



Is it the end for low rates? **Don Stammer** reports on bond market signals for the general investor on **Tuesday in Wealth**.

Shell-shocked Orica is regaining favour with investors. Dividend Detective **Darren Katz** reveals the numbers on **Tuesday in Wealth**.

## After tackling turbulence, Qantas turnaround shines a light on its retail bonds

LIZ MORAN  
SMART INCOME



Less than a year ago, when Qantas reported a \$2.8 billion statutory loss, some commentators were calling the curtain on our domestic carrier.

But to their credit, CEO Alan Joyce and his management team have turned the airline around, with some help from a surprise decline in oil prices, and Qantas's fortunes look a world away from where they were a short time ago.

The airline industry is tough and there have been some spectacular failures. It's cyclical and

characterised by its utility-like service transporting passengers, subjecting it to fierce price discounting. Other risks range from fuel prices and currency fluctuations to regulatory risk, not to mention plane crashes.

Qantas has proved more resilient than many investors thought. It looks like management's focus on its cost base is paying off, closing in on rates achieved by competitors. The company is on track to reduce debt by \$1 billion, as previously forecast, this financial

year. The recent announcement of the possibility it will reinstate dividends after a six-year hiatus sent shares up over 7 per cent this week.

Even when the company was at its lowest, I always believed that Qantas was a survivor, making it easy to recommend its bonds. The fact that companies must pay bond-holders interest and return capital at maturity, combined with the fact that shares are higher risk than bonds as they must be wiped out before bondholders take on any loss, provided the additional

comfort to invest in an otherwise high-risk sector.

Qantas's high-yielding bonds were attractive from the start, when the first of the three domestic bonds was launched back in April 2013, maturing seven years later, paying a fixed rate of 6.5 per cent per annum.

Since first issue, the April 2020 bond price has moved around, depending on company news, market sentiment and interest rates. An improved outlook as well as the expectation of low interest rates

saw the bond price recover from \$98 in August 2014 to reach a high of \$108 last month, only to decline to its current price of \$106.

The good news over the past week was dwarfed by the expectation of higher interest rates over the next few years, resulting in the pullback — remember higher interest rates lead to lower fixed-rate bond prices.

If you bought the Qantas 2020 bond, available to all investors, at the current price of \$106, it would have a yield to maturity of 4.74 per

cent per annum. That's a good fixed return in a low interest rate environment.

Qantas has two other longer dated bonds, maturing in June 2021 and May 2022 with yields to maturity of 5.32 per cent per annum and 5.43 per cent per annum, respectively. These bonds benefit from an additional clause where interest is increased if the credit rating agencies downgrade the bonds. While the current conditions make this unlikely, it's an important benefit for a company

in a cyclical, high-risk industry. Unlike the retail-focused 2020 bond, these bonds are only available to sophisticated or wholesale investors.

My pick of the three is the 2021 bond. It has a pick-up of 0.58 per cent over the 2020 bond and matures before the 2022 issue, so it is less risky. The higher yield of 0.11 per cent on the 2022 doesn't compensate enough for the extra year.

Retirees need a replacement income and fixed-rate bonds provide certainty.

## Bad new days of big government

Canberra should get out of the way of private enterprise

STIRLING LARKIN  
GLOBAL INVESTOR



During our preparatory schooling, here in Australia, we were taught democracy was a system of polity that by its very nature walked in lock-step with the principles of free market capitalism.

In contrast, we were also taught that socialist and communist systems, by their very different existence, put the state or government, not the individual, at the centre of all economic, social and geopolitical decisions made on behalf of a populace.

Living within a supposed liberalised democracy, it has become alarming to see Australia's obsession with the role of its state, level of expected government intervention and also general mindset.

The colossal attention to this week's budget attests to this obsession.

Some global investors, rightfully so, are starting to become ever more concerned with Australia's mentality towards democracy, free and liberal markets and our balance between free enterprise and the role of our state.

To be clear, government should be and is a very important stakeholder in any system, including democracies. But by definition within our polity, governments should be there to facilitate free enterprise, entrepreneurialism and business, not crowd it out nor replicate it.

The fact that Australia has not recently experienced a technically defined recession — an important part of any healthy economy's business cycle — nor has it any economic plan for the future, has set off alarm bells in some global investment quarters.

As discussed within this column previously, Australia partook in the international Globalisation Accord three decades ago, which saw us undertake the first half of this agreement very effectively.

We got rid of parts of our economy in which we were not most competitive, for example, textiles, clothing and footwear (TCF).

We then, however, miserably

failed to undertake the second half of this process, which ironically was the easier of the two halves to honour.

This second half would see our economy and nation-state then decide where best to allocate our human capital, resources, ingenuity and, ultimately, our main focus.

Failure to do so has seen Australia drift without any concrete plans.

Such plans, in a liberal democracy, should not be decided by our government but by us, the people.

In this context, "the people" refers to big and small businesses, entrepreneurs, investors, academics and even unions.

The graph illustrates that Australia's budget, by international standards, still remains appropriate, but what has concerned the global investment communities, and continues to do so, is our own domestic mindset, which heavily leans towards socialist not democratic ideals.

There should be daylight between systems and currently, in Australia, one could well argue, there is not.

It was understandable why the government stepped in during the GFC crisis years but it is now time for them to "exit stage left".

As US president Ronald Reagan once aptly said, "no government ever voluntarily reduces itself in size. Government programs, once launched, never (voluntarily) disappear."

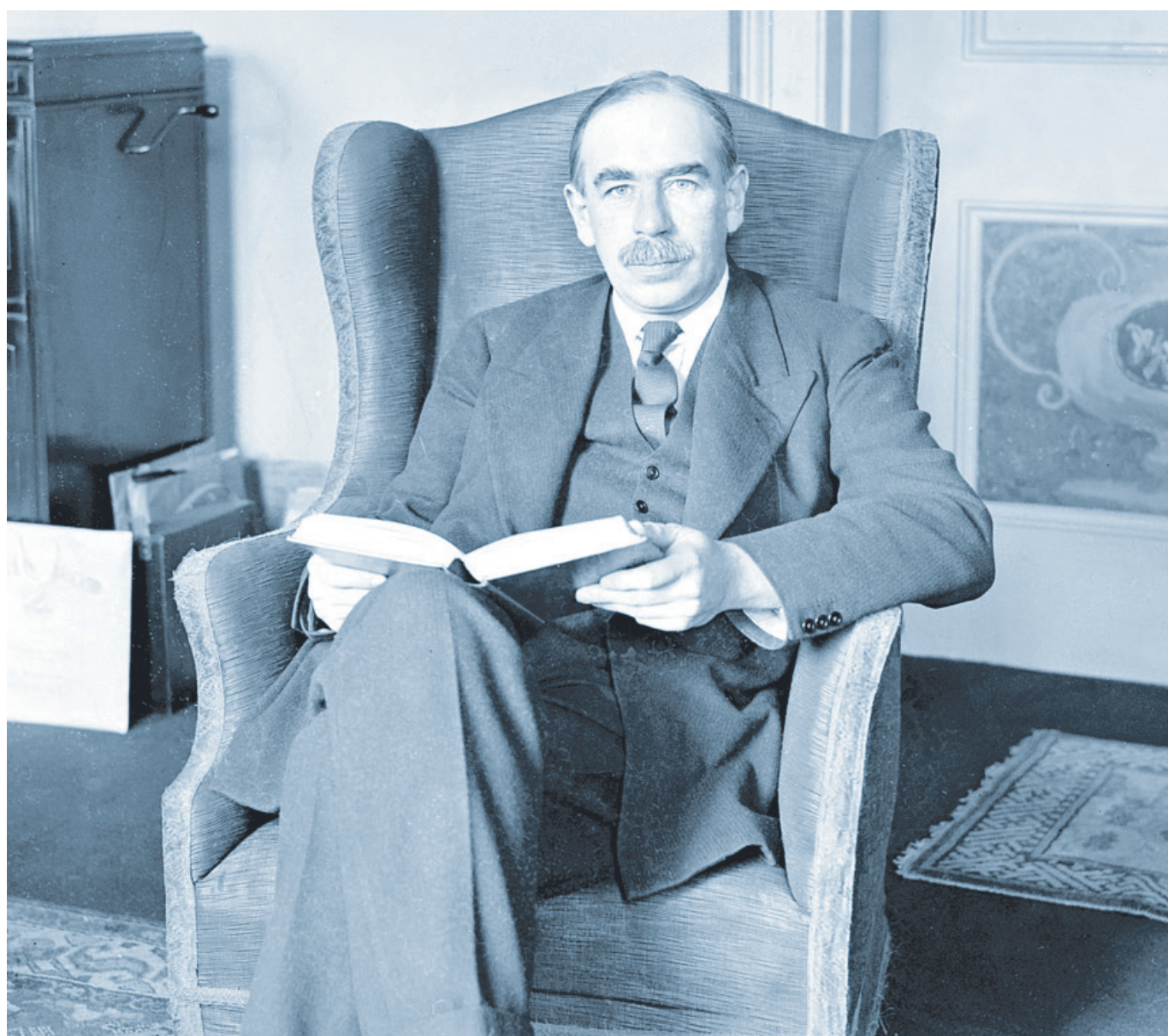
On this, Reagan also astutely asserted: "To sit back hoping that some day, some way, someone will make things right, is to go on feeding the crocodile, hoping he will eat you last — but eat you he will."

Starting to sound like a broken record, an outlier and increasingly a lone voice on this subject, Australia lacks both a vision and a plan and both these should be decided by us, the community.

Australia's fiscal arm of government, represented by the Liberal Party of Australia, and its monetary arm, represented by the Reserve Bank of Australia, are stakeholders in our economy but they do not constitute our core nor even our periphery. They are both servants of our economy and should not be confused as being our economic stewards.

The disproportionate focus on this week's budget and the continued frenzies surrounding RBA interest rate policies should concern all Australian investment and business communities, as much as it is increasingly concerning global investors.

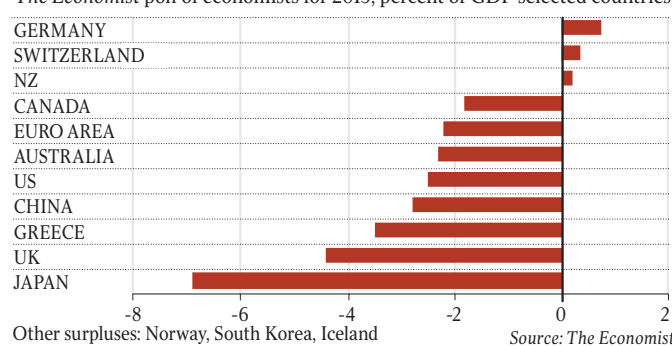
However justified, the size of government in this country has



Economist John Keynes: his outmoded over-spending is still with us

### Global budget comparisons

The Economist poll of economists for 2015, percent of GDP selected countries



ballooned past balanced levels and this week's budget could not be considered anything less than outmoded Keynesian over-spending.

With our Australian ASX 200 listed stockmarket valuations currently supported by unjustifiable and unsustainable pillars, a seri-

ous, circumspect appraisal needs to be made.

Domestic Ultra High Net Worth (UHNW) investors, like any other investment community, will continue to allocate their investment capital to its most effective likely use and these allocations increasingly see them

invest more and more abroad. The knock-on effect of over-reliance on government is that in a comparatively small economy such as ours, oligopolies have been allowed to prosper — best evidenced by the continued state endorsement of the "Four Pillars" banking policy.

This has, in turn, seen ASX 200 companies, which have had capacity to invest, choose, thus far on the whole, not to do so.

Ironically, this exemplar of state-sanctioned big oligopoly enterprise is akin to that currently challenging Chinese Communist State Owned Enterprises (SOEs).

The daylight between our two predicaments, in this respect, is currently hard to see.

It is time to redirect our national conversation back to asking what is our economic plan and how can we provide opportunities for Australian investment mar-

kets to prosper, grow and in so doing, rise through prosperity not synthetic inflation measures or feigned expansion.

Government can assist with broader economic productivity growth and efficiencies — which are very important — but they should not continue to crowd the private sector in either investment or spending.

Nor should they even dictate to us our national economic direction, which is for us, the people to decide.

I, for one, am willing to fight for our democracy, free-market entrepreneurial ideals and liberties.

In so doing, we all advance Australia's fair.

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## Markets getting warm ... but not boiling over

ROGER MONTGOMERY



With the government and the Reserve Bank talking of "green shoots" in the economy, you'd be forgiven for thinking we have just emerged from a prolonged recession. Over in the US, the situation is somewhat different. The US economy has been expanding for almost seven years and green shoots have turned into celebratory fireworks in some sectors.

Of course, after a full description of some of those fireworks you might be left thinking the only green shoots emerging are those of a bubble.

Take a look at a business called Noodle & Co. Noodle & Co is a takeaway chain with its head office based in Broomfield, Colorado. Broomfield has a population of 59,000 people.

Given this business is listed on the US Nasdaq exchange you might reasonably ask what earth-shattering wares are proffered by this chain. The answer to that is nothing really. The company sells noodles. You get to choose from an eclectic line of macaroni and cheese, noodles with butter, pad thai, spaghetti and meatballs, and steak stroganoff with cream sauce and egg noodles.

A regular-sized portion of pad thai from the Tempe Arizona store will set you back \$US5.69. An extra \$US2.99 will get you some oven-roasted meatballs on that or some marinated steak, and for \$US7.5c you can add extra Italian parmesan cheese. Yes that's right, cheese and meatballs on your pad thai!

You wonder how many of these meals they can dish up. According to one source, food critics began identifying it, in the late 1990s, as the best fast-food restaurant in their respective cities and it won awards for fast growth, healthy food and being family friendly. Revenues in 1996 were \$300,000 but by the time the company listed in 2013, revenues had reached \$US300 million from 410 stores.

For the first three months of 2015 ending March 31, revenue increased 18.1 per cent to \$US105.8m, up from \$US89.5m for the same quarter last year. Like-for-like comparable

restaurant sales grew 0.8 per cent for company-owned restaurants, 1.4 per cent for franchise restaurants and 0.9 per cent system-wide. Over the quarter 16 new restaurants opened, of which 13 were company-owned and three franchises.

But net profit fell to a loss of \$US2.8m from a profit of \$US1.4m in the previous corresponding period. The company recorded a \$US5.9m pre-tax impairment charge related to eight restaurants this year. Yet shares in Noodle & Co are trading at a staggering 44 times earnings!

Another company that caught our attention in the US is Potbelly. Potbelly started out as an antique shop called Hindsight that also served toasted sandwiches to its bric-a-brac-fossicking customers.

Entrepreneur Bryant Keil bought the original store in Chicago and has since expanded it to more than 280 Potbelly Sandwich shops across the US that still maintain a local store vibe (think 1980s TV show Cheers) offering live jazz and blues as well as, perhaps unremarkably, soup, shakes, malts, smoothies, and cookies.

For the first three months of 2015 ending March 29, total revenues grew 16.1 per cent to \$US85.8m from \$US73.9m and company-operated comparable store sales rose 5.4 per cent. Net profit attributable to Potbelly Corporation was \$US0.5m, compared with net loss of \$US0.3m during the same fiscal period last year. According to estimates, Potbelly trades between 81 and 101 times earnings.

None of this is normal. And as mathematician Herbert Stein once wryly observed, "If something cannot go on forever, it will stop."

But before you pull the sell trigger, it is imperative to know that these pockets of irrational exuberance are not having a dramatic impact on our local market and while there are some businesses whose shares are trading at all-time highs, more than two-thirds of the 70 per cent invested in equities in the Montgomery Fund is allocated to companies that still trade at a discount to our estimate of their intrinsic value. This suggests to us that, while dangers are indeed increasing, there may be more growth in those green shoots.

Roger Montgomery is founder and chief information officer of the Montgomery Fund.

## Global performance <sup>2</sup>

Performance 30 April 2015 Net of all fees*	6 months %	1 year %	3 years % p.a.	5 years % p.a.	Since Inception % p.a.
K2 Global High Alpha Fund	20.9	29.8	28.2	26.4	25.8
K2 Asian Fund	24.7	34.9	21.1	10.3	12.2
K2 Select International Fund	23.2	30.4	18.4	12.1	12.6

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