WEALTH

POWERED BY eureka report

theaustralian.com.au/wealth Edited by James Kirby

“China is dumping about 111 million tonnes of steel that it doesn’t need on the open market each year.”
ROGER MONTGOMERY

Ad groups sell messages better than themselves

TIM BOREHAM
CRITERION

STW Communications (SGN) 58c Enero (EGG) 71c

The theory behind investing in the listed advertising and marketing houses is that they are agnostic when it comes to delivery channels and thus immune from the digital migration. But they are, of course, sensitive to media-buying activity as influenced by business and consumer sentiment.

When it comes to selling themselves to investors, STW and Enero have done a poor job of late. STW this month reported an impairment blighted net loss of $73 million, which even its Cannings PR arm would find hard to spin.

Once controlled by adman John Singleton, STW is the holding company for no fewer than 75 agencies, including Ogilvy, Hawker Britton, Colmar Brunton and the Buchanan Group.

Enero is the reconstructed Photon Group and the umbrella company for marketing and communications businesses including Frank, CPR, Jigsaw and Corporate Edge.

CCZ Equities’ Roger Colman describes both stocks as “keenly priced”, given they are not affected by structural change in the media. “It is a question of which one has the highest certainty of earnings.”

Enero derives 60 per cent of its earnings from the northern hemisphere, an advantage given Australia’s slower media spend. STW derives 80 per cent of its receipts locally, the remainder from New Zealand and Asia.

Enero reported a full-year loss of $2.8m, although operating EBITDA improved 2 per cent to $9.2m on 3 per cent cost reduction, including 10 per cent of staff expenses.

Management isn’t game on guidance, but says the depreciating dollar added $3.5m to revenue and $800,000 to EBITDA (earnings before interest, tax, depreciation and amortisation) in the first half.

“The insecurity raised by the inability of any of three operating territories to stabilise revenues is of concern,” Colman says. Colman cites Enero’s “superb” cost-cutting but says with staff numbers falling from 1000 to 600 over five years it’s also a shrinking business.

STW’s advantage is a 21.5 per cent shareholding in the global WPP and benefits from steady earnings via two local joint ventures O&M and JWT.

The group generated a $15.1m underlying profit for the half, down 22 per cent, but guides to a full-year number of $40m, or $30m after “excluding the impact of impairment charges and one off-restructure costs”.

STW chief executive Michael Connaghan says: “The first half of the year has been disappointing. However, the tough decisions we have made and costs incurred will begin to deliver benefits in the second half.”

STW has a poor track record of guidance, with calendar-year earnings originally envisaging a mid-single-digit rise from the previous year’s $49.5m.

Colman puts Enero on a current year (2015-16) earnings multiple of about four times, falling to about three times in 2016-17. STW trades on 4.4 times for calendar 2015, falling to 4.1 times in 2016.

Relative to either local service stocks or global ad peers, that’s cheap. While attempts at corralling creative types under a corporate umbrella have been problematic in the past, we reckon they are worth a **spec buy** punt. STW shares in particular were smashed in last month’s market rout.

Colorpak (CKL) 50c

When it comes to a listed packaging exposure, it’s hard to go past the global reach of Amcor, its local spin-off Orora or Ralph Geminder’s recently listed Pact Group. But smaller trans-Tasman Colorpak adds a dollop of corporate intrigue, given Geminder lurks on the register with a 15 per cent stake and a reputation for not being an idle bystander.

Colorpak chief Alex Commins concedes the specialist packager’s full-year numbers are as flat as its raw material of cardboard, but notes the $12.8m of underlying earnings beat earlier guidance of $11m. “That’s not sheep stations, but it’s something,” he says.

Colorpak’s numbers are also cleaner as management has finalised a plant rationalisation that followed the 2010 purchase of Carter Holt Harvey’s folding cardboard operations.

The sale effectively ended a bruising margin war that also engulfed Amcor’s former division (now Orora).

Commins admits Colorpak isn’t quite enjoying the expected cost savings because of relentless margin pressure, but the second-half trends are encouraging.

Colorpak makes products such as paper cups, folding cartons and sachets, mainly for the pharmaceutical and food and beverage sectors. Given the declining dollar, Colorpak is benefiting from the decline of fully finished goods (such as drugs) being sourced from Asia.

On the flip side, Colorpak sources its raw cardboard from the US and Scandinavia.

Main rival Orora faces the same sensitivities, having closed its Petrie cardboard mill ahead of the 2013 demerger from Amcor.

As with local manufacturers of any hue, Colorpak has had its vicissitudes but finally looks to be reaping the rewards of its painful downsizing.

“We are good at what we do and we have been doing it for a long time,” Commins says of the family-controlled stayer.

The Weekend Australian accepts no responsibility for stock recommendations. Readers should contact a licensed financial adviser. The author does not own shares in the companies mentioned.

Future Fund’s allocation lessons for private investors

JAMES KIRBY

The Future Fund pulled in another very strong set of investment results this week and usefully — for the private investor — this $117 billion operator also revealed both its asset allocations and its view of the future.

Using the Future Fund as a role model for the individual investor is flawed, because the fund operates in a different space to most investors — even most super funds — but allowing for these exceptions there are still highly valuable investment insights on offer here

The fund has a terrific fundamental objective that could be applicable to any investor: it promises to earn at least 4.5 per cent more than inflation every year (the result is measured on a ten-year basis to iron out deviations). These days that means you should aim for a total investment return of about 6.8 per cent a year.

As a fund that operates out of a Melbourne office tower, the Future Fund shows absolutely no bias towards its “home” economy — indeed Australian shares have slipped from 9.4 per cent to 6.8 per cent in the fund’s asset allocation (see table): since our market has waned faster and harder than Wall Street during this now extended correction, this hard-nosed rationalist position taken by the fund has paid off. Most investors would struggle to be as disciplined as a sovereign wealth fund — and indeed the seduction of franked dividends will always make local stocks relatively attractive, but the lesson is: you must move investments offshore to get a healthy diversification.

A window into the workings of the fund is the broader movements in allocation, particularly the movement in money flows over the year to June. There are three points of guidance here:

● The outstanding item to note is that the fund moved heavily into cash. It’s ironic that most Australian investors have been earbashed for three years about getting out of cash into risk assets for better returns. Indeed, there are signs this is happening: the savings rate has finally drifted down to less than 8 per cent from 10 per cent in 2010. In other words, the new Future Fund figures show the value of keeping on top of not just markets, but sentiment in markets such as the ever changing attitude to cash levels.

Cash is now a very significant holding in the fund — certainly at the end of June when these figures were reported it had shot to 19.5 per cent up sharply from 11.2 per cent a year earlier.

Of course, “cash” for the Future Fund does not mean putting it into a local bank at 2 per cent — the fund holds its cash in a range of currencies: its US dollar cash holdings would have made a nice profit this year just be being in the right currency.

● A perennial message from the fund is that more than 30 per cent of its entire portfolio, represented by holdings in alternative assets, private equity, infrastructure and timberland, are not directly exposed to our securities markets. Indeed it is these “non-correlated” holdings that should act as the ballast for the fund during the challenging times we are having right now especially on the ASX and Wall Street.

As a private investor you will find yourself consistently excluded from these asset classes unless you qualify as a sophisticated investor with investable assets of $2.5 million or an annual income for the last two years north of $250,000. These “sophisticated” investments are seen as too complex and too risky for most investors (though since our bank stocks have plunged by 20 per cent plus in a matter of months risk is a relatively concept here). Slowly, more alternative and private equity products are emerging in the market for mainstream retail investors and the sooner the better.

● The fund has increased its holdings in property: its property holdings inched up from 9 to 10 per cent. This level of property exposure would probably be much less than the exposure of many individual investors.

This is a fascinating move, which is obviously in global property and would cross both commercial and residential property. It would have been very interesting to receive more explicit information on just what property investments are on the books but little detail has been offered, though we do know the fund has been active in residential property developments in the recovering US housing market.

Overall, the fund will be not getting any garlands from the ethical investor movement — with chairman Peter Costello waving away questions about coal and oil investments. All the same, it’s on the record that the fund has quit armaments and tobacco, which implicitly suggests over the longer term the fund will move with market consensus on whatever is deemed to be “ethical” as the notion evolves.

For ever investor, the outstanding takeaway from the Future Fund results is the comment of Costello that the market — and public servants lucky enough to be entitled to this fund — cannot expect these sort of 15 per cent returns to continue. Running at the double the target rate to return — in an era of low rates and low returns and in nervous markets — the fund has peeled back community expectations — it’s something the average investor will have to do as well.

James Kirby is managing editor of Eureka Report

AP

Australia’s Future Fund, which is active in US property, has lifted its exposure from 9 to 10 per cent

Future Fund asset allocation

Asset class	30 June 2014 A$ million	30 June 2014 % of fund	30 June 2015 A$ million	30 June 2015 % of fund
Australian equities	9,565	9.4	**7,957**	**6.8**
Global equities				
Developed markets	23,451	23.1	**20,629**	**17.6**
Emerging markets	9,840	9.7	**11,034**	**9.4**
Private equity	8,481	8.3	**12,609**	**10.8**
Property	5,475	5.4	**6,980**	**6.0**
Infrastructure & Timberland	8,326	8.2	**8,751**	**7.5**
Debt securities	11,344	11.2	**11,467**	**9.8**
Alternative assets	13,729	13.5	**14,904**	**12.7**
Cash	11,375	11.2	**22,890**	**19.5**
TOTAL	101,587	100.0	**117,222**	**100.0**

Source: Future Fund presentation

Let’s get real: China won’t stop overproducing steel

ROGER MONTGOMERY

As a young lad I was wisely advised that to be successful you must at least start out as an optimist. Now, you can be a paranoid optimist or a survivor optimist and you should be fine, but you cannot be a naive optimist.

Naive optimists are the business world’s ostriches. With their heads in the sand they’re slow to make strategically sensible decisions.

I mention this only because business is full of such optimists and it is rather simple to profit from them through the divergence of expectations that exists. When naive optimists — such as those who simply point to more than a billion people in China as a reason to invest in anything there — are in control of share prices, there is certainly an opportunity not to be missed.

Witness those still buying shares in iron ore and coal producers as well as steel manufacturers. Each day, the recording of lower and lower share prices confirms the buying of those same shares by an optimist. Could they be right?

When we look at other iron ore stocks such as Vale and Fortescue, we find it nearly impossible to put forward a robust argument for investing today. Both are highly indebted, negative cash-flow companies and despite producing a commodity where the price is declining precipitously they are forced to produce even more to meet the relatively fixed costs associated with their debts.

Recently we investigated the investment thesis for borrowing and selling the shares (it’s called “shorting”) of the world’s biggest steelmaker, ArcelorMittal. With a market capitalisation of about $US16 billion ($23bn), the company’s total market value is less than its debt of $US21.3bn. The enterprise value (market cap plus debt, minus cash) is $US32.7bn, which is 11 times EBIT (earnings before interest and tax). Given our outlook for China and Brazil, and demand for steel, we believe ArcelorMittal is materially overvalued by the market, despite the fact that the share price has already fallen from $US15 to about $US7.50.

Our thesis on China for the last few years is playing out as expected and it is our current belief that the situation will get worse before it gets better. The twin forces of debt restructurings along with the impact on consumers of a property and share-market collapse indicates that a significant slowdown is the best-case scenario.

China is dumping about 111 million tonnes of steel that it doesn’t need each year, as fixed-asset investment by local governments in infrastructure dries up amid poor returns and relatively higher interest bills.

ArcelorMittal is the largest steel producer in the world, shipping 88 million tonnes and there is no chance it can escape the impact of a steel oversupply. The optimists believe China will stop overproducing steel because more than half of the mills are making losses. There is also no chance ArcelorMittal can escape its exposure to a deteriorating Brazilian economy because that country accounts for such a large proportion of its earnings.

For the second quarter of 2015 sales fell 18 per cent year on year and EBIT declined by 30 per cent, highlighting the adverse impact of operating leverage when sales reverse. Like Vale and Fortescue, free cashflow for ArcelorMittal was negative at minus $US407 million but it was the company’s commentary that was more interesting.

Management noted: “Yes, if I could just comment on Brazil, I think we had expected and maybe even have said at the last earnings call that Q2 would be a bottom for that market. I think that was in fact the consensus. I think now there’s a view that we can more or less write off the prospects for any improvement for the rest of this year.”

That doesn’t sound like optimism. But perhaps this does: “I think we clearly are in an environment where EBITDA is lower, but I don’t believe it’s structurally lower. I think the area that we look at is China.

“And there’s been a lot of data coming out of China demonstrating the lack of profitability of Chinese mills … almost half of the Chinese steel producers are loss making, there’s significant billions of dollars of losses that they’re making …”

Many analysts once (incorrectly) proposed that the iron ore price would not fall below the cost of its production. Now many executives at steel producers believe China — the world’s biggest steel producer at 50 per cent — will cease overproduction and lay off some of the 3.5 million people it employs. Yep. Naive optimism. No large organisation is immune.

Roger Montgomery is founder and CIO of the Montgomery Fund.

THE COACH

I am a 62-year-old female pensioner who has about $60,000 to invest for the rest of my life. I am not risk averse, but also know that this must grow to provide for the rest of my life. I am thinking of investing in gold that can be sold when I need extra cash. I have no experience in self-managed super, but my money must be invested in super so my pension cannot be affected (until I reach 65 and a half). Is investing in gold a good idea? Can it be held in a super account?

Given your age I assume you are on a disability support pension that will revert to the age pension after age 65.5. To qualify to receive the disability support pension, your assets would need to be less than $202,000 as a single homeowner to qualify to receive the full benefit. Given you have investment assets of $60,000 you would appear to be well under the cap. While I am a big believer in using the superannuation system, given your circumstances, I don’t believe holding the money inside or outside superannuation will have an impact on your entitlements now or in the future.

In planning for your retirement you need to consider your income needs, your capital needs, your appetite for investment risk and how complicated you wish to make your financial affairs.

In terms of income needs, identify how much income you need on a fortnightly basis to meet your living expenses. How you source that income should form part of your future strategy.

Your capital needs relate to likely larger capital expenses you may need to fund beyond your income requirements. For example, to replace a motor vehicle or maintain your home.

Investment risk reflects how much volatility you are prepared to experience in your portfolio as a result of your choice of investments. Typically a retiree would diversify their portfolio between about 50 per cent growth assets such as shares and property and 50 per cent defensive assets such as cash and fixed interest to provide a balance between growth and income.

I would strongly encourage you to keep your financial planning as simple as possible. It would not be cost effective for you to establish and manage a self-managed super fund (SMSF).

I do not believe investing a meaningful portion of your assets in gold to fund your retirement is a good idea. Gold does not generate an income. Unlike conventional investments, the asset itself will not grow in size. It is a static lump of shiny metal, whose value will rise and fall on the basis of demand.

Identify your income needs and build a strategy around how best to meet them through a combination of pension benefits and investment income.

I believe you need to seek financial planning advice. You cannot afford to get this wrong.

Visit Wealth at theaustralian.com.au to send questions to Andrew Heaven, an AMP financial planner at Wealth-Partners Financial Solutions.