

XP cut after power surge

After just four months, and a 68 per cent gain, XP Power has been dropped from the Thrifty 30 portfolio. Richard Beddard explains why

In an efficient stock market – one in which information flows freely – undervalued companies should not exist. As soon as a share price drops lower than a company's true value, canny investors should buy, lifting the price back into line.

Long before academics developed mathematical models of market efficiency, value investors were making money from inefficient markets. Study after study confirms the existence of the 'value effect'.

Over the long term, large portfolios of companies judged to be cheap – even by simple measures such as the price/earnings ratio or price to book value (see Share Sleuth, August 2010) – do better than companies judged to be expensive.

The most compelling explanation for the value effect is that it is contrarian. Investors tend to favour shares that are doing well and shun those doing badly. Their confidence, or lack of it, exaggerates the trend, pushing prices unreasonably high or low.

Buying shares when their prices are unreasonably low is uncomfortable, which is why so few people do it. It means rejecting the consensus view and choosing companies with chequered

reputations and uninspiring prospects, such as those in our Thrifty 30 portfolio.

But that's only half the story. Value investing is twice as taxing because it also means selling shares that have done well and recycling the cash into companies that have not. Trust me, I know. This month I ejected high-flyer **XP Power** from the portfolio and added fallen angel International Greetings. The sell decision was even harder than the buy.

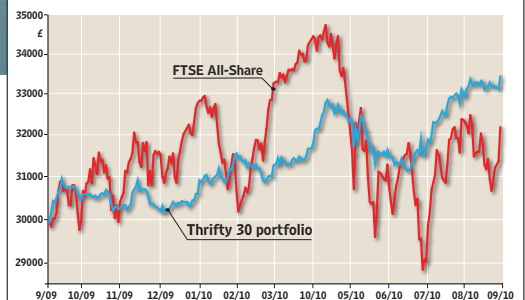
I added XP on the last day of March this year and disposed of it in early August for a 68 per cent profit after costs. I thought it was cheap at 13 times average earnings over the past six years.

Generally, I consider a share trading at 10 times earnings or below bargain territory if a company is financially strong and competitive, because it suggests the share will deliver a 10 per cent annual return. Earnings (or net profit) belong to shareholders so, on the conservative assumption that future profits remain at a similar level, investors should earn back one 10th of their investment in a typical year.

It's worth paying more, though, as I did with XP, if profits are likely to be higher in future, but only if that judgement is backed by hard statistical evidence – usually a record of consistently high profitability. Companies that earn a high return should have lots of money to invest and good opportunities to invest it. That means higher profits in future.

XP is a good example. Over the past decade, it has switched from distributing power adapters to manufacturing them. Today it makes 90 per cent of the adapters it sells, and its record of growing profits and paying back debt through the recession vindicates the company's claim that increased control over quality and costs means more profit. Over the

THRIFTY 30 CONTINUES ITS SURGE



Notes: Cost includes £10 broker fee and 0.5% stamp duty for each transaction. Cash earns no interest. Dividends and sale proceeds are credited to the cash balance. £30,000 invested on 9 Sep 2009 was worth £33,416 on 1 Sep 2010. £30,000 invested in a FTSE All-Share ETF was worth £33,180 (dividends reinvested). Objective: To beat a FTSE All-Share ETF handsomely over any five-year period. Source: Sharescope, 1 September 2010

past five years it has earned a 13 per cent annual return on assets. That puts most of other Thrifty 30 companies to shame.

But by August this year, the shares cost more than 20 times average earnings and just under 20 times this year's earnings, which means investors expected higher profits. XP is now popular, and if its price is to rise in the long run, it must grow more strongly than investors anticipate.

It might. But I prefer to invest where expectations are lower and the chances of exceeding them higher – in companies such as troubled gift-wrap and Christmas cracker manufacturer International Greetings, for example. New management seems to be restoring the company's profitability and financial strength.

MORE THRIFTY 30 INFORMATION

<http://blog.iii.co.uk/about-the-thrifty-30>

In August, I re-evaluated three Thrifty 30 companies because they had published their 2010 annual reports. Games Workshop is recovering well, so well it may soon be time to sell. Airline and haulage company Dart still looks cheap, strong and competitive. And while I have some reservations about software house Anite, I'm sticking with it too. <http://blog.iii.co.uk>

RETURN ON TOTAL ASSETS

Profit is the money left over once a company's costs have been deducted from sales. But comparing the amount of profit a company makes to the amount it has made in the past, or the profits of other companies, doesn't tell you whether it is doing a better job.

To do that you

need to compare the company's profit to its investment in machinery, offices, staff and so on, using a profitability ratio. The simplest and most conservative ratio, because it includes all the assets the company has invested in, is profit divided by total assets, or return on total assets.