

Value investing is often seen as the search for small, obscure and out of fashion companies. While this is often the case, it doesn't have to be. The principles of value investing can be applied to some of the best UK companies by the average investor.

Defensive Value Investing

The search for value among large, prosperous businesses.

UKValueInvestor.com
A Special Report

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The value of investments and the income from them may fall as well as rise and be affected by changes in exchange rates.

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Standing on the shoulders of giants

The problem of designing or choosing an investment strategy is as difficult today as it has ever been.

The internet has created an explosion of information and data, some of it useful, much of it not. Every day, new strategies are dreamt up and new investment articles are written. Everybody has an opinion on which stocks to buy and for the average investor, confusion is the norm.

A lucky few may stumble upon value investing. This highly successful approach has a long history of beating the market with both real world and academic results to back it up.

This report outlines, in simple terms, an approach to value investing which is designed to pick some of the best companies in the UK and the world, and to buy them when they represent excellent value for money. It's an approach that was originally developed by the Father of value investing, Benjamin Graham.

Ben Graham was Warren Buffett's mentor and in the first half of the 20th century he developed a sensible, safety-first approach to investing which he thought the average investor (also known as the 'defensive investors') could follow.

In 1949, he wrote:

"The selection of common stocks for the defensive investor is a relatively simple matter. Here we would suggest four rules to be followed:

- (1) There should be adequate though not excessive diversification. This might mean a minimum of ten different issues and a maximum of about thirty.*
- (2) Each company selected should be large, prominent, and conservatively financed. Indefinite as these adjectives must be, their general sense is clear.*
- (3) Each company should have a long record of continuous dividend payments.*
- (4) The price paid should be reasonable in relation to its average earnings for the last five years or longer. We would recommend a price not to exceed twenty times such earnings. This would protect the investor against the common error of buying good*

stocks at high levels of the general market. It would also bar the purchase, even in normal markets, of a number of fine issues which sell at unduly high prices in anticipation of greatly increased future earnings"

Those four simple points may be some of the most important words ever written in the field of investing.

By following the rules above the average investor would have their money in a list of up to thirty leading, prosperous, dividend paying companies, all bought at a low price relative to past earnings.

It would be difficult to have a more sound and sensible investment policy than that.

In addition, he had this to say about growing companies:

"The stock of a growing company, if purchasable at a suitable price, is obviously preferable to others. No matter how enthusiastic the investor may feel about the prospects of a particular company, however, he should set a limit upon the price that he is willing to pay for such prospects"

These six points laid out so clearly by Ben Graham can be grouped under two headings which he also used: Safety of Principle (i.e. safety of the original money invested), and Adequate Return. Graham's method for the majority of investors can be summarised as:

Safety of Principle

1. Diversify enough, but not too much
2. Buy large, prominent companies
3. Avoid excessive debt

Adequate Return

4. Income – Insist on a good yield and a long history of dividends
5. Value - Pay a low price relative to past earnings
6. Growth - Favour growing companies, but do not over-pay for them

Given Graham's genius, it's not surprising that recent studies have shown that the three factors of dividends, a low purchase price and earnings growth have been the main drivers of equity returns over the long term.

The rest of this report outlines a simple, understandable approach to building a portfolio using the principles above.

Safety of principle

“Rule number 1: Never lose money. Rule number 2: Never forget rule number 1.” – Warren Buffett

After almost losing everything in the great depression, Ben Graham became a safety-first investor. The principles he laid out were intended to be suitable for anyone for whom the risk of losing all their money was not acceptable.

By stating that the average investor should be interested first in safety of principle and only then in an adequate return, he was laying out his position as the very opposite of a high risk win-or-bust speculator.

Diversify enough, but not too much

“I prefer to keep all my eggs in one basket and watch that basket closely” – Warren Buffett

Ben Graham suggested splitting equity investments across twenty to thirty different companies. The reason for this is that no matter how much research you do into a company, you cannot know how the company will do in the future, and more importantly, you cannot know how the stock market will price the company in the future.

In fact, a FTSE 100 index tracker uses the same method of diversification to reduce risk by buying into the largest 100 companies in the UK markets.

However, going far beyond thirty companies when you're managing each investment yourself may be more trouble than it's worth. The reduction in risk becomes less and less for each new company added, and yet the additional workload of managing more investments increases more and more.

There are other factors which can be diversified. The main ones are industry and location.

Companies within the same industry are often affected by the same kinds of issues and so diversifying across many industries can make a portfolio more robust. If a portfolio is diversified across many industries then anything that affects a single industry will only have a relatively small effect on the portfolio.

The same thinking applies to location, where a local problem or recession will have a smaller impact on a portfolio if the companies within it are geographically diverse.

In short, Ben Graham advised that twenty to thirty companies are all that is needed to be reasonably diversified. On top of that, being industrially and geographically diverse can also help.

Buy large, prominent companies

“Time is the friend of the wonderful company, the enemy of the mediocre” – Warren Buffett

To expand on Ben Graham’s comments about investing in large and prominent companies, these are companies that:

- You can scarcely imagine going bust
- Most people have heard of
- Have been around for decades
- Are typically in the top three in their industry
- Could be classified as ‘blue-chip’

With these companies there should be a general sense of permanence and stability. Your blood should not run cold (or hot for that matter) at the thought of investing in them.

So why would this sort of company be more appropriate for the average/defensive investor than small and unknown companies?

There are many reasons, but Graham’s point relates mostly to safety.

Larger companies are generally less risky than smaller companies

Larger companies tend to have fewer bankruptcies than smaller companies. Companies which are prominent leaders in their industry usually got to the front by being better than the competition in some way. Studies have shown that these advantages don’t usually disappear overnight.

With Graham’s approach to investing, shares in a company can be held for a number of years. By picking large and prominent companies the risk that one of them will go bust in the next few years is reduced.

Just as importantly, these blue-chip type companies are usually able to keep earning profits and paying dividends right through the worst of recessions, so there is increased safety of income too.

Large companies are often able to survive bad news

Value investors often find the best opportunities when there is bad news in the air. Most investors hate bad news and if there is any surrounding a company, its industry or the economy in general, they'll often sell in fear, which pushes the price down.

It's the presence of bad news which stops value investing from becoming a popular strategy, despite its history of success. At the same time, it is this lack of popularity which makes the approach work in the first place.

The best companies can often take bad news in their stride. All companies have problems at one time or another, so companies that are robust and able to survive whatever the world can throw at them can reduce the level of risk in a portfolio.

Is the prosperity likely to continue?

Investing is, after all, about the future returns of the company and so it's prudent to check for any reason why the past prosperity may not continue.

The way this is typically done is through forecasting, where an analyst would look at the global economy, then the national economy, the industry and finally the individual company, and try to work out how one will affect another. This is known as top down investing and a number of studies have shown it to be very unreliable.

A different approach to forecasting is to assume that the future will look like the past. Using this approach you would just look for a company that is growing consistently and profitably and assume that will continue into the future. Despite its simplicity, this approach does have some academic backing when applied to stable, consistent companies, and it is easy to do since all you do is look for stable, consistently growing and profitable companies.

Another approach is to be more cautious and look for reasons why past prosperity might not continue into the future. This is fraught with problems though, for the same reasons as top down investing. Basically, people can come up with a million reasons why a particular future may or may not happen, and almost all of the time they are wrong.

On the other hand, if a company is currently dealing with a large and obvious problem which will mean a definite and significant reduction in sales or profits for the long term, then it may be reasonable to assume that the future will not look as rosy as the past.

As much as is reasonably possible, investing should be about facts, not opinions.

To look for large companies, it can be as simple as sticking to FTSE 100 and FTSE 250 listed companies. Together these represent the largest 350 companies in the UK markets.

One way to look for prosperous companies is to select only those that have made a profit for every one of the last ten years. On top of that, earnings per share should at the very least have been stable over the years and preferably show an upward trend. Revenue should also have shown a similar pattern of increases over the long term. Finally, dividends should have been paid in every one of the last ten years and preferably never cut.

This will help weed out companies that struggle to make a profit and are therefore unlikely to be leaders in their field.

Avoid excessive debt

“I do not like debt and do not like to invest in companies that have too much debt, particularly long-term debt” – Warren Buffett

No matter how good a large and prosperous business may be, if it has a lot of debt it can be at risk of bankruptcy if something goes wrong.

Debt is probably the biggest corporate killer and that's precisely why it should be avoided. At the same time, the best companies typically don't need a lot of debt to generate outstanding returns.

There are certain industries that are reliant on large amounts of debt, most obviously the banking industry. To invest in these industries you need industry specific debt ceilings and those are beyond the scope of this report. The guidelines below will exclude from consideration companies that operate in highly leveraged industries such as banking, but this should not affect returns.

In addition, the guidelines below do not guarantee that a company will not run into debt problems. If profits or cash flow fall considerably and for a long enough period of time, then almost any company can find itself at the mercy of its creditors. By focusing on large, prosperous and consistently profitable companies which are conservatively financed, it's reasonable to say that you would have done all that you can to avoid debt related problems.

There are many ways to measure what is or is not an acceptable level of debt, but one measure which Warren Buffett may have used is to avoid companies where interest bearing debt was more than five times the operating profits. An additional measure would be to look for operating profits to be at least five times more than interest payments and preferably ten times or more.

This level of debt is more than enough for most companies to operate effectively and not have their profitability restricted. At the same time, if the company is large, prosperous and of 'investment grade', it is a level of debt that is unlikely to cause problems.

Adequate return

“To achieve satisfactory investment results is easier than most people realize; to achieve superior results is harder than it looks” – Ben Graham

Exactly what is an adequate return? Ben Graham was always at pains to point out the difficulties of attempting to beat the market. At no point did he ever say that the intelligent investor could achieve outstanding, amazing or incredible returns. Instead he used words like adequate and satisfactory; sensible words which reflect the hype-free way in which he invested.

Even Warren Buffett is said to target ‘only’ fifteen percent a year, over the long term. That’s not a mile above the eight to ten percent that could be expected from a simple index tracker.

Fifteen percent may not be exciting, but it is realistic. Although a far cry from the ridiculous claims of five percent a month that you can find all over the internet, Buffett has actually returned just over twenty percent a year for decades, which over the long run was enough to make his early investors very rich indeed.

In reality, any results beyond that achieved by the market must be seen as an adequate return, if it can be sustained over a long period of time.

But if any return beyond the market is to be achieved, it’s important to focus on where those returns will come from. Graham focused on income, value and growth over fifty years ago and more recently studies have shown that once again, he was right.

One such study comes from MSCI Barra and is called ‘What Drives Long-Term Equity Returns?’. It showed that long term returns can be broken down into inflation, dividend income, earnings growth, and changes in valuation measures like price to book ratio and price to earnings ratio.

An investment approach which seeks to increase dividend income, earnings growth and value at purchase may in turn increase long term returns.

Income - Insist on a good yield and a long history of dividends

"A cow for her milk. A hen for her eggs, And a stock, by heck, for her dividends." - John Burr Williams

It's a surprise to many that dividends are a key part of investment returns. A lot of people just think investing is about capital gains when the latest hot stock doubles overnight, and that bonds or savings are for income.

Nothing could be further from the truth.

For example, the 2011 Barclay's Equity Gilt Study showed that £100 invested in equities in 1899 would have grown to £12,655 if dividends had been withdrawn. If dividends had been reinvested then the investment would have grown to £1,697,204. **Dividends increased the gains tenfold (and in real terms the gains were a staggering 300 times better).**

Dividends are that part of corporate earnings which are paid out to shareholders, and it's their job to decide how to invest them. So it's possible to look at earnings as being split into two parts:

The first part is retained by the company and reinvested in either well or poorly, depending on the rate of return that management can get.

This is where Warren Buffett has an advantage in that he can tell his managers that they should only retain earnings if they can get a 15% annual return on them. Otherwise they should be paid to Buffett and he can look for somewhere to invest those earnings at a higher rate.

The second part is paid to shareholders as the dividend and that's the bit where you (if you were a shareholder) get to play Buffett's role.

If you wanted to invest those dividends in a new car then that's up to you, but as the equity gilt study shows, **if you withdraw dividends from a portfolio then their effective rate of return is minus 100 percent**, which is a big drag on future growth.

One way to benefit from this long term driver would be to demand a relatively high dividend yield. To make sure the dividend is likely to be reliable, only companies with at least ten years of unbroken dividend payments would be considered. It may be preferable if the company has a stated progressive dividend policy where they intend to increase the dividend through all phases of the business cycle.

Value - Pay a low price relative to past earnings

*“Buy stocks like you buy everything else – when they are on sale” –
Christopher Browne*

One of the key measures used in investing is the price to earnings ratio, or PE. This ratio gives investors a starting point when beginning to think about whether a particular stock is ‘cheap’ or ‘expensive’.

A low PE is considered ‘cheap’ because it means you are getting more earnings for your money. The inverse of the PE is the earnings yield and a low PE results in a high earnings yield and a high earnings yield is in many ways like a high yield on a savings account; the higher the yield the better.

The PE has its problems though. Earnings from one year to the next can be quite volatile and so the PE can change quite a lot, even if the price and the underlying value of the company don’t actually change at all.

When looking at large, prosperous companies which have relatively stable earnings, it may be better to look at the current price compared to the average earnings over a number of years, which is exactly what Ben Graham suggested.

By using the ten year average earnings you have a relatively stable value to compare the price to. PE10 (as this measure is known) is much less dependent on what the current year’s earnings are, and so it gives a much more stable estimate of whether the shares are cheap or not.

Extensive studies have shown that in the case of markets such as the S&P500, when the PE10 is low it is likely to increase largely due to price increases. When it is high it is more likely to decrease through price drops. This is because valuation metrics like PE10 are mean reverting, which just means that when they are below average they are likely to increase, and when they are above average they are likely to decrease.

By buying large and prosperous companies when the PE10 is historically low, you are likely to be buying more earnings power for your money and are also more likely to profit from price increases.

To select companies that are cheap relative to their ten year average earnings, simply take the current price and divide it by the ten year average earnings (or adjusted earnings). This gives the PE10 ratio

which can then be used to compare one company to another. Remember, the lower the better, but make sure the company is still strong and prosperous.

Growth - Favour growing companies, but do not over pay for them

“Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now” – Warren Buffett

Growth is the one feature that most investors look for in a company. However, as we have seen, it is only part of the whole story of equity returns. By focusing only on growth, most investors miss out on excess returns from income and valuation mean reversion.

To begin with, it may be helpful to look at where growth typically comes from.

Other than general inflation, growth generally comes from companies reinvesting their retained earnings into profitable ventures.

For example a company may earn £100million, of which £40million is paid out to shareholders as a dividend. The remaining £60million is kept within the company and invested into a new factory in order to grow the company's future earnings.

If that new factory generates £30million in profits the following year then the management have managed to get a fifty percent return on the original £60million. So now the company would be earning £130million instead of £100million; in other words it has grown by profitably reinvesting its retained earnings.

The real point here is that different companies generate different rates of return on their retained earnings, and some companies retain more than others. This means that growth rates can vary dramatically.

Over the long term the companies that make up the FTSE 100 have returned about ten percent on their retained earnings. That's made up of some companies which return more and others which return less.

The obvious conclusion here is that all else being equal, more growth is better than less. But it's important to note the kind of growth that we're after.

Buffett has said much more about growth than Graham and most of it applies directly to the large and prosperous companies we're looking at here. Buffett isn't interested in companies that have managed to grow quickly in the last year or two, or companies that grow inconsistently.

What Buffett is after is steady growth over the long term. He wants to see a company that is able to consistently increase revenues, earnings and dividends over long periods of time. This doesn't mean every year, but most years should see a record of some sort.

Part of this steady increase will be down to inflation, but Buffett expects his investments to grow their businesses faster than inflation, often much faster.

Graham felt that no matter how high a company's growth, no company could ever reasonably be worth more than twenty times its ten year earnings average (in other words, a PE10 of twenty). As ever with Graham, this is a profoundly sensible piece of advice.

Long term, steady growth can be found by looking for companies that have grown earnings in the last ten years. Although there is no single, set formula for calculating growth, it may be useful to look for companies where they have generated record revenues and earnings in most of the last ten years.

Ben Graham had a novel way of calculating long term earnings growth. He took the latest three year average earnings figure and compared it to the three year average earnings from ten years ago. The growth rate between these two figures was an initial guide to the company's long term growth potential.

Selling – Often ignored, always important

“Buy when most people...including experts...are pessimistic, and sell when they are actively optimistic.” – Ben Graham

Most analysts and investors spend almost all their time talking about buying; what to buy, when to buy, how much to buy. Buying is exciting and fun, but selling is every bit as important.

Since selling is largely the opposite of buying, the criteria are also largely the opposite. The goal of buying is to buy good companies at low prices, so the goal of selling is to sell those companies either when they are no longer good companies, or when the price is high.

For example, at some point one of the companies in a portfolio might have a good run and pick up a lot of good news. If there is enough buying demand from other investors pulled in by the good news, the company's shares may become so expensive that it no longer represents good value. Remember, the higher the price the lower the dividend and earnings yield, and the higher the price the further the shares have to fall.

If you can find something else in the market which represents a better combination of value, income and growth then the rational thing to do is to sell the expensive holding and replace it with something that is better value for money.

Repeat this process of selling the 'weakest link' over time and the portfolio should always represent excellent value for money with above average value, income and growth. That in turn may lead to above average future returns.

The above selling policy could easily be made a regular part of a portfolio management strategy. For example, comparing the various holdings to one another at the start of each month would allow the 'weakest link' to be reviewed and sold, if a sufficiently better investment was available in the market.

A regular system like this would be much easier if there were a way to combine value, income and growth into a single number that allowed various investments to be directly compared to one another. The following chapter covers one such metric.

A simple way to combine income, value and growth

"There is now an overwhelming amount of data to suggest that in many environments, simple [numeric] models significantly outperform human (expert) judgements" – James Montier

At this stage it's clear that a focus on growth and income, as well as value, may be a sound investment strategy. The next step is to find a way to combine these factors into a single number that can quickly pinpoint those stocks that may be worth a deeper look, as well as providing an easy way to compare existing holdings.

One proven technique for optimising multiple factors and generating a single usable 'score' has been popularised by Professor Joel Greenblatt of Magic Formula fame. His book, *The Little Book That Beats The Market*, showed a method of combining 'earnings yield' and 'return on capital' based on the combination of a company's 'rank' in each of those factors. The same method can be applied to the factors which are important to defensive value investing.

Starting with income, we can define a good income as a high dividend yield, so the first step is to sort the whole universe of some 2,000 or so UK listed companies by dividend yield. Each company is then given an income rank starting with 1 for the highest yielding company, 2 for the next highest and so on.

Turning to value, if the whole universe of stocks is then sorted by PE10 (stock price relative to the 10 year earnings average) we can generate a value rank starting with 1 for the lowest PE10 company and so on.

Finally, for growth we can sort the whole universe by the Ben Graham growth rate and generate a growth rank with 1 for the fastest growing company as before.

These three ranks are then simply added together to create a single rank, the Defensive Value Rank.

This is a relatively quick and easy way to compare potential investments. If it is applied to a list of large and prosperous companies then it is a reasonable way to compare one stock to another with hard data rather than a vague, guesswork approach to investing.

Of course, a high rank would be just the first step in judging an investment. Additional checks would be required such as those outlined in this report, which are:

1. Adequate diversification in terms of number of companies, industry and geography
2. A focus on large, prosperous companies with consistent sales and profits
3. The avoidance of excessive debt
4. A long history of steady dividend payments
5. A low price relative to past earnings
6. Steady growth over the long term or, at the minimum, no signs of a decline

Next steps

If you've read through this book because you wanted to know more about value investing then I hope it has given you a lot of new ideas to play with and to weave into your existing process.

If you want to know more then the rest of the [UKValueInvestor.com](http://ukvalueinvestor.com) web site can fill in many of the gaps, and the internet is of course an almost infinite source of information.

If you're still not sure about how this investment approach works, or how the system can be used year in year out then you might be interested in my newsletter, the *Defensive Value Report*.

The newsletter follows a £50,000 model portfolio which invests using the process in this report; buying, selling, managing dividends, all of the major steps of portfolio management are covered. You can download a sample issue and a user guide from the link below:

[Defensive Value Report](#)

It's a premium subscription newsletter where subscribers get the following in each edition:

- A review of the market and an up to date valuation of the FTSE 100 in order to understand how things may pan out over the next few years
- A review of the model portfolio including recent dividends, new annual reports and any company re-valuations where necessary
- A 'buy alert' if any new holdings are being added, as well as a detailed Buy Report on new company
- A 'sell alert' if a company is being sold and a detailed Sell Report on the investment, its total returns and whether it turned out as expected
- Two 'Quick Lists' of FTSE 350 companies, the first of which is sorted by the Defensive Value Rank so that you can find the most highly rated stocks immediately, while the second is sorted by company name so you can see the rank of any particular company

Thank you

I'd like to thank you for taking the time to read through this special report. I hope it has been of some use to you on your journey as a value investor.

If you have any questions about defensive value investing or the associated newsletter, please email me at the address below. If you decide to subscribe then that's great and I'm sure we'll be in contact soon. If not, just remember to keep a long term focus and don't get sucked in by the day to day noise.

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