Mayne's makeover proves just the tonic

UNDER THE RADAR

RICHARD HEMMING

ONE of the advantages small companies have is the ability to reinvent themselves much faster than their bigger counterparts. You only have to look at the performance of the upstart Virgin Australia, led by John Borghetti, compared with the relatively cumbersome Qantas.

Virgin has repositioned its brand from purely budget to budget and up-market, enabling it to compete for the entire market. Meanwhile Qantas has a bigger cost base and the 65 per cent domestic market line in the sand, which is acting as a millstone around its neck as far as profits are concerned.

There are many other stocks that have reinvented themselves or are in the process of doing so, and these are among the best investments you will find. These include Under the Radar favourites such as specialist food producer Freedom Foods, retirement communities group Ingenia, pharmaceutical group Mayne Pharma and almond producer Select Harvests.

The list goes on, and the point is that reinvention can mean big returns. Some of these stocks have more than tripled in value in the past few years.

One of the biggest transformations has been Mayne Pharma, whose shares have more than quadrupled in the past 18 months. Late last month, the company announced first-half sales of $70 million, which produced a net profit after tax of $9.4m. Only three years ago its sales were $36m and it made a net profit of $3.3m.

Before this, it was even worse. For many years the only people consistently making money out of Mayne Pharma's stock seemed to be investment bankers and lawyers. After several name and ownership changes, things seemed to be on the up and in 2009 the board of the then-named Halcygen decided it wanted to put the old Mayne Group back together again. It put in charge Scott Richards, a virtual prodigal son, having previously worked at FH Faulding.

Richards's big move was acquiring US-based Metrics late in 2012, which effectively doubled Mayne's size. Metrics is a manufacturer, developer and a marketer of generic drugs in the US. It specialises in narcotics, or sedatives, which are heavily regulated and can only be produced domestically.

This time last year Mayne Pharma had one registered drug in the US and a portfolio of about five drugs in Australia. Now it has nine approved products in Australia and 20 in the US. It also has 40 products in development, 10 of which are pending approval by the US Food and Drug Administration and 10 by Australia's version, the Therapeutic Goods Administration.

The year ahead will be exciting for Mayne Pharma as some of the successes of its research and development pipeline start coming through. Shareholders will be hoping that its reinvention leads to even bigger returns.

Richard Hemming is an independent analyst who edits undertheradarreport.com.au. The author does not own shares in any of the stocks mentioned.

No housing bubble but beware of froth in areas, warns Bouris

The Yellow Brick Road founder sees some warning signs

ANDREW MAIN
PROPERTY

NIKKI SHORT

Mark Bouris says that in some locations, apartments off the plan are 'selling to a particular market' and their pricing is 'a bit irrational'

IS now the time to buy an investment property?

Mark Bouris, founder of Yellow Brick Road and a substantial lender thanks to the fact that its biggest shareholder is Macquarie Bank, says he's never seen the percentage of investment loans so high as they are now, at 42 per cent of the total being made for residential real estate purchases.

"That's the highest I've ever seen it, certainly since 1998 when I first got involved in this business," Bouris says.

But he doesn't buy the suggestion that Australia is in the grip of a housing mania.

"On a national level I would rely heavily on the Reserve Bank's position", which he describes as "relatively relaxed".

Its February minutes say: "The effects of low interest rates were clearly evident in the housing market, where prices had increased further and turnover had picked up to be just below average. These conditions were expected to provide further support to new dwelling activity over the period ahead, and leading indicators of dwelling investment had increased."

The RBA also says a quiet commercial building sector means there is labour available to support the strong growth of higher-density dwelling construction.

"Growth of housing credit was gradually picking up, particularly so for investors," the RBA says.

"They're saying there's no bubble," Bouris says, "but that doesn't mean there's no froth in certain segments.

"You'd have to say people should have a careful look at buying off the plan in Sydney, Melbourne and Brisbane," he adds, referring to one form of purchase where overseas investors have carte blanche to buy and, what's more, may even get a $5000 grant for doing so, at least in NSW.

State Treasurer Mike Baird says the extra building activity stimulated by the grants makes economic sense, even if it's not so electorally popular.

"Within Sydney, Melbourne and Brisbane there has been extraordinary growth," Bouris says.

"You'd have to be careful in the investor market because when aggregate demand is so high, you have to start considering that their pricing is potentially above where it should be."

He says big confusion comes from the fact that although there has been a 10 per cent lift in prices overall in the past 12 months, "averages are deceiving".

"Some of them are up 30 per cent and that's where you have to be careful," he says.

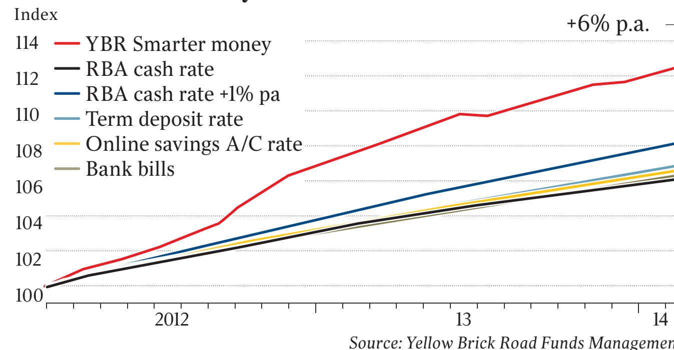
Choosing his words with care, he says that in some locations, apartments off the plan are "selling to a particular market" and that their pricing is "a bit irrational. It doesn't equal the yield".

Bouris's rule of thumb, or what he calls the "sweet spot" for property valuation, is that the price of the asset should not exceed, if possible, a figure six times the annual earnings of the cohort of its potential buyers.

"Make sure to check the asset price to income ratio, in equities or any asset class," he says.

"If the average income is around $100,000 and you are paying $1 million, that's 10 times — that's unsustainable. If the average price is around $500,000 or $600,000, then you're OK."

YBR Smarter Money total net returns v other benchmarks



He says the RBA's guide for the ratio is "about 6.2 times on average", above which the price might be on the high side.

"If you own a place where houses are selling at 10 times, maybe you should look at selling into that, not buying into it, and investing somewhere else where the ratio is lower, as long as there's no problem with the area."

Bouris himself is comfortable about Yellow Brick Road's model, which started out as a straight mortgage arranger but which has branched out into areas such as a retail, floating rate-based bond fund called Smarter Money, launched two years ago.

More than 40 per cent of YBR's revenue and 55 per cent of its transactions are non-mortgage, he says.

"There's no money in that fund that goes to mortgages, and never will be," he says, noting that most of the mortgages are funded on a "white label" basis by Macquarie.

That's maybe no bad thing.

The Smarter Money fund has been returning just over 6 per cent per year, net of fees, to the retail investors who are in it, while YBR's standard mortgage rate is 4.94 per cent.

It's a good thing people must buy houses with the money lent, or they'd be trying the old "revolving door" trick of borrowing cheap and lending at a higher rate.

Think about it: 1 per cent a year margin on $1m is a nice $10,000.

And what about Basel III, which will discourage banks from taking deposits of less than a year?

"Basel III affects all the banks and I hope the banks do move away from short-term money, because we're not a bank and it would be to our advantage," Bouris says.

"But I won't have a fight with the banks. Don't forget, we invest into banks and basically we're a client of the banks now.

"We all need them. I'm not one to smack banks around as it just doesn't work.

"We're a distributor and get products out and we still have to work with the banks.

"We can't do without them."

You're at risk of getting egg on your face in FoFA food fight

MICHAEL VRISAKIS

THE loud debate about whether Assistant Treasurer Arthur Sinodinos should wind back elements of the Future of Financial Advice legislation is actually the symptom of a complex ideological and commercial stoush between different sectors of the financial services industry. It is not new.

It flows way back to the original Treasury peak consultative group convened to examine the Ripoll report. Perhaps no one foresaw the ripples that would flow from Ripoll, but in hindsight you didn't need to be a genius. In the olden days the stoush would have been settled at the OK Corral; in quick time and with finality.

In more modern days a more genteel pillow fight, or food fight, has occurred and is continuing.

At the heart of the fight are two main protagonists: on the one hand is the Old Ghost of Christmas Past, or what we could label paternalism, and on the other is capitalism and the free market.

This is not a new debate. Other examples exist in related areas, such as whether a superannuation member should be allowed to give an unbridled investment direction to the trustee of the fund, or whether they need to be protected from themselves.

There are probably four main bones of contention.

The first is the removal of the last limb of the "best interests duty", which adds to the various specific steps required to satisfy the defence a catch-all requirement to take additional steps to serve the best interests of the client. It has been contended that removal of this step neuters the best-interests obligation of the adviser. In the immortal words of Sting, I don't (and many other legal commentators do not) subscribe to this point of view. There are five main reasons why not.

One, the defence has been put forward as a "safe harbour", but the open-ended nature of the catch-all requirement means that in reality it is unsafe.

Two, specific steps that are staying in require the adviser to base their advice on the client's needs.

Three, the adviser is elsewhere obliged to only give appropriate advice.

Four, the adviser is obliged elsewhere to prioritise the client's interests over his or her own.

Five, the general law holds an adviser to a professional standard of care, and the requirements of the general law are specifically preserved by the FoFA legislation.

The second bone of contention is that scoped advice can still result in inappropriate advice. However, there is an overriding requirement to give appropriate advice.

The third is that the removal of general advice from the ambit of conflicted remuneration neuters the conflicted remuneration prohibition. General advice is essentially an impersonal form of advice and cannot be used as a substitute for needs-based advice.

The Corporations Act prohibits the use of general advice as a substitute for needs-based advice. In other words, an adviser cannot meaningfully engage with a client to assess their needs and purport to give general advice. The exclusion of general advice occurs in a contained area and against the backdrop of a statutory safety net.

Finally, there is the contention among opponents of the changes that the reforms cannot be introduced by regulations. The government does not just need to rely on one general power to make regulations, as has been the main focus of the debate. It has two additional sources of power under the act specific to the part of the act where the FoFA legislation resides and also within the FoFA legislation itself.

The debate needs to be considered in the light of both the philosophical polarisation described above and with a bi-focal set of legal lenses which have regard to all relevant requirements of the FoFA legislation, as well as the general law.

To round out the metaphor, if there is going to be a food fight, let's make sure we properly identify what we are throwing and resist the thinking that someone is throwing food from a grassy knoll.

Michael Vrisakis is a partner at Herbert Smith Freehills and a specialist in financial services law.

Buffett's still got it, despite fall

ROGER MONTGOMERY

IS Berkshire Hathaway a victim of its own success?

Warren Buffett's recently published letter to shareholders was, as always, an informative and interesting read for Berkshire Hathaway shareholders and non-shareholders alike.

There are a few interesting aspects to this year's letter, particularly Berkshire Hathaway's track record of growth in per-share book value. For the first time, its growth has underperformed the S&P 500 index over a five-year period, and it is worth thinking about what, if anything, this tells us.

Berkshire Hathaway's long-term track record is extraordinary: $US1 invested in 1965 (when current management took over) would have grown to more than $US6000 today, compared with about $US100 if it had been invested in the S&P 500. This phenomenal result reflects the benefits of compounding over many years at a good rate of return (in this case, close to 20 per cent per annum for Berkshire versus about 10 per cent for the index).

Another point to note is that Berkshire's track record is measured in terms of book value per share, rather than market value (as is the case for the S&P 500). Book value is a more stable metric than market value, and it follows that when the S&P 500 rises strongly, Berkshire is likely to fare less well, and when the S&P 500 "falls out of bed", the comparison will probably favour Berkshire.

Returning to the recent underperformance, there are a few possible explanations. One possibility is that the past five years have been a strong period for the S&P 500, and we should expect Berkshire to lag. The past five years incorporate the market recovery post the global financial crisis and the returns from the S&P 500 have been well above historical averages. The previous five years (including the crisis) were relatively grim.

To address this, we have looked at a longer-term performance comparison showing Berkshire's average outperformance over rolling 10-year periods. The results are shown below.

The chart shows that, over 10-year periods, Berkshire has always beaten the market. However, the level of outperformance appears to be steadily declining over time. The most recent 10-year period is the worst to date. In this light, the most recent five years appears to be part of a continuing trend, rather than a statistical anomaly.

The first thing that comes to mind in explaining this decline is the sheer size of Berkshire. With close to $US500 billion ($553bn) in total assets, Berkshire has become a huge organisation, and Buffett has made clear over the years that returns must decline with the size of the group. There are simply not enough attractive opportunities big enough to "move the needle" on an enterprise as big as this.

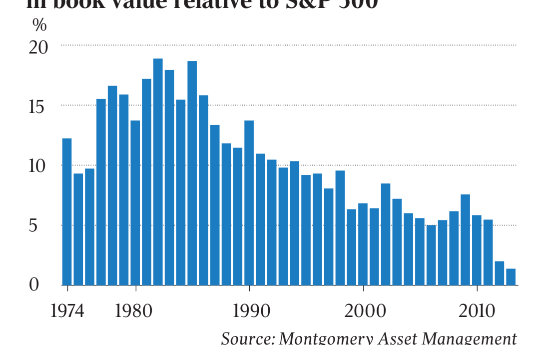
Is there more to the observed decline than size? Certainly, recent performance appears low and we might ask whether Buffet's legendary investment skill has as much value as it did previously.

One factor that might support this view is that, for each of the past two years, Buffett's potential successors Todd Combs and Ted Weschler have delivered better returns from their listed investment portfolios than Buffett has from his. However, it may just be that Combs and Weschler are less-conservative investors, and a full cycle is needed to make a fair comparison.

In the coming years we may gather more information that will allow us to better gauge whether Buffet's investment magic is still intact. In the meantime, for my part, I think that deep insight, common sense and patience will always be valuable attributes in an investor, and reading Buffett's letter leaves me in no doubt that he still has these in good measure.

Roger Montgomery is the founder of Montgomery Investment Management.

Berkshire Hathaway rolling 10-year growth in book value relative to S&P 500



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