

# Fortnightly Market Wrap Up

24 February 2013



Warwick  
Investment  
Club

## The WIC Market Wrap-Up

The WIC Market Wrap-Up is published fortnightly by the Warwick Finance Societies' (WFS) Warwick Investment Club (WIC) Research Team. Receive the Wrap Up via email newsletter by joining the WFS, or look out for current and archived issues on [www.wfsocieties.com](http://www.wfsocieties.com).

### In This Issue:

**Global Economy and Markets – page 3**

#### **Global Markets Overview**

*By Vassil Kirtchev, Co-Editor*

**UK Credit Rating – page 4**

#### **Moody's UK Credit Rating Downgrade**

*By Eleanor Gaffney*

**Foreign Exchange – page 5**

#### **BoJ Governor Candidates and the Impact on the Yen**

*By Marco Ross, Co-Editor*

**Foreign Exchange – page 7**

#### **Rebound in the Carry Trade**

*By William Caffrey*

**Financial Theory – page 8**

#### **Equity Markets and the Winner's Curse**

*By Richard Low*

**WIC Investment Fund – page 9**

#### **ENRC, Tesco and Aviva**

*By Christopher Viggor and John Peter Ong*

## Global Economy and Markets

## Global Markets Overview

*By Vassil Kirtchev, Co-Editor*

The year of 2012 turned out to be a solid year for equity investors. Equities outperformed bonds, and foreign equities outperformed the S&P 500. With such a terrible performance in 2011, it's not surprising that equity markets recovered somewhat in the year. However, the market's performance cannot be completely traced back to improving fundamentals. In fact, throughout 2012, analysts continued to walk their estimates for 2013 GDP growth for developed economies downward. While S&P 500 earnings in the US have grown 5.5% this year, the number is slower than the 14.5% we saw in 2011, and suggests the 10.5% growth expectation for 2013 could be a challenge to hit in light of current developments with respect to fiscal tightening.

Looking at asset class performance in 2012, it's evident we've seen an underperformance of commodities, especially gold miners. Some of this can be traced to industry-specific events. For example, with gold miners several of the majors have seen rapidly increasing costs of production, protests in foreign countries and disappointing production numbers due to weather, low grades of ore or simply due to overly optimistic guidance provided by the management to investors. With energy companies, we have seen a significant amount of supply come online while costs of production are rising. Despite all of these events, we would not have expected commodity names to have underperformed other equities so drastically. In our opinion, commodities are slightly more sensitive to changes in economic growth than the broader equity market and we think that commodities are underperforming as a result of caution over the risk for a slowdown in GDP growth next year.

Turning to specific stock market performance in 2012, most markets had a very solid year as a significant amount of risk was removed from the economy due to unprecedented policy actions. Australia and Canada slightly

underperformed due to their significant exposure to commodities. Japan underperformed due to an extremely strong Yen and the pressure the currency placed on exporters. Brazil also faced growth headwinds due to a slowdown in their export markets and heavy-handed government intervention. Some consider Brazil's renewal of energy concessions in 2012 as outright theft of foreign investor capital and a political power play, and sentiment amongst investors at this time is extremely low.

Over the past month, there has been an uptick in optimism, but what is driving it? After all, most Purchasing Manager Index (PMI) numbers remain near 50 (meaning that manufacturing and service activity is not expanding nor shrinking), unemployment in most regions remains fairly high and almost every developed economy is facing pressure on their exports. Meanwhile, governments are talking about cutting back spending while the private sector remains in a deleveraging phase with high unemployment and near-zero real wage growth. What then has driven the rally in 2012 and the increase in optimism for next year? In our opinion, the sheer number of policy responses in 2012, while not necessarily improving the picture for real economic growth, did remove some of the risks in the world economy. Anytime the market sees reduced risk, it allows for an expansion of the valuation multiple. Of the most significant policy events, there were approximately twelve in all, amounting to one significant policy item for each month in the year of 2012. No wonder equities have performed so well despite continued expectations for shrinking GDP growth in 2013. Looking forward to next year, while recent events do provide some hope, the outcome will likely continue to, unfortunately, depend largely on how policy makers move forward. While we do believe fundamentals will begin to play a larger role, we can't ignore the significance of the Fiscal Cliff and the impact it may have on earnings growth. Additionally, we shouldn't ignore the risk of how policy makers in the Eurozone will respond to Spain's almost certain request for bailout assistance next year, given their EUR 180 billion financing need, while the entire region remains in a recession. Multiple risks are apparent in other economies as well, and a slowing developed world will impact emerging economies too, particularly those that depend on the US and Europe for export growth.

We see two possible scenarios for 2013 based on how fiscal policy develops. If governments choose to aggressively reign in spending and raise taxes, we believe the economy could be at risk for a recession and we could see a pullback in equities that may present a very attractive buying opportunity, especially in hard assets. If governments choose to continue to run very large deficits, favouring “growth” over austerity, we would expect 2013 could see another year of low-quality GDP growth driven primarily by government spending, and that equities and commodities may perform somewhat favourably. While the two outcomes seem so different, we believe we can position investors appropriately for such a range of scenarios. We recommend going into the year with a balanced allocation, where the cyclical portion of the portfolio is allocated to natural resources that have underperformed the broader market this year. For the remainder of the portfolio, we would focus on high quality, large, defensible businesses with strong balance sheets, and/or international bonds, depending on each investor’s unique needs. This type of posturing should give investors the ability to participate in any further rally in the market and generate income, yet also preserve some dry powder in the event that we see a more attractive buying opportunity in 2013.

## UK Credit Rating

# Moody’s UK Credit Rating Downgrade

By Eleanor Gaffney

### Introduction

February 22<sup>nd</sup> saw the UK lose its coveted triple-A credit rating, a rating the UK had managed to maintain since 1978. Moody’s, the credit rating agency, cited subdued growth prospects and a high and rising debt burden as key reasons for the downgrade. The news comes as a severe blow to George Osborne, who in the election campaign indicated that maintaining the “glowing approval of the credit rating agencies”, i.e. the credit rating, were key

priorities. Over the past year, market sentiment regarding the prospect of a credit rating downgrade had appeared to grow<sup>1</sup> and indeed with the current outlook for the UK economy and the forewarning from Moody’s last February, the downgrade has come as no great surprise (see also Marco Ross’ *Prospect for a UK Rating Downgrade* from our 27 January edition).

### What is a Credit Rating Agency?

There are three main credit rating agencies: Standard & Poor’s, Fitch, and Moody’s. Essentially credit rating agencies provide individual and institutional investors with information that assists them in determining whether issuers of debt and fixed-income securities will be able to meet their obligations with respect to those securities. Countries are issued sovereign credit ratings. This rating analyzes the general creditworthiness of a country taking into account the overall economic conditions of a country including the volume of foreign, public and private investment, capital market transparency and foreign currency reserves. Sovereign ratings also assess political conditions such as overall political stability and the level of

Fitch	S&P	Moody’s	Rating grade description (Moody’s)		
AAA	AAA	Aaa	Investment grade	Minimal credit risk	
AA+	AA+	Aa1		Very low credit risk	
AA	AA	Aa2			
AA-	AA-	Aa3			
A+	A+	A1			Low credit risk
A	A	A2			
A-	A-	A3			
BBB+	BBB+	Baa1	Moderate credit risk		
BBB	BBB	Baa2			
BBB-	BBB-	Baa3			
BB+	BB+	Ba1	Speculative grade	Substantial credit risk	
BB	BB	Ba2			
BB-	BB-	Ba3			
B+	B+	B1		High credit risk	
B	B	B2			
B-	B-	B3			
CCC+	CCC+	Caa1		Very high credit risk	
CCC	CCC	Caa2			
CCC-	CCC-	Caa3			
CC	CC	Ca	In or near default, with possibility of recovery		
C	C				
DDD	SD	C			
DD	D		In default, with little chance of recovery		
D					

economic stability a country will maintain during times of political transition. S&P and Fitch have not yet announced whether they will follow Moody’s decision although they have already accorded the UK a negative outlook.

### Why has it happened?

Moody's has cited three key interrelated drivers of its decision to downgrade.

Firstly the continuing weakness in the UK's medium-term growth outlook, with a period of sluggish growth which Moody's now expects will extend into the second half of the decade. Secondly the challenges that subdued medium-term growth prospects pose to the government's fiscal consolidation programme, which will now extend well into the next parliament and finally as a consequence of the UK's high and rising debt burden, a deterioration in the shock-absorption capacity of the government's balance sheet, which is unlikely to reverse before 2016.

The stable outlook on the UK's Aa1 sovereign rating reflects Moody's expectation that a combination of political will and medium-term fundamental underlying economic strengths will, in time, allow the government to implement its fiscal consolidation plan and reverse the UK's debt trajectory. Moreover, although the UK's economy has considerable risk exposure, through trade and financial linkages, to a potential escalation in the euro area sovereign debt crisis, its contagion risk is mitigated by the flexibility afforded by the UK's independent monetary policy framework and sterling's global status as one of the important reserve currencies.

### What Happens Now?

The treasury has announced that the downgrade "is a stark reminder of the debt problems facing our country". With the budget rapidly approaching, the question is whether the government will stick to the austerity drive or whether it can afford to be more flexible with the budget as it no longer has the constraint and pressure to maintain the credit rating. George Osborne's recent comments seem to clearly answer this question with him stating that "far from weakening our resolve to deliver our economic recovery plan, this decision redoubles it." It is also worth noting that while the UK has been downgraded, they have been downgraded to stable status meaning there will be no further downgrades in the near future; the same cannot be said of the US or France.

Moody's downgrade is likely to hurt the pound, which fell to a two year low against the dollar upon the news to

\$1.5163. There has been a downward pressure on the pound in recent weeks amid concerns over the state of the UK economy following poor quarter four GDP results which led markets to fear a triple-dip recession. The recent release of the Monetary Policy committee minutes also depressed the pound as it was announced three of the nine MPC members, including Mervyn King had voted for more quantitative easing to boost UK growth. Whilst this may be positive news for UK exporters, the weakened pound now runs the risk of leading to imported cost-push inflation as UK imports become more expensive.

While the downgrade is politically damaging for the government, it remains to be seen whether this downgrade will be particularly damaging in financial terms with many market analysts suggesting the downgrade has already been priced in following rumours of a downgrade for some time.

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## Foreign Exchange

### BoJ Governor Candidates and the Impact on the Yen

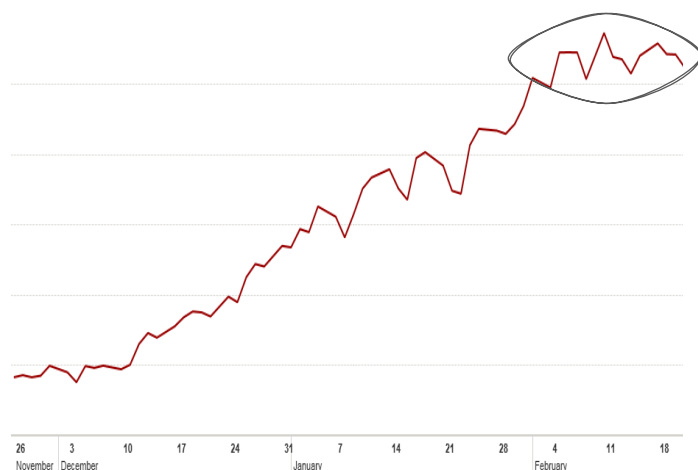
*By Marco Ross, Co-Editor*

#### Background

The Yen began its much-discussed decline in October 2012, with USDJPY now standing at 93.41 and the Yen having lost nearly 19% of its value against the greenback since the pair's 2012 lows. The rise in USDJPY since late 2012 initially seemed unrelenting; however, as shown in Figure 1, February has so far proven to be a difficult month for the pair with range-bound trading ensuing between roughly 92.5 and 94.0. Much of this indecision can be attributed to the imminent nomination of the next Bank of Japan (BoJ) Governor by Japan's Prime Minister, Shinzo Abe. With the current governor Masaaki Shirakawa due to leave the central bank in March, one month prior to the completion of his five-year term, the market is eagerly anticipating the announcement of his successor. A range of candidates have been in the running and the decision is very likely to markedly impact the Yen as the monetary policy aggressiveness of the next bank chief is factored into the

currency's value. Top candidates include former BoJ Deputy Governor Toshiro Muto, former government economist Kazumasa Iwata, University of Tokyo professor Takatoshi Ito, and Haruhiko Kuroda, the current Asian Development Bank (ADB) President. While either candidate represents a more dovish alternative to Shirakawa, each candidate's nomination would bring with it a distinct impact on USDJPY; the various potential outcomes and their ramifications for the Yen are considered in what follows.

Figure 1 – USDJPY since late November



### **Toshiro Muto**

Toshiro Muto has been until recently regarded as the frontrunner for the position although his nomination would be regarded as negative for USDJPY. While the former BoJ Deputy Governor (2003-8) views unconventional monetary policy, such as domestic government bond purchases positively and favours and expansion thereof, he is not a strong proponent of foreign bond buying and is less enthusiastic about the 2% inflation target than other candidates. Furthermore, he is opposed to BoJ law change that would remove its independence. Finally, there are fears that the opposition would oppose his appointment as BoJ Governor. His appointment to the head of the central bank would certainly deal the largest blow to USDJPY bulls.

### **Kazumasa Iwata**

In stark contrast to Muto, Iwata has been suggested as the most dovish of candidates. He strongly favours foreign

bond buying by the central bank as a method to weaken JPY and beat deflation, having recently suggested the establishment of a JPY 50tn (\$535bn) fund for the purchase of Eurozone debt. The former BoJ Deputy Governor (served from 2003 to 2008 alongside Muto) also strongly supports the 2% inflation target. Iwata at the helm of the BoJ, vis-à-vis the alternatives, is expected to result in the most pronounced weakening of the Yen.

### **Takatoshi Ito**

While initially considered a top candidate, Ito has seen his chances of leading the Bank of Japan become increasingly slim in the recent period. Nevertheless, his appointment remains on the table – at minimum for one of the two open Deputy Governor positions if not for the bank's lead – and his potential impact on USDJPY is worthy of consideration. While not opposed to foreign bond buying, Ito looks upon the 2% inflation target significantly more favourably and is distinctly impressed by the Fed's aggressive purchase of unconventional assets. Despite his academic background and consequent lacking managerial experience, he is expected to maintain very dovish policy which would translate into a weaker Yen – though likely not to the extent that Iwata's appointment could achieve.

### **Haruhiko Kuroda**

In recent days Kuroda – still the President of the Asian Development Bank – seems to have emerged as the leading candidate for the position according to the Japanese press. Kuroda sees much scope for easing though he prefers purchasing JGBs and other domestic assets over foreign bond purchases. He is also positive on the newly set inflation target and sees the Yen as overvalued. However, his appointment to the BoJ would likely require his resignation from the ADB; this would be unfavourable for Japan given that the ADB is traditionally headed by a Japanese figure. Overall, his nomination would be seen as bearish for JPY though less so than an Iwata-nomination and also likely less so than Ito being nominated.

### **Conclusion**

With the exception of Muto being nominated as the new BoJ head, a further quick rise in USDJPY can be expected following the nomination, which may come as early as next week. It must however be considered that there are also

two open Deputy Governor positions – which may also be filled by the above candidates – and much attention will be paid to the overall expected policy picture painted by the three-person combination heading the bank. A further point to note is that Abe’s leading LDP does not have a majority in the upper house and so will require opposition support for the nomination to pass; this is however not seen as a major obstacle. Ultimately, regardless of who will take over after Shirakawa, dovish monetary policy is expected in the long-run; the BoJ Governor appointment appears to be more of a question of how markets will turn in the near-term as there appears to be little reason for the Yen to strengthen significantly anytime soon.

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## Foreign Exchange

### Rebound in the Carry Trade

*By William Caffrey*

In the last three months the yen has fallen 13% versus the USD. It hit a two-and-a-half-year low against the greenback on Monday. The Yen has been in the news a lot recently due to allegations of competitive devaluations by the Japanese government. This has overshadowed an interesting development in the currency markets however – the resurgence of the carry trade.

#### What is the carry trade?

The carry trade involves borrowing in a low yielding currency and then using this relatively cheap funding to invest in higher yielding (more risky) assets in another country. This type of trade was hugely popular from 2004-2008 among hedge funds and was a very profitable strategy. The carry trade was primarily utilised between Japan and the so called commodity currencies, of which Australia is a prime example. At the height of its popularity, the Japanese interest rate was near zero, while the Australian rate was above 5%, earning investors about 5% returns. The carry trade is particularly effective when the borrowed currency is depreciating or when the currency invested in appreciates, as the amount investors must effectively repay falls with the currency, increasing

profits above the level implied by the interest rate differential.

As the global financial crisis hit in 2007/08, the carry trade experienced a massive unwind as investors fled risky trades and searched for so-called “safe haven” currencies. The yen, instead of being a funding currency suddenly became a safe haven and experienced an appreciation versus a basket of currencies.

#### Current Carry Trade

Shinzo Abe, the Japanese Prime Minister, has precipitated the recent fall of the yen with his promise of massive monetary stimulus. This, coupled with a risk-on attitude among investors has brought the carry trade back into the limelight. The current trade is slightly different to previous as investors are still relatively cautious due to a stop-start British economy and looming US debt negotiations just over the horizon. What’s more, the yen now has competition as the funding currency of choice as US and EU interest rates are at record lows with no real signs of an increase in the near future.

The rise of the carry trade has been accompanied by a fall in “safe haven” currencies, i.e. the pound and Swiss Franc, as well as the yen. This can be construed as an increase in investors’ risk appetite. Indeed, many analysts consider there to be a high correlation between risk appetite and these currencies. More evidence of the return of risk appetite can be seen in the on-going great rotation from bonds into equities as investors search for yield.

#### Risk of the Carry Trade

The carry trade is not risk free. The risk comes from the possibility of the funding currency rising and eating into profits gained from the interest rate differential. If this move is large enough, it could even cause losses. As mentioned above, today’s carry trade is more cautious than in the past for many reasons. One of the main reasons however, is that interest rates in all major economies are converging towards zero making the interest rate differential, and profit, smaller and less able to absorb adverse movements in the different currencies.

A falling yen and an increase in risk appetite have resulted in the resurgence of the yen carry trade but there is a long

way to go to reach the dizzying heights of the pre-crisis era. In particular, there needs to be evidence of monetary easing providing benefits for the real economy and solid growth to allay investor concerns regarding low interest rates globally.

## Financial Theory

# Equity Markets and the Winner's Curse

By Richard Low

Since the start of the year, the markets have picked up significantly and the equity capital market has been one star performer. It has come a long way from its moribund state; last year alone, it shrunk by over 30% in volumes and deals and even the IPOs of Facebook (\$16bn) and Japan Airlines (\$8.5bn) – the two largest IPOs of yesteryear – were unable to lift the overall mood. In fact, many IPOs that debuted in the second half of 2012 were trading below their IPO prices by the end of the year.

The current surge in equity markets has gifted corporations the chance to re-enter the equity market. In Asia alone, over \$24bn has been raised in the first 5 weeks of the year (4 times the amount raised in the same period last year or about a fifth of what was raised for the whole of last year). Against a backdrop of increased risk sentiment, we could see a bumper crop this year. Some transactions for 2013 could include Twitter, Dropbox, SeaWorld, the Bombay Stock Exchange and even the Royal Mail. However, IPOs are not all glitz and glamour and this report will discuss the “Winner’s Curse” and how we might mitigate it.

Many investors will have their favourite IPO moment. On the 5<sup>th</sup> of April 2000, Kripsy Kreme opened at US\$32 before closing at US\$37. Its IPO share price was only \$21, which meant a nifty profit of 50%-75% for investors in just a day. My own experience was with Bumitama Agri Limited<sup>1</sup>, which netted over a third of my initial investment. So with

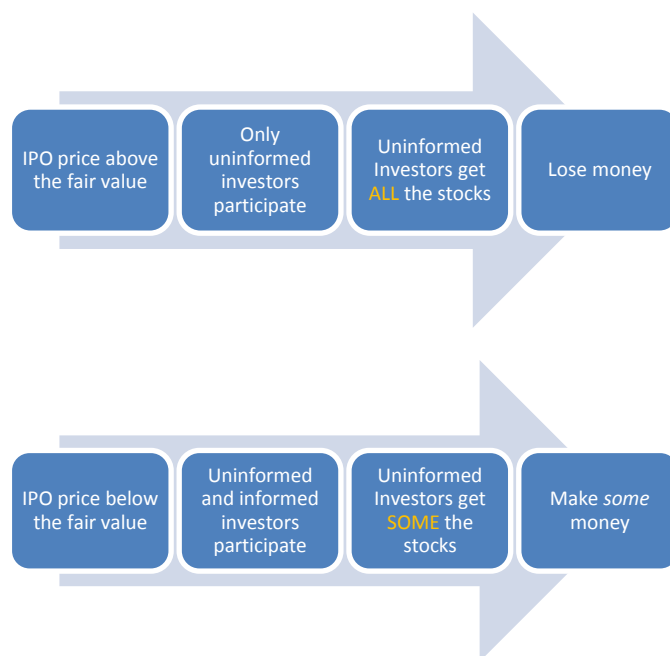
<sup>1</sup> Bumitama IPO'd in April 2012 and I was very fortunate to be allocated a few lots.

2013 having all the signs of a blockbuster year, this might be a good time to do some IPOs trading.

With short terms returns in excess of 16%, it is little wonder that IPOs are popular with investors and thus, they are often oversubscribed<sup>2</sup>. This might be because IPOs are usually priced at a discount to their “fair value” and in the case of Krispy Kreme, over US\$48m on the table for investors to take. Now, that’s a lot of donuts.

But the discount exists because there are information asymmetries between investors. Rock (1986)<sup>3</sup> claims that the discount *compensates* uninformed investors for their participation in an IPO and this phenomena is now commonly known as the “Winner’s Curse” (see figure 1). The “Winner’s Curse” can be summarised as follows: even though IPOs usually make money in the first few days of trading, we are usually allocated insufficient stocks in good issues to make up for the losses from the bad issues (because we were allocated more stocks in the bad issue as it is not as oversubscribed given information asymmetries).

Figure 1 – Understanding Winner’s Curse<sup>4</sup>



<sup>2</sup> This occurs when the number of shares demanded is larger than the number of shares available. IPOs are usually several times oversubscribed.

<sup>3</sup> Rock (1986). “Why new issues are underpriced?”

<sup>4</sup> The model assumes that the uninformed investors take part in all IPOs. To simplify the mechanics of the model, it is assumed that the stock price will revert to its fair value.

Thus, IPOs are not a definite sure win exercise and there are 4 takeaways for IPO investors:

**Read the prospectus** – All investments have risks but in the case of IPOs, the risks can be mitigated; taking part in the wrong IPOs can be a drag on your portfolio's performance. Besides understanding the company's fundamentals, learning about the principal investors in IPOs is also useful. Institutional investors and company insiders usually are more information than the retail investor and the participation of good-quality principal investors and holding of stock by company insiders usually signals quality.

**Bid more than what you hope to get** – As IPOs tend to be oversubscribed, you are likely to only be allocated a percentage of your bid (if at all). In some countries, you are also required to put the entire investment size with your broker even before you are allocated shares and thus, after adjusting for this, your returns are significantly smaller than the headline numbers.

**Remember that IPOs tend to underperform over longer horizons<sup>5</sup>** – This is down to two main reasons. Firstly, investors tend to be overoptimistic about prospects of a young company. Secondly, companies have an incentive to raise capital during an "up market" and this creates an inherent premium into the IPO price.

**Understand that prices are essentially determined by demand and supply** – IPOs are often complex exercises and all IPOs are different. The size of the retail tranche might be useful in determining the prices of an IPO because cornerstone investors might not be able to sell their stocks for the first few weeks and thus, with a restricted supply, it is reasonable that the prices will increase during the first few days of trading.

### Conclusion

IPOs are definitely an interesting way to learn more about the markets and with 2013 set to be a bumper year, there will definitely have enough "good" issues to keep you busy. Happy hunting and I hope you will get your donuts.

## WIC Investment Fund

# ENRC, Tesco and Aviva

*By Christopher Viggor and John Peter Ong*

The Investment Team this week investigated Eurasian Natural Resources Corporation for its low P/E ratio, Tesco for its solid fundamentals and earnings stability, and Aviva due to its very attractive current dividend yield.

### Eurasian Natural Resources Corporation

#### Company Description

Eurasian Natural Resources Corporation PLC is a diversified natural resources company. The company operates in six segments: The Ferroalloys Division accounted for 40.8% of the Group revenue, the Iron Ore Division 30.3%, the Alumina and Aluminium Division 13.6%, the Other Non-Ferrous Division 9.3%, the Energy Division 4.7% and the Logistics Division 1.3%.

#### Brief

##### *Earnings Stability*

Historically ENRC's earnings have fluctuated quite substantially. It's EPS record over the past 5 years has been \$1.53 (2011), \$1.52 (2010), \$0.81 (2009), \$2.05 (2008) and \$0.79 (2007). Of late its EPS have been steadily declining from \$0.91 for the half year to June 2011 to \$0.63 for the half year to December 2011 to the miner's most recent results of \$0.36 for the half year to June 2012. The revenue decrease to June 2012 has primarily reflected reduced commodity prices, in particular in the Ferroalloys and Iron Ore Divisions, and lower sales volumes in the Ferroalloys Division. The declining earnings of Eurasian Natural Resources Corp have been reflected in a declining share price.

##### *Commodity Prices*

As ENRC's earnings are closely correlated with the prices of the commodities they produce it is important to look at

<sup>5</sup> Ritter (1991). "The Long-Run Performance of initial Public Offerings."

their recent record too. The average prices for Ferroalloys dropped by 7.7% compared to the average prices in the same period last year (H1 2011). The chrome ore average price was lower by 36.9% and manganese concentrate average price by 11.7% compared to H1 2011. In addition, the Ferroalloys Division revenue was impacted by lower sales volumes, notably for chrome ore and high-carbon ferrochrome. Iron ore concentrate and iron ore pellets average prices in the first half of 2012 were significantly lower compared to the same period last year – by 25.0% and 19.9%, respectively. Iron ore is a central ingredient in the production of steel which is primarily used in construction. Uncertainty in global markets has naturally resulted in increased volatility in the demand for the group's commodities. ENRC's Production Report for the Fourth Quarter ended 31<sup>st</sup> December 2012 provides hope as the miner "achieved the highest annual production volumes since the IPO (December 2007) for saleable ferroalloys, electricity and coal" – Felix Vulis, CEO of ENRC.

#### *Balance Sheet*

ENRC's Net Assets currently stand at \$10,977m with Property, Plant and Equipment and Current Assets including Cash and Short Term Investments making up the most substantial portion of this. At 368.5p (GBP) per share the current Market Capitalisation of ENRC is \$7,064m. The declining share price of ENRC has left the market to value the miner at only 65% of its potential liquidating value. This presents a significant margin of safety to investment in Eurasian Natural Resources Corp and to quote the father of value investing Benjamin Graham "If you were to distil the secret of sound investment into three words, we venture the motto, Margin of Safety".

#### **Conclusion**

We believe ENRC's recent earnings performance does not reflect a systematic shift in its fundamental profitability but is a temporary setback due to suppressed trading conditions resulting from the volatility and uncertainty currently emanating across global markets. Taking into account the difficult trading environment, with most recent EPS of \$0.36 for the half year to June 2012 this corresponds

to a Price-to-Earnings (P/E) ratio of 7.7. This is low when compared to the wider market with the FTSE 100 P/E ratio currently 14. Therefore when confidence returns to the global macro economy in the future we can foresee significant upside in the earnings potential of ENRC. China's (a major importer of raw materials in the use of construction) most recent economic data already provides confidence with growth speeding up to 7.9% in the fourth quarter, ending a seven quarter slowdown. Growth may gain 8.1% this quarter, the median estimate compiled by Bloomberg suggests. Most importantly however ENRC's strong Net Asset position provides a significant margin of safety for this long term view and against a further decline in the group's share price.

#### Tesco

##### **Company description**

Tesco is an international retailer, and also provides financial services through its subsidiary, Tesco Bank. Its closest competitors are J Sainsbury and Wm. Morrison; these companies are used in our Comparable Company Analysis.

##### **Brief**

##### *Earnings stability*

Tesco has had high earnings stability, given the economics of its business. It has been growing its revenue steadily by £4bn per year since 2008, the first of many years of financial turmoil. Given its dominant position in this particular industry, a precipitous drop in sales is unlikely.

##### *Profitability*

Tesco has had greater profitability than its closest competitors, evidenced by its larger EBITDA margin. This is essential for grocers, which operate as low-margin, high-turnover businesses, thus magnifying any comparative advantages.

			Earnings Stability		Profitability		Dividends	Leverage	Value
			Revenue		EBITDA margin		Div yield	Debt/EBITDA	PE
Company	Mkt Cap	Mkt Share	2012	2011	2012	2011	2012	2012	2012
Tesco	30,127M	30.40%	64,539	60,455	5.94%	6.02%	4.00%	8.61	10.38
Wm. Morrison	6,515M	16.90%	17,663	16,479	5.36%	5.30%	4.20%	4.71	9.29
J Sainsbury	6,121M	11.90%	22,294	21,102	3.58%	3.92%	4.64%	8.40	10.17

#### *Dividends and Leverage*

Tesco's dividend and leverage multiples are not as favorable as its competitors'. However, its dividend yield is a function of its stock price, and was still decent in absolute terms, providing a cash buffer in the near future (April). Its leverage is in line with Sainsbury and reflects its growth strategy, such as its forays into online shopping, where it continues to build its lead.

#### *Value*

Tesco is not of particularly good value in terms of PE.

#### **Conclusion**

Tesco has solid fundamentals and propitious business prospects. To quote Warren Buffett, "in business, I look for economic castles protected by unbreachable moats;" given its dominant market position and focus on competitiveness and growth, Tesco is conceivably here to stay. Ultimately, while a wider margin of safety would be optimal, this is a good company at a fair price – we expect profits over a long horizon.

#### Aviva

#### **Company description**

Aviva provides long-term insurance, savings, and fund management services, and has an international presence. It has several competitors – Prudential, Old Mutual, Legal & General Group, and Standard Life. We decided to analyse this stock primarily due to its attractive dividend yield (7.10%).

#### **Brief**

#### *Dividend yield*

A misguided extrapolation of Aviva's DPS (dividend per share) might suggest that its DPS will remain at 0.26, thus allowing the investor to net a cool 7.10% dividend yield, which is significantly greater than the industrial average. However, this analysis is incomplete.

#### *Earnings stability*

Aviva's revenues have been steadily declining since 2009. While this has been in line with the industrial average and is understandable since Aviva provides financial services, and was thus directly affected by the recent crises, this trend affects the expectations of future dividends, which are essentially cash payouts from retained earnings. Notably, DPS in this industry has been relatively variable over these few years; the increase in DPS in 2011 is likely to be unsustainable, compelling management to reduce DPS.

Company	Dividends				Earning stability		Profitability		Value
	Div. yield	DPS			Revenue		Net profit margin		PE
	2012	2012	2011	2010	2011	2010	Q2 (Jun'12)	TTM	2012
<b>Aviva</b>	<b>7.10%</b>	<b>0.26</b>	<b>0.26</b>	<b>0.242</b>	<b>36,003</b>	<b>50,501</b>	<b>-3.11%</b>	<b>-1.52%</b>	<b>NA*</b>
Prudential	2.71%	0.256	0.252	0.201	36,506	47,646	3.99%	3.97%	15.59
OM	2.92%	(Split)	0.057	0.044	9,784	19,797	5.83%	4.52%	63.57 (split)
L&G	4.43%	0.067	0.063	0.047	18,317	38,440	3.39%	3.87%	11.59
SL	4.15%	0.0135	0.013	0.0125	9,086	18,569	3.32%	3.19%	22.52

\*(EPS: -0.24, share price 366.29)

### *Profitability*

Much of Aviva's abnormally high dividend yield is explained from its net profit margin. Of all of its insurance competitors, Aviva is the only unprofitable firm, and has in fact made a substantial loss in the recent quarter. This implies that its retained earnings have been decreasing over the past financial year, further heightening the likelihood that dividends will be reduced.

### **Conclusion**

A closer look at Aviva's fundamentals suggests that its dividend yield (past DPS over current share price) is beguiling. Barring an assessment of its business viability, a

purchase that is made to gain a 7.1% yield is flawed. In fact, it is likely that its dividend yield is so high because the market has already priced in expectations of reduced DPS. Thus, investing in Aviva to gain a high dividend yield is unjustified; there ought to be no shortage of better alternatives for a dividend income strategy.

If you are interested in joining the Investment Team or if you have an investment idea you would like to share with the team and see published in the WIC's Market Wrap-Up please contact Christopher Viggor at [c.f.j.viggor@warwick.ac.uk](mailto:c.f.j.viggor@warwick.ac.uk).

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**As an Analyst.** Undergraduates and postgraduates with keen interest in the markets may apply to the team's Analyst Programme; candidates with prior research experience will be considered for a Co-Editor role. Do get in touch with Daryl at [d.chia@wfsocieties.com](mailto:d.chia@wfsocieties.com) if you are keen on contributing.

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