CREDO WEALTH

Margin and opportunity

As long-term investors looking at the fundamentals of a company, we analyse what the intrinsic value of a business is. This is not a single number, but a range of scenarios. Any models created are questions rather than answers. A key focus is getting an idea of what 'normal' earnings are.

Two competing issues in working out 'normal', are the dynamism of the market and mean-reversion.

History is full of examples of companies that were doing very well, and then they weren't. Before cars, makers of Buggy Whips may have had quality businesses. That you may not know what a Buggy Whip is, shows how dramatically daily rituals disappear. They were whips designed to spur animals pulling carts to go faster. Then we got cars. Cars respond to accelerators, and ignore whips.

Mean-reversion is an equally powerful historical observation. Although things do change and we have some big (often painful) examples that we tend to remember vividly (think Kodak and print film), normal tends to be closely related to long-term history, and this time normally isn't different. Earnings often revert to their average.

The challenge for sound investing is to be able to develop a deep understanding of normal. To use market panic to find opportunities where a reversion to normal is not in the price, but not to be contrary for the sake of being contrary.

We have recently sold out of two holdings in pharmaceutical retail (CVS), and distribution (McKesson).

CVS operates a network of retail pharmacies. It dispenses prescriptions, and sells over the counter drugs and other general merchandise. In their Pharmacy Services segment, CVS operates as a Pharmacy Benefit Manager (PBM). PBMs help manage the costs of paying for healthcare for insurers or employers. They pool the buying power of their clients to negotiate on drug pricing.

McKesson is an American pharmaceutical distributor operating throughout North America and internationally. It delivers pharmaceutical and medical products to retail pharmacies and institutional providers (e.g. hospitals and health systems).

More recently, there have been rumours circulating in the press about Amazon potentially looking to enter the pharmaceuticals market. On the 30th January 2018, in a joint statement, it was announced that Amazon would partner with JP Morgan and Berkshire Hathaway in order to set up a new independent, not-for-profit health care company. Whilst details are still scarce and it is likely that efforts will be focussed on internal staff at first, it is clear that this new company will have the fire power to significantly disrupt the sector.

Amazon is unburdened by the costs of running physical stores and so able to offer cheaper prices. It has shown a willingness to lose money initially on product sales in order to build sufficient market share in a sector. The pharmacy market is more regulated than other sectors, but it shares many characteristics with segments that have already been targeted by Amazon. For example, the opportunity to undercut existing retail pharmacies on price by eliminating the costs associated with physical stores. It is for this reason that we believe it is most likely Amazon will initially target this segment of the market.

Jeff Bezos believes "Your margin is my opportunity". As contrarian investors, who believe in mean-reversion, we would often get excited by opportunities where a stock is disliked because their margins are below normal. This is only if we can build conviction that those margins are likely to recover. Amazon entering the sector does change things, creating a "new normal" and probably not one in which the companies competing against Amazon are as profitable as they were historically.

Investment is capital allocation. We don't have to decide whether Amazon will disrupt the market or not, if we don't hold the stock. We do have to have conviction they probably won't, if we do. There are other ideas where we can more confidently put that capital to work.

Important notice

This document has been created for information purposes only and has been compiled from sources believed to be reliable. None of Credo, its directors, officers or employees accepts liability for any loss arising from the use hereof or reliance hereon or for any act or omission by any such person, or makes any representations as to its accuracy and completeness. This document does not constitute an offer or solicitation to invest or divest, it is not advice or a personal recommendation nor does it take into account the particular investment objectives, financial situation or needs of individual clients and if you are interested in any of the information contained herein, it is recommended that you seek advice concerning suitability from your investment advisor. Investors are warned that past performance is not necessarily a guide to future performance, income is not guaranteed, share prices may go up or down and you may not get back the original capital invested. The value of your investment may also rise or fall due to changes in tax rates and rates of exchange if different to the currency in which you measure your wealth. Credo Capital plc is authorised and regulated by the Financial Conduct Authority, is a member of the London Stock Exchange, and is an Authorised Financial Services Provider in South Africa.