Can we depend on big mining stocks for yield? **David Walker** investigates in **WEALTH on Tuesday**

Funds Minority: Will Hamilton on the hidden costs of male-dominated funds management in **WEALTH on Tuesday**

Paradice found: Ophir's dig unearths 200pc stock gold

Andrew Mitchell has learned that 'money doesn't sleep'

DAMON KITNEY

The Books of Kings and Chronicles in the Hebrew Bible recount a joint expedition to an ancient city called Ophir by King Solomon and the Tyrian king Hiram I where they discovered large amounts of gold and precious stones. It became known as the "gold of Ophir".

Centuries later in 1851 history repeated itself on the other side of the world when gold was first discovered in NSW at the town of Ophir near the Macquarie River, northeast of Orange. The discovery led to the Australian gold rushes.

So when Andrew Mitchell and Steven Ng left David Paradice's Paradice Asset Management at the end of 2011 to strike out on their own, they couldn't think of a better namesake for their boutique fund management business.

"We pride ourselves being the first institutional investor in a new stock — that's where the real money is made," Mitchell says. Since opening its doors in August 2012, Ophir Asset Management has become a trendsetter in small-cap investing, delivering a gross return before fees of 209.6 per cent compared to the Small Ordinaries index return of about 17 per cent. The performance has put Ophir at the top of Australian equity fund managers over that period, to the delight of Ophir's backers, that include Paradice himself.

After starting with a pool of $10 million seeded by the Mitchell and Ng families and friends as well as Paradice (or "Para", as they call him) and a handful of wealthy private investors, Ophir's funds under management has grown to about $300m.

Mitchell and Ng own 100 per cent of Ophir, giving them complete autonomy, and have a team of five. "We were lucky we knew we had the support of David Paradice and super funds when we started. Super funds expect to see three to five years working capital to support the business in a downturn so we had to basically put all our life savings into the business and generate good performance before they invested. It is not easy," Mitchell says. "Timing is very important starting a boutique fund. We started in August 2012 very close to the bottom of the market. We think we are now in the second half of the bull market, it would be very hard to start now without the guaranteed support of superannuation funds." There are 55 stocks in the fund, with its maximum weighting in a single stock generally around 5 per cent.

Ophir is only open to sophisticated wholesale investors or private individuals with a net worth of more than $2.5m. The minimum single investment is $100,000. It has a standard fee structure of 1.5 per cent base and 20 per cent performance.

Mitchell says Paradice taught he and Ng many lessons, but the most important was to live and breathe stocks. "I remember when I first started at Paradice I went to Adelaide for the weekend and walked into all of Coventry Group's retail shops with a list of questions that David had given to me," Mitchell says.

Now Mitchell himself is travelling around Texas and bailing up Wal-Mart store managers finding out how many Yowie chocolates they have sold to safeguard Ophir's Investment in the ASX-listed Yowie Group. The emails from Paradice to his proteges would stop at about 12am and start up again at about 5am.

"Money doesn't sleep, it seemed like Para didn't either," Mitchell says. "If you want to do well in this industry, you have to love it and be obsessed with it. And go the extra work — do the work others don't."

"You need to be prepared to spend a lot of time on the road travelling, kicking tyres. Sometimes you can do 50 meetings and see nothing and from nowhere a great idea pops out. When you are confident you do the work; you do the checks on management; you understand the key drivers to earnings and you have to back yourself and go hard."

Paradice preached another mantra: plan for the worst and hope for the best. "We needed to build scale in the fund with super fund investors, family offices and high net worth investors in case there is another GFC. It is important to be diverse as retail investors will pull their money out straight away if there is another major correction," Mitchell says.

He says Ophir's best bets so far have been G8 Education, Magellan, and more recently Mayne Pharma. But he and Ng are wary of complacency — they are determined not to let the strong performance thus far go to their heads.

"When you let your ego get in the way that is when you make mistakes. The best guys I have seen have very little ego," Mitchell says. "The smartest people in our industry aren't the ones who make all the money, it is the hardest-working, street-smart guys that do. You have to be quick and quite often go with your gut feel."

RENEE NOWYTARGER

Ophir's Andrew Mitchell. 'You have to be quick and quite often go with your gut feel'

At the high end, profit margin, revenue growth can be a luxury

ROGER MONTGOMERY

What is luxury? That's not a question you would typically expect a fund manager to be contemplating. I normally don't care for expensive baubles and I'd break in a second anything too finely crafted.

But as we begin investing in global stocks on behalf of our clients, the answer to that question may allow our clients to luxuriate with the profits.

According to some, true luxury is a "careful balancing of authentic quality and ethereal yet undeniable emotions, which leads to irrational purchasing behaviour".

Irrational purchasing behaviour however can be achieved by much less grandiose brands.

The M&M store in New York, for example, makes many consumers buy tons of plastic every day. In simply displaying a lot of it, in every colour, it seems to sell more.

Travel to Paris, New York, Singapore or London and there appears to be a Prada, Gucci, Zegna or Chanel store everywhere and anywhere.

And it got me thinking: is true luxury really available on every street corner? Clearly the answer is no.

Advertising your "liquidity" by wearing it on your wrist, neck or arm, or by parking it somewhere noticeable isn't luxury either — that's just insecurity, which luxury brands feed off.

In trying to the answer the question I simply invert it — I find it is much easier to know what luxury is not.

Unfortunately for many of the world's luxury brands, as they expand their storefronts to convenience store-like ubiquity, they lose their prestige and become so-called "masstige" (combining the words mass and prestige, and described as "prestige for the masses" — basically affordable goods perceived as luxury).

Witness the increasing number of Italian and English car brands building limited edition, customised super car or the proliferation of hipster cordwainers in the lanes of Melbourne.

Everywhere you turn, masstige is driving consumers to something even more exclusive or even more exotic.

> The destruction of luxury through ubiquity is seen in the same-store sales of some of the top brands

The destruction of luxury through ubiquity might just be what we have picked up on in the same-store sales numbers for some of the world's luxury brands.

Prada's 594 stores are now each growing revenue by an average minus 13 per cent.

Over at Coach, same-store sales across its 973 stores are falling at 23 per cent, Michael Kors — minus 6 per cent and Abercrombie & Fitch — minus 8 per cent.

When revenue on a same-stores sales basis turns negative, operating leverage becomes a noose, placing pressure on EBITDA (earnings before interest, tax, depreciation and amortisation) margins.

When same-stores sales declines can be attributed to the economy, you might argue that the situation is cyclical.

And it is certainly true that the global economy is not strong. But if the same-stores sales decline is due to a proliferation of competitors setting up on every street corner or due to the loss of the brand's perceived prestige then the effects might be longer lasting and/or structural respectively.

Meanwhile, the global analysts covering this sector are displaying some of the optimism usually reserved for the customers that frequent the stores.

In the case of Prada, listed in Hong Kong, despite EBITDA margins falling from near 32 per cent to 27 per cent in the last two years and revenue growth declining from 30 per cent to zero, analysts still have the company's profit margins recovering sharply over the next few years and revenue growth bouncing back up to 10 per cent.

In the case of Coach, sales growth was zero in the first quarter of 2014 and now it is minus 15 per cent. Analysts have sales growth recovering by 2016 to over 5 per cent growth.

In the case of Abercrombie & Fitch sales growth has varied from zero per cent in the second quarter of 2015 to negative 14 per cent most recently. Analysts have revenue growing at 2 per cent by 2017.

The company's operating margins have declined from 9 per cent in early 2014 to 1 per cent most recently and yet analysts have the company's margins recovering, somewhat magically, to over 4 per cent by 2017.

So what does all that tell you? It tells you that there's a very high possibility that a divergence exists between reality and expectations. It's a divergence that can be profitably exploited by investors in the right kind of fund.

And if profits do indeed accrue, investors can decide for themselves what true "luxury" is.

Roger Montgomery is founder and CIO of the Montgomery Fund.

Better than the average bear ... China's stockmarket value indicators beginning to shine

STIRLING LARKIN
GLOBAL INVESTOR

Eight years past the Great Recession, too many still confuse its cause with its effect.

Confusing the levels of excessive leverage as the cause, it was, in fact, the misrepresentation and inaccurate pricing of risk in US credit markets that triggered the global "dystopia" that rippled throughout the global economy.

The significant amounts of gearing throughout US and European financial markets only amplified these ripples, which then became tidal waves in other OECD economies and even tsunamis in some emerging markets.

Acceptance of this "causal-nexus" is crucial for the global investor today, because any comprehension of where Chinese stock, bond, credit, commodity or real estate markets are currently at needs to be anchored against the backdrop of what happened last time excessive leverage was confused for the misrepresentation of risks.

For all of the noise made during July, the following concrete facts remain — Australian stockbrokers, as the graph highlights, remain more exposed to equity markets and are geared greater than their Chinese Hong Kong, H-share and mainland A-share counterparts.

Australian Ultra High Net Worth (UHNW) investors, who generally face global markets via global investment banks (Global IB), including those based in Switzerland, also interact with counterparties who are geared greater than current Chinese domestic broker participants.

These facts, viewed in isolation, do not deserve much attention but do become topical when we question whether China's stockmarket retreat was a symptom of overleverage or rather a natural pull-back faced by any bull market cycle.

Since the end of the deep recession of 1973-1975, which was caused by the "Nixon Shock" — when president Richard Nixon unilaterally cancelled the direct convertibility of the US dollar to gold — and combined with the hyperinflation triggered by the 1973 OPEC crisis, global stock bull markets have faced a 44 per cent probability of seeing a 20 per cent or greater correction, driven by P/E retracements, with a key trailing P/E support level of 15 times.

Why these statistics are important today is that they help us assess whether China is undergoing such a correction and is not heading into a systemic bear market, as many have proposed.

Since the CSI300 retracement began early this month, the Shanghai and Shenzhen constituent entities still being quoted have been repriced at a forward P/E of 14.4 times and those excluding state-owned enterprise banks at 18.7 times, as of this week.

Albeit volatile, this market-driven retracement back to value-enhancing multiples should be interpreted as a sign that this is a collection of bourses representing entities that are expected to enjoy improving sequential growth for the remainder of this calendar year ... this is an important sign to see.

Shadow banking off-balance sheet leverage, which fronted this stockmarket volatility, has now been largely unwound.

Bank plus broker capital remains in place; adequate enough, even juxtaposed against the financial loss of 9 trillion yuan ($2 trillion) by free-float market capitalisation seen on Chinese bourses — CSI300, Hong Kong, ChiNext and Chinese companies quoted on US Exchanges via American Depository Receipts (ADRs) — since July 1.

It should be remembered that Chinese official banks still retain 53 trillion yuan in household domestic deposits and enjoy total balance sheets in excess of 220 trillion yuan, by declared and verifiable accounts.

The news this week that, for the first time since 1993, the People's Bank of China has been a net seller of euros should also be seen as a positive and supportive measure taken by this central bank. This demonstration that the PBOC will deploy its deep capital reserves to buttress select mainland markets only goes towards reassuring listed Chinese entities that the integrity of their listed market architecture will continue to be supported, amid "velocity" in local equity and fixed income markets.

The PBOC will favour stability in the yuan and use their $US3.7 trillion ($5 trillion) in reserves as needed.

As, historically, bull markets retracements take approximately four to six months to recover, the global investor and specifically, Australian UHNW investors who access China A-sharemarkets via 'Global IB' participants need to pay acute attention to which CSI300 constituents suffer "leverage overhangs" and which, particularly in the larger capitalisation spectrum, present value momentum.

The Chinese economy and respective stockmarkets are still developing and remain a command economy.

But why so many Australian market commentators continue to appear sour on China, both economically and in the investment universe, is because they still fail to identify how Australian investors can access these markets other than via loose proxies, such as listed Australian iron ore exporters or New Zealand dairy farmers.

This disconnect also goes a long way towards explaining why traditional Australian stockbroking models and financial planning networks are facing their death-knell and why Australian investors, smaller retail to very large UHNWs, are all actively investigating fresh investment advisory channels, which deliver asset allocations that properly reflect the globalised economy within which we now live.

These ASX 200-centric Australian advice channels fail to provide Australians guidance nor access to such examples as the Chinese Industrial, Shenzhen Inovance Technology (300124: CH), the healthcare giant Tasly Pharmaceutical (600535: CH) or, even in many instances, the Sino consumer discretionary darling, Jumei International (JMEI: US), which is listed in New York.

Eight years past the Great Recession, too many are still blaming markets and not their own business models for why the world is the way it is, but that is why it is so critically important that the global investor differentiates between objective guidance and biased disdain.

Remembering that CSI300 has gained 121 per cent from its June 2014 low, even after factoring in the retirement of July 2015, and understanding what and where the risks lie goes well towards helping us decide whether China is a bull on retracement or a bear about to slumber.

Larkin Group is a Wholesale Wealth Adviser focusing on high yielding global investments.

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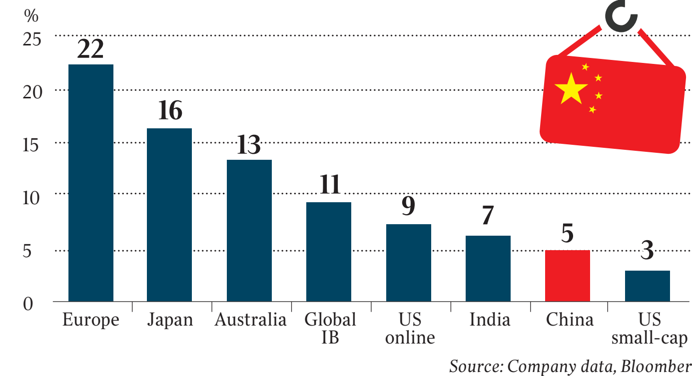
Chinese brokers' average leverage (assets/equity)



	%
Europe	22
Japan	16
Australia	13
Global IB	11
US online	9
India	7
China	5
US small-cap	3

Source: Company data, Bloomberg

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