Thesis approach to UK equities

At Thesis, we aim to control risk within all the portfolios we manage and to deliver consistent returns over the long term for our clients. UK equities form a core part of many clients' portfolios. They have the potential to provide both income and capital growth, and with roughly three quarters of the revenues of FTSE 100 companies coming from overseas, they offer a more diversified exposure to the world economy than many other countries' national markets. Thesis has proven expertise in managing UK equity portfolios. One of the methods we use to identify good UK stocks to include in our portfolios (and poor stocks to be avoided) is a proprietary quantitative tool called TESS, which stands for Thesis Equity Stock Screen.

Introducing TESS

TESS was created in response to a desire within Thesis to ensure our UK equity selection process is rigorous and consistent. Based around the simple premise that 'good companies produce good numbers', we sought to develop a method of sifting out the stocks with the best long-term prospects based on their fundamental data, meaning we do not have to follow the opinionated and often unreliable recommendations from brokers and other market sources, which are often focused on the short term. The intention was to create a more distilled essence of the real health of a company from which to formulate a decision: TESS is a quantitative process for filtering stocks.

Developing the screen

A leading university worked with us to develop TESS. With so many possible different ratios to look at, initially we simply needed to establish a list of measures to analyse company financials (the profit and loss account, the balance sheet and the cash flow statement) which we anticipated could be predictive of future performance. Having ensured we had readily available data going back as far as possible, we then established which had historically been the most reliable indicators. Through further research we reduced the number of ratios to six that are consistent and reliable.

In our initial development work, we subjected the largest 250 non-financial companies for which reliable financial data was available to TESS and tracked the returns of the 50 top scoring companies through an 18-year back test. We analysed the data and found outperformance in the 50 companies rated most highly by the TESS screen in 16 of the 18 years in the test period (1992-2009). While some sectors were more heavily represented in the top 50 portfolio, on average over the 18 year period, no sector accounted for over 10.2% of the portfolio. The TESS screen has a slight value bias in its outputs, but this is unsurprising as value stocks have tended to outperform growth stocks over the long term.

TESS scores are calculated based on ratios representing profitability, yield, growth, margins, assets and momentum, together with historic return data. We believe these indicators together provide a reliable method of forecasting how the company's shares are likely to perform. Over the years about 50% of the stocks in our universe have remained on the buy/hold lists, about 25% have moved in and out of favour, and about 25% have exited and not returned.

We exclude IPOs, since a company new to market doesn't have the history of market data that we require to apply the screen. This helps to reduce risk, since large established companies tend to be more stable, predictable and diversified than smaller and/or new companies.

Financial stocks are looked at separately, because their balance sheets are not usually directly comparable with non-financial companies, and their returns can be driven by different factors. Here we use a different set of ratios which we call TESS-F. The behaviour of financial stocks tends to be less predictable than non-financials, as events since 2008 can testify, but our back testing shows that TESS-F would still have delivered statistically significant long-term outperformance.

TESS in practice

Today we apply TESS and TESS-F to a total of about 350 UK companies, roughly the same constituents as the FTSE 350 Index. This means that we have an underlying 'view' on 350 stocks at any one time, and each company will be given a portfolio recommendation according to its TESS score (buy, strong hold, hold, sale review, sell). The top 20% of the universe (approximately 70 stocks) are likely to be fairly consistent outperformers and therefore form the provisional buy list. However, while TESS is a very powerful tool for highlighting stocks that merit further analysis, we do not see it as a 'black box' to be followed slavishly or unthinkingly.

Refining the TESS outputs

Once the TESS scores have been calculated the research team completes a deeper analysis of the first quintile stocks, those in the top 20% of scores which the back testing has shown tend to outperform.

The published accounting figures used to calculate the original scores can be influenced by certain actions taken by the company that may flatter or distort that year's financial accounts and therefore influence the score. An example of this would be the gain or loss on disposal of a discontinued operation which is accounted for in the income statement, and thus influences some of the ratios used to calculate the TESS score. Such events are more than likely one-off events that artificially boost earnings so need to be removed from the accounts and the scores recalculated.

Another area which often requires attention is the dividend yield. Given the increased use of special distributions (also intended to be one-off in nature) there is scope for the dividend score to be artificially inflated. We therefore identify stocks which have made special distributions and recalculate the scores based on the normal dividend policy. The market will usually have rewarded the extra return of cash by increasing the price of the shares, and it will therefore already be reflected in the momentum component of the TESS score.

Once the financial analysis is complete, further due diligence work is carried out on the shortlisted companies. This can include quantitative analysis on valuation, profit momentum and cash generation, top-down views on macroeconomics and sector rotation, together with qualitative work on the company's strategy, the quality of its management and its customer base. The resulting findings and recommendations are presented to the UK Equity Committee for approval. The Committee consists of equity specialists from our research team and investment managers. This dual composition ensures that different perspectives are included and the research team's analysis receives appropriate challenge and scrutiny.

The filtering process results in a 'best ideas' list of about 30 stocks: the original universe of about 350 companies is subjected to the TESS screen to give us the top quintile of 70 or so stocks, which are subjected in turn to the scrutiny and selection of the research team and the UK Equity Committee to choose the 30 or so most promising portfolio holdings.

Aside from the stock selection process, industry and market analysis is completed to aid in the allocation process. A steer is taken from the outputs of the stock screening process, but the UK Equity Committee has the overriding decision on sector allocation. For example, if five of the top 70 stocks were mining companies, we might decide to hold just two companies instead of all five, but then increase the size of the aggregate holding to match the proportion of the original universe represented by mining companies (in this case, roughly 7%). This ensures that the buy list remains diversified, but extra emphasis is placed on the highest scoring stocks.

The TESS screen is updated and the results scrutinised each calendar quarter, although some ad hoc updates may also take place, for example to accommodate corporate actions.

Applying restraint

Where a stock shows a very strong increase in its TESS indicator, this would not necessarily result in a buy recommendation being made immediately to our investment managers. The UK Equity Committee may decide to monitor the stock for a period to ensure that the score stays high, or to target a particular entry point. Similarly, stocks whose scores fall out of the first quintile may be retained on the buy list if the Committee believes that the stock is still good value and the factors affecting the score are likely to be temporary in nature. It is not just the TESS outputs that indicate a change of position, there is a research and common sense overlay, as well as technical analysis on price movements.

This restraint helps to avoid excessive turnover in portfolio holdings, and prevents investment managers from needing to purchase or dispose of assets that are subject to short term market influences. For liquidity reasons, we typically would not include in portfolios any company with a market cap of less than £750m.

UK equities in model and bespoke portfolios

Each stock in a client's bespoke portfolio is subject to the oversight of the Thesis investment manager, to ensure it is appropriate and proportionate to that particular client's mandate. For example, a client with a bespoke portfolio may already have a large holding of a stock in a particular sector, possibly from a previous employer's remuneration or severance package, which cannot be sold without incurring a large tax liability. It would not make sense for the client's investment manager to act on a buy recommendation for a similar stock if this created an unacceptable overweight position in the sector.

Some clients want to invest ethically, so their investment manager would bear any restrictions in mind before making portfolio changes. For clients who want more comprehensive ethical oversight of their portfolios our ethical investment team completes detailed positive screening on the top-scoring TESS stocks and offers clients a filtered version of the equity buy list to match their personal requirements.

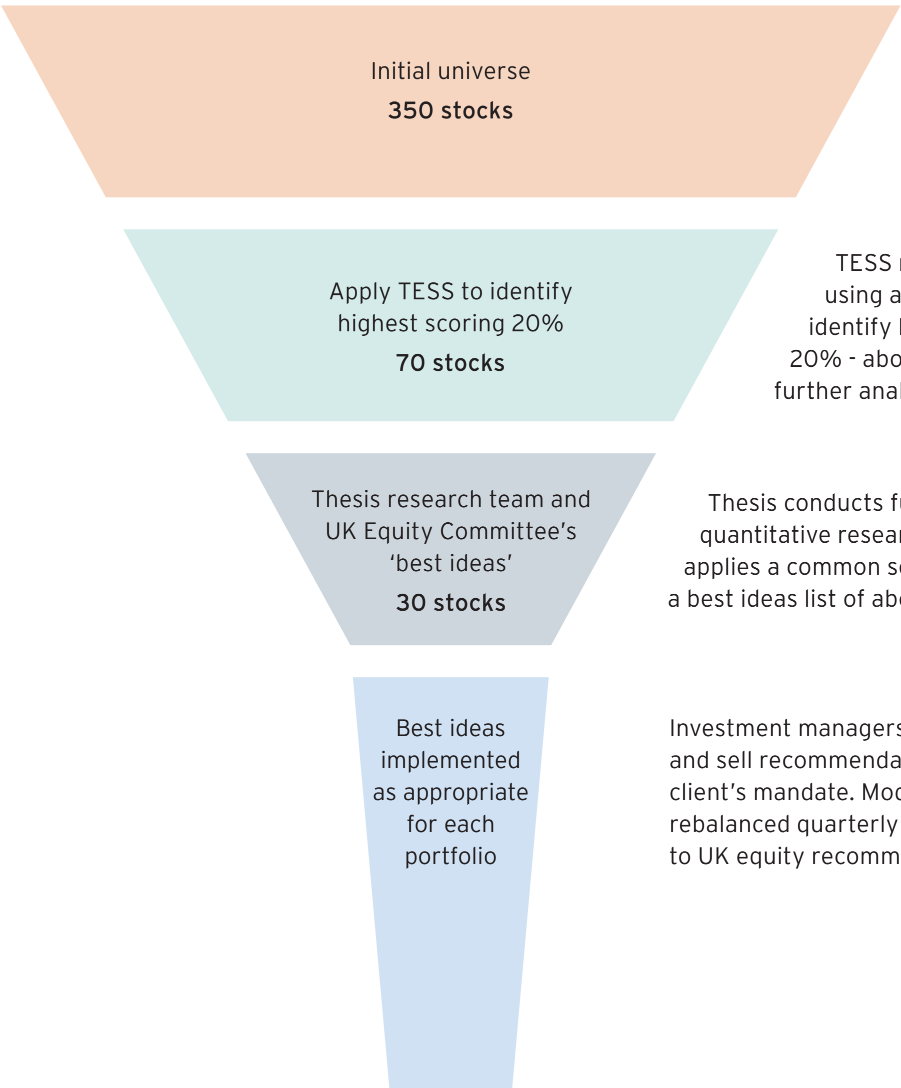
We also manage model portfolios that hold UK stocks directly. These portfolios always hold our current buy list, and therefore gain speedy access to our best ideas, although turnover may be higher than in a bespoke portfolio. A further advantage of holding securities directly in these portfolios lies in the exposure to UK equities without incurring the management and administration charges associated with holding funds. Exposure to other equity markets and asset classes in these models is achieved through exchange traded and collective funds, as we currently only use TESS to screen UK equities.

An aid to identifying winners and losers

Our overall aim has always been to identify those companies that will prosper in both good and bad times, and equally to identify and discard those that will languish. Avoiding the companies that will lose in a challenging environment is just as important as picking likely winners, in terms of ensuring competitive investment returns for our clients.

We would not contend that TESS uses the best combination of ratios – there may still be another combination that could be shown to perform better. However, we are confident that TESS offers a reliable initial screening process that is enhanced by our subsequent research, analysis and due diligence on the stocks concerned.

Stages of UK equity selection



Our starting point is a universe of stocks which approximately equates to the FTSE 350 Index

TESS ranks each stock quantitatively using a number of financial ratios to identify likely outperformers. The top 20% - about 70 stocks - are flagged for further analysis by our research team

Thesis conducts further qualitative and quantitative research and analysis and applies a common sense overlay to create a best ideas list of about 30 stocks

Investment managers implement buy and sell recommendations to suit each client's mandate. Model portfolios are rebalanced quarterly to reflect changes to UK equity recommendations

Note that the number of stocks shown at each stage is approximate and we may consider more or fewer stocks for inclusion in portfolios as markets and our views on current risks change.

Contact us

To find out how Thesis can deliver the right investment management services for your clients, please contact our business development team.

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