Cadence hits right notes

UNDER THE RADAR

RICHARD HEMMING

HOLDERS of big bank stocks might be comforted to know that one of Australia's best performing listed investment companies, Cadence Capital, holds about as much in the financial sector as it is possible to hold.

Cadence has more than quadrupled its shareholder returns in the past 8½ years, so you should take note of what its investments team is doing. Eight of the fund's top 15 holdings are in financial services, and the fund only owns about 20 stocks.

The principal of buying more in rising markets and selling in declining ones has served Cadence extremely well, after leaving the resources market just over two years ago. That was, not coincidentally, the same time the fund started buying financial services stocks.

"If you looked at our portfolio about five years ago it would have been resources-heavy (with a 36 per cent weighting). Commodities prices were rallying quickly, causing strong earnings growth," says founder Karl Siegling, who also sits on Under the Radar's investment committee.

These days Siegling sees the same growth phenomenon, but in another asset class — financial services.

"It goes without saying that the superannuation savings pool introduced into Australia in the mid-80s has grown into the fourth-largest pension pool in the world, and it's soon to be the third-largest. It will probably eclipse the whole banking sector in next five to 10 years.

"Not surprisingly, with a sector that's growing that quickly, it's easy to find stocks that are growing well."

The fund's biggest holding is in the British fund manager Henderson, which is followed by Macquarie Group, NAB and ANZ. The fund also holds Commonwealth Bank. At the smaller end the fund owns the Bank of Queensland, the fund manager Perpetual and the consumer goods lending specialist FlexiGroup.

Subscribers to Under the Radar have more than doubled their money on specialty financier Silver Chef and on financial planning group SFG. But we differ on the banks, which are trading at record levels.

Three of the big four, the NAB, NAB and Westpac, are in the midst of reporting their half-year profit results. If you add in CBA, which reported its interim profit in mid-February, the total profit for six months should be close to $14.5 billion.

Behind these big numbers there is risk because banks are the most leveraged vehicle in an overleveraged domestic economy. But Siegling knows the banks are safe because a government guarantee exists in the form of deposit insurance.

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

Time to protect your assets

One of George Soros's hedge funds took out protection late last year, and others are following suit
AP

STIRLING LARKIN
GLOBAL INVESTOR

THE sharpest investors know that the best time to take out downside protection is when the market's enjoying a bull phase and insurance strategies are cheap.

For instance, recent US Securities and Exchange Commission disclosures revealed that one of the most successful hedge funds of all time, Soros Fund Management, had taken out sizeable downside protection over its S&P 500 portfolio during the final quarter of 2013. At that time, this protection represented the fund's single largest position.

Traditionally, this downside protection has been realised through the purchase of exchange traded, or over-the-counter, put options over either single positions or entire indices.

Nearly six months later and the rest of the market are beginning to play catch up. Discussions about Soros's position are becoming more frequent and many sophisticated investors are starting to think about the potential downside risks that exist in their index-heavy portfolios.

Nowhere is this more evident than here in Australia. Increasingly, investors are looking for advice on what is currently cheap, what's expensive and how suitable are these opportunities for self-managed superannuation funds. There appears to be no better time to consider portfolio protection measures for all Australian investors.

This is because both US and Australian stockmarkets appear to be hovering near record levels but without the heightened volatility often seen when markets rally.

This means that reasonable volatility levels are priced into downside protection choices. These levels can be measured in Australia via the S&P/ASX 200 VIX Index, colloquially referred to as the A-VIX index.

Furthermore, many single position and portfolio protection strategies are now allowable within Australian SMSFs.

So in essence this means that downside protection choices are currently cheap, stockmarkets are relatively expensive — based on fundamentals — and that there is no more prudent time than now to consider appropriate protection strategies for Australian SMSFs.

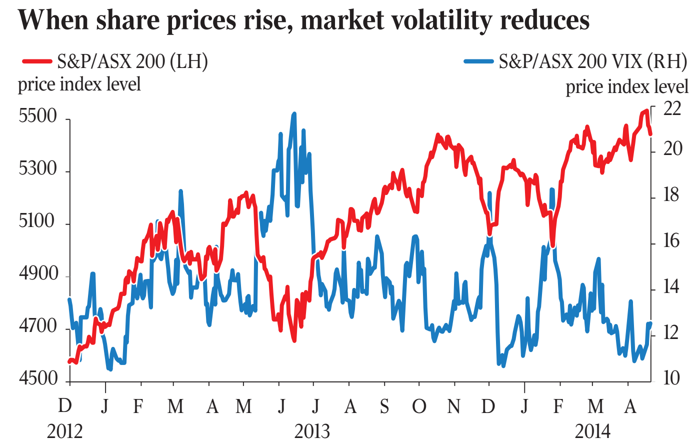
Within the Ultra High Net Worth investment community, this conversation has centred on how best to achieve this protection and what are the alternatives for managing market risk.

The need for more versatile solutions was realised during the global financial crisis when investors required a greater choice of hedges and better pricing.

The issue of pricing was due to the fact that these products relied heavily upon a valuation model that reflected the stockmarket's volatility levels. The GFC, however, caused many extreme spikes in these levels and therefore made these hedging solutions punitively expensive.

Shortly thereafter, a newer generation of downside protection solutions began to be offered in Australia. These solutions protected portfolios more accurately and were better priced thanks to the fact that they no longer relied upon volatility-sensitive valuation models.

When share prices rise, market volatility reduces



Source: ASX

Adopted from Europe and referred to as "delta one" products, they had proven themselves abroad to be versatile during all market conditions, regardless of volatility.

They have now allowed Australian investors to more comprehensively protect their entire portfolios, which may include commodities, real estate assets and debt market instruments.

Even though we have not yet seen a recent downturn in our market, the above hedge fund example highlights that the active global investor attempts to stay one step ahead of the market at all times. These global investors know that we need to prepare for the turn; if we can see it, it's already too late.

These tenured global investors also know that if we keep one step ahead of the market, we're proactive; but if we think we're two steps ahead, we are sure to run into folly.

Therefore, the key to implementing these strategies is timing, and the time appears to be now.

Global investors agree that there exist dislocations between current market prices and fundamental valuations. There is an emerging consensus that stocks are expensive, based on simple measures such as price/earnings ratios or the more robust valuation measures such as the cyclically adjusted price/earnings ratio, known as CAPE, which is a measure of prices divided by their average of 10 years of earnings, adjusted for inflation.

We know that this is attributable to the reflation measures undertaken by the US Federal Reserve, Bank of Japan and other central banks around the world.

We also know that these reflation measures are unorthodox and without precedent. They are an experiment where the outcome is unknown.

It then becomes important that when these central banks begin to wind back these measures in the years to come, Australian investors and particularly SMSFs find ways to protect against these unknowns.

In particular, a legacy issue for many Australian SMSFs is a disproportionate weighting of Australian bank stocks within their portfolios. Many of them held the shares since they were either demutualised or listed during the 1980s and 1990s. Selling down these positions may trigger capital gains tax liabilities.

Therefore, as Australian banks appear to be fully valued in this market and as it becomes clearer that these institutions are competing in a subdued credit growth environment, now is the time to protect entire portfolios and overweight sector positions, such as Australian banks.

There are several practical ways Australian SMSFs can achieve this. Single stock positions can be protected using a quoted MINI short warrant or the more traditional listed single stock put option. If the SMSF needs protection against an entire sector, a more cost-effective hedge is often achieved by taking out protection over a sector exchange traded fund or one of the new sector-linked products now available, on and off market.

Making portfolio protection decisions does not mean we believe bad times are immediately ahead, but building wealth involves managing risks at all times.

The UHNW investment community has also explored the other options for managing this market risk. Managed funds that champion what are referred to as "portable alpha" strategies have become topical in the past six months, particularly as regional agribusiness opportunities have increased. Larkin Group, for example, is in the process of building what's referred to as a protection fund, which during positive markets runs at a loss but adds value when momentum turns, often sharply. These are already being customised for individual wholesale clients here in Australia and across the region.

Downside protection is like brakes on a racing car, allowing you to go faster without fear of hitting a wall and losing all those hard-won gains. Including portfolio protection in our decision-making is very important.

Larkin Group is a wholesale wealth adviser focusing on high-yielding regional investments. stirling.larkin@larkin.org.au

Don't get thirsty for Coke just yet

ROGER MONTGOMERY

WITH the trend to longer trading hours and one-stop shopping, Woolworths and Coles continue taking market share from the milkman, the butcher, the baker, the greengrocer and the corner store. Many developed economies are witnessing pressure on traditional strip shopping and there are reports of "the death of the high street". With a combined annual forecast revenue from Woolworths and Coles of $115 billion and about 75 per cent of the Australian grocery sector, there are increasingly serious ramifications for domestic food producers and processors.

Lower cost imports of both private-label and branded food products have seen Australia's net imports of food and grocery products increase since 2008. And with the positive correlation between private-label sales and industry concentration, it seems likely that Woolworths, Coles and Aldi will continue to espouse the benefits of their private-label products. Industry experts believe private label could account for more than 40 per cent of supermarket sales by 2020.

Many people would expect Coca-Cola, one of the strongest brands in the world, to be able to withstand the competitive threat of the Australian grocery retail sector and rising private-label market share. Not so.

In the past 12 months, the Coca-Cola Amatil (ASX: CCL) share price has declined by 40 per cent, from an all-time high of $15.15 to the current $9.20. Coca-Cola appears to be on a strict diet of shrinking volumes and slightly less shrinking values. For example, in all of the past six quarters (to March this year), year-on-year Australian volumes were down, while in four of the past six quarters (to March), year-on-year Australian sales were down.

In the year to December 2013, the company reported an underlying net profit, excluding the $400 million impairment charge against its SPC Ardmona business, of $503m, down 10 per cent on the 2012 results. Recently installed managing director Alison Watkins has announced another decline in expected earnings — about 15 per cent for the six months to June this year, together with a strategic review.

We believe a certain portion of this strategic review will focus on the increasing competition from the private-label drinks. For example, Nielson data over recent few years reveals the following trends. Coca-Cola's share of the Australian soft-drink market has declined in volume terms from 50 per cent to an estimated 42 per cent, and in value terms from 66 per cent to an estimated 62 per cent.

Private label has been the big winner. Over the same period, its volume of the Australian soft-drink market has grown from 13 per cent to an estimated 21 per cent, while in value terms the increase has been from 4 per cent to an estimated 6 per cent. Schweppes's market share has been relatively steady at 29 per cent by volume and an estimated 24 per cent by value.

So what does Coca-Cola Amatil do with the increasing competition from private-label soft-drinks, especially given Coca-Cola's price per unit sells at an estimated 64 per cent premium to the competition? That is, if Coca-Cola's products sell for $5 a unit, the competitors' price averages closer to $3 a unit — and that is an enormous difference for most Australians.

The crucial question for all Australian food processors becomes: are these gorilla grocery retailers distributing our products, competing with our products or, indeed, both?

Or does the Coca-Cola Amatil strategic review simply acknowledge that fighting the highly concentrated structure that is the Australian grocery retail sector, combined with the increase in the private-label market share, is very difficult to counter, all the while accepting a gentle decline in volumes and a lesser decline in value over the long-term is highly probable?

At Montgomery Investment Management, we would prefer to see the conclusions of the strategic review before considering an investment in Coca-Cola Amatil.

Roger Montgomery is the founder of Montgomery Investment Management. Montgomery funds own shares in Woolworths.