SIMON THOMPSON

Seeking alpha

A shrewd stock-picker has generated eye-watering returns since the millennium, and it's worth finding out how

It's not often that a research note can be described as an essential read, but it's certainly the case when a seasoned investor who has produced an annual capital return of 15 per cent on his equity portfolio over the past 16 years decides to share his observations ('Smart investing and how to generate positive Alpha', observations by Paul Hill, May 2016). That period includes two savage bear markets and two of the longest running bull markets on record, so to generate such an eye-catching return is quite some feat.

Paul Hill is more than just a smart investor; he is a fine equity analyst, too, at equity research firm Equity Development, a company that specialises in small-cap equity research, my own hunting ground. In fact, it was after reading his equity research note on hospital superbug buster **Tristel (TSTL)** a couple of years ago that I recommended buying in to this special situation. By the time I advised exiting the holding earlier this year, the shares had more than doubled in value. It wasn't an isolated example of successful stockpicking either: between March 2000 and April 2016 Mr Hill has purchased 200 stocks, held them for two years on average, and achieved a hit rate of winners to losers of 1.6 times.

Importantly, the average gain on those winners is double the financial hit on the losers, hence the thumping 15 per cent average annual gain on his portfolio. To achieve this return, Mr Hill typically buys what he describes as "under-researched" and "out-of-favour" small- and micro-caps (market value less than £100m) where pricing anomalies tend to be greatest. He also follows some hard and fast rules, which he has outlined in an in-depth 73-page research note that can be viewed for free at *www.equitydevelopment.co.uk/doc/1490.pdf*. I would advise doing just that because it's full of some of the most sensible observations I have come across in the 25 years I have followed equity markets, and ones that I also follow in my own stockpicking.

For instance, Mr Hill readily admits that taking on greater risk doesn't mean greater return and that adopting a purely 'high risk' strategy nearly always ends in disaster, adding that "luck favours the brave, but not the stupid". So to tilt the odds in his favour, he consistently applies value or Garp (growth at a reasonable price) principles to identify quality companies and determine what they are worth; stress tests valuations with regards to different scenarios; buys shares priced well below their intrinsic value (30 per cent-plus discount for small-caps and 10 per cent-plus discount for large-caps), and where he has an 80 per cent-plus certainty of generating a positive return.

He defines this as the "margin of safety", or an insurance policy to limit the downside risk, and ideally the company will have a pristine balance sheet with plenty of cash, too. When he uncovers a company that ticks all the boxes he will weight his investment accordingly in his portfolio.

Moreover, as regular readers of my online updates on past recommendations will be aware, it pays to monitor companies closely, re-evaluate the investment case regularly and not be afraid to modify views as new information emerges. Mr Hill adheres to this disciplined approach and monitors his investment performance in relation to the ratio of winners to losers to determine his 'hit rate'. He has no problem selling holdings, either, when they become too expensive or when the rationale behind the decision to invest no longer holds. He also learns from his mistakes and has dedicated a whole section in his report to this area.

Avoiding costly mistakes

To avoid making costly mistakes, Mr Hill adopts strict financial discipline. For instance, he avoids companies with significant outstanding debt as defined by net borrowings of more than 2.5 times cash profits; avoids companies that have heavy working capital cycles (defined as more than 25 per cent of annual sales) or operate in cut-throat markets; and makes sure there is not too much stock/sector concentration which "can kill a portfolio especially during black swan events".

Sector exposure is a very important issue, so much so that he has compiled a hit list of industries to tread carefully in, including those dogged by overcapacity and 'predatory' pricing – citing steel, solar panels and shipbuilding as prime examples; those suffering from price deflation; environmentally unfriendly sectors (coal mining, chemicals, diesel, solid waste land-fill owners); and where there is a commoditisation risk if China decides to class a market as being "strategically important", as it will inevitably be flooded with new supply. He is also wary of any companies exposed to a backlash against processed foods containing high sugar, fat and salt content, as consumers adopt healthier diets; those selling capital equipment to the public sector, and to the NHS; and cyclical industries coming off the boil, such as commercial property.

Of course, it makes life far easier, and your finances far healthier, if you can weed out companies displaying red flags, too. Mr Hill has a list of 27 tell-tale warnings signs to look out for here, including companies with poor cash conversion rates (operating cash flow less than 75 per cent of operating profit) or where trade working capital exceeds more than 25 per cent of sales; are single customer businesses or one with high counter-party risk; are involved in major litigation; can

Simon Thompson's book **Stock Picking for Profit** *can be purchased online at www.ypdbooks.com, or by telephoning YPD Books on 01904 431 213 and is being sold through no other source. It is priced at £14.99, plus £2.95 postage and packaging. Simon has published an article outlining the content, 'Secrets to successful stockpicking', which can be read on the Investors Chronicle website.*

only grow by acquisition and not organically; have large pension deficits that could drain future cash flows or act as a poison pill for potential acquirers; display poor debt collection (defined as debtor days over 60 days) and/or revenue recognition issues; excessively window-dress their results; report big one-off costs every year; and capitalise much more research & development costs on the balance sheet than is amortised through the income statement.

He is also wary of companies that have changed their auditor, nominated adviser or finance director more than once in the past two years; have completed excessive related-party transactions with directors; and have one controlling shareholder, or an overly dominant chief executive. Other red flags include companies listed on Aim, but headquartered in emerging markets, as this raises corporate governance issues; those where management seems accident-prone, thus bringing into question the quality of leadership; and those operating businesses that are too complex to understand.

Growth sectors to consider

Mr Hill's hit list of growth areas to consider include many that are on my own watchlist of industries and sectors, so there is a fair degree of crossover here. Specifically, he is interested in investment opportunities in technology, software, 'internet of things', new payment methods, content digitisation and social media; robotics, driver-less vehicles and automation of corporates/households; combating global warming, climate change and the need for cleaner energy forms; tackling terrorism, migration, tax evasion/avoidance, cyber crime and ID theft; peer-to-peer banking/finance; artificial intelligence; growth of emerging markets and Africa; and population growth and need for water conservation.

He also gives some sensible advice when considering early turnaround situations, an area in which I have a keen interest given that over the years I have managed to produce some eye-watering gains on buy recommendations, including the likes of technology firms **Netcall (NET)**, and consumer-focused companies Ideal Shopping Direct and **Walker Greenbank (WGB)**. In fact, I dedicated case studies on all three in my book *Stock Picking for Profit*.

In particular, Mr Hill believes turnarounds can take twice as long, and cost twice as much as originally planned – meaning there is usually no desperate rush for investors to get on board immediately. Before then it's necessary to determine a sensible valuation for the business and to understand "what sustainable revenues and operating margins can be achieved under normal conditions". As part of this process, "competitor growth rates and profit margins are taken as benchmarks". He then discounts these back using a suitable "risk-adjusted" rate and relevant valuation multiple (for example 10 times enterprise value to operating profit) to arrive at an indicative valuation range. And only then invests if the upside is substantial, reflecting the elevated risk, and in small amounts initially until the recovery starts to take shape.

Mr Hill prefers 'special situations' that have plenty of cash, or own valuable non-core assets that can be sold, so if there are hiccups there is no need for an emergency fund-raising. This chimes with me as I prefer to factor in a decent 'margin of safety' in my own stock selection and target asset-rich companies with little or no debt to mitigate financing risk. Indeed, it was no coincidence that all three companies I mentioned above had strong balance sheets when I initiated coverage. Mr Hill also believes experienced and strong management is essential in such special situations, as strong leadership is clearly required to turn previously poorly-performing businesses round.

What to look out for in great companies

Having identified the sectors and a watchlist of companies within them to target, Mr Hill has a shopping list of key characteristics that make for great companies and investment opportunities. In particular, he is seeking out companies that meet the following criteria: pricing power derived from dominant market positions, brands, patents, software, cost advantage and high switching costs; secular and growing demand for products (organic growth rates of more than 1.5 times GDP growth rate); winning market share; recurring revenues at least 50 per cent of turnover; and less dependent on the economic cycle and/or one-off orders.

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In terms of the financial metrics, he targets companies generating gross and operating margins in excess of 45 per cent and 10 per cent, respectively; offering a scalable business model with good geographical reach and low counterparty risk; producing strong cash generation – operating cash conversion in excess of 90 per cent of operating profit; and where trade working capital is less than 15 per cent of sales. Ideally, the company should also have a solid balance sheet with borrowings less than one times cash profits, and a pension deficit or other liabilities less than 10 per cent of the market capitalisation.

In terms of management, it's always good to have a top-rate team of insiders who own a significant amount of the equity so they have skin in the game, too. To complete the wishlist, and Mr Hill stresses that very few companies possess all the above qualities, he is looking for companies that consistently generate a return on capital employed in excess of 15 per cent through the cycle.

So, having identified the target, it's time to crunch the numbers as "great companies are clearly not worth buying at any price". Mr Hill's preferred metrics of enterprise value to operating profit, price-to-earnings ratio, PEG ratio and cash flow yield are some of my favoured ones, too, although I also use price-to-book value ratios and sum-of-the-parts valuations to uncover anomalously priced investment opportunities. For good measure, Mr Hill's research note also includes some worked examples.

Clearly, there is no magic formula to stockpicking, and different techniques or valuation methods have varying degrees of success at different points in the stock market cycle. However, Mr Hill has proved that his investment techniques have generated returns that the best fund managers would be proud of, and that's why I feel his observations are well worth noting.

Please note that I am now on annual leave and my next online column will be published at 12pm on Wednesday, 25 May 2016. A comprehensive list of the 175 investment columns I have written in 2016 is available on my home page at www.investorschronicle.co.uk/comment/simon-thompson

MORE ONLINE

Simon has published the following articles since 4 May.

- **Minds + Machines:** Buy at 8.5p ('Bargain shares updates', 4 May 2016).
- **AB Dynamics:** Run profits at 485p ('Bargain shares updates', 4 May 2016).
- **Bioquell:** Buy at 165p ('Bargain shares updates', 4 May 2016).
- **Trakm8:** Buy at 290p, target 400p ('Poised to track higher', 4 May 2016).
- **First Property:** Buy at 40p ('First Property sell-off buying opportunity, 4 May 2016).
- **Leaf Clean Energy:** Hold at 38p ('Latest twist for Leaf Clean Energy', 4 May 2016).
- **Sanderson:** Buy at 82p ('Tapping into solid profit growth', 5 May 2016).
- **London & Associated Properties:** Buy at 26.5p ('Voids fall sharply at London & Associated', 5 May 2016).
- **Character Group:** Buy at 525p, target 625p to 675p ('Toying with a break-out', 9 May 2016).
- **Cambria Automobiles:** Buy at 78p, target 95p ('Priced to motor', 10 May 2016).
- **Fairpoint:** Run profits at 130p ('Fairpoint de-rating unfair', 11 May 2016).
- **LXB Retail Properties:** Buy at 100p, target 120p ('Exploiting a valuation anomaly', 11 May 2016).
- **Vertu Motors:** Buy at 58.25p, target 85p to 90p ('A bumper performance', 12 May 2016).