Superstocks built to surge

Four decades ago investors believed nothing could beat the Nifty Fifty. They were wrong. Today fund managers believe a new breed of nifty global shares will handsomely outperform in a decade of anaemic growth. But private investors can construct their own portfolio of 30 nifty, but thrifty, shares without having to worry about market timing. Richard Beddard sets the scene and reveals how we will construct a UK Nifty Thrifty

The year is 1972. In the US President Nixon has been re-elected by one of the biggest margins in history, Apollo 17 becomes the sixth manned mission to land on the Moon and a group of 50 companies – the Nifty Fifty – are leading the US stock market into the stratosphere. For the first time the Dow Jones Industrial Average, an index of 30 huge companies, breaks through the 1000 mark.

Investors believe large, popular companies that have grown profits and dividends year after year – think Coca-Cola, IBM, Polaroid and Xerox – are 'one-decision' shares to buy and hold forever. Fund managers love them because the shares are so liquid: there are so many ways to buy and sell them.

"Super-cap stocks" offer an alternative to risky government bonds

Guy Monson

Smaller companies, with less consistent records, severely declined in the bear market of the late 1960s, resulting in a two-tier market where the only shares worth buying were in companies that were so profitable they prospered no matter what. Almost 40 years later some fund managers foresee a new generation of superstocks: a new Nifty Fifty. Bill Mott, manager of the PSigma Income fund, who earned the moniker Mr Income in his 30-year stint at Credit Suisse, has identified the return of the Nifty Fifty as one of the themes guiding the composition of his fund this year.

He predicts a decade of anaemic global growth. 'Those companies that can grow their earnings faster than average in a bracing, but not impossible, environment will be re-rated,' he predicts.

Mott thinks global consumer staples companies promise the best trade-off between growth and economic risk because they depend less on economic policy in the West and more on the inevitable growth of a westernised middle-class in emerging markets.

'What we are looking to own in that space are consumer staple companies that are providing everyday products, whether it be toothpaste, disposable nappies or dishwasher powder for newly purchased dishwashers,' he says, citing companies such as Unilever, Reckitt Benckiser, Tesco, Nestlé, Colgate Palmolive, Procter & Gamble, Johnson & Johnson and Coca-Cola.

There's also space in his fund for other companies with good growth prospects. In Pearson, he's locking on to a growth trend in education. Serco and Compass are likely to benefit from an increase in outsourcing as the new UK government tries to save money. Reckitt Benckiser, Unilever, Tesco, Compass and Serco are all blessed with superior management.

At Sarasin & Partners, chief investment officer Guy Monson urges investors to concentrate on the healthy profits of multinational corporations benefiting from strong growth in emerging markets and low inflation and interest rates at home. It's an 'export machine' that has halved the US trade deficit in three years.

He thinks institutional investors will favour the new Nifty Fifty: a group of 'international super-cap stocks' offering an alternative to increasingly risky government bonds. Since their dividend yields are as much as gilts, they're a logical alternative and, unlike bonds, rising dividends and valuations compensate for inflation, which Monson sees as a big risk for the remainder of the decade.

Novartis, the Swiss pharmaceutical company, yields 3.7 per cent and is growing profits at 15 per cent a year. Its dividend has risen every year since 1996 and its balance sheet has an AA+ rating.

'Novartis is, to me, the new default investment,' says Monson. 'It gives you a yield equivalent to government bonds. It grows its yield by close to inflation so it's inflation-protected. It's got a balance sheet that even the ratings agencies think is better than most governments.'

Cash-rich Intel, another dividend payer, in this case with a dominant position in the central processor market, could be a 'low risk, high cash flow way to play growth in the emerging world'.

CRASH OF 1974

It's January 1973. December's Apollo 17 mission is the last time men go to the Moon as budget cuts force Nasa to switch its attention to the Space Shuttle. Americans are beginning to doubt their president as two of his aides are convicted for conspiracy, burglary and wire-tapping following the Watergate scandal. The Dow Jones Industrial Average drops 10 per cent. It's the beginning of a stock market crash.

Two years later, after a worldwide recession triggered by spiralling oil prices and an embargo on oil shipments from Arab producers to the US, the Dow is at 577; 45 per cent below its peak. It's the second-worst crash of the 20th century and among the big casualties are the companies in the Nifty Fifty. Nifty Fifty shares were so popular their prices became unhinged from the profits the companies earned. Investors only bought them because their prices kept rising.

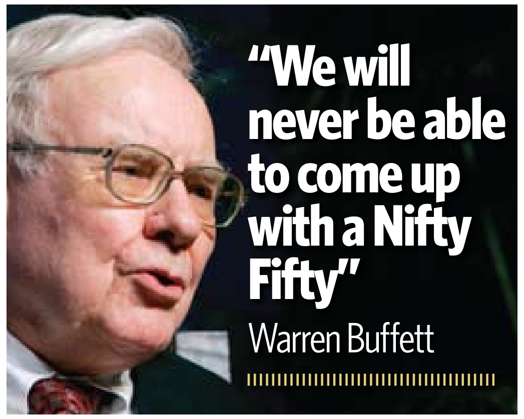
The relationship between price and profit matters though. The more a company earns the more it can pay to shareholders as dividends and the more it can invest to become a bigger, more profitable business. If management does a good job shareholders benefit either way, so the higher the market price of a company's shares relative to its profits (per share) the more confident investors are that it will grow and prosper in future.

That confidence measure is encapsulated in the price/earnings ratio. In 1972 the p/e ratio of the average Nifty Fifty share was 42 – more than double the p/e ratio of the S&P 500 index. Polaroid's p/e ratio was 95 according to Jeremy Siegel, professor of finance at the Wharton Scool of the University of Pennsylvania, who studied the Nifty Fifty.

Investors were paying 95 times Polaroid's annual profit per share for their stake in the business. In theory, if Polaroid's profits remained the same it would take investors 95 years to earn a return equal to the amount of money they had originally invested, giving an annual return of just 1.1 per cent. If Polaroid grew its profits year after year the return would be higher. But it didn't. It went bankrupt in 2001.

The high p/e ratios investors paid in 1972 were a sign of overconfidence. Those that had put their faith in the Nifty Fifty, such as Morgan Guaranty, the US's largest pension fund manager, paid the price. Morgan Guaranty had lost about two-thirds of its clients' money by December 2004.

It was a list of Nifty Fifty companies compiled by Morgan Guaranty that Siegel used in his study. He calculated that, based on their share prices in 2001 and dividends between 1972 and 2001, some of the Nifty Fifty – Philip Morris, Pfizer, Gillette, Coca-Cola and Johnson & Johnson, for example – had been extremely good investments. But investors who bought all of the Nifty Fifty and held them for 29 years did marginally less well than the stock market average. The more highly rated technology companies such as IBM, Texas Instruments and Xerox simply failed to meet investors' expectations.



"We will never be able to come up with a Nifty Fifty"
Warren Buffett

Other studies cast the Nifty Fifty in an even less favourable light. It's likely that few investors who bought the shares exuberantly in 1972 held on to them long

The original Nifty Fifty from the 1970s included stalwarts such as Coca-Cola, Johnson & Johnson and Procter & Gamble

enough to get anywhere near the market return. The problem wasn't so much profit as price.

COCA-COLA MULTIPLES

Value investors, who buy shares when they are cheap, tend to be sceptical about anything nifty because popular shares are often expensive.

In his book, *Margin of Safety*, value investor Seth Klarman describes the Nifty Fifty as a recurring fad. He warned shareholders in his Baupost fund of a new craze in 1998: 'Just as in the early 1970s,' he wrote in a letter to shareholders, 'there has been a stampede to own a Nifty Fifty: several dozen widely admired companies seeming to promise an investment utopia of safety, stability, steady growth and liquidity. Once again, no price is regarded as too high to pay for these characteristics.'

Among those companies, the largest on the US stock exchanges were new names propelled into the big league by the craze for technology stocks, companies such as Microsoft, Intel, Cisco Systems and Dell Computer, all of which now trade at a fraction of their boom-time peaks.

Investors latch on to trendy brands, new technology or sheer size, and assume companies will dominate and earn outsized profits indefinitely. Consequently, they're prepared to pay more than they should for the shares, which Klarman describes as attaching 'a Coca-Cola multiple to a Cabbage Patch concept'. Cabbage Patch Dolls were ubiquitous in the 1980s but their appeal has diminished.

Few companies prosper and endure like Coca-Cola, a fact that led Warren Buffett, perhaps the world's greatest investor, to label Coca-Cola and Gillette 'inevitables'. Managed correctly, such companies are so sound that an investor can truly buy and hold them forever.

However, for every inevitable, Buffett, who owns shares in some of Mott's picks, including Tesco and Coca-Cola, told Berkshire Hathaway shareholders in his 1996 letter: 'There are dozens of "impostors" – companies now riding high, but vulnerable to competitive attacks. Considering what it takes to be an inevitable, Charlie [Munger] and I recognise that we will never be able to come up with a Nifty Fifty or even a Twinkling Twenty. To the inevitables in our portfolio, therefore, we add a few "highly probables".'

BUFFETTOLOGY

If Buffett and his partner Charlie Munger can't stuff their investment company with inevitables, how can a private investor safely invest in nifty companies?

One approach may be to buy funds such as Mott's and Monson's that appear to be buying nifty companies while they are cheap, and trust they'll not make the same mistake past fund managers made, should history repeat itself.

'The crash we finally saw in 1973-74 came a long time after the initial concept was conceived and, as so often happens in investment bubbles, the fundamental reason for the initial appreciation of the stock is normally completely valid. It's just that the story gets better and better. It becomes self-reinforcing and you get huge overvaluation,' says Monson.

Harking back to the 1990s, before the technology boom, he says: 'If you look at the projections about the growth of the internet, the volume of traffic and e-commerce, they were massive underestimates. They were actually far too bearish. But the investment community got much too bullish. I don't think just because it ends eventually in disaster this invalidates the initial logic. So I hope I'm in 1968-69, compared to a final dénouement in 1974.'

The likes of Intel, he says, are not expensive; they've been sidelined by investors for almost a decade. In 2000 Intel was trading at 32 times earnings and the shares now cost 12 times earnings. But once the Nifty Fifty gathers momentum, and index funds and exchange traded funds are forced to follow, it could become unstoppable.

'In the last Nifty Fifty, no small-cap manager, no active manager, no growth manager could keep up at all. You just had to buy and hold these stocks and they steamrollered everything else,' Monson recalls.

Mott says last year was marked by a

A EUROPEAN NIFTY THRIFTY THIRTY

Rank	Name	Sector	Capitalisation ($m)	F-Score
1	OPAP	Consumer discretionary	6,447	6
2	ROLLS-ROYCE GROUP	Industrials	16,318	8
3	SONGA OFFSHORE	Energy	781	7
4	MOBISTAR	Telecommunication services	3,704	6
5	ASTRAZENECA	Healthcare	63,780	7
6	GAME GROUP	Consumer discretionary	502	5
7	AURUBIS	Materials	2,046	7
8	TGS NOPEC GEOPHYSICAL CO	Energy	1,980	7
9	SUBSEA SEVEN	Energy	2,906	7
10	ALSTOM	Industrials	16,857	6
11	WHSMITH	Consumer discretionary	1,184	8
12	PARMALAT	Consumer staples	4,494	6
13	BELGACOM	Telecommunication services	11,782	7
14	ALLIANCE OIL COMPANY	Energy	2,793	6
15	DE LA RUE	Industrials	1,370	5
16	MAIRE TECNIMONT	Industrials	1,315	8
17	UNITED INTERNET	Information technology	3,783	5
18	GLAXOSMITHKLINE	Healthcare	95,686	5
19	GOLDEN OCEAN GROUP	Industrials	924	5
20	DANIELI & CO ORD	Industrials	1,039	7
21	WARTSILA B	Industrials	4,921	7
22	ALMIRALL	Healthcare	1,777	8
23	M6-METROPOLE TELEVISION	Consumer discretionary	3,345	7
24	ORION-YHTYMAE B	Healthcare	1,679	6
25	LADBROKES	Consumer discretionary	2,141	6
26	PETROFAC	Energy	5,981	5
27	NCC B	Industrials	961	7
28	TELE2 B	Telecommunication services	7,055	6
29	HOCHTIEF	Industrials	5,743	5
30	GEOX	Consumer discretionary	1,705	6

Source: MSCI, Worldscope, Morgan Stanley Research, May 2010. Data based on last 12 months of reported data and the latest pricing. **Exclusions:** financials and stocks that rank below the 55th percentile on a 52-week average daily trading volume (or a minimum of $3 million) or 67th percentile on free-float-adjusted market cap (where possible). Equivalent to $4.5 million of a 52-week average daily trading volume or $1.75 billion market cap.

Our UK Thrifty Thirty includes (from left to right) Rolls-Royce, Petrofac, GlaxoSmithKline and Balfour Beatty

INTRODUCING
THE NIFTY THRIFTY PORTFOLIO ON MONEYOBSERVER.COM

IN EARLY JUNE WE'LL choose the first 10 shares in a Nifty Thrifty portfolio populated by big, UK-listed companies that are cheap, financially strong and profitable.

Every three months we'll add to the portfolio to reach our target of 30 shares, using a combination of Joel Greenblatt's Magic Formula and Joseph Piotroski's F-Score to select from among the UK's 300 largest listed companies.

Nifty Thrifty updates will appear in July, October, January, and April editions, but the shares will apear first on moneyobserver.com. Eventually we will sell the shares we've held for a year and replace them with those ranked most highly by the formula.

dramatic recovery in economically sensitive companies which were priced for an Armageddon that never happened because governments took extraordinary measures to mitigate the recession. The stronger companies – the new Nifty Fifty – have been left behind.

'Of course, if they get to outrageously expensive levels we would look to sell them, but I think there is the opportunity for them to deliver good earnings growth but also for the shares to be re-rated upwards. I think there's a possibility of that double-whammy.'

The stats bear Mott and Monson out. They run income funds that, in addition to holding Nifty Fifty-style shares, also contain high-yielding companies that are, by definition, cheap. Neither fund is expensive. In April, the average prospective p/e ratio of all the companies in the PSigma Income fund was 11.5 compared with 12.7 for its FTSE 350 benchmark. Sarasin Global Equity Income fund's current p/e ratio is 12.5 compared with 16 for the MSCI World index.

Another approach is to search for Buffett-like probables: companies that are probably high quality and ought, as a group, to beat the market as long as we don't get carried away and pay too much for them.

The problem for private investors is correctly identifying the elusive 'quality' factor. Establishing what gives a company its competitive advantage – the means to earn outsized profits in future – means assessing its products, management and competitors, how efficiently it operates, the value of its brands and the loyalty of customers. It's a lot of work.

Instead, we can use statistical shorthand. Just as investors can use valuation ratios such as the p/e ratio to determine whether a share is cheap or expensive, they can use return on capital (ROC) as a proxy for profitability. ROC compares annual profits with the money the company uses to earn the profit. Companies with a high ROC are more profitable than companies with a low ROC, and the more profitable a company is the more money it has to plough back into the business and grow its value for shareholders.

A company earning above-average returns probably has a competitive advantage. But that won't always be true as ROC can mislead when a company earns bumper profits in one year but is unable to repeat the feat. No financial statistic infallibly predicts future performance, but Joel Greenblatt, another US value investor with a remarkable public record, put his faith in ROC when he invented the Magic Formula.

MAGIC FORMULA

The Magic Formula ranks companies according to just two factors. The higher the return on capital, and the higher the earnings yield, the better.

A UK NIFTY THRIFTY THIRTY

Rank	Name	Sector	Capitalisation (£m)	F-Score
1	ASTRAZENECA	Pharma and biotechnology	41,269	7
2	CARILLION	Support services	1,343	7
3	BALFOUR BEATTY	Construction and materials	1,823	5
4	UNILEVER	Food producers	24,474	5
5	NEXT	General retailers	4,089	8
6	GLAXOSMITHKLINE	Pharma and biotechnology	61,903	7
7	ULTRA ELECTRONICS	Aerospace and defence	1,063	6
8	NEW BRITAIN PALM OIL	Food producers	771	5
9	AMEC	Oil equipment – services	2,682	8
10	ROTORK	Industrial engineering	1,183	8
11	TRAVIS PERKINS	Support services	1,650	5
12	PETROFAC	Oil equipment – services	3,713	5
13	BRITISH AMERICAN TOBACCO	Tobacco	41,033	8
14	SPIRENT COMMUNICATIONS	Tech hardware and equipment	785	7
15	ROLLS-ROYCE	Aerospace and defence	10,549	6
16	DRAGON OIL	Oil and gas producers	2,481	6
17	WEIR GROUP	Industrial engineering	1,955	9
18	WPP GROUP	Media	8,407	5
19	COBHAM	Aerospace and defence	2,982	7
20	HOME RETAIL	General retailers	2,358	6
21	GLANBIA	Food producers	772	5
22	BAE SYSTEMS	Aerospace and defence	11,951	6
23	AEGIS GROUP	Media	1,457	7
24	INTERNATIONAL POWER	Electricity	4,840	7
25	LADBROKES	Travel and leisure	1,342	5
26	RIGHTMOVE	Media	794	6
27	BUNZL	Support services	2,413	7
28	PEARSON	Media	8,015	7
29	ANTOFAGASTA	Mining	8,731	6
30	REGUS	Support services	1,070	7

Source: Sharelockholmes.com, May 2010. Data based on the last reported results and the latest pricing. **Exclusions:** financials, companies that last reported year ends before 30 November 2009 and companies below a £650 million market capitalisation.

Traditionally, the earnings yield is the inverse of the p/e ratio, its profit as a percentage of the market value of a company's shares. A company with a high earnings yield earns a lot of profit, compared with its market value, and is considered cheap, so the Magic Formula finds above-average companies at below-average prices. In other words, companies that are thrifty as well as nifty.

Instead of using the traditional earnings yield, Greenblatt divides earnings before interest and tax by enterprise value, which is the value of the company's shares and its debt. This means he calculates the market's valuation of a company as if all the debt were repaid by the shareholders, a pretence that allows us to effectively compare companies with different levels of debt and tax rates.

Greenblatt also excludes the surplus assets the company owns from his calculation of return on capital. But these are refinements. An investor using better- known measures, such as the p/e ratio and return on total assets, should prosper.

A person employing the Magic Formula should do magically. In his book, *The Little Book That Beats The Market*, published in 2006, Greenblatt demonstrated that portfolios of 30 shares, each held for a year and subsequently reinvested in high-ranking companies, would have made almost 31 per cent a year between 1988 and 2004 – enough to turn $11,000 into $1,000,000. Over the same period the US stock market made about 12 per cent a year, turning $11,000 into just under $80,000. Even when he turned his attention to the largest 1,000 US companies the formula still returned almost 23 per cent a year.

According to Formula Investing, a US stockbrokerage founded by Greenblatt, which invests clients' money using the Magic Formula, the formula returned about 289 per cent in the last decade. The S&P 500 index returned -1.5 per cent, including dividends.

The Magic Formula doesn't work for every company or every year. If it did, everybody would use it. But it works well enough provided – and this is the difficult bit – you keep using it even when it's doing badly.

NIFTY THRIFTY THIRTY

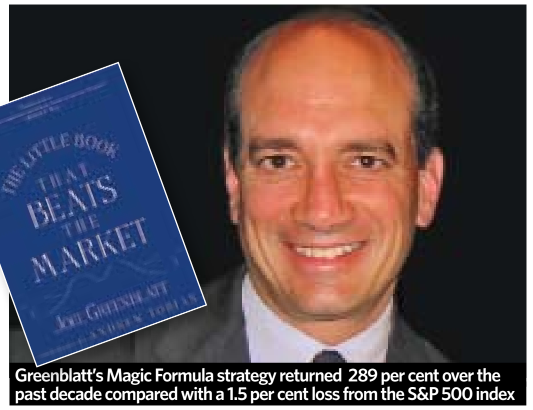
One group of analysts thinks it can improve on the Magic Formula by making it safer. Tests by a team at Morgan Stanley show that higher returns, with fewer bad years, can be achieved by combining the Magic Formula with the F-Score, which was invented by professor of accounting Joseph Piotroski (see The F factor, *Money Observer*, December 2008 or blog.iii.co.uk/piotroski).

The F-Score, a credit score for companies, brings financial strength into play alongside profitability and value. It weeds out heavily indebted or cash-strapped companies that can earn good profits when they're booming but are more likely to go bust when they aren't.

When Morgan Stanley tested large European companies it found that the highest ranked Magic Formula companies beat the MSCI Europe index by an average of 6 per cent a year between 1990 and 2008, but if it excluded companies that were financially weak, scoring less than five out of nine on the F-Score, the enhanced 'combo' filter beat the index by 8 per cent a year.

The tables (on pages 28 and 30) show some of the companies that meet Morgan Stanley's criteria today. Although we've aimed our Nifty Thrifty Thirty filter at large profitable companies with strong finances, there are unfancied companies in the tables too, partly because we chose from UK and European companies rather than global ones, but also because of the mechanical investing methodology we've employed.

By keeping to the discipline of buying the best companies at the cheapest prices, we're ignoring trends in the global economy and the financial bubbles they drive. For the Nifty Fifty advocates anticipating those bubbles is more important.



Greenblatt's Magic Formula strategy returned 289 per cent over the past decade compared with a 1.5 per cent loss from the S&P 500 index

Now here's a fantasy for you and not one you'd necessarily wish for. It's 2015. President Sarah Palin has cancelled the first manned mission to Mars as the global economy emerges from the second leg of the great recession. By insisting on quality, strength and value, some investors are prospering again. They lost money in the crash of 2012 to 2013, but not as much as investors who bought the original Nifty Fifty and forgot to be thrifty.

Richard Beddard is companies and markets editor of our sister website Interactive Investor. See page 88 for contact details.