My Investment Philosophy

By Roger Lawson

It is a duty of anyone who writes on investment matters to at some point summarize his or her approach to investing. Otherwise misunderstandings can creep into the public on how one has managed to achieve some success at investing. One either has to describe one's investment philosophy or explain in detail all the investment decisions you have made in the past so that readers could understand the approach indirectly. The latter would be both lengthy and tedious, still require copious explanations and be unwise for other reasons. This note attempts to give folks some guidance on how I approach investment, and how my outlook has developed over the years.

I first started to invest in the stock market seriously 20 years ago when I retired from full time employment as a director of software companies. As it has been my money and my pension funds I have been managing ever since, I have taken a somewhat conservative approach. That was particularly so in the first few years when I would buy somewhat boring and defensive large cap stocks and rarely trade them until I learned that this approach did not generate returns as good as one could achieve by a relatively more active style.

The overall results since then have been fairly good though – a total return including dividends over 5.7 times the original capital over 19 years. There have been some down years in that period (down 28% in 2008 for example), but most years I beat the FTSE-AllShare, which is my main objective, from a very diversified portfolio.

There are many aspects of investment that one can learn about. Indeed one of the problems is that of "information overload" where you get deluged with data and opinions on companies. So I will try to summarise just a few of the key points I have learned over the years:

Analysis

Before I invest in a company I try to understand the business and do some basic financial analysis. What I focus on is Return on Capital, Profit Margins, Profits that turn into Cash, the growth in revenue and profits and the strength of the balance sheet. On the last point, I don't like debt except in certain types of companies. It's certainly to be avoided in high growth technology businesses. All companies, even good ones, tend to trip up at some point from management errors, regulatory changes and market swings. A company needs to be able to survive such events to be a good long-term investment. High debt usually means the company ends up in the control of its bankers if events are traumatic.

I like growing businesses, and a good return on capital almost guarantees that. If they are generating cash rather than consuming it, and can reinvest it profitably, then it's almost certain to be a good investment.

Nowadays there are lots of tools available to do most of the basic financial analysis for you – products such as Stockopedia and Sharescope/Sharepad.

Business Perspective

But having great looking fundamental financial ratios is not enough because it can lead you into some very deep pitfalls. Even FTSE-100 companies can suddenly come unstuck and instantly move from looking cheap to expensive (Provident Financial was a recent example as profits rapidly disappeared). This is particularly so with small cap companies such as AIM stocks where the historic financial numbers can be doubtful and the future forecasts even more so.

So as Warren Buffett realised early on in his investment career, how the company generates profits and cash is even more important. There have been whole books written on the subject of what makes a "good" company, but the key questions to ask are whether a company has a defensible market position and the ability to price its products or services at a premium. Does it have patents, trade secrets or other intellectual property (like great brand names)? Does it have other barriers to market entry by dominance of the market, ultra low costs or something else?

Does it have high recurring revenue where the customers are bound to come back for more? One reason why I like software companies is that I learned from a career in that field that the customers are very "sticky" and will often pay an annual rental or support fee ensuring high repeat revenue. Once they have bought a product and get accustomed to using it, they are very unlikely to give it up because it gets embedded into their corporate or personal life (hence that is why I am using Microsoft Word to write this note – a product first released in 1983 and still being sold).

Any company subject to regulatory risk or Government interference is by its nature, one to avoid. Likewise some kinds of companies produce unpredictable fluctuations in revenues let alone profits. This is where experience, and prejudice, come into play. So technology hardware companies, can be volatile as competitors often "leapfrog" their products with better versions. Mining and oil/gas exploration companies are ones I avoid simply because they tend to be a bet on hitting success. Likewise I tend to avoid most commodity producers (i.e. even producing mining companies) because their profits tend to be closely related to the price of the commodity they produce – which is usually unpredictable and often driven by speculation and global politics rather than consumption. Similarly I avoid banks because not only are their accounts opaque and open to manipulation, but profits depend on Government policies. In general I am not a fan of financial businesses because their accounts are often difficult to understand – just try reading the annual report of a FTSE-100 insurance company.

The Management

Are the managers of a company important? If you are investing in a small, private equity backed business then undoubtedly so. But for large public companies, I tend to look for trustworthiness and good corporate governance in the directors. As the directors rarely last long these days (unfortunately they earn so much now they can often afford to depart after very few years), a sound corporate culture can be more important than the individual. Meeting the management can be helpful, but can also be misleading as they are often good salesmen and know how to tell a good story.

Avoid Cheap Companies

Companies frequently look cheap on fundamentals (i.e. trade on lower p/e's than comparable companies, or appear to have undervalued assets) but so often when you look into the quality of the business there is something lacking. They frequently face major strategic risks or have a patchy history of unfortunate events. Paying a relatively high dividend is often a sign that something is amiss. Yes there may be opportunities to acquire some businesses cheaply but don't forget that the market is now so efficient that these are few and far between. You may be lucky to find a small company which has been little researched, but with larger FTSE companies the market price is likely to reflect all the known factors. Cheap companies are usually cheap for a reason. What matters is not so much today's price, but what the company will generate in profits, and how it will grow them, over the next ten years.

That is not to say that I avoid very risky small cap stocks with little revenue or profits. Sometimes I take a small holding in such a company if it meets my other criteria and I wait to see how it develops. If it does not I sell it before a significant loss arises.

Monitoring Investments

It is important I find to monitor your investments closely. That means not just following RNS announcements but attending or watching presentations they give, and attending AGMs – the latter can still be useful events to learn more about the business and the strategy of the directors.

It's also worth reading a lot of background material, both financial and otherwise. All the great investors seem to be avid readers. But I spend very little time on financial bulletin boards – one's time is more effectively used and more valuable in other areas.

A Balanced and Diversified Portfolio

We all pick the occasional dud. Simple fraud in smaller companies or non-disclosure of relevant facts can distort your view of the business. Having a diversified portfolio minimizes the impact of the collapse of any one business. I like to have a core portfolio of about 40 companies (including some investment trusts to give me a stake in areas that I would find difficulty to invest directly in) with another 10 to 20 where I am building up from a small stake or still learning about.

I prefer not to have any one company exceed more than 5% of the overall portfolio value so I would top slice the holding if the share price rose to a level to give that outcome.

Sectors

I tend to focus on market sectors I am familiar with, but I have a very mixed spread of businesses in relation to the markets in which they operate.

I don’t like to hold companies in declining market sectors or those at risk of regulatory interventions. So coal, oil and gas companies I am not excited about, even if they offer high dividend yields, and tobacco companies are also ones I avoid.

What I like to invest in are companies where technological change is having a major positive impact – companies where the internet enables them to do business in a new way or at lower cost, and software companies that provide the tools for such businesses. The world is changing and faster than ever, and I like to keep up with those dynamics.

Market Trends, Momentum and Trading

I will follow market trends. If everyone else is selling a particular stock, or the whole market, I will tend to follow them, unless I judge there are very good reasons to take a contrary view. Momentum investing has been shown to be very effective, if not taken to excess. So I sell the losers and buy more of the winners in my portfolio, following the gardening analogy – nurture the growing plants and cull the weeds. That is particularly so after good or bad news from the company. As a result I build up a portfolio of companies which have successfully grown over time. If I buy a new holding that looks cheap on the fundamentals, I will take a small stake and see how it develops (and that applies whether it is a large or small business).

I could be said to be an active trader because the above “style” tends to result in lots of relatively small trades - several hundred per year in total over a large portfolio. But I will preferably hold the same company for many years. I am not a “buy and hold forever” investor, but agree with Warren Buffett that my preference is to hold forever while in reality I may sell at any time if the business changes in a major way.

In essence I am a fundamental investor, not a speculator, so I never expect to get in and out in hours, days or even weeks. Months and years are my investing horizon as the fundamentals of a business that made it a sound investment in the first place rarely change rapidly. The longer you hold a stock, the more you learn about it.

Life is too short to spend time speculating to make a quick turn which can use a lot of resources to little effect in my experience.

What Really Matters Is Total Return

I probably did not emphasize enough early on in this article the importance of investing in businesses that generate the best returns (profits, or even better cash), from the money they have tied up in the company. That’s the return on net assets, the return on overall capital employed or the return on equity. That I learned from running companies myself.

Now it is regularly reported that the most popular investment funds are those with an income focus. Some investment trusts put “income” into their name even though most of the returns are from capital growth so as to attract new investors.

But all that I care about is total return because I know that capital is easily turned into income – you just sell a few shares.

One reason I have not mentioned individual investment successes or failures in this note is because they are only partly relevant to the overall story. It's better to get a consistent 30% per annum return from a company than from a shooting star that can fall to earth from the slightest error. It would also take a much bigger article to cover the individual stories, however fascinating and educational they might be.

Minimising Costs

One key to maximizing returns overall is to ensure the returns come to you and do not get soaked up in financial intermediaries' fees (stockbroker charges, fund management fees). For similar reasons, if I do invest in collective funds these tend to be investment funds and not unit trusts/OEICS – or if the latter I look very carefully at their costs.

Most of my portfolios are direct share holdings in UK listed stocks or investment trusts and I avoid index tracking funds for philosophical reasons.

Tax Planning

Sometimes there are tax differences between income and capital gains (and where they come from), so sometimes it is worth considering the different outcome and impacts. If one is trading a fair few times a week, as I typically do, it is best to keep that done within an ISA or SIPP in the first instance. Otherwise I try to minimize capital gains tax by longer term holding in my direct accounts, or using investment trusts where the gains arising within the trusts are not taxed until paid out as dividends.

One's potential liability to inheritance tax might also influence one's holdings but in reality I ignore it. The reason I hold quite a high proportion of small cap stocks is because that is where exceptional returns can be made, not because AIM stocks qualify for Business Property Relief.

My Attitude to Risk

If you ever talk to a Financial Advisor, or want to open a new advisory stock broking account, they will ask questions about your attitude to risk. These are typically simplistic and rather pointless questions.

Risk is something to manage by constructing a portfolio that is well diversified and holding investments that are not all likely to collapse at the same time. Following the conventional wisdom of holding a lot of fixed interest stocks as one gets older I consider absolutely foolish given the way Governments have driven down interest rates to artificially low levels by quantitative easing in recent years. Bonds are as dangerous as James Bond at this point in time.

The risk in any individual stock is not related to the volatility of the share price as some academics would have you believe, but is more a function of the market in which the business operates, its financial structure and how it is managed. You won't find that measurable by a single number.

Conclusion

So I have made it all sound very simple perhaps. But one does learn from experience. Investment is one of the few fields where age and experience can still be helpful it seems. I certainly have fewer failures of late although the overall returns go up and down mainly driven by market trends. The fewer failures may simply indicate I am not taking as many risks as I might be, as happened when I first started investing, and that might actually be reducing my overall returns. I will have to keep an eye on that issue for the future.

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