

Investing in the cloud computing boom **Clay Carter** reports in **WEALTH** on **TUESDAY**

Social Impact Bonds What's the deal? **Elizabeth Moran** examines the industry in **WEALTH** on **TUESDAY**

Getting world class returns from dull market

Investors are looking to smart domestic asset managers

STIRLING LARKIN
GLOBAL INVESTOR



It should not come as much of a surprise to learn that the Australian stockmarket has been the worst performer, in terms of total returns, this year to date.

Total returns include dividends and given that the ASX 200 is well recognised as being a higher-yielding dividend market, this indictment has even more sting in its tail.

As the graph highlights, alongside Canada, the Australian bourse has not only underperformed other developed markets but also those in China and eurozone — two blocs that have received almost all of the attention and concern this year.

What is interesting to observe is that unlike Japan, Europe or the US, where stockmarkets are not necessarily a reflection of their underlying economies, because of the distortions achieved through unconventional monetary policies, the Australian stockmarket is, on a whole, reflective on its real underlying economy.

This economy is paying the belated cost of avoiding a cyclical recession since 1991 and it is also

suffering from a commodity super-cycle heading in only one direction.

The evidence for this can directly be seen in the weekly data on iron ore freight activity at major ports in Australia and Brazil, which indicates that shipments continue to decline from their record highs.

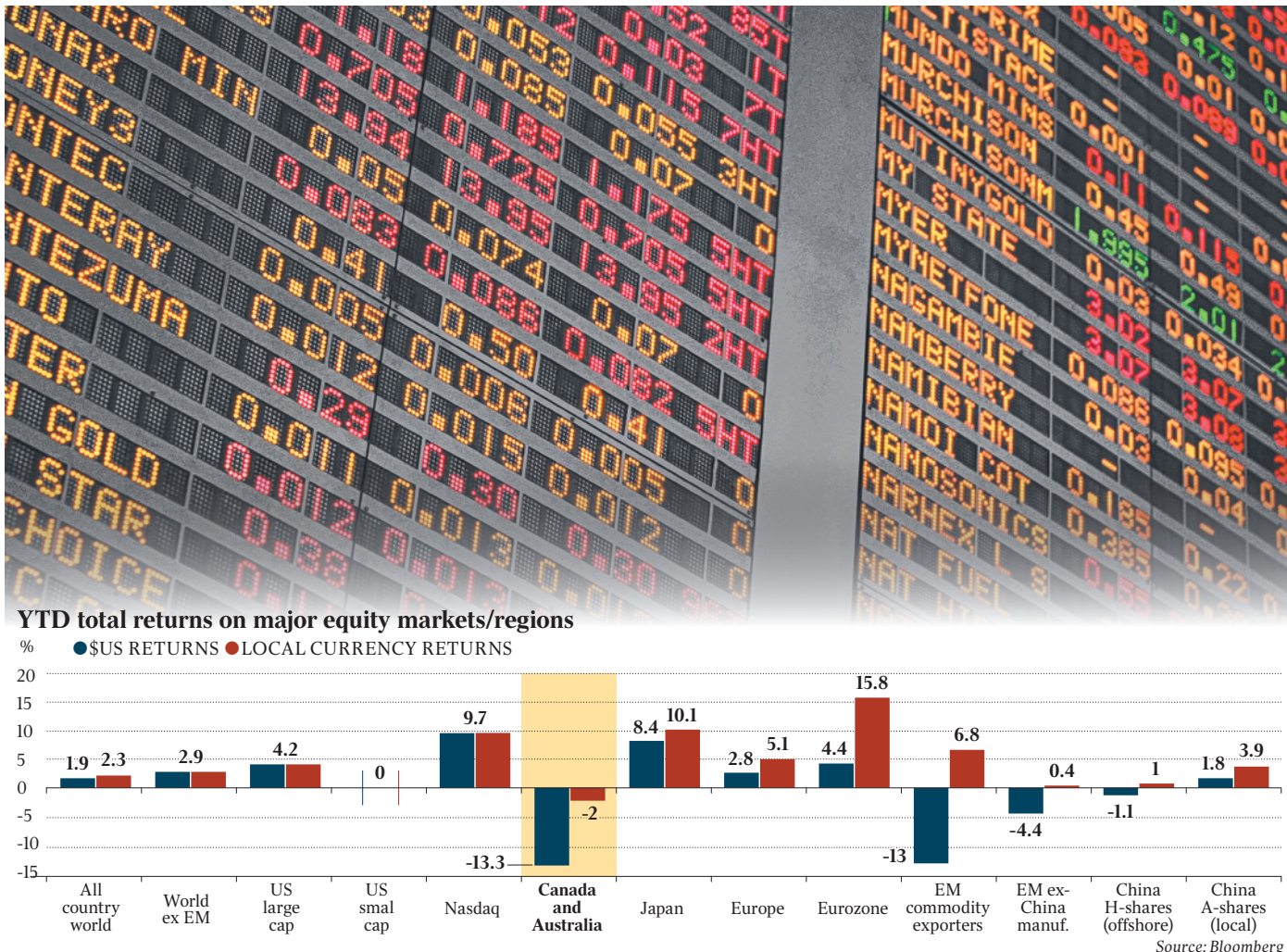
Even with a reduction of Brazilian supply following the tragic Samarco accident, the scale of global iron ore oversupply means that ore prices will only continue to head in one direction for now.

But as well as seeking greater diversification through global markets, Australian ultra high net worth investors are looking to smart domestic asset and hedge fund managers, who have found opportunity and returns within the broadly underperforming Australian stockmarket.

One such example has been Ophir Asset Management, who manage a portfolio of Australian listed stocks outside the ASX 100 and has returned 265 per cent before fees, since inception in August 2012 and 45.0 per cent year-to-date.

According to portfolio manager Andrew Mitchell, their success has been found by constructing a portfolio away from resources and towards companies leveraged to Chinese consumption and the recent free trade agreement with China, which include Blackmores (BKL), Bellamy's (BAL) and A2 Milk (A2M).

According to Mitchell, "we really try and stay away from cyclical companies. We are looking for good management running a business in a GDP agnostic market that is able to capture market



share and these companies will continue to grow no matter what the cycle is. When good management is able to add an acquisition or two ... that is nirvana."

Ophir has also looked to those focused on the US economy and placed emphasis on companies

leveraged to the US economy and the US Dollar and has found several Australian companies kicking goals in the US at the moment.

These include intellectual property services firm Spruson and Ferguson (IPH), medical device company Sirtex (SRX), telco

services provider Speedcast (SDA) and pharmaceutical group Mayne Pharma (MYX): all of these companies are growing strongly overseas.

Mitchell stresses that "as an Australian fund we don't need to be handcuffed to the Australian

economy." While Australian managers such as Ophir have found success by identifying Australian businesses that position well with the global economy, other managers have found opportunity and returns by more technical differentiation.

One such example has been Qato Capital, which recently won the best emerging manager award at the Australian Hedge Fund awards and which has returned 32.72 per cent net of fees, since August last year.

According to CEO, Ben Silluzio, "this was achieved because, firstly, our market neutral fund isn't as volatile as the broader market and we deliver uncorrelated returns by investing in long 'low-risk' and short 'high-risk' companies, therefore we are not impacted to the same degree by broader market contractions."

Silluzio adds that "secondly, our technical methodology selects companies with improving fundamentals (long) and deteriorating fundamentals (short), allowing us to generate returns both on our long and short positions."

Recent "long" examples for the fund have included

- Qantas (QAN),
- gaming machines group Aristocrat Leisure (ALL)
- Casino group Echo Entertainment (EGP).

While recent examples of the fund's "shorts" have included companies such as

- BHP (BHP),
- mining services company Downer EDI (DOW) and
- Alumina (AWC).

Of course, one does not have to only allocate to a professional manager to achieve outperformance but given that the Australian economy is stumbling on so many fronts, the challenge to identify the cream within the crop often becomes very difficult.

For Australian UHNW investors who are often more focused on their foundation businesses,

the suboptimal Australian economy is, in itself, a far greater and immediate concern.

The silver lining of having an economy that does, broadly speaking, reflect its true underlying real economy — for better or worse — is the fact that when distortions in valuations do appear, the global investor can identify them more easily and potentially arbitrage mispricing.

And as global policy uncertainty has been well correlated with international equity valuations over the past decade and the jump in Chinese uncertainty looks to have contributed to a marginal rerating of global P/E ratios, the Australian market should benefit when underperformance reverses; at least in the short term.

An important indicator of undistorted value can be seen in the spread between trailing dividend yields, which for the ASX 200 have recently touched 5 per cent, compared to Australian bond yields at 2.7 per cent.

This gap between the two is the largest on record, outside of the Great Recession and this tells us that, even with the Australian bourse being the worst performer year-to-date, investors continue to support growth assets, despite the undeniable macroeconomic bad news written on the wall.

For those that accept that the Australian economy is currently a kite dancing in a global hurricane, there is a place for smart professional managers within portfolios.

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Turning gambling industry woes into a winning hand

ROGER MONTGOMERY



Recently reviewing the gambling industry, in particular the poker machine business, it struck me something was wrong — put simply, younger people are no longer playing the "slots" or pokies.

There are issues all over the world. In Macau where Crown Group in a joint venture with Melco has just opened an enormous casino — the Studio City complex — gaming revenue fell almost a quarter in a single month — the sharpest drop on record. As it turned out, mainland Chinese gamblers, amid the crackdown on corruption and conspicuous consumption, sidestepped gambling as a form of entertainment.

We also learned of a wave of disruption, as financially strapped US state governments sought to boost tax revenue by opening the door to new forms of gambling including online gaming. All the while, casinos were extending their replacement cycles of poker machines — in other words, taking longer to replace ageing machines — in turn, making them less attractive to customers.

And then we witnessed a wave of debt-fuelled consolidation of the US poker machine manufacturers. In just 18 months, there were five multi-billion-dollar mergers.

In October 2013, lottery provider Scientific Games spent \$1.5 billion to buy slot machine maker WMS Industries.

Two months later, gaming equipment manufacturer Bally Technologies finalised its \$1.3bn purchase of table game producer SHFL Entertainment.

In November last year, Scientific Games spent another \$5.1bn to acquire Bally. In December, payment processing and ATM company Global Cash Access completed its \$1.2bn acquisition of slot machine company Multi-media Games.

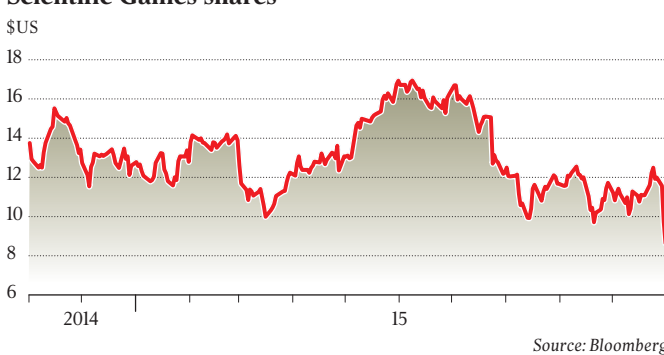
And in April this year, GTECH completed its acquisition of US gaming supplier International Game Technology.

Ostensibly seeking synergies and human resource efficiencies through debt-fuelled mergers, but amid structurally declining revenue, is a poor yet oft-repeated strategy.

And it is that which triggered our Montaka Global Fund's interest in Scientific Games as an investment that might profit from a declining share price — in other words, shorting the gambling industry.

Adjusting for the transactions in October and November last

Scientific Games shares



year, pro forma revenue in the first quarter of 2015 was declining 10 per cent year on year (YoY).

Research and development is the lifeblood of many companies, and while it can crimp margins it is essential for future product sales and revenue. But R&D was falling by 25 per cent annually — faster than revenue declines.

By the second quarter of 2015, reported revenue was growing at 66 per cent annually, but pro forma revenue was falling at 10 per cent, and sales of gaming machines were down to just 20 per cent of total revenue. New shipments of gaming machines, on a pro forma basis, were down 35 per cent YoY while free cashflow fell to a negative \$34 million.

Despite this, we noted divergent expectations. Analysts were still too optimistic about the prospects for the business.

Indeed, despite all the evidence

to the contrary, it appeared analysts were expecting 4 per cent total revenue growth for some years to come; their EBIT margins would have to include ongoing 20 per cent declines in overheads for years and the enterprise value of the company was 29 times EBIT (and EBIT looked unsustainable anyway).

The combination of deteriorating industry dynamics, asymmetric risk associated with the debt-laden balance sheet and divergent expectations, was the reason Montaka increased its short position in Scientific Games.

At the most recent third quarter results, performance turned decidedly south.

The company announced a \$US535m (\$749m) writedown along with commentary that the review would be completed in the fourth quarter — suggesting further writedowns to come. The

company's negative equity quadrupled to a billion dollars and the deterioration in sales accelerated, and despite cuts in costs and R&D there was no margin expansion.

It should come as no surprise, then, that on the day of the announcement of the third-quarter results, the shares fell 22 per cent in after-market trading. Since the announcement, the shares have fallen from \$US11.50 to \$US8.70. It seems consensus is catching up.

I'm constantly surprised at how slow the market is to recognise a deteriorating industry dynamic. On this occasion it was a poker machine business in the US, but it can happen anywhere.

Whether it is due to a general unwillingness by broker analysts in the US to put "sell" recommendations on stocks, or an unwillingness to slap a "sell" on something previously promoted as a "buy", this sloth-like approach to keeping investors updated produces a regular stream of opportunities we call "divergent expectations".

While a weak share price at Scientific Games will see us cover some of our position on behalf of investors in the Montaka Global and Montaka Global Access funds, the outlook for this stock does not appear to be improving anytime soon.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund. www.montinvest.com

Big names join the delinquent list as small caps exact their revenge

TIM BOREHAM
CRITERION



For the first time in your columnist's admittedly unreliable memory, the small-cap sector is easily outperforming the supposedly rock-solid pillars of the market.

Since the start of the calendar year, the 197 constituent stocks of the small-cap index have gained just under 1 per cent.

The ASX 50 index — replete with the banks and the Telstras and the big miners we know and used to love — is 9 per cent off the pace and getting worse by the day.

The worst performers — Origin Energy (ORG, down 56 per cent) and Santos (STO, down 52 per cent) have raised billions of capital in the wake of the oil price swoon which turned all the worse late in the week.

But Woolworths (WOW, -22 per cent), ANZ Bank (ANZ, -17 per cent) and online pioneer Seek (-21 per cent) are seldom on the delinquent list. BHP shares have lost almost one-third and yester-

day fell below \$20 a share. Considering the big miner is far from any whisper of balance sheet or cashflow stress, buying below \$20 might be a once-in-a-decade opportunity. But reflecting the unfolding nature of the Brazilian disaster, our long-term buy moves to a speculative buy.

Santos shares, meanwhile, are trading perilously close to the \$3.85 a share level at which the rights issue has been struck.

For retail investors, participating in the issue is lineball. But given the institutional component was well supported we would on balance suggest doing so. The best small-cap performer, by the way, was not that purveyor of white gold Bellamy's (BAL) — but "real" gold producer St Barbara (SBM) with a 1070 per cent gain.

Infant food maker Bellamy's has climbed almost 500 per cent, while similarly China-focused vitamins maker Blackmores (BKL) takes third place with a 370 per cent gain. Reflecting turmoil in the mining services sector, the worst two small-cap stocks have been Bradken (BKN) and MMA Offshore (MMA), down 86 per cent and 80 per cent respectively.

JC International (not yet listed)

The latest Chinese entity to brave

a local listing is the oriental equivalent of labour wrangler Skilled Group (now Programmed Group) and vocational training provider, not that either are flattering comparisons at the moment.

There's more than a passing comparison with Skilled in that JC's chairman is former Skilled director John Dixon.

JC is a one-stop contractor for large construction projects undertaken by Chinese state-owned entities, increasingly outside of China. It also runs China's biggest training school at its HQ in Maanshan, 350km west of Shanghai.

JC was founded by local carpenter John Tang, China's equivalent of Skilled founder Frank Hargraves, in 2003. Projects to date include Kuwait's Olympia Towers and a sugar plant in Guyana, Algerian apartments and a facility for Kuwait university and, closer to home, PNG's Waigani National Courts Complex. Dixon says the listing imbues the credibility for JC to compete more widely in the SOE sector.

The Weekend Australian accepts no responsibility for stock recommendations. Readers should contact a licensed financial adviser. The author holds shares in BHP, Woolworths and Programmed Group.



Don't put all your nest eggs in one basket.

With interest rates low and market volatility high, cash and equities may not provide the income, growth and capital stability your portfolio needs. Make sure your portfolio has the right balance. Include bonds in your portfolio.

To find out more talk to FIIG, the fixed income experts



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