Making a splash in bigger ponds

UNDER THE RADAR

RICHARD HEMMING

VETERAN fund manager Geoff Wilson might be doing well, but that doesn't mean he's not wary of the current bout of bullishness.

The listed investment companies in his company's stable are WAM Capital, WAM Research and WAM Active. All have performed phenomenally well, with the flagship and longest running WAM Capital returning 21.8 per cent a year for the past five years.

But outperformance is a double-edged sword, according to Wilson, who is also on the investment committee for Under the Radar Report.

"All our funds are trading above the value of their assets," he says. "This is a great compliment for us as the investors because people believe the funds' performance will be better than the assets would be able to normally return. But it is also another sign that the market is overheated. After all, normally an investor looks to buy things at a discount."

Wilson was not selling before the interim results reporting season, which ended in February, because of the prevalence of profit downgrades, which meant expectations were low. However, during the actual reporting season, investors bought many companies that simply met those downgraded expectations, which indicates a level of optimism about future earnings growth, which he thinks is unwarranted.

Since the start of last year, the ASX All Ords Accumulation Index has climbed just over 14 per cent and stands at 5½-year highs. Much of the heavy lifting was done by a select band of industrial stocks, which have become expensive. Internet stocks such as realestate.com.au owner REA, Seek and Carsales.com, as well as Dominos Pizza, trade on PE multiples in excess of 30 times.

Although Wilson's team is taking profits, it is also buying new stocks, and these include companies growing their businesses offshore. This strategy has proven successful with product appliance marketing group Breville, which expanded into the US, and with the solicitors Slater & Gordon, which bought a big British law firm. His fund has sold out its position in Breville, but is holding on to Slater & Gordon. Most recently it has bought Ardent Leisure, which owns and operates leisure and entertainment assets across Australia and New Zealand. It has also been expanding into North America.

"When a company successfully grows offshore, the market will re-rate it higher. We saw this with Breville and with Slater & Gordon. Ardent will be re-rated if it gets its US strategy right," he says.

For Wilson, his team at WAM, and increasingly the small caps they're investing in, Australia is just too small a pond.

Richard Hemming is an independent analyst who edits undertheradarreport.com.au, which provides investment opportunities in small caps. The author does not own shares in any of the stocks mentioned.

SMSFs aren't going mad about residential property

It's a different story with Chinese investors

ANDREW MAIN

IT'S a myth that Australian self-managed super fund trustees are going mad on residential property, Credit Suisse analyst Hasan Tevfik says.

While they put just over $1.4 billion into that asset class in 2012-13, their rate of investment is slowing sharply and they will only invest about $700 million, or half that amount, in housing in 2013-14, he says.

"While SMSFs are increasingly allocating to equities, they're now buying residential real estate in Australia at a slower rate," he says.

This means their investments are dwarfed by some foreign players such as those from China.

Tevfik estimates that Chinese investors are pouring $5.4bn a year into Australian residential housing, equivalent to 12 per cent of new supply.

Non-resident investors are not allowed to buy established houses but may buy off the plan.

He is not passing judgment on the level of Chinese buying, which has been widely reported, so much as emphasising that buying residential real estate is not where he believes SMSFs are, or should be, investing.

"The benefits of owning a residential property in your SMSF have always been marginal," he says in a report titled A Nation of Selfies.

"Banks will lend to SMSFs to buy property, but the rates are higher than normal," he says.

The tight rules on borrowing to invest in property in SMSFs require a separate bare trustee structure to be set up, specifically so that loans are "limited recourse". That's to protect the super fund if the loan goes bad, but not surprisingly the banks charge higher rates on the loans. The only way round that problem, and there is always a way round a financial problem, is for the bank to demand a personal guarantee on the loan. That way the SMSF trustees' personal assets, rather than their super fund, are at risk.

Tevfik says tax benefits from negative gearing are less significant and that, most important, "the yield on Australian residential property is low when compared to property trusts or stocks".

He sees the hunt for dividends as being self-fulfilling to a degree. "It is clear companies know that SMSFs are powerful and they try to keep their precious investors happy," he says.

"By being income-focused, SMSFs could be distorting the capital allocation decision. In an attempt to grow dividends and keep SMSFs happy, companies may have to revert to more cost cuts, less capital expenditure and scrip dividend payments."

He says his colleague Richard Hitchens, a quantitative analyst, has noted that the hunt for dividends has caused a distortion in corporate behaviour.

Hitchens says it is unusual "to have dividends continuing to perform as a factor this far into a market recovery".

The most negative element in Tevfik's report, at least as regards the mania for dividends, is that the distortions may well have negative consequences for our economy. "SMSF trustees should understand that higher dividends could come at the expense of their children getting jobs.

"After all, the Telstra call centre has now moved to lower-cost Manila.

"With a low cost of debt, low cost of equity and plenty of cashflow, companies should be investing, creating more jobs and, hopefully, helping the economy to rebalance away from mining investment."

So what is he recommending?

He says that after screening for companies with reasonable dividend yields and a solid dividend growth rate, the list of recommendations includes Fortescue, Macquarie Group and Sonic Healthcare.

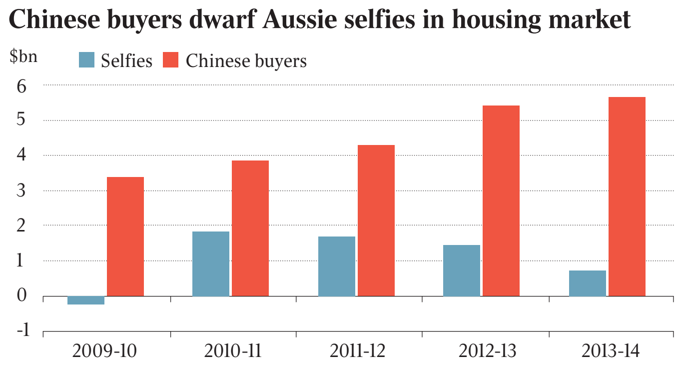
On the negative side, "companies where the dividend outlook is poor and which have elicited cashflow cover include Qantas, Crown and Metcash".

"We add Sonic to our strategy long portfolio and Metcash to our strategy short portfolio," he says, meaning that for investors well enough organised to short-sell stocks, Metcash has just achieved the dubious privilege of being a better share to sell than to buy.

JAMES CROUCHER

Hasan Tevfik says while SMSFs are increasingly allocating to equities, they're now buying residential real estate in Australia at a slower rate

Chinese buyers dwarf Aussie selfies in housing market



Source: Credit Suisse

Flying start for Perth Airport as investors seek steady income

LIZ MORAN

SMART INCOME

BOND investors like monopoly infrastructure assets with defined income streams as it gives them confidence that interest payments will be on time and they can lock in a good rate of return for an extended period, which enables them to plan ahead.

This week Perth Airport came to the market with a new over-the-counter seven-year fixed rate bond, maturing in March 2021. Like other recent issues, the initial $150 million proposed as the amount required was oversubscribed and the airport accepted bids for $400m.

The raising was twice that originally stated and shows the demand from investors for corporate bonds in Australia.

The Perth Airport bond adds diversification, being unlisted and not on any indices but more importantly for wholesale investors meets their risk and return assessment.

Strong demand also meant the bond was issued at the lower end of the indicative price range and settled at a margin of 165 basis points (100 basis points equals 1 per cent) over the benchmark swap rate.

A simple definition of swap is the bank's future expectations of interest rates and it is a common term used when talking about bonds. It enables investors to compare different bond issues with various maturity dates. The yield to maturity of the fixed-rate Perth bond is 5.7 per cent.

There are other airport bonds in the market. Melbourne, Brisbane and Sydney airports also have bonds in the over-the-counter market.

Melbourne Airport has a bond over a similar term that matures in April 2020. Its current margin is 105 basis points over swap and yield to maturity is 5.05 per cent.

Brisbane, too, has an October 2020 maturity trading at a margin of 120 basis points with a yield to maturity of 5.2 per cent. Comparing the new Perth Airport issue with these two bonds makes the 5.7 per cent yield look attractive.

Sydney Airport is a larger airport and more highly geared ($5.4 billion in total of rated bond issues), meaning it has issued more bonds with a range of maturities offering various yields. Sydney Airport has a November 2021 floating rate bond that last traded at a margin over swap of 150 basis points, making the new Perth bond competitive at 165 basis points.

But the value is the Sydney Airport November 2020 inflation-linked bond.

While not directly comparable to the new Perth bond and the other bonds mentioned, as its returns are calculated making assumptions about inflation, we can use the implied yield to maturity for comparison.

The Sydney Airport November 2020 inflation-linked bond pays a current margin over the Consumer Price Index of 370 basis points. If we assume inflation runs at the Reserve Bank target midpoint of 2.5 per cent, the implied yield to maturity is 2.5 per cent plus 380 points equals 6.3 per cent. The final return can be more or less depending on inflation, where there is greater certainty with the fixed-rate Perth bond.

Both the Sydney Airport and Perth Airport bonds are similar risk investments (both rated the same by the credit rating agencies) over similar terms. The new Perth Airport bond, though, is only available in $500,000 parcels. Sydney Airport 2020 inflation-linked bonds are available in smaller parcels from $10,000 (as part of a minimum $50,000) and available to retail investors.

Elizabeth Moran is director, education and research at FIIG Fixed Income Specialists.

Airport securities

Issuer	Maturity date	Bond type	Yield to maturity	Minimum investment
Sydney Airport	20/11/2020	Inflation linked	6.30%#	$10,000
Perth Airport*	25/03/2021	Fixed	5.75%	$500,000
Perth Airport*	23/07/2020	Fixed	5.30%	$10,000
Brisbane Airport*	21/10/2020	Fixed	5.20%	$500,000
Melbourne Airport*	25/08/2016	Fixed	3.85%	$500,000

*Note: Prices quoted are accurate as at March 20, 2014 but subject to change * Wholesale investors only # Projected assuming inflation is 2.5 per cent*

Source: FIIG Securities, Bloomberg

Be patient and you will prosper

ROGER MONTGOMERY

THE path to investment success is fraught with peril. It needn't be this way, but along the road there are many traps for the unwary, and it seems that the natural state for we humans — at least when it comes to investments — is a certain level of unwariness. With this in mind, I've set out below what I see as some of the main pitfalls along the way, and some thoughts on how you might avoid them.

Pitfall 1: Not knowing the long-term objective.

Any investment strategy should be built on a solid foundation of knowing what the strategy is meant to achieve. It's hard to steer the ship if you don't know your destination, and the critical element here is being realistic. Investing can certainly make you wealthy slowly, but it is far less likely to make you get rich quick. If your objective is the former (and it probably should be), you should act accordingly.

Investors who lose sight of this are prone to take on too much risk trying to turbocharge their short-term returns. This can manifest in excessive leverage, placing big bets on companies of dubious quality and trading too frequently. On the other hand, a clear view of what you are trying to achieve (and when) can give you the patience to avoid temptation.

A reasonable expectation from the equity market is a long-term average return of about 11 per cent a year. Over long stretches of time, this is enough to achieve meaningful wealth accumulation, and if you can do a bit better than this through wise investment selection then so much the better. However, if you neglect the long game and instead try to hit the ball out of the park today, there is a good chance the long-run outcome will suffer.

Pitfall 2: Allowing emotion to take over.

Q: What do most share investors feel when the stockmarket has risen strongly? A: Happy!

Q: What should they feel? A: Concerned.

It is a well-established fact that we typically form our views on the stockmarket with one eye in the rear-view mirror. This is understandable, as the windscreen can be very cloudy. Research has shown that investors consistently pour money into the equity market when it has been rising, and take money out after it has fallen. The same research shows that this behaviour is devastating to long-term returns because it means investors get the timing wrong. Like clockwork. If you have successfully negotiated Pitfall 1 and are taking a patient approach to wealth creation, it will be easier to deal with Pitfall 2. Taking a long-term view means not worrying about what return you got last year — or might get next year — but taking steps to ensure a good result on average over the long haul.

We have a client in our funds management business who takes no interest in monthly investment updates. Instead, he has satisfied himself that what we are doing is sensible and, having made the decision to invest, now plans to check back with us in 10 years.

There are no guarantees in this game, but this type of approach is as close as you can get to a guaranteed good outcome. On the other hand, we had another client who recently invested with us, and then two months later withdrew the money because the results in the intervening two months had fallen short of the index. We can't do much to help this client; we doubt any fund manager can.

Pitfall 3: Forgetting risk.

Risk management is the forgotten, frumpy cousin of investment. It deserves more attention.

In the short term, taking on risk can lead to better investment returns, but in the long run risk is risk and sooner or later its downside emerges.

Astute readers may have noticed that the three pitfalls I've identified are all sides of the one (oddly shaped) coin: patience.

Many years of observing investor behaviour has made one thing very clear. There will be twists and turns from year to year, but in the long run the equity market takes wealth from impatient investors and delivers it to patient investors. Those who sell shares at discounted prices in the midst of a crisis are planting the seeds of future wealth for those willing to wait for it, and those who chase spectacular returns may succeed for a time, but sooner or later most will get caught.

Patience is boring and does not make for racy investment stories, but if your goal is long-term wealth accumulation there's probably nothing that will get you there faster.

Roger Montgomery is the founder of Montgomery Investment Management.