

# GET IN SHAPE



Fight the flab in  
your portfolio with  
**Robert Merrifield's** guide  
to spotting the signs  
telling you it could be time  
to sell a particular share

**R**unning your winners and cutting your losers has always been good advice – but as any seasoned investor knows it is not quite as easy as it sounds. Winners often turn into losers, and when they do their fall from grace can be anything from a long gradual descent to a devastating collapse in the share price. Today we are going to look at what is perhaps the most neglected part of the investment process, selling, and focus on ideas to help improve our profitability.

I say neglected because collectively we spend most of our time looking for new investment opportunities or reviewing information that confirms our positive view on the stocks we already hold, something behavioural experts call ‘confirmation bias’. We spend little time critically re-evaluating our investment case and as time progresses and profits rise we are likely to do so even less. Such complacency is dangerous. To maximise our profits we need to remember that our view is just one of many and it is what other investors collectively think of the stock that will drive the price and not what we think.

### Profit warnings

There has been a steady stream of profit warnings over the past two years and if you are invested directly in shares it is likely that you have been involved in one or more. While many today are associated with the consumer slowdown, they occur for all sorts of reasons and remind us that the underlying performance of a business is actually driven by the daily efforts of its staff and management and their interaction with their customers and suppliers. They also remind us that there are many moving parts over which management has little or no control.

After a profit warning the corporate PR machine pumps out reassurance that the situation is under control. But in everything we do we find that problems normally take far longer to resolve than we first hoped and that small bill usually increases in size, so why should managing a company be so very different? Early optimism is a high-risk strategy. A safer way to look at the first profit warning is that it puts everybody on notice that business is not going to plan and that it will set off a spiral of events that is unavoidable. Management focus will be taken off growth and building the business, sales will be lost as customers take their business elsewhere, suppliers will tighten their credit terms, staff will be distracted, reducing productivity, cash flow will deteriorate, investments will be cancelled, debt service will become an issue and competitors will seek to take advantage of the situation. Further warnings are highly likely until the situation stabilises, often with a refinancing, disposals and new management.

Falls of 50 per cent or so are common as this process works itself out, even in blue-chip companies. With short sellers and momentum traders pushing the share price lower and the earnings expectation lifecycle (see box on page 23) suggesting there are no natural buyers until the shares become very cheap and offer a high margin of safety, why rush to invest?

All too often the first warning is still a selling opportunity. It pays to remember the old adage that ‘profit warnings come in threes’.

So can we get ahead of the curve and avoid them? Not entirely, but more often than you might think.

### The three pillars

To keep things simple and because we each have our own investment process, we can think of share prices as supported by three pillars: story, valuation and technical. Each pillar covers a wide spectrum, but essentially if you have a good story, and the valuation and technical factors are supportive then the odds are weighted in your favour whether you are selling or buying. If one is weak you are taking excess risk, but if one is negative the odds are probably against you and it is time for a rethink.

Confirmation bias makes it harder for us to tell when our favourite story is fading. And our job is further complicated by a corporate PR machine that understands all too well how to put a positive gloss on a poor story, by the sheer volume of news thrown at us daily and because we are all time constrained. Add an accounting industry well-versed in how to make even the dullest numbers shine and it is really easy to see how as individuals we can get caught out. To improve our selling skills we need to spend less time feeling warm and cosy about our winners and more time looking for signs that could warn us when our investment case is beginning to fail. Because we are so slow to recognise the changing story and because valuations can be stretched for long periods we often see the first warning signs in our technical pillar.

### Technical pillar

For our purposes this pillar largely consists of simple chart analysis, director dealings, major shareholdings, stock overhangs and other technical or anecdotal indicators we can use to assess what is going on, for example business climate surveys. But we need to be aware that it is also home to the growing number of quant and other investors who use technology to power their decisions. This is only going to grow.

As we’re looking back to see what we missed that might have helped us avoid losses, charts can be very helpful. Armed with nothing more than a ruler, we can easily pinpoint when news or other events had a significant impact on the share price. We can also see when trends were broken as the balance of buyers and sellers changed and how some patterns occur repeatedly – although these are often only obvious late in the day.

Trend changes are important because price momentum is a key investment factor. Research Affiliates, the firm behind the US boom in factor investing, identifies it as one of the few factors that empirically displays robust equity returns: if a share is rising, the chances are it will keep rising. As we would expect, most of the effect is actually explained by earnings momentum. But research also shows that investors are usually slow to react to an unexpected uptick or downtick in earnings, waiting for the next earnings release to confirm the prior report ►

‘To maximise our profits we need to remember that our view is just one of many and it is what other investors collectively think of the stock that will drive the price’

## FEATURE

► before registering the importance of the change in trend. We often see this lag when we look back at companies that later fell sharply on profit warnings. When we look back we often see other warning flags we should have paid more attention to. One of the best known is director dealing.

In theory nobody is better placed to know how a company is doing than its directors. So director dealings can provide a useful warning and keeping an eye on it should be a normal part of the investment process. But not all deals are equal, so we need to be careful. We know that the chief financial officer and chief executive are best placed to forecast what is going on, so their dealing carries more weight. But a modern service contract may require a new appointee to invest a minimum amount in stock within a set period of joining. Similarly, directors may be expected to hold on to shares that result from the bonus, savings and option schemes they take part in. It would be wrong to be overenthusiastic about the timing of these purchases.

Directors' sales are much more useful. Sales send a negative message to the market, so directors tend to accumulate stock and run those positions only while they can see further gains make it worth it. Again, we need to be careful. Directors also defect to rivals and retire, which leaves them free to sell, but this time under the radar. Remember also that typically a defector will be compensated for loss of options etc by their new employer, while as good leavers retirees can exercise their rights in option and other share-based incentive schemes. Quite apart from the loss of business connections and expertise, these 'disposals' should also raise a warning flag.

### EXAMPLE 1: NEXT

We can illustrate the sort of lessons we can learn looking at the past with **Next (NXT)**, chosen for no other reason than we all know what it does and that it fell from grace suddenly. In 2015 Next consisted largely of a mature UK retail business and Directory, the UK internet business where higher growth appeared to be slowing. A quick look at the 10-year numbers on the company website tells us that between January 2008 and January 2015 sales in the retail arm rose just 4.1 per cent to £2.35bn while profits rose by 20 per cent. It looks as though profit growth was driven largely by lower costs. Over the same period, sales in the Directory arm rose by 92.6 per cent to £1.5bn and profits by 130 per cent to £377m, led largely by sales growth, a much more valuable and sustainable source of profit growth than cost-cutting. Underlying earnings per share rose by 172 per cent and the valuation moved higher, the historic price-earnings (PE) ratio rising from 8.1 to 17.0. By January 2015, with earnings growth expected to fall from the mid-teens to below 10 per cent, the shares were very expensive on many measures, including a PEG ratio in excess of 1.7 times. They rose anyway.

A quick look at a five-year line chart shows how what was then a three-year uptrend broke down in mid-December 2015 and provided fans of technical



**Next fell from grace suddenly, while there were three warning flags that marked Provident Financial as at high risk of collapse**



analysis first with a triple-top pattern and shortly afterwards with a dead cross as price, 50-day and 200-day moving averages fell together. By mid-December, well before the 4 January 2016 trading statement confirmed poor trading, the chart was negative rather than supportive, removing one of our pillars. There were other warning signs.

We should have been aware of the departure of three directors with an average of 29 years' service each between May 2014 and April 2015. This was a huge loss of expertise in such a short period and included the finance director and head of product, two crucial team members. While the head of product went to Abercrombie & Fitch, the other two retired, making it hard to argue that they left only because they had seen the writing on the wall. We can't read every paper, but Next's problems were widely debated in the press and well summarised in an April 2015 national newspaper article that also highlighted something that confirmed that these departures were a strong warning flag: a string of senior management defections.

At the very minimum this was a strong warning to override our innate confirmation bias and to spend time fishing around for other warning signs, paying greater attention to the bear case.

Share prices rise when there are more buyers than sellers, so who was buying Next shares? The largest buyer was Next itself, which bought back a staggering 23.9 per cent of its shares between January 2008 and January 2015. This was cash Next chose not to reinvest in the growth of its brand internationally, in its internet business or to use to buy another business as many others would have done. While it was not 'dumb money' because Next set a maximum price annually based on an 8 per cent hurdle rate, the scale of the buybacks also tells us that a large proportion of shareholders were happy to take their cash out along the way. Presumably they expected higher returns elsewhere. Another source of buyers, the rapidly



growing but valuation insensitive tracker industry will also have helped limit the impact of those sellers, while income buyers attracted to the occasional special dividend may not have looked quite as closely at the underlying business as they should have. With plenty of buyers, the remaining investors and analysts seem to have been lulled into a false sense of security and were less alert to the risk to the share price as the valuation became stretched.

The buyback program itself provided a timely warning flag, with the January 2015 announcement that Next would pay up to £69.62 for shares in the year to January 2016. A company is usually the most optimistic about its prospects and if, unusually, management is suggesting an upside limit then we should pay attention to it.

### Takeaways

■ Strictly speaking the old adage that profit warnings come in threes was not accurate on this occasion because there was a succession of minor ones over a long period. But with hindsight we can see that we had more than enough warning that we needed to keep a very close eye on Next and to stay clear once the momentum reversed.

■ In simple terms, a company can only grow its profits by selling more units, increasing unit prices or cutting costs. Low inflation limited the scope for Next to raise prices, while the shift out of town, lower corporation tax, better buying and other measures provided an eventually finite source of cost cuts.

To grow, Next needed to generate sales and find new customers, perhaps emulating the international growth of retailers H&M and Inditex, or successful internet retailers. The catch was that both would require very substantial investment and came with no guarantee of success. But while adding complexity to our simple model using financial engineering, buying back so many shares, prolonged the earnings expectation lifecycle it only postponed the underlying problem. Perhaps this is what our leavers understood. Companies that carry out extensive buybacks or rely on cost-cutting to grow profits should sit at a large discount to those where the underlying business is generating the profit and growth in cash flow and earnings per share.

Share buybacks do not return cash to shareholders but to departing shareholders. For shareholders they are effectively a tax-advantaged dividend reinvestment plan, where we end up with a greater share of the company rather than more shares in it. As Next bought back 23.9 per cent of its shares private shareholders' share of those remaining rose by 31.4 per cent (100 per cent of shareholders equity/76.1 per cent shares outstanding). Share buybacks provide a large buyer in the market for institutions to sell to, but the expense of selling small numbers of shares deters private investors from taking part. It is an area we need to look at more closely in future.

## EXAMPLE 2: PROVIDENT FINANCIAL

A brief look at **Provident Financial (PFG)** identifies three warning flags that marked it as at high risk of loss before the August collapse.

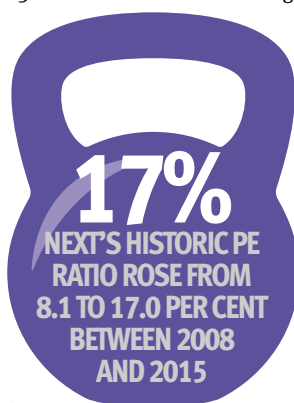
There was a substantial change to the business model. Large changes to a longstanding proven business model should make us pay close attention in the same way that a large acquisition should. Both carry a high risk of failure and in each case we should ignore the corporate PR and look more closely at why management needed to make the change.

Provident Financial had already issued a profit warning on 21 June, which torpedoed earnings and also justified a lower rating. This removed valuation as a support.

And as profit warnings typically come in threes, investors should have anticipated more bad news and price weakness. In fact, many did and the chart was negative despite Neil Woodford and Invesco buying several per cent of the company ahead of the second warning in a move that might otherwise have put a floor under the price. Short-sellers and momentum traders can only have been encouraged by the formation of a dead cross as the price, 50-day and 200-day moving averages all fell. The technical picture was negative.

The severity of the price fall reflected the extent to which the story had changed, further complicated by the enquiry into the company's Vanquis credit card arm. It also illustrates how trust that has been built up over years can be lost in seconds.

### Provident (PFG)



## The earnings expectation lifecycle

Research shows that price momentum is one of the few factors that empirically displays robust equity returns and that this is largely explained by earnings momentum. The earnings expectation lifecycle can be used to illustrate how corporate earnings change over time and how the type of investor holding the shares changes. It tells us that when we are holding a growth stock the skill we need is knowing when to sell.

This is because growth investors tend to be the last in a chain of holders that starts with value and contrarian investors who have bought undervalued, undervalued stocks because they are expecting positive



change. Those changes generate positive earnings surprises and upgrades, so valuation and price rise. Over a period of years the value investors sell out to growth-orientated investors who are willing to pay up for reliable earnings momentum in order to get strong price momentum.

As a growth investor we will pay a high multiple for high earnings momentum,

perhaps using the PEG ratio to justify our buy case. While we are comfortable with this, our problems start when earnings momentum peaks or is torpedoed by an unexpected event. The company now delivers negative earnings surprises and downgrades and these justify a lower multiple. The price falls until a new group of buyers is found, typically contrarian and value investors buying cheap assets that will one day generate higher profits. Both require a high margin of safety and may have to hold the shares for some time before the cycle turns up again. For them, the skill they need is patience; knowing when to buy.