Seek finds a way to offset declining market

ROGER MONTGOMERY

THE owner of an IGA supermarket in Edgewater, Western Australia, recently placed an advertisement in a community newspaper for a part-time retail assistant.

Usually, this type of position attracts a handful of responses. But in this instance, the owner had to stop accepting applicants when the number hit 140.

The job market in Western Australia is slowing dramatically. In fact, the Australian Bureau of Statistics has released data that showed there were more unemployed people in WA during the March quarter than during the peak of the GFC.

Job advertisements serve as a leading indicator for the unemployment rate, and numbers have been in steady decline since the start of the year. We at Montgomery Investment Management have been closely monitoring this trend because of the significant relationship it has with the earnings of one of our major holdings, Seek.

Seek is Australia's leading job website, with 75 per cent of the listed advertisements in the domestic market. Seek's business model is driven by job listing fees, and traditionally its earnings per share has exhibited a remarkable correlation with the total number of internet job advertisements. The chart below plots this relationship. You can see from the chart that prior to 2009, earnings tracked online ads very closely. But in the period after 2009, earnings recovered far quicker and continued to increase while the number of ads declined. What explains this divergence?

Seek management foresaw that the domestic advertising market would eventually mature, and sought to diversify the company's earnings by acquiring online education providers. Education serves as a natural hedge against a falling jobs market — people are more inclined to further their education when the market is in a downturn.

Management began acquiring educational providers in 2004, and was able to successfully integrate these businesses before the GFC hit in 2008. This served to insulate the group's earnings.

Management continued to diversify earnings by investing overseas. While the company expanded into New Zealand in 1999, it wasn't until 2006 that the company aggressively pursued international interests. Management's strategy has been to acquire small stakes in international job boards, and slowly increase these stakes as the businesses grew their earnings. Seek now has interests in China, Mexico, Brazil and greater Asia. The international division is now providing the catalyst for growth as domestic earnings plateau.

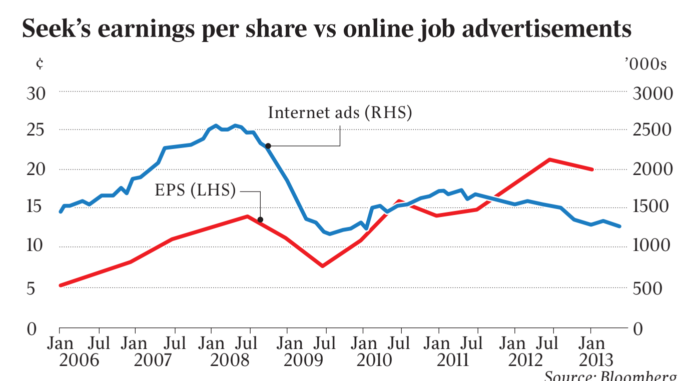
The domestic advertisement division now comprises 65 per cent of Seek's earnings, which compares to a 90 per cent contribution in 2008. Despite this diversification, risks remain to the company's profitability if the domestic job market continues to weaken. When you examine the chart, you will note that the number of job advertisements is nearing the lows of the GFC, and this trend seems likely to continue.

Seek has the ability to limit the impact on earnings from declining volumes by raising prices. Seek provides a service that is in such high demand that it is able to review prices each year without a significant decrease in its customer base. From July 1, Seek will increase the price of a standard job ad by 5.5 per cent.

Seek is a quality business which we will continue to hold in our portfolio, particularly because the company is in a much stronger financial position than it was during the previous downturn. In saying that, we are never able to predict short-term share prices.

But there is one thing we do know. IGA stores in WA are going to have the most efficient shelf-stackers in the country.

Seek's earnings per share vs online job advertisements



FEWER INVESTMENT OPPORTUNITIES AVAILABLE

Future Fund target 'tough call'

EXCLUSIVE

KATHERINE JIMENEZ

MARK Burgess, the man at the helm of Australia's $88 billion Future Fund, has signalled for the first time that if investment assets become very expensive the fund's mandated long-term investment return target of 4.5-5.5 per cent above the consumer price index could be hard to reach.

While adamant the investment target is still "achievable", the managing director cautions the overall tone is that "returns are becoming harder to get".

"We are certainly finding less opportunities at this point in the cycle than we have in the past," he says. "When we were investing four or five years ago, there were a huge number of bargains where the upside potential was very significant.

"Looking forward, the upside potential is less, but we can still find a sufficient number of assets to invest in to get the target."

Burgess says if assets become very expensive, "the forward looking target may then become harder to achieve".

"There is no question that the target is becoming more difficult. That is why you have to consider your risk carefully."

The fund is on track this year to meet the mandated target, with returns in the 12 months to March tracking at 10.6 per cent.

Over the three and five-year periods, the fund has generated annualised returns of 8.1 per cent and 6.4 per cent respectively.

One eminent academic who has been studying international investment-return cycles for 30 years, Paul Marsh, a finance professor from the London Business School, believes the Future Fund's mandated target is simply too high for what he and his colleagues, Elroy Dimson and Mike Staunton, are forecasting will be a 20-year period of low investment returns.

Based on the current asset mix of the Future Fund, he projects return for the fund over the next 20 years will be closer to 3 per cent in real terms. "So I think the target is too high by between 1.5 and 2 per cent," he says.

On March 31, the fund asset allocation was about 35 per cent for equity, 6.8 per cent private equity, property 6.4 per cent, infrastructure/timber 6.5 per cent; debt securities 16.6 per cent, alternatives 15.3 per cent; and cash 12.9 per cent.

For the fund to hit its target, Marsh believes it will require "a significant increase in risk (and hence a significant shift in asset mix)."

"But note this will by no means guarantee that the fund will hit its target, because risk means 'risk'. Increasing the risk profile will also increase the possibility of poor outcomes as well as good ones."

Earlier this year, Marsh co-authored a report with Dimson and Staunton entitled The Credit Suisse Global Investment Returns Yearbook, which foreshadowed a "low-return world" over the next 20 years.

Essentially, the report concludes that an investor with a 20-30 year horizon faces close to zero real returns on inflation-protected government bonds.

Some countries, it says, offer higher yields, but only because of default or convertibility risk.

The report says the expected real return on conventional long bonds is forecast to be a little higher, so the annualised real return on a rolling investment in cash is likely to be negative by as much as 0.5 per cent over, say, 20 years, and close to zero over 30 years.

In addition, it says, "adding an equity premium of 3 per cent to 3.5 per cent to these negative/low real expected cash returns gives an expected real equity return in the region of 3 per cent to 3.5 per cent over 20-30 years".

"We are indeed living in a low-return world," it concludes.

In Australia, Marsh says, real yields are much higher, and so "my estimate for the real return on 10-year bonds would be closer to 0.9 per cent, with my estimate for equity returns closer to 4 per cent".

"But you then need to deduct management fees and costs (and the investor needs to factor in tax)."

Even Norway's Government Pension Fund Global — the largest sovereign fund in the world at $717bn — seeks to achieve only a 4 per cent real return each year.

It is also worth noting that Dimson is also the chairman of the strategy council for the Norwegian sovereign wealth fund. The Norway fund has a target asset allocation of 60 per cent equities, 35-40 per cent fixed income and up to 5 per cent in real estate.

Asked what he believes the asset mix of the Future Fund will need to be to achieve the mandated target, Burgess says some people look at a 60 per cent equities and 40 per cent bonds portfolio and they think "we are similar to that — (but) in fact we are quite a bit different".

"Take our fixed-income portfolio; it's a credit portfolio. It has had terrific gains because it's been credit related," he says. "Overall, our portfolio has elements of growth to it, where we can find it, or value where we can find it, ways in which to add extra return without taking excessive risk."

As an example, he cites commercial property.

"We are finding core property, very basic CBD property, quite expensive and so we try and find properties where we can add extra value or where we think the market is mispricing it."

The fund's expected target asset allocation for June 30 is 41 per cent in equities, 16.5 per cent tangible assets, 17.5 per cent debt, 17.5 per cent alternatives and 7.5 per cent in cash.

It should be noted that since March the fund has added nearly $1bn in assets to its infrastructure portfolio.

Despite the tougher investment environment, Burgess insists management is still finding "value pockets" and emphasises it will not be stepping up risk excessively to do that.

> 'We are indeed living in a low-return world'
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"What we won't do is chase returns that aren't there or that present excessive risk," he says.

More broadly, Burgess sees a couple of risks in the investment landscape over the next two or three years.

One — not applying to the Future Fund — applies if you are an investor just used to buying yielding assets.

"Maybe yielding assets won't give you satisfactory yield and the temptation will be to buy complex yielding assets or yielding assets that have hidden risks to them," he says. "That I think is an inherent danger."

Burgess also sees a world struggling to get growth, with different policies being implemented, such as the quantitative easing measures in the US or the transition in China to becoming a "domestic oriented economy".

"These are all policy issues that could affect investment returns if mistakes are made," Burgess warns.

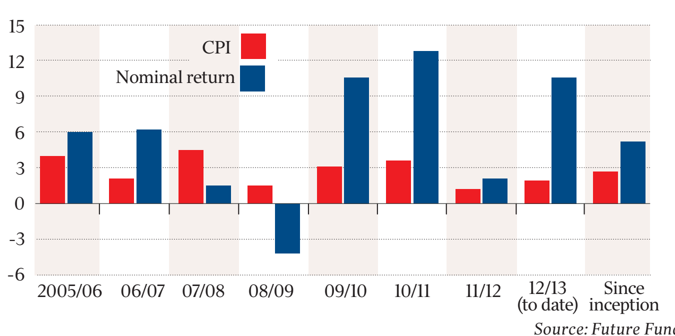
Against that backdrop, he says, the Future Fund looks at about six different scenarios and assesses what would happen to the portfolio during those different scenarios to try to make sure that "we are trying to manage through the series of potential scenarios, most of which we give a very low probability."

Burgess says management has oriented the portfolio towards its core scenario, which is a "relatively low-growth world that has to work its way through reducing the debt profile, with some demographic barriers and other barriers."

STUART McEVOY

Future Fund managing director Mark Burgess in Melbourne. 'We can still find a sufficient number of assets to invest in'

Nominal return and CPI



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