The Secret of Gambling

By Malcolm Howard

Being basically idle and wanting to earn money without too much effort, I have spent many years researching the secret of gambling. The discovery came about when I researched why it was so difficult to win on the horses. The secret is that you can only win on the horses in the long term when the bookmakers get the odds wrong; but they are experts and rarely do. Those with inside knowledge may win because the opening odds will reflect the horse's form and will not take into account the improvement they know about, but once their bet is on the odds will come tumbling down. In other words, the betting market is a 'perfect market' as just before the off the odds will reflect all known information. Now, given this, as bookmakers build into the odds a margin in their favour they are guaranteed to win in the long term. Therefore it follows that punters betting at starting prices must lose in the long term.

That is not to say that those gambling against the odds cannot win. Some get lucky and some make fortunes by betting on the lottery. But what we can say for certain is that the majority of gamblers lose. So what is the difference between a gambler and an investor? Well, they can be defined as follows:

A gambler (for example, a punter) is someone who bets when the odds are against him.
An investor (for example, a bookmaker) is someone who bets only when the odds are in their favour.

Unlike the horse race betting market, the stock market is imperfect and therefore it gives investors the chance to win when the market has 'got the odds wrong'.

You can classify companies on the stock exchange into two categories:

- Speculative investments; and
- Assessable investments.

Anyone investing in speculative investments is gambling; they cannot know the future and are merely hoping their investments will come good. Such companies often experience volatility in their share price. Examples of speculative investments:

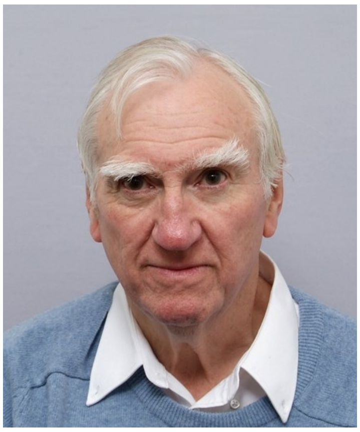
Rolls Royce – made a £4 billion loss in 2016 (but generated operating cash of £1.4 billion in the process) and at 31 December 2016 had a net debt of nearly £6 billion, although £5 billion of this related to derivatives. Given these derivatives what happens next is merely speculation.

Royal Bank of Scotland – never made a profit since being bailed out by the government. The bank lost £7 billion in 2016, after losing £2 billion the previous year. Asset backing for the share price is steadily deteriorating.

Tesco – Lost close to £6 billion in 2015, but made a profit of £129 million in 2016. However, at 27 February 2016 had net debt of £8.6 billion, equal to 106p per share. Booker takeover might improve things, but it is impossible to predict the future. Being embroiled in false accounting accusations adds mud to the water.

BHP Billiton – Lost $6.4 billion in 2016 after making a profit of $1.9 billion in 2015. At 30 June 2016 net debt stood at a staggering $25 billion. Add into the equation commodity prices and we have a great deal of uncertainty.

Assessable investments relate to companies that make a profit, generate cash and usually pay a dividend. In these cases it is possible to compare the growth built into the share price with the projected growth



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based on historical values and what can be gleaned from 'analyst' style meetings. This, of course, is where UKSA meetings can be extremely useful although you have to remember that 'investor relations managers' tend to be over-optimistic and you have to be able to read between the lines. BP plc is an example of this:

<u>BP</u> – Lost $9.6 billion before tax in 2015 and a further $2.2 billion in 2016. The problem is that Income Statements include judgemental adjustments and only the Cash Flow Statement shows the true picture. Here it could be seen that the company is in a downward spiral. $33 billion of cash was generated in 2014, but this fell to $19 billion in 2015 and $11 billion in 2016. At the UKSA meeting we were told that $9 billion of cost and capital had been delivered one year early, so why had net debt increased from $27 billion in 2015 to $35 billion in 2016? The 'gearing ratio' is defined as 'long term debt divided by capital employed x 100'. On this basis, the company's gearing ratio was 36.9%, yet we were told that by the end of 2017 this ratio would be between 20% and 30%. We were told that the strategy was 'getting back to growth' but whether this happens or not is purely speculative.

Growth calculations are based on 'effective earnings per share' (eeps). This is defined as 'cash inflow from operating activities before movement in working capital, divided by the number of diluted shares.' Having assessed what a share price should be, the figure calculated should be discounted for risk. The greatest risk is debt because being unable to borrow more when a key payment is due (such as corporation tax) is what leads to liquidation. Having high and increasing inventory days or receivable days is a potential problem, as is having significant liabilities on the company's pension scheme. But after all this, we are asking: has the market got the odds wrong? Examples of assessable companies and potential risk are as below:

<u>Waterman Group</u> – Annualised EEPS = year to 30/6/15 – 7.6p, year to 30/6/16 – 11.3p and six months to 31/12/16 – 13.9p. The company had no debt and cash balances in the same three accounting periods were £4.7 million, £5.9 million and £7.0 million. The company had no inventories and debtor days were 137 days, 123 days and 121 days. There was no retirement benefit deficit. There was no assessable risk and at 75p the share price was suggesting 11% negative growth when the company was clearly growing in terms of both profit and cash generation. The market had clearly got it wrong as was confirmed in mid-May when the company received and accepted a takeover bid of 140p per share.

<u>Titon Group</u> – This is another company visit organised by UKSA. EEPS from 30/9/14 to 30/9/16 moved from 15.6p per share to 17.9p per share and 19.6p per share. The company had consistent cash balances of around £2.5 million and no debt, which was proved by the fact that each year the company earned interest rather than paid it. There were no pension liabilities. At 120p per share there was 7% negative growth built into the share price, whereas the company was clearly growing, but there was a potential problem in that inventory days had moved from 88 days to 100 days and debtor days had moved from 82 days to 103 days. This was a risk and the assessment had to be made whether this was a temporary problem or a major problem that would become significant. Then the company issued its interim figures for the half year to 31 March 2017. Growth was still there (the rate had slowed slightly) but inventory days were back down to 91 days and debtor days were down to 88 days. The share price shot up to 168p. Readers can make their own judgement as to what it should be.

The message is that if you are a lucky gambler you might win, but overall and in the long term investors will achieve a better return.

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