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When the prices are not right

Is inflation that low? Working out the true rate is important

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In this current environment, when all natural market metrics fail to make sense, it becomes more important than ever before to solidify our world views and come to reassess the basic laws of the jungle.

The graph illustrates that year to date, the global sectors performing the best are those that defy all the classic presumptions of "markets microstructure" — the central science of how markets should behave — and there does not appear to be any fundamental patterns that can be confirmed.

This is not necessarily a bad thing. This reality does, though, shake the very bedrock of a vast majority of our investment portfolios; whether we are assertive active traders or uber conservative superannuation pension investors.

Australian Ultra High Net Worth (UHNW) investors, in particular, are put in an even more odd position because, due to the innate nature of those who asset allocate wealth that is dispersed across conservative and exploratory boundaries, mixed outcomes are being seen, not always in the desired pairings.

In other words, Australian UHNW investors often hold both conservative and risky investments within their broader portfolios at the same time and sometimes in combinations that provide them the worst of both worlds.

Through all the insanity fit for an asylum, the rational among us can take a step back and remember what it was that motivated us to invest in the first place.

The Oxford Dictionary defines the word "investment" as: the action or process of investing money for profit. The operative word in that sentence is not "investing" nor "profit" but rather "money".

This is because, over many years, the trickiest art within investing is the appreciation of what and how money actually works.

Money is far more complex than most realise.

Collectively recognised as "currency", money, by its very nature, has behavioural traits that investors often underestimate.

On this, most of us (hopefully) have come to grasp the concept of "inflation" and why one dollar today is not the same value as one dollar in 2020 or 2010.

In this contemporary era, we understand that inflation is a reflection of a general increase in prices, directly representing the purchasing value of money. What we still struggle with is how it should be measured.

The astute global investor knows that benchmarking investments — whether they be made domestically or abroad — against conventional "Consumer Price Index" (CPI) is a foolish path that only lemmings follow.

CPI was never meant to be used in the vast and wide ways that it is in today's global economies.

To understand why, it is helpful to look to its genesis and ask why it was created in the first place.

In 1917 the US Bureau of Labour Statistics first set out to devise a measure of prices in order to learn what it cost an American family to meet its basic needs.

This meant more than simply sending surveyors across the country to record the cost of a specified basket of goods, as the bureau had previously done. It meant figuring out how prices shaped consumption and how new goods pushed out old ones.

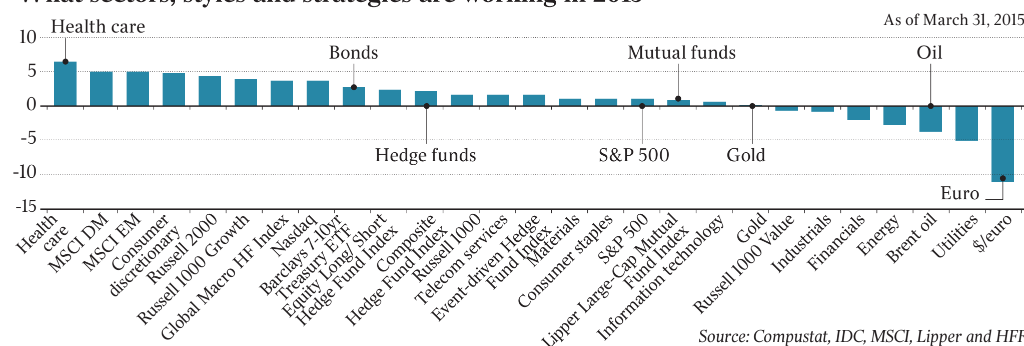
Without that, as the economist Zachary Karabell highlights, the CPI used to measure inflation today might still include horse-whips and the IBM Selectric typewriter. It was never intended to be used as an investment benchmark, as "asset inflation" was a different kettle of fish already.

During the post war years (1945-1970), though, this is how it came to be employed. Until the 1970s, most were not particularly interested in inflationary measurements — with the exception of union members, whose leaders demanded that wage increases be pegged to inflation. In Australia, ACTU president Bob Hawke rose to power on the back of this issue.

AFP

Alan Greenspan suggested that if the true inflation rate were calculated, it would be lower than the official figure

What sectors, styles and strategies are working in 2015



Source: Compustat, IDC, MSCI, Lipper and HFR

But the so-called "Great Inflation" of the 1970s, when official inflation levels exceeded 10 per cent, saw the index propelled to the centre of public debate and, of equal importance, moved investment conversations away from prima facie results to ones where inflation adjustments were included. Today, we refer to this as real versus nominal returns — anyone with money in term deposits will know those terms well.

In 1977 in the US, insisting that the traditional methods of measurement were making things seem worse than they really were, government statisticians introduced the "core CPI", which measures inflation without taking into account goods such as petrol and food, whose prices frequently change.

On this, Karabell argues that, of course, for most people, those are the goods that matter most, coupled with the fact that many of their investments had been made in industries and sectors directly confronting such inflation.

Regardless, the core CPI became the preferred gauge for policymakers around the developed world, precisely because it removed goods with volatile prices, which could easily skew perceptions.

In the 1990s, the question of whether official estimates overstated the inflation rate emerged once again.

The myopically sighted Alan Greenspan suggested that if the true rate were calculated, it would be lower than the official figure.

This was blatantly wrong.

Official inflation statistics remain a contentious topic and it falls upon the savvy global investor to seek out their own ways of gauging broader, consumer and asset inflation measures.

Within a year when fundamental market patterns make no discernible sense, boiling down investment decisions to their bones involves determining for oneself what is now considered "investing", "profit" and, most importantly, "money".

Abstracting the true nature of inflation today becomes paramount and, remembering that lemmings fall off cliffs, thinking for oneself also becomes the best investment one can make.

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Lower for longer: the truth about iron ore

ROGER MONTGOMERY

Listening to the overnight market reports each morning on television, what stands out is the audible surprise in the voice of the reporter when describing another fall in the price of iron ore to new decade-lows.

The price of iron ore is important, not only because of its direct impact on the fortunes of investors who might have inherited BHP or RIO shares from their parents, but also for the fortunes of the Australian economy. It stands in testimony about successive governments' ineptitude in planning for the long-term prosperity of Australia.

Commencing in early 2010, and ever since, I have warned investors that the iron ore price boom was a Potemkin Village (those fake villages the Russians would build to impress visiting nobility). I've said for a long time now that avoiding shares in iron ore producers was a given. This was despite the rather implausible arguments from some of my contemporaries that a floor in the price of the commodity would exist at the average production cost. What nonsense. Since time began commodity prices have traded below production costs at various times and marginal producers have gone broke.

I recall appearing on the ABC's *Inside Business* program: following Fortescue CEO Nev Power's observation that their long-term forecast for iron ore was $US100 a tonne, I observed that one should not ask a barber whether one requires a haircut!

With the iron ore price now close to $US50/tonne, many experts are forecasting prices that coalesce around the current price. That's just typical! Humans are notoriously under-equipped to forecast turning points and markets tend to fall and rise to extremes previously unexpected. Westpac, for example, is forecasting iron ore to hit a low of $US47/tonne this year before recovering to $US69/tonne, on average, in 2016. Good luck with that.

If you want to be an accurate forecaster, forecast often!

If only forecasting so precisely was possible.

Commodity prices are related to cycles of prosperity and decline or stagnation. Quite simply during times of prosperity, for example when China was recently building its own Potemkin Villages in unprecedented quantities, the competition for productive inputs, such as iron ore, drove higher prices.

The resultant commodity boom was unprecedented. The iron ore price rose from $US20/tonne in 2004 to $US187/tonne in 2011, a historic high.

Of course, the rate of industrial urbanisation in China triggered the imagination of analysts who yet again suggested "this time is different", claiming that the boom would last for 100 years and was justified by the industrialisation and urbanisation of China, followed by India and then even Africa.

Unsurprisingly, supply intentions increased and it wasn't long before brokers were recommending iron ore producers, based on increased production expectations multiplied by the new higher prices.

Of course, nobody had thought to aggregate the individual company production forecasts and what emerged was a picture of supply many times greater than the entire iron-rich Pilbara region produced annually.

However, lead times in the project development and production of iron ore are long, so the reconciliation of demand with supply can be pushed out far enough to be irrelevant. But time catches up quickly and only those who believed it was better to be six months early than six minutes late sidestepped the collapse in prices currently being experienced.

With that little bit of history safely tucked away, the question now is: how low can iron ore prices go?

Step one is to ignore the forecasts, a sample of which was provided above. For many decades prior to 2004, the price of iron ore traded between $US10/tonne and $US20/tonne. At those levels BHP and Rio did not go broke. But they didn't make a great deal of money, in today's dollars, either.

It would be a mistake to think prices couldn't go there again.

The game now being played is to drive the price of iron ore lower, which in turn sends higher cost producers to the wall.

The last man standing wins. Even if the price of iron ore is $US10/tonne. Don't be surprised if it gets there.

Roger Montgomery is founder and CIO of the Montgomery Fund.

Hills chief counts on true believers as he pursues vision of growth

RICHARD HEMMING
UNDER THE RADAR

No one has ever accused Ted Pretty of lacking vision, but many fund managers question whether the Hills managing director can combat stiff headwinds.

The ex-Telstra director and dotcom era IT guru took over the reins at Hills in September 2012, whereupon the shares quickly dived from $1.10 to as low as 64c, before climbing above $2 last year.

But after a poor first-half result the shares seem to be in the doldrums again, trading at 87c.

The problem is Hills' core business of selling security products is struggling as it faces increasing competition and higher prices in Australian dollars, owing to the weakness of the currency.

The division delivered three-quarters of the earnings for the half and was behind the market's disappointment, which led to a 32 per cent fall in Hills' stock price on the day of the result's release in February.

We looked at Hills because it generates about $420 million in revenue and about $40m in operating earnings (EBITDA) and appears very cheap, trading on a price-earnings ratio of 10 times.

Also, in the land of small caps, you are perennially backing somebody's vision.

At Hills there has been one outstanding question: can Pretty lead the company back into the land of profit growth?

Fund managers I've spoken to were divided. One said: "The company is lucky it has no debt because its core business is struggling." In contrast, another broker said Hills "was one good acquisition away from a complete transformation".

Having sold its famed Hills hoist to Woolworths last year, Pretty has been busy in the past 2½ years transforming Hills into a less capital-intensive seller of security technologies and health services.

Instead of manufacturing the Hills hoist, the business now relies on licencing agreements and revenue streams from HAaaS (Home Automation as a Service) and VSaaS (Video Surveillance as a Service) as well as hospital communications technology, which would "unify patient platforms".

A lot of acronyms and jargon to be sure, but sometimes these provide opportunities to make big money because the market is not good at valuing companies that change their business models.

There will be some slippage in earnings as the transformation occurs, but Pretty knows true believers will look through this and see his vision.

Like fellow small cap Azure Healthcare, Hills is looking to take advantage of the trend towards eHealth, in which hospitals are digitising their systems and using software such as Azure's nurse call system, which enables them to manage their hospital bed services more effectively.

As I understand it, Pretty's vision is for hospitals to use Hills' technology in conjunction with the pay-TV technology they already use. A patient's data would be accessed via television, which would be used to communicate with nurses and doctors — in other words, a screen where clinicians can share charts, scans and test results.

It sounds like the future and it may well be. But sometimes all the vision in the world can't match the immediate reality of declining profitability.

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