



Insights, Tacit Thought | Weekly Investment Insights

## Defensive Stocks

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A discussion about utilities act as weights on the eyelids and will put most people to sleep. This reputation is well deserved. Utilities are boring companies engaged in supplying a necessary service like electricity, water, internet and mobile services that customers will pay for come rain or shine. While some of the traditional utility companies in the UK are oligopolies, they don't enjoy the pricing power exercised by other oligopolies. They are also at risk of nationalisation below market values if Corbyn comes into power.

What makes a utility a defensive stock? Long term recurring contracts with customers. As we mentioned before, not all contracts need to be literal. [Metaphorical contracts](#) are often harder to break than those requiring a signature above the dotted line.

One of our main holdings across all of our strategies is the Finsbury Growth and Income Trust. The fund invests in companies that have metaphorical contracts with its customers. The three largest holdings in the fund are Unilever, Diageo and Relx which account for 30% of the assets, were all up last month while the broader UK market fell.

Unilever and Diageo have recurring metaphorical contracts with their customers created by habit patterns which snowball over time and tether the customer to a product. Relx has literal recurring contracts with its customers. These companies would never be included in any index of utility companies because investors often have a very narrow view of what a utility is.

These companies are disguised utilities without the regulatory risk. They are also asset light compared to the traditional utilities. The second point is especially important for long term investors. The mathematics of having an asset light utility cannot be overstated.

Imagine a traditional utility like a power station. Steam turbines are used to generate electricity and have a useful life of say 20 years. If the steam turbines cost a total of £100 million and have a useful life of 20 years, accounting rules say they must be depreciated at 5% every year. However, this depreciation charge understates the actual cost of replacement. If inflation grows at 3% annualised for the next 20 years, the power station will need to spend £180 million when the time comes to replace the turbines – almost double its initial cost.

This means that the utility will always exaggerate how much money it is making – its income statement will look healthy but its cash flow statement less so. At the end of the day, cash is still king. Dividends, share repurchases and R&D spend depend on cash, not an accounting profit.

Asset light utilities like Unilever, Diageo and Relx are disguised defensive stocks that can protect on the downside and also deliver growth on the upside.

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