Cover: Is tobacco investment going up in smoke?

By Beth Brearley 3rd August 2016 8:22 am

Loved by equity income managers and shunned by socially responsible investors, tobacco has long been a divisive sector, albeit one that has managed con-stantly to churn out dividends over the past 20 years. But as the UK government ramps up its campaign to encourage smokers to kick the habit with the introduction of plain packaging, and insurance behemoth Axa remembers its raison d’être and retreats from the sector, are the tables turning for tobacco?

There are currently over a billion smokers in the world, according to the World Health Organisation. The harmful effects of tobacco have been widely reported for decades, with WHO calling it “one of the biggest public health threats the world has ever faced”.

In the developed world, the message is resonating. Since the Office for National Statistics began recording the UK's smoking habits in 1976, the number of smokers has fallen from 46 per cent of the adult population to 19 per cent in the latest statistics from 2014, although this figure has remained the same since 2013. However, the number of cigarettes smoked per day has fallen to its lowest point in 40 years at 11.4 cigarettes, down from 12.1 in 2013 and 16.8 in 1976. Cancer Research UK asserts the number of smokers is on track to fall to 10 per cent by 2035.

According to British American Tobacco (BAT), the global tobacco industry is valued at around £450-£500bn. But BAT is under no illusion about the declining numbers of smokers in the developed world and has turned its attention to the emerging markets.

"Generally speaking, we think that individual smokers will consume fewer cigarettes each and smaller percentages of populations will smoke," the firm says in its outlook. "While cigarette sales in developed countries continue to decline year on year, sustained volume growth is widely predicted in emerging markets, driven by population growth and increasing disposable income. As a result, the overall value of the tobacco market continues to increase."

The UK introduced plain packaging for tobacco products on 20 May this year, following in the footsteps of Australia, which adopted plain packaging in 2012. Colours and logos have been replaced with standardised product names and are adorned with graphic photos showing the dangers of smoking.

> "You have to look at sales and packaging rules in the UK to ask 'how long can this go on for?'"

Not surprisingly, BAT has opposed plain packaging, claiming it is unlawful on the grounds the government is "taking property from businesses without paying for it". This reaction is not unprecedented; Philip Morris Inter-national (PMI) sued the Australian government over plain packaging, claiming it was in violation of a bilateral trade agreement with Hong Kong. Australia won the legal battle.

Jamie Clark, fund manager in the macro-thematic team at Liontrust, says the new packaging laws will compound the secular decline of smoking and hinder pricing hikes.

He says: "There is now a social stigma to the habit. While the bull case for tobacco is that the contraction in volumes will be offset by the increase in price, if tobacco companies can't advertise or brand their packaging, it will be difficult for them to increase their pricing."

Clark says the team has not owned tobacco stocks in their portfolios since 2012 on the grounds that "the investment credentials of tobacco [are] gradually eroding". He points to research released by Citigroup in 2010 that suggested smoking will die out by 2050. Although he forecasts the decline to be "much stickier than that", he is bearish on the prospects for tobacco.

"There is also a social stigma in the developing world. China is the key engine of growth for tobacco, but it is introducing a ban on smoking in public places. They are introducing social education programmes and pre-school children in China are taught to tell adults to stop smoking. We are seeing a sea change in the perception of the habit."

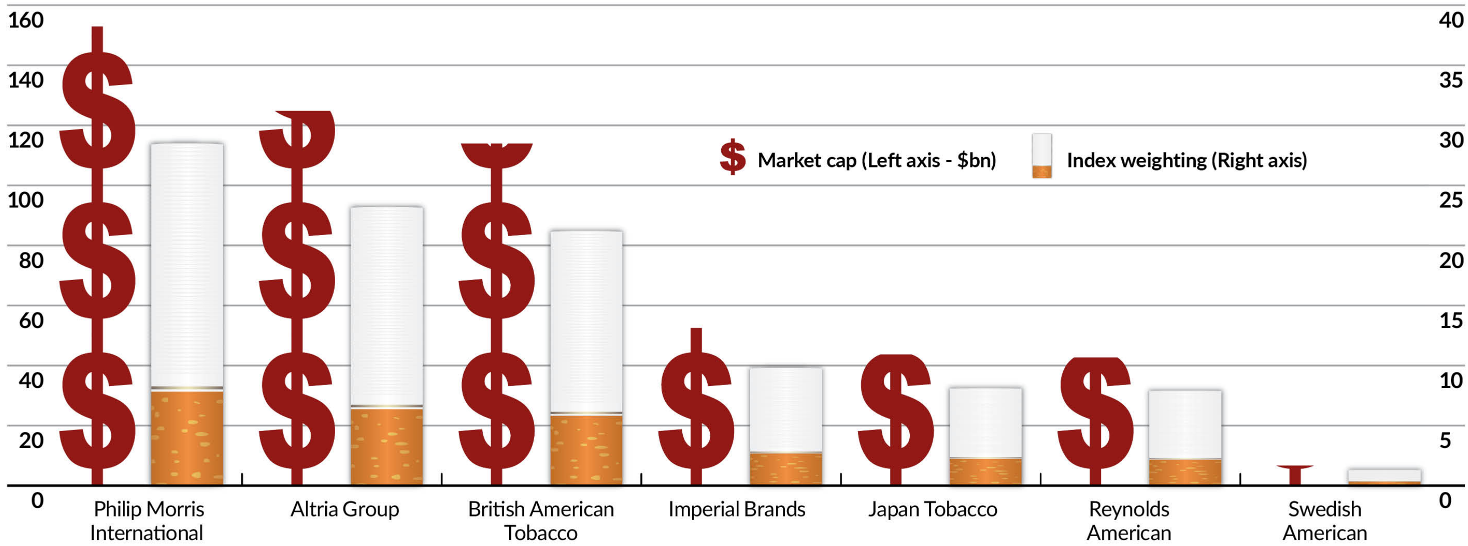
James Horniman, portfolio manager at James Hambro & Partners, does not currently invest in tobacco, saying: "There are cleaner ways of making money for clients than investing in tobacco. It leaves a bad taste in the mouth."

He adds: "So far the industry has survived in the face of the legal battles against it, but you just have to look at the sales and packaging rules in the UK to ask 'how long can this go on for?'"

Elsewhere, fund managers are rather more blasé on the impact of plain packaging, with some even suggesting it will make monopolies of the major brands.

Martin Cholwell, equity income manager at Royal London Asset Management, says: “For established players such as Imperial, plain packaging could be a great advantage as it will be virtually impossible for new entrants to come to market. Their relationship with retailers will be even more important.”

Top 7 constituents of the MSCI World Tobacco Index



Source: MSCI World Tobacco Index

Miton’s David Jane, who has around 10 per cent of the Miton Cautious Monthly Income fund invested in tobacco, points out that the addictive nature of tobacco holds more sway than pictures on a box and says the investment credentials of tobacco remain intact – for now.

“The grotesque packaging may deter new smokers, but the number of existing smokers is shrinking only relatively slowly,” he says. “Yes, it’s a dying product over time, but that doesn’t make it a poor investment.”

According to a review by the Australian Government, plain packaging in combination with graphic health warnings contributed to the decline in smoking by around 0.55 percentage points between December 2012 and September 2015, equivalent to one quarter of the total drop. However, the introduction of plain packaging in Australia has been dismissed as ineffective in some quarters.

Michael Clark, fund manager at Fidelity, says the Australian figures suggest the UK’s law will have little effect.

“We don’t think plain packaging will have a major impact, looking at the experiences in other markets, such as Australia,” he says. “Tobacco is a declining business in all the developed markets. The falls in Australia continued -after the introduction of packaging a couple of years ago.

It hasn’t changed the way the market works in a big way.”

While the Government is seen to be taking an active role in attempting to curb smoking in the UK, should such responsibilities extend to financial services?

In May this year, insurance giant Axa announced it would cease to invest in tobacco in its €552bn general account and would be divesting its holdings – to the tune of €1.8bn – from the industry. The group swiftly began selling its equity holdings in tobacco companies, valued at €0.2bn, and said it would run off its existing tobacco bond holdings, worth just under €1.6bn. The group’s third-party funds are not affected.

The announcement is the latest in a series of socially responsible measures taken by the firm, following its move away from coal mining investments in 2015 and its pledge to triple the green investments in its general account to more than €3bn by 2020.

In a statement issued in May, Axa’s deputy chief executive, Thomas Buberl, said of the tobacco divestment: “This decision has a cost for us, but the case for divestment is clear: the human cost of tobacco is tragic; its economic cost is huge. It makes no sense for us to continue our investments within the tobacco industry.”

The move was applauded by the UK arm of Tobacco Free Portfolios, funded by CRUK. Not-for-profit organisation Tobacco Free Portfolios was launched in Australia by radiation oncologist Bronwyn King in 2010 with the aim of reducing and eventually eliminating tobacco from investment portfolios worldwide through collaborative work with the industry.

Funds with the highest exposure to tobacco in the IA UK Equity Income sector

FUND	FUND SIZE GBP (M)	EQUITY INDUSTRY TOBACCO % (NET)
CF Woodford Equity Income	8,491	17.05
Old Mutual Woodford Equity Income	240	15.83
Investec UK Equity Income	16	14.47
Fidelity MoneyBuilder Dividend	1,046	12.71
Old Mutual Newton UK Income	28	10.72
Newton UK Income	1,636	10.52
Troy Trojan Income	2,649	10.32
BlackRock UK Income	329	10.26
HSBC Income Retail Income	200	9.78
M&G Dividend	558	9.77

Source: Morningstar

However Axa's announcement has been met with mixed feeling in the investment community. David Jane dubbed the move "a marketing decision", saying "it looks good for an insurance company to put their money where their mouth is".

Jane doesn't see tobacco investment as unethical, and suggests that if investors want to "do good" they should reinvest profits they are uncomfortable with in good causes.

He says: "It is up to people if they want to smoke or not. The tobacco companies are definitely not misleading anyone. I don't see it as unethical."

Jane argues that managers have a fiduciary duty to invest in tobacco if it constitutes a sound investment.

"If managers are not investing in tobacco, they need to give a rational investment reason. If it is for socially responsible reasons, they need to apply them to every investment they make. As it stands I think tobacco is a good investment. There are plenty of products out there that pose a risk of harm, so where do you draw the line? Even if you are running a socially responsible mandate, you would still struggle to know where the line is."

Colin McLean, a fund manager at SVM, suggests that far from tobacco divestment gaining traction, we could see a reversal of the trend. He points to the Norwegian sovereign wealth fund, the largest in the world, which removed 17 tobacco companies from its portfolio on ethical grounds in 2010. The move meant the sovereign wealth fund missed out on $1.9bn in profits, the FT reported earlier this year, and McLean says the sovereign wealth fund is now debating whether it should reinvest in tobacco.

"The outperformance of tobacco is causing angst. It wouldn't be impossible for people to re-enter; it is not a one-way street."

However, Horniman says he can see other groups following Axa's stance. "Axa is making a stand," he says. "Tobacco divestment will be a very common thing."

He adds: "I just don't see the need to invest in tobacco. Companies such as Reckitt Benckiser, Unilever and Kerry Group are consumer staples with a good growth profile."

While the combustibles market continues to decline in the developed world, a potential area of growth is "next generation products", such as electronic cigarettes and heat-not-burn devices.

According to Action on Smoking and Health (ASH), an estimated 2.8 million adults in Great Britain currently use electronic cigarettes, accounting for 6 per cent of the population, up from 700,000 in 2012. While still significantly smaller than the combustibles market, are such products the future for tobacco companies?

BAT says that although next generation products are gaining traction, combustibles will be "the mainstay of the industry's profits for some years to come".

> "Yes, it's a dying product over time, but that doesn't make it a poor investment."

Horniman labels the current interest in e-cigarettes "a fad". He says: "I think tobacco companies will branch out, but whether they will be highly successful, I am not sure."

Fidelity's Clark says that while there appear to be health benefits associated with switching from tobacco to electronic cigarettes, it is too early to tell whether that will translate to a profitable business model.

"Vaping has come from nowhere in 2012 to a big market now," he says. "It will grow as there are definitely health benefits. The Royal College of Physicians has said it is much better for you than smoking – not great, but better. Vaping is growing rapidly and heat-not-burn technology is being developed by PMI and BAT. There is some doubt about it as it contains tobacco, so it hasn't had a public health endorsement. But things may well change there. The question is, does the new low-harm technology change the tobacco profit model? It is too early to give an answer."

Jane points out that it will be the large tobacco companies that benefit from the new-generation products in the long run because they have all the power when it comes to distribution.

"The tobacco companies have got the financial wherewithal and the distribution. It's a distribution game, not a manufacturing game. The people in the vaping market think they are new age, but they will buy the profit of a big company as a big company will squish the new company."

The question is, does the investment case for holding tobacco still stand? And will the tobacco companies be able to maintain their growing dividends that have made them so popular with income seekers?

Looking purely at the performance of the tobacco stocks, the MSCI Tobacco index has beaten the MSCI World index every year based on annual performance since 2002, except for 2012. In 2015, the MSCI Tobacco index returned 18.6 per cent against the 0.87 per cent decline in the MSCI World index.

Furthermore, data from AJ Bell shows BAT's dividend yield is expected to rise from 3.5 per cent to 3.7 per cent in 2017, while Imperial's dividend yield is projected to rise from 3.9 per cent to 4.3 per cent in 2017. The estimated dividend cover for both BAT and Imperial Tobacco is 1.45 times in 2016. Indeed, Imperial has forecast a 10 per cent growth in its dividend policy over the medium term and recently reiterated this target at its investor day, says Martin Cholwell, who holds 3.9 per cent in British American Tobacco and 2 per cent in Imperial. He adds that tobacco remains a cash-generative industry.

Good vs Bad

In 2003 Baillie Gifford launched a fund that invested in large and mid-cap UK stocks excluding tobacco companies. But the British ex Tobacco fund closed in early 2011 with a meagre £1.7m citing a lack of interest, having failed to keep up with the sector average in terms of performance.

At the other end of the spectrum is the US-domiciled Barrier fund, previously called the Vice fund, which invests in vice stocks, or "industries that have significant barriers to entry" such as tobacco, alcohol, gaming, and weapons companies. The $226m fund's top three holdings – representing 16.8 per cent of the portfolio – are in tobacco companies.

"The industry has a good pricing discipline. Although volumes are in decline, revenue lines are gently increasing; the real prices of cigarettes are up pre-duty. Providing the companies continue with steady dividend growth, they are a great source of dividends."

Russ Mould, investment director at AJ Bell, points out that Imperial and BAT are two of the 25 companies in the FTSE that have grown their dividends in the past 10 years.

"I expect they will continue to grow their dividends for some time," he says. "They have cut costs, are digesting their acquisitions and are seeing growth in emerging markets. I generally like dividend cover to be north of two times, although that is more for cyclical companies. I'm happy with dividend cover of 1.4 times for tobacco companies."

However, Nick Clay, who has a 13 per cent weighting in tobacco in the Newton Global Income fund, warns tobacco stocks are now looking expensive.

He says: "Where it starts to go wrong is on valuations. When we were buying tobacco stocks, they were cheap, with free cashflow yields of 7.5 per cent; now they are 4.5 per cent. They are certainly getting expensive. We are not adding new money to the sector but we are diversifying away from the US, from companies such as Reynolds and Altria and into BAT and PMI, purely because of valuations."

While managers may be at odds over the ethical implications of investing in tobacco, it is clear tobacco com-panies have the characteristics income managers are looking for in today's low-growth environment. And while they may well have a limited life, David Jane is taking a pragmatic view. "Will the tobacco companies be massive in 20 to 30 years? Probably not," he says. "But they will still be selling cigarettes in 10 years' time. While the highly-developed economies are pressing down on tobacco companies, the rest of the world likes them because of the tax revenue.

"If you think tobacco won't exist in six years' time, it is not a good investment. If you think it will be around for 10 years-plus, it is going to be fine. There is an existing cohort of smokers – plenty of 20-year-olds smoke. No government will ban smoking as they need the revenue stream in these times of fiscal austerity."

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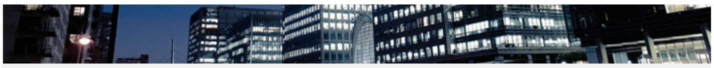

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