The Telegraph

Questor share tip: buy Sage, owned by four top managers with 'skin in the game'

Questor admires fund managers who broadly follow Warren Buffett's methods

By Richard Evans, personal finance editor

28 SEPTEMBER 2016 • 6:47AM

Welcome to the first of Questor's new Wednesday columns, in which our share selections are prompted by where the professional investors we most admire are putting their clients' savings. But the "follow the money" idea goes further than merely aping the investment decisions of some prominent portfolio managers.

- Read our introduction to the revamped Questor column here

The professionals whose actions we believe are most worthy of private investors' attention are those who invest their own money in the funds they run and in the asset management firms they work for. This gives them the best possible incentive for making decisions that will enrich their clients.

Many fund managers, unfortunately, are more motivated to make their funds as large as possible, as their employers' income is normally a percentage of fund value.

There is a final element to the follow the money method: we will be particularly inclined to invest in companies whose directors have large shareholdings.

Many of the portfolio managers we respect share a similar approach to investing, which is broadly along the lines of Warren Buffett's. They are long-term holders of shares, and pay great attention to the quality of the management teams concerned. They look for effective and sustainable barriers to competition – Mr Buffett's famous "economic moats".

Buy | Sage Group

Market value: £7.9bn

Dividend yield: 1.9pc

Year of formation: 1981

Turnover: £1.4bn

Pre-tax profits: £184m

Debt: £405m

Return on capital (including goodwill): 18pc

p/e ratio: 40.4

Cash generation as a percentage of profits: 111pc

Source: Sage, AJ Bell

When it comes to financial performance, we follow the advice of those professionals who say the most important measures are return on capital, the ability to deliver profits in hard cash rather than as a notional figure that derives from complex accounting techniques, and low debt.

The best growth comes from those companies that can produce these high cashflows from their assets and then reinvest that money in new assets at similar rates of return. Any business that can do this reliably over the long term will deliver a strong compounding effect and should reward shareholders handsomely.

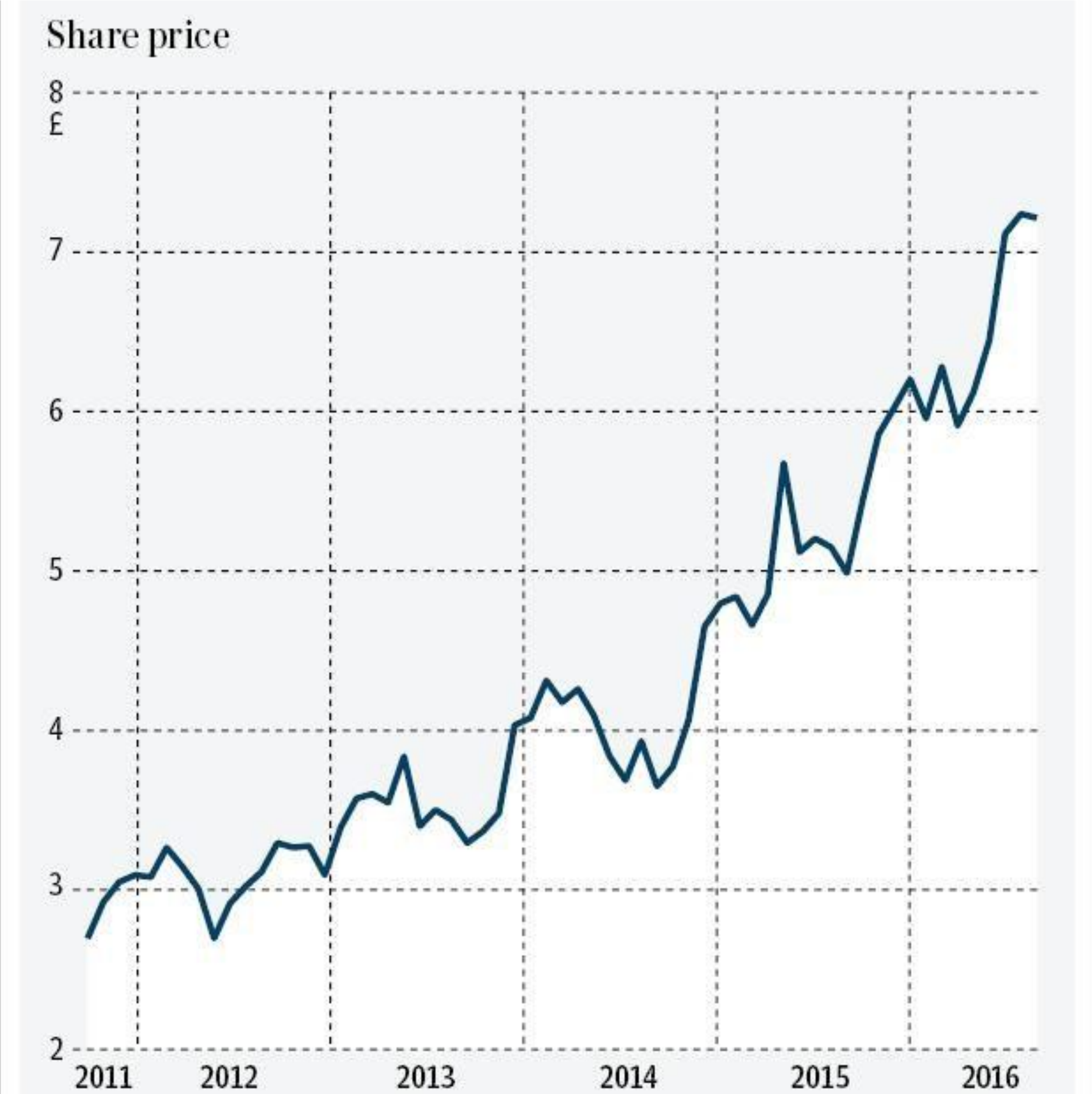
The only instance where such a company will not deliver for shareholders is when the shares were bought at too high a price. As a valuation yardstick, we will look at the much-loved price-earnings (p/e) ratio.

Among the professional investors who focus on return on capital, cash generation and low debt are Terry Smith of Fundsmith, Nick Train of Lindsell Train, Sebastian Lyon of Troy Asset Management and Hugh Yarrow of Evenlode.

Mr Smith founded Fundsmith and has a large stake in his flagship Fundsmith Equity fund, while Mr Train co-founded the firm he works for and has a multi-million-pound holding in the Finsbury Growth & Income investment trust, which he manages.

Mr Lyon has a similarly large stake in his Personal Assets investment trust. The family of Hugh Yarrow, manager of the Evenlode Income fund, owns a large slice of the management company.

All can therefore be said to have significant "skin in the game" – and all four of the portfolios mentioned own a stake in today's tipped share, Sage Group.



The software company has modest debts and good return on capital of 18pc (Mr Smith looks for figures in the mid-teens or higher). “Cash conversion” – which reflects the firm’s ability to produce real profits unadulterated by accounting trickery – is more than 100pc.

The firm has a record of investing the money it produces in bolt-on acquisitions that allow the group to show decent growth – profits on a per-share basis have grown by an average of 7pc over the past five years, according to Morningstar, the investment analyst, while the dividend has grown by 9.5pc annually over the same period.

While Morningstar has rated Sage’s economic moat as “narrow” it pointed out that “the company’s brand is well-recognised throughout Europe ”. It added that Sage had “created a great deal of trust in the small business community, with more than 50pc of sales generated by word of mouth”.

Questor has been a long-term holder of Sage. Our one concern would be the valuation, which is on the high side.

Fundsmith Equity also holds Intertek, recently tipped by Questor. Andre Lacroix, Intertek’s chief executive, has a large holding in the firm.

For investors who prefer funds or investment trusts to individual shares, we would happily recommend all those named above.

Your feedback

We want Questor's followers to continue enjoying and benefiting from our columns. Let us know what you think by emailing questor@telegraph.co.uk or by writing to Questor, 111 Buckingham Palace Road, London SW1W 0DT.