Glenda Korporaal reports on the unsavoury business of 'elder financial abuse' and how to stop it in **WEALTH on TUESDAY**

Will Hamilton asks if residential property investors really have anything to worry about with rising rates and escalating valuations in **WEALTH on TUESDAY**

Vitamins and formulas for stock price bubbles

Blackmores and Bellamy's are great, but overpriced, plays

DAVID WALKER

It's one of the great business stories of our time: the dramatic rise in a pair of stocks — Blackmores and Bellamy's — two food-related companies that have captured both the current opportunity and the future possibility of our links with China

You need only visit a shop in any international airport lounge across Australia to see the change that has taken place: where once there was whiskey and cigars we now see shelves full of vitamins and baby milk formula.

What's going on?

For Blackmores, Australia's largest dietary supplements company, and Bellamy's, a Tasmanian organic baby formula brand, trust is the key attraction. Consumers will seek out and pay a premium for brands they perceive offer the greatest health benefits.

Australian food and dietary supplements have premium status in Asia because Australia has tight food quality controls and its agricultural environment is perceived as cleaner than Asia, where consumers are wary of domestically produced food after a string of product quality scandals.

In a remarkable twist on the traditional export picture, Chinese tourists and residents are buying large quantities of product in Australia and forwarding it to China; Blackmores estimated this accounted for 14 per cent of sales this year, almost as much as Asia-based sales.

But is it wise to buy an expensive stock hoping someone else will pay even more to take it off you? This is the risky game investors are playing in Blackmores and Bellamy's Australia, which are respectively 345 and 450 per cent higher than a year ago — even after respective corrections since September. There are two outstanding problems:

- Both stocks are pricing in bullish scenarios, which most likely can't be achieved.
- Buyers at current prices are momentum-trading the shares and face capital loss if either stock disappoints.

Ironically, the operations behind both these stocks are absolutely fine: both are quality businesses selling into booming demand in Asia, where Australian health foods and supplements are popular with the fast-growing middle class.

But popular stocks rarely make great investments.

Unfortunately, outstanding stock performance reduces potential profits by borrowing from future returns and thus tends to predict future ordinary performance. If everyone likes a stock there is a significant risk the share price will fall if the market changes its collective mind and everyone runs for the exit.

Momentum trades like Bellamy's and Blackmores can end badly with a sharp correction on a slight disappointment or they can just reach a point of exhaustion among buyers. The worst-placed participants are those armed only with a strong narrative, no sense of what the share price implies and no valuation against which to benchmark.

So for Blackmores and Bellamy's it pays to be cautious and investigate whether expectations implied by the share prices are realistic.

ROSS MARSDEN

Bellamy's CEO Laura McBain has seen a sevenfold increase in the babyfood company's stockprice

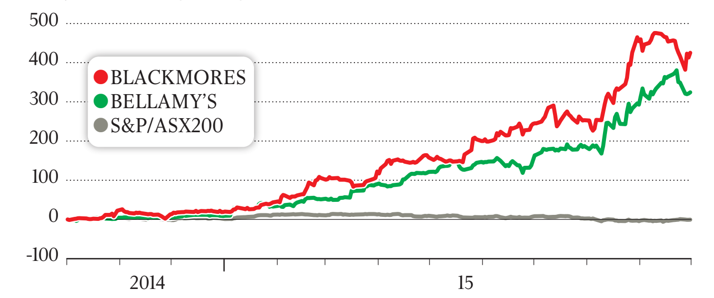
- Here's the Blackmores situation: at a reasonable 11.3 per cent "required return", the discount rate that summarises the level of risk to the investor, and a conservative dividend payout ratio Blackmores shares are pricing in a return on equity of 91 per cent in perpetuity (forever) when the company achieved a return on equity of 63 per cent this year, that's probably unsustainable.

For context the return on equity of the All Ordinaries Index is 10 per cent. Higher returns attract competition and profitability generally reverts to the average. In Australia, where Blackmores made 70 per cent of sales in FY15, CEO Christina Holgate faces strong competition from Swisse, recently acquired by Hong Kong's Biostime.

There is also the pressure created by the constant rollout of generic products or house brands by the dominant retailers. Consolidation of pharmacies, particularly by Chemist Warehouse and Priceline. Sooner or later this could lead to margin compression as aggressive trading terms may be sought by chemist retailers. Although Asia provides a significant long-term growth opportunity for the business, execution risk remains and Blackmores' implied 91 return on equity forever is impossible.

Blackmores, Bellamy's and the S&P/ASX200

Past year (percentage change)



Source: Bloomberg

Blackmores' share price is a bubble and the 6 per cent share price fall on Monday this week is a reminder of how quickly stocks can fall when the market wakes up to overvaluation.

- Here's the Bellamy's situation: the smaller Tasmanian-based specialist in infant formula led Laura McBain by looks expensive — it floated in at $1.00 and yesterday they were trading at $7.64.

Using a 12.5 per cent required return (similar to other mid-cap agricultural stocks such as Bega Cheese, Warrnambool Cheese and Freedom Foods), and adopting a dividend payout ratio in line with company guidance, Bellamy's share price assumes the company reinvests a large 65 per cent of earnings at a very high rate of return of 50 per cent into perpetuity. I'd suggest no company can do this.

Increased competition from larger global players like Nestle and Mead Johnston could erode the high returns and Bellamy's will eventually exhaust investment options and increase its dividend payout ratio, which would make the stock less valuable.

Possibly the company will be taken over before then by a food major seeking an established Australian brand in Asia.

There is a lot to like about our two superstar food stocks but the bullish cases are priced in. Great companies, excessive share prices. Superior investments are those where a bearish case is unfairly priced in.

David Walker is senior analyst at StocksInValue.com.au

Hard economic numbers will beat soft sentiment any day

STIRLING LARKIN
GLOBAL INVESTOR

Galileo, the Italian renaissance scientist, said that if he were to begin his studies again, he would have followed the advice of Greek philosopher Plato and begun with mathematics.

As qualitative and interpretative as finance has been allowed to become, at the end of the day, the maths is really all that matters.

For the arithmetically driven global investor, September's US Federal Reserve FOMC (Federal Open Market Committee) meeting chaired by the "data-driven" chair, Janet Yellen, could fairly have been considered "quantitatively uneasy" and this unease is motivating some to find new ways of redefining the rules of the financial road.

The most explicit example of this was seen last week, when Blackrock, the world's largest asset manager, proposed new and somewhat radical rules for extreme sessions of market-wide volatility.

In response to August 24's "flash crash mark II" — which saw extreme volatility, erroneous trades and by the end of that trading session, one in five exchange-traded products on NYSE Arca platform being suspended — BlackRock proposed that regulators consider market-wide "circuit breakers", which, put simply, would see the entire S&P 500 shut down on such days.

Such suggestions have dangerous implications and fly in the face of the free-market "price discovery" mechanisms upon which the US S&P 500 and Australian ASX 200 rely.

But the significance surrounding the timing of this proposal is that larger institutional market participants, such as BlackRock, now believe that the FOMC's September ambiguity allows them the scope to test new boundaries.

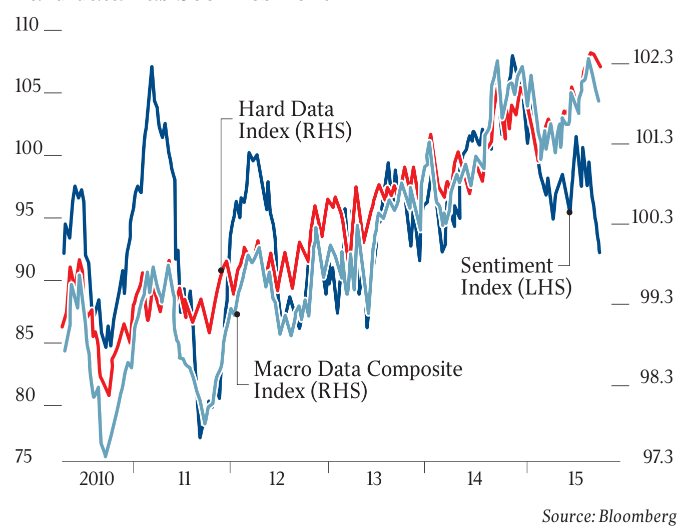
By the Fed acknowledging that market "tantrums" can, and have, influenced their decisions, it is now not unreasonable to expect more changes to come, or, at the very least, more being tested.

Such perceived carte blanche matters to Australian domestic stockmarket investors, who rely upon very similar rules to those established in the US and as our ASX's Central Limit Order Book, or CLOB, is also built to facilitate "price discovery", during both calm and volatile trading sessions, any change to this relative status quo will affect how Australians approach investing — both in and outside of superannuation.

The uneasiness surrounding how Yellen and the FOMC managed September's much anticipated Federal Reserve meeting can best be seen in the graph, which reflects aggregated global PMI sentiment surveys, benchmarked against quantitatively objective hard data indices.

Interpreted at face value, even though the economic numbers pertaining to the performance of the US real economy look sound, the sentiment of both global investors and US commerce is anything but.

Sentiment data has been weak while hard data has been resilient



Source: Bloomberg

The outgoing chief economist of the IMF, Oliver Blanchard, has even suggested governments, rather than following QE programs, might increase their fiscal deficits by spending on national infrastructure projects: central banks would then purchase the debt components of these projects with newly created money.

In relation to the global investor experience, although often calcified in their ways, this current debate has motivated the resolve of many Australian ultra high net worth investors to reappraise what continued distortions, caused by ambitious monetary policies, mean for their respective wholesale investment allocations.

> It is now not unreasonable to expect more changes to come, or more being tested

With specific reference to ASX miners, Goldman Sachs reminded clients this week that "given the distortion of multiple and return metrics, we think cashflow and NAV valuations provide a better indication of value".

According to Koby Jones, managing director of The SILC Group and Larkin Group advisory board member: "We are seeing a heightened interest from Australian wholesale investors to seek clarity in listed and unlisted markets given the volatility and confusion around economic activity and global markets."

Jones adds: "UHNW clients, more than ever, are seeking greater accessibility and enhanced choices in order to meet their risk and return objectives."

Balancing the influence of global and sectorial distortions against the foreseeable trends in Australian rates, real estate and equity markets, the comments of RBA deputy governor Philip Lowe this week that a peak of the current housing cycle was very near, should be received particularly well.

This is because domestic certainty — even if unfavourable — provides much needed stability, when set against the current global financial and economic flux.

Coupled with the knowledge that the risk of severe drought in Australia and New Zealand has risen sharply and if eventuating, will lead to the historically significant 20 per cent median GDP decline, it is not difficult to foretell where our Reserve Bank is headed.

Respecting the basic maths adds up.

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

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Spot the winners, shed the goners

ROGER MONTGOMERY

Many investors want to know if the market is going up or down. It doesn't matter.

What matters is that quality and value are present in the companies you buy. Buy extraordinary companies at rational prices and, over the long run, you cannot help but do well.

Many investors also want to know who is going to win in this era of disruption. That's also hard to tell. But it is almost boringly easy to find those companies that will lose. In a moment I'll explain how to make money from those.

It's clear to me that investors are enamoured with Tesla. The electric car company is changing the world one car at a time and having just installed their supercharging stations in Goulburn and Wodonga along the Hume Highway, it's easy to get excited about the potential.

But BMW, which is also producing electric cars, sells 2 million cars a year, while Tesla only sells 50,000 cars a year. It makes no sense that Tesla's market cap is almost half that of BMW.

In this era of creative destruction, transition and disruption, finding the winners can be a challenge so it's worth exploring strategies that can win even if you cannot easily isolate the winners.

Suppose your neighbour had a brand new Toyota Camry and you knew that the local Toyota dealership was going to hold a Christmas sale on Camrys at 50 per cent off. If you borrowed the neighbour's car and sold it at, say, $30,000 you'd put thirty grand in the bank. If you then went along to the car yard sale and bought a new Camry for $15,000, you could return a new car to your neighbour and keep $15,000 profit.

When the "horseless carriage" first chugged past the blacksmith, it would have been impossible to know which start-up carmaker would survive and prosper. It would have been far easier to conclude that the Blacksmith was a "goner" no matter who won the race to automotive nirvana.

By building a portfolio of extraordinary global businesses and simultaneously selling a portfolio of blacksmiths, not only can you add "alpha" (outperformance) to your portfolio but you can also reduce your net exposure to the vicissitudes of the market.

For example, if you buy $100 worth of outstanding businesses and sell a $60 portfolio of "blacksmiths", your net exposure is $40. If the market fell 10 per cent, you would expect to see your portfolio decline by only 4 per cent.

If you cannot find a prime broker willing to allow you to build a short portfolio of blacksmiths, find a fund manager that can do it for you. In this age of low returns, investors must find reliable ways of generating returns beyond those available from miserly yields on stable low-growth companies. So who might be the blacksmiths of the world?

- McDonalds is struggling to find its mojo and franchisees are wanting out. Despite thousands more stores being added to the network over the last few years, revenue hasn't risen a dollar.
- The coal company Teck Resources recently announced a long-term streaming agreement to forward sell silver production. The problem is that at the current rate of cash burn the money it earns from the deal will be gone in 12 months. At the same time the cash it raises only reduces it debt by 8 per cent. Meanwhile, coal is in oversupply, China demand is weakening and costs are in a deflationary spiral meaning supply will not be cut for some time.
- Over at Prada, the company has been using store growth to mask deterioration in per-store sales, which equates to a deterioration in margins as operating leverage works in reverse on a per-store basis. The company is also negatively exposed to the Beijing corruption crackdown.
- Finally, at Barnes & Noble, the US-based brick and mortar retailer of books, CDs, DVDs and vinyl LPs, the company is in what appears to be structural decline.

Instead of looking to predict the direction of markets, find and buy companies with the brightest of prospects and sell a portfolio of blacksmiths. You will not only profit from disruption but you can reduce your overall exposure to uncertain markets as well.

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