
Big and boring - when playing it safe pays off

Written by Chief Investment Officer Steve Johnson and originally published in Money Magazine.

When it comes to investing, does being boring ever pay off?

The contrarian approach to investing is not a new concept. If you want to generate returns better than the crowd, you need to be different.

Against the backdrop of a tumultuous past year and a half, the easiest thing was to play it safe in the light of uncertainty. That's exactly what many people did, including some high-profile professional investors who converted their portfolios to cash in March 2020.

For us, being agile, open-minded and willing to be contrarian was more important than ever last year. It allowed us to invest in a collection of unloved businesses at once-in-a-lifetime prices.

And it paid off.

The 2021 financial year was the best on record for Forager across both our Australian Shares Fund and International Shares Fund.

That was then, what about now?

The current environment reminds me a lot of 2017. We had had a wonderful few years of outperformance leading up to that year, with many of our contrarian investments paying off handsomely. The following two years, however, were our two worst on record.

When I reflect on that 2018-2019 period, our biggest mistake was to keep being contrarian simply for the sake of it. I wrote an article at the end of 2017 that identified 10 blue chip stocks that made for a nice defensive portfolio in a generally expensive market. Not only did those 10 stocks perform well over the subsequent year, on average they outperformed our Australian Shares Fund by some 20%.

There is a time and place for contrarian bets. And there's a time for playing it safe.

Right now, interest rates remain at record lows, stock markets are trading at all-time highs, people are inventing new metrics like revenue multiples to justify absurd prices for growth stocks, inflation is becoming a serious concern and COVID resurgences are weighing on the economic recovery.

More importantly, there are very few pockets of undue pessimism.

It is time, once again, to be thinking about the benefits of safe and boring. Once again, like 2017, investor obsession with hyper growth and high returns has left some of these stocks neglected.

The beauty of being big and boring

Let's take a look at two big and boring stocks currently in our Australian Shares Fund: Downer EDI and TPG Telecom.

Employing some 52,000 people in Australia and New Zealand, Downer Group is one of the antipodes' largest industrial services companies. Its operations range from maintaining buildings and railway lines through to building roads and runways for the defence force.

If that sounds boring, that's the whole point. After a number of slip-ups in recent years, the company has been focussing on making itself as boring as possible. It has been winding down its higher-risk construction business, has offloaded most of its mining services businesses and sold its laundries operations for a tidy sum. By 2024, we estimate 80-90% of revenue will come from government-related entities.

This transformation has gone largely unrewarded by investors. Up until its latest results were released in August, the share price was languishing at 2016 levels. We think it can generate an 8-9% cash return from these prices, is committed to sharing most of that cash with shareholders and should be able to generate growth in line with the wider economy. In a world of expensive assets, that adds up to just fine.

Telcos out of fashion

TPG is earlier in its transformation journey. The original TPG was a popular founder-led business which David Teoh built from the ground up and created a huge amount of shareholder value.

His final act was to merge with Vodafone, much to Rod Sims ire. The ACCC Chairman didn't like the impact this merger could have on competition and the deal ended up in the courts. TPG won, the ACCC lost and the combined company is now a significant player with more than five million mobile subscribers and two million fixed broadband subscribers.

Teoh has now left the business and the days of rapid growth are well behind TPG. But we think the concerns Sims had about competition suggest a brighter future ahead for the sector.

On the fixed side of the business, margins have been compressed by the transition from reselling ADSL to lower margin NBN contracts. From here on, there is upside in potential NBN price cuts and the networks themselves are starting to bypass the NBN with home 5G wireless devices (my household uses one, it's super fast and was the easiest installation I have ever experienced).

And in mobile all three large players are talking about a "better" pricing environment, with all of them selling new contracts at better than the current average. Sims won't like that, but it is good news for shareholders.

We think all of this adds up to a business that can generate a cash return of roughly 8% on today's market capitalisation. Unlike Downer, we might need to wait a few years while TPG repays some debt, but shareholders should see most of that paid out as dividends from the 2023 financial year.

The telco sector is mature, boring and stable, but we will take 8% over most of the opportunities we are seeing today.

The lesson: you don't always need to be different

Forager's motto is "opportunity in unlikely places". It's an approach that has served us well over the past decade. Despite the odd year of poor performance, our clients are still well ahead of the index since our Australian Fund's inception in 2009.

We have learned an important lesson from those difficult years, though. You don't always need to be doing better than the crowd.

Keeping it simple is not always easy. Especially when, like us, you have a reputation for being contrarian. To turn to our loyal client base and say "you know how we look for opportunity in unlikely places?". Well, we just bought Downer EDI. That doesn't sit well with how we view ourselves or what our clients have come to expect. And that's what makes it so hard.

But we know how important it is. The contrarian's time will come again. And, while we wait, boring stocks like Downer and TPG can give us some perfectly sensible returns.