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Montgomery Funds' Andy Macken picks Prada as world's leading short candidate

Montgomery Funds analyst Andy Macken says luxury brand Prada is the world's best candidate for short selling. **Daniel Munoz**

by **Jonathan Shapiro**

Short sellers are supposed to be the devious scourge of the financial markets, if you believe the outspoken executives who need to pin the blame for their sliding share prices elsewhere.

But Wagga Wagga NSW-born analyst Andrew Macken of Montgomery Investment Management does much to dispel this outdated myth.

Macken is the portfolio manager heading a high-calibre team in charge of Montaka – Montgomery's new fund that will take long and short positions in global companies.

The concept behind the wholesale fund, which launches in July, is to use a value process to find companies to buy and adopt a different mentality to find companies to short.

"The long process is to look for high-quality businesses, with great prospects, that trade at discounts to intrinsic value," says Macken.

"The short process is not simply the inverse of that. You can't just short overvalued companies. If you short on valuation alone you'll get hurt."

Macken knows a thing or two about how to find and how to execute a good short. He

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spent nearly four years at the world's most famous short shop, Jim Chanos' New York-based hedge fund Kynikos Associates, best known for its role in identifying the fraud at Enron in 2002.

His experience there led him to develop a framework for finding companies to short – based on four "characteristics": thematics, divergent expectations, asymmetries and misperceptions.

First up, "thematics" refers to structural changes that will permanently alter the business outlook, such as technological disruption or an oversupply of a commodity.

Second, "divergent expectations" describes fads, roll-ups and high-growth companies where analysts and the market are "often guilty of living in denial and don't update their expectations quick enough when the growth outlook changes."

Third, "asymmetries" are stocks exposed to sudden negative changes either through highly leveraged balance sheets or changes to regulation.

"For asymmetric shorts, you don't get paid until they work so they require patience, and your timing has to be spot on otherwise you feel the pain."

Finally "misperceptions" are stocks that have engaged in aggressive accounting or worse yet, fraud, a term that Chanos stresses should be used with extreme caution.

These, too, are "dangerous shorts" as aggressive accounting and misperceptions can continue well beyond when they are first discovered by short sellers. For this reason, risk management is a vital part of the shorting process.

"Shorts can run against you, so you have to diversify and have smaller positions because if they go against you your position actually grows – at the very time you may want to add to the position you actually have to reduce it to manage the risk."

A good short displays at least one or more of these four characteristics, a great short displays them all.

So which company, among thousands globally, does he think is a good short? He's picked one that would surprise some readers, especially those whose credit cards have been on the wrong end of this high-end fashion brand.

But Macken believes Hong Kong-listed Italian luxury brand Prada is primed to plunge. The thematic component is Beijing's crackdown on corruption that has hit sales in all the megaluxury brands that had been booming. But there's more to it than that. Macken says Prada has been opening more stores to mask declining same-store sales and prop up falling revenues. This is the "misperceptions" element.

There are "divergent expectations" at play too. Analysts haven't adjusted their earnings expectations to factor in ongoing declines and are instead assuming relatively heroic recoveries in revenues and earnings.

Prada floated on the Hong Kong Stock Exchange in June 2011 at HK$39.50 (then $A4.77) valuing the firm at €9 billion ($12 billion). It reached a high of $HK82.30 (then $A10.20) in March 2013 and later that year began its descent.

While the share price has fallen from a 2015 high of $HK51.60 it has disconnected from the revised, yet still optimistic, earnings forecasts.

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"So not only are the earnings forecasts too optimistic but the stock is too optimistic relative to the optimistic earnings," Macken says.

Add a whole lot of governance concerns – the company is 80 per cent owned and operated by Miucca Prada and her husband – and we have a stock that has the qualities of a fine short.

Macken says Prada, by virtue of its valuable brand and lack of financial leverage, isn't a stock that's going to zero.

But in some instances its strong brand can be a weakness. Prada has nearly 240 days of inventory, up from 175 days the previous year, while it hasn't increased charges for obsolete inventory. For most retailers a fire-sale would do the trick, but it's hard to imagine an "everything must go" clearance event at its flagship Soho store. Nor would it be a good idea for the brand.

That's the short of it.

Which companies will Montaka be backing? One Macken has picked out is Qualcomm. The $US113 billion ($147 billion) Nasdaq-listed wireless technology firm isn't one most investors in Australia have heard of. But they are very much a part of our everyday lives – as the effective owners of much of the 3G and 4G technology that our mobile phones use to access the internet. The company derives roughly 70 per cent of its earnings from royalties paid by wireless device manufacturers to use the technology, making the stock an efficient way to profit from the inevitable ubiquity of smart phones.

Says Macken: "It's a bit like owning the English language and then charging anyone that learns to speak English."