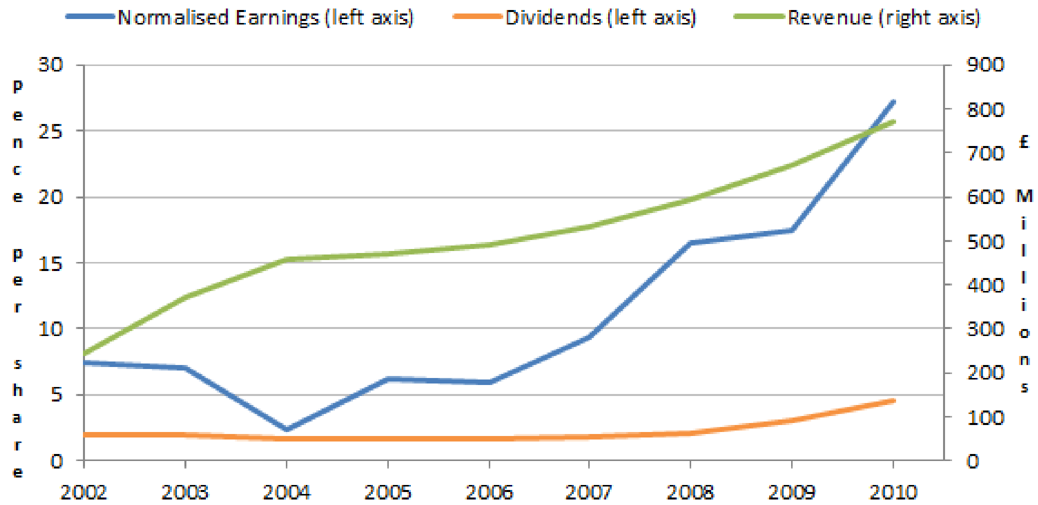
As a consequence of those gains the valuation is now a little too high for my liking.

Buying: A successful retailer in an uncertain retail environment

JD Sports' results in the years before 2011 were a mixed bag. During the first half of the 2000s the company's profits and dividends had stagnated and declined.

The principle cause of this was the very large acquisition of First Sports and its 209 stores. This ambitious growth project turned out to be more difficult to pull off than expected and the new executive Chairman lasted less than a year before heading for the exit.

But as the chart below shows (or at least hints at), the new stores were eventually integrated and brought up to standard, the debts were paid down and profitability and profits took off.



The company's key stats at the time of purchase are shown in the table below (using my current stock ranking methodology, which differs slightly from that used in 2011):

16 Mar '11	Growth	Quality	Profitability	PE	Yield	PE10	PD10
JD Sports	14.9%	79.2%	22.0%	8.4	2.0%	20.6	100.9
FTSE 100 (at 5,965)	6.1%	68.8%	10%	12.3	3.0%	15.2	34.5

As the subtle green highlighting hopefully shows (indicating the "winner" for each column), JD Sports was a high growth company trading at a reasonable price, rather than a slow growth company at a bargain basement price.

The PD10 ratio (price to 10-year average dividend) is highlighted in red because it was far above my rule of thumb maximum of 60 for that ratio. However, I didn't use that rule of thumb in 2011 and even if I did I may have invested anyway (it's a rule of thumb, not a hard rule).

Why? Because the reason for JD's high PD10 ratio was its policy of retaining the vast majority of its earnings for investment in future growth (in other words it didn't pay out much of a dividend), which is an entirely acceptable policy for the small-cap high growth company it was in 2011.

Another factor of note which came up during my initial analysis was the company's acquisition history. JD has a history of making small acquisitions in most years interspersed with the occasional large one (which I define as costing more than than a single year's profit).

As well as the £53m spent on 209 First Sports stores (priced at around 500% of JD's profits at the time) it also purchased around 180 AllSports stores in 2005, hoovering them up from administration for £15m (about 130% of JD's profits at the time).

The company was clearly more than willing to take on large acquisition projects and their associated risks in order to boost growth. I'm not a big fan of big acquisitions, but even so, I felt that JD Sports was a quality retailer at a reasonable price and so I added the company to the model portfolio.

Holding: A slow start leads to an explosive finish

The holding period for JD Sports can be broken down in to two clear halves. The first half runs from the purchase date in March 2011 up until the Q1 interim management statement in June 2013. The second half runs from that date up until today.

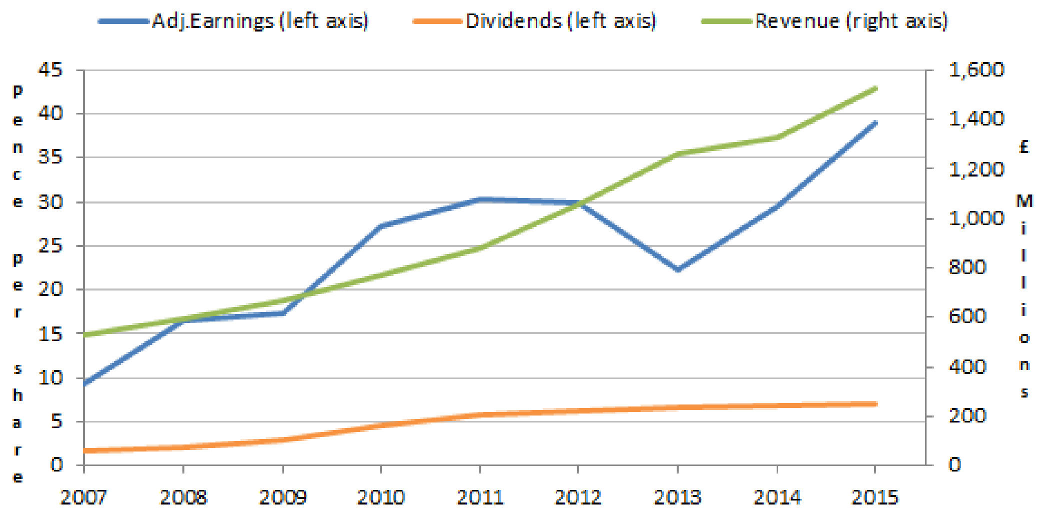
Throughout that first period, which lasted more than two years, JD Sports did not look like a dazzlingly successful investment. The 2011 annual results announced that *"the Board is extremely cautious in its outlook"* due to the difficult UK economy at the time.

The market was also not pleased with another relatively downbeat Q3 statement later that year. By the end of 2011 the shares were down almost 40% from the purchase price.

2012 was not much better.

The year began with the £20m acquisition of Blacks Leisure (Blacks and Milletts) which was expected to produce short-term losses as the struggling company was turned around and integrated. It did not disappoint. Results were also held back as the company's new distribution centre was brought online.

Negativity peaked in April 2013 after the annual results reported losses of £15m on the recently acquired Blacks business (you can see the slump in 2013 group profits in the chart below). At that point the share price was still showing a loss after two very forgettable years.



But shortly after that, things started to change. At the August 2013 half year results profits increased massively from the previous (admittedly weak) year, up by more than 100%.

This reflected an improved economic environment in the UK, but also that JD's core sports fashion business had been progressing all through 2011 and 2012, even though various short-term factors had conspired to hide that fact.

Through the rest of 2013 those negative factors (including the Blacks acquisition, the weak economy and new distribution facilities) faded and JD's true potential soon became clear, with the November 2013 Q3 announcement forecasting "earnings at least in line with current expectations".

The 2014 annual results (published in April 2014) were also positive and the share price increased rapidly up to a 100% gain on the purchase price. Later in 2014 I sold close to half of the investment in order to take profits and lower risk by reducing its position size from 6% to 4% of the portfolio.

However, it wasn't long before I had to do that again as the share price literally took off after the 2015 annual results. The company's profits had broken through the £100m barrier for the first time, revenues had gone past £1.5bn and the share price went from 500p to almost 1,000p in just a few months.

Selling: The current valuation is only justified if earnings growth is sustained

Over the investment period JD Sports has produced a very credible set of results. Its

revenues have increased by 100%, its earnings have increased by more than 40% and its dividend has increased by more than 50%. That is very impressive indeed.

I also think it's likely that the company will continue to produce good results. It seems to be a very high quality outfit; very efficient and with deep knowledge about how to run a highly profitable sports and fashion retail business. I admire what they have achieved and I think it's a great company.

However, the share price has increased by a massive 340% in less than five years and so the question now is:

After such a rapid increase in share price, is the investment still attractively valued?

One the one hand I can argue the case that it is, even though its valuation ratios are now a little stretched.

On the valuation side it has:

- PE of 25,
- Dividend yield of just 0.7%,
- PE10 ratio of 39 (my preferred maximum is 30) and
- PD10 ratio of 198 (my preferred maximum is 60)

All of which are much worse than the market average, but on the fundamental side it also has:

- Growth rate of 16.4%,
- Growth quality score of 88% and
- Profitability of 24%

All of which are much better than the market average. So JD's high valuation is justified, to some extent at least, by its rapid, consistent, highly profitable growth.

That's why, even at its current price of 1,002p, it still has a fairly good stock screen rank of 88 out of the 235 dividend paying stocks that I track.

It is also not the lowest ranked holding in the model portfolio and so on that basis is not the obvious choice to sell (I usually aim to sell the lowest ranked holding every other month and then replace it with a more attractive stock the following month).

There is a problem with that argument though, at least it's a problem for me as a value investor.

To justify those high valuation ratios you have to assume that the company can continue to grow at strong double digit rates for the foreseeable future. That may well turn out to be the case, but I am not a growth investor and I cannot rely so heavily upon rapid future growth to justify an investment's current price.

I am intrinsically and professionally a contrarian and so when things are going well, I expect them to go badly, and vice versa. This is precisely why I bought JD Sports at a time when it's future success was far from certain and when it was struggling in a difficult economic environment.

Now that its future appears to be paved with gold I cannot help but expect the company to trip up at some point. And such a trip could have catastrophic consequences for an elevated share price.

So even though JD was not the lowest ranked stock in the model portfolio (there were three other holdings that faired worse on the stock screen) I have decided to sell it now and lock in those impressive gains once and for all.

As usual I will reinvest the proceeds into a new holding in January 2016, although I doubt that JD's replacement will produce anything like the same results.

The UKVI model portfolio returns 14.3% in 2015

30th December 2015

With 2015 almost in the bag this is a good time to sit back and review your investment performance for the year.

For me there are a few things I'm most interested in checking: 1) Total returns, 2) dividend yield and 3) what I learned this year that may help improve my approach and returns in the future.

But first, a little background info:

- I run a virtual model portfolio which is identical to my personal portfolio in terms of holdings
- I manage it according to a defensive value investing strategy which I have been developing since 2010
- The portfolio and its benchmark (the Aberdeen UK Tracker Trust) started in March 2011 as virtual portfolios valued at £50,000 pound each
- Buy or sell trades include the bid/ask spread, 0.5% stamp duty and £10 broker commission
- All dividends and other cash returns are reinvested

14.3% total return in 2015 versus 0.8% for the FTSE All-Share

The model portfolio went from £71,358 at the start of the 2015 to £81,551 at the end, for a total return of 14.3%. This is significantly better than the All-Share tracker benchmark, which went from £67,498 to £68,050, a total return of 0.8%.

Outperforming the market by 13.5% is the portfolio's best one-year result relative to the market so far, so I am of course very pleased with that. It beats the previous record, where it outperformed the market by 6.5% in 2012, by a country mile.

However, **although I am pleased to have thoroughly beaten the market in 2015 I am well aware that this degree of outperformance is very unlikely to continue.**

More realistically, I would like to beat the market by at least 3% annualised over the long-term, so let's have a look at how the long-term returns are going.

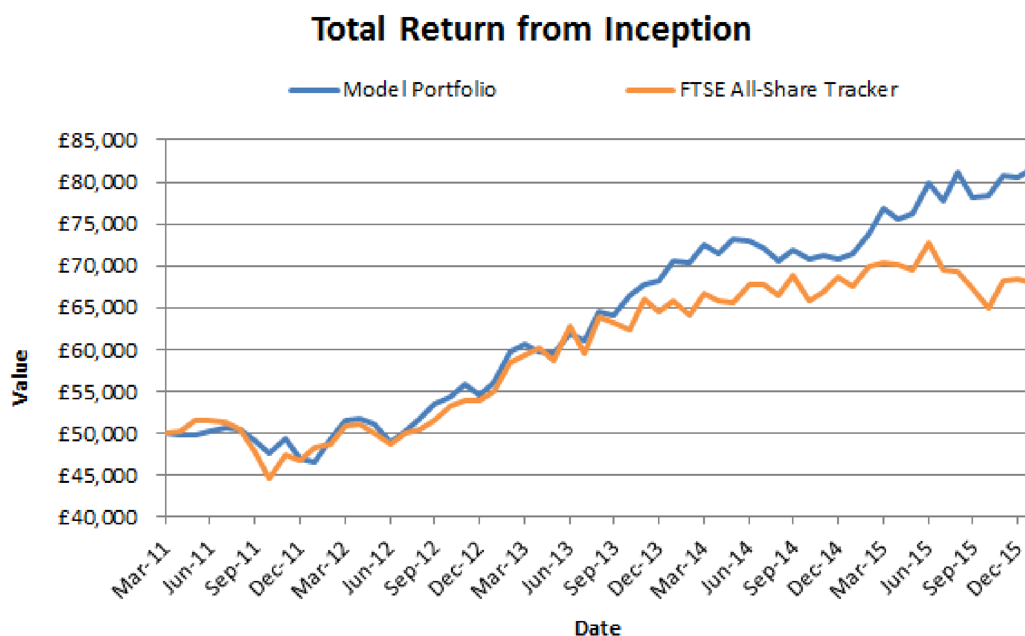
10.7% annualised return since 2011 versus 6.6% annualised return for the FTSE All-Share

Since I started managing and tracking these portfolios in early 2011, the model portfolio has, at least most of the time, achieved my goal of beating the market by 3% over the long-term.

With a 10.7% annualised return compared to 6.6% for the UK market, the rate of outperformance has been 4.1%. I'm happy with that, although of course I realise that the past is not always a good guide to the future!

Having said that, as the years roll by I am gradually becoming more confident that my strategy and the defensive value approach in general are likely to outperform the market under most circumstances.

Here's a chart of the returns to date.



Past performance is not a guide to future performance

And here's a table with the total return results for the model portfolio and its FTSE All-Share tracker benchmark for each individual year:

Year	Model Portfolio	All-Share Tracker	Difference
2011	-6.9%	-3.4%	-3.5%
2012	20.4%	13.9%	6.5%
2013	25.8%	19.5%	6.3%
2014	1.2%	2.7%	-1.5%
2015	14.3%	0.8%	13.5%
Annualised	10.7%	6.6%	4.1%

That's the total return picture, but I am just as interested in dividend growth and the dividend yield as I am in capital gains, so let's have a look at those.

Dividend yield of 4% versus 3.5% for the FTSE All-Share

One of my goals is to have the model portfolio produce a higher yield than the FTSE All-Share at all times. So far it has achieved this every day since 2011, and it currently has a 4% yield compared to 3.5% for the All-Share.

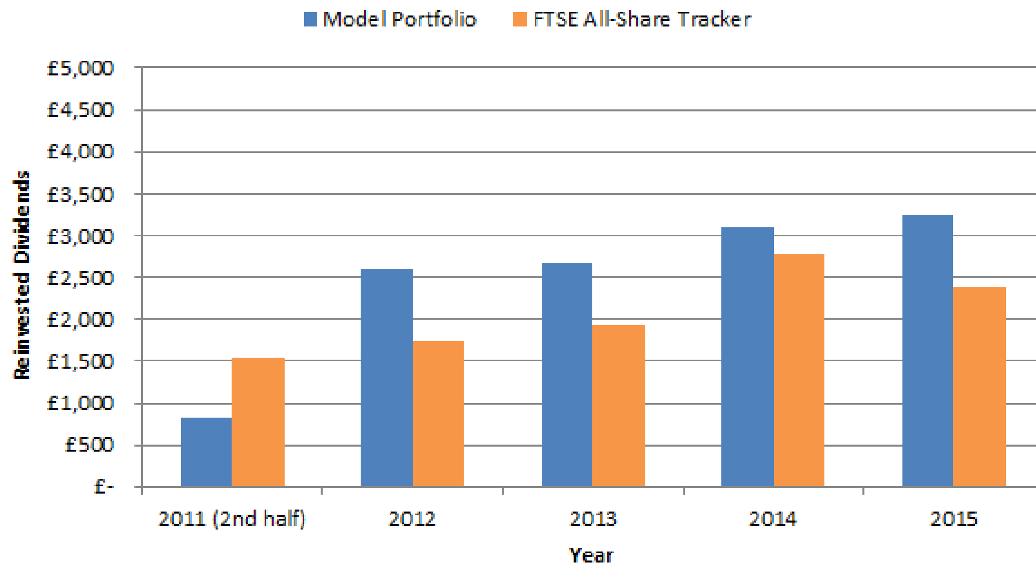
To be considered as an equity income fund, a unit trust must have a yield of 110% of the All-Share's yield, or 3.85% today, so the portfolio makes the grade on that basis too.

Dividend return of £3,243 versus £2,384 from the All-Share Tracker

Given that the model portfolio is worth more than the FTSE All-Share and that it has a higher yield as well, it should be no surprise that it has produced far more in dividends this year; 36% more to be precise.

This comparison is somewhat confused by changes to the dividend payment dates of the benchmark investment trust, but I think the comparison is broadly representative of the underlying (rather than market) value of the two portfolio's holdings.

The chart below shows the dividends paid in each individual year.



In terms of raw performance then, I am more than happy with 2015. However, it wasn't all plain sailing and there were some problems through the year that needed to be addressed and learned from.

2015's winners, losers and lessons learned

No portfolio goes up in a straight line (unless your name is Bernie Madoff) and few equity investors will get through a year without suffering share price declines or operational problems with some of their holdings, and I am no different.

2015 was the first year in which I sold an investment at a loss since I switched from deep value to defensive value back at the beginning of 2011. It was not a pleasant experience, but so far it has not been a frequent one either.

Overall I would say I have enjoyed investing in 2015, despite a bit of a rough patch in the middle of the year thanks to weak performances from Serco, Balfour Beatty and RSA.

Hopefully your results have been even better than mine, but either way let's hope for a positive 2016 in both the stock market and beyond.

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