# Economy well placed to buck market bears

There's more to our ties with China than just selling dirt

ROBERT GUY

As a natural resources powerhouse feeding China's growth machine, Australia's economy — and its currency — rode high during the halcyon days of double-digit growth. But the dollar has become a one-way bet, falling from a high of $US1.10 in mid-2011 to US69c in January as China's growth decelerated and mining investment in Australia waned.

However, there's more to the Australian economy — and to the longer-term prospects for our currency — than just being a quarry with a beach view.

Sure, Australia will continue to benefit from China's long-term development of its inner provinces and its ambitions to build a new Silk Road linking the Middle Kingdom to Europe. But in the beauty contest that is the global currency market, the Aussie looks attractive given the nation's low net debt to GDP ratio, a triple A credit rating, faster growth than that in other advanced economies, higher yields, and policy coherence reflected in 25 consecutive years of growth.

The Reserve Bank's recent interest rate cut to a record low of 1.75 per cent is intended to support the rebalancing of the economy and help steer low inflation back into the central bank's target range of between 2 and 3 per cent.

The short-term focus for the Aussie is whether the commodity rally has legs. Brent oil is up 51 per cent from its February low and copper has risen 11 per cent from its nadir in January, while iron ore has surged more than 76 per cent from its December low.

Veteran emerging market investor Mark Mobius told Bloomberg a few days ago a rebound in commodity prices and stocks could be "extreme" because they had "gone down too far".

So how can investors ride the renewed strength in commodities and the dollar?

The easiest way to play the rally is through the iShares MSCI Australia exchange-traded fund, which has gained 20 per cent, to $US19.51, from its January low. The Aberdeen Australia Equity closed-end fund, up 18 per cent from its low, is also attractive, trading at an 11 per cent discount to net asset value and offering a 12 per cent payout.

Those wanting a more direct play on the commodities rebound should look at mining giant BHP Billiton, which has experienced a 43 per cent rally in its American depositary receipts from their January low. Australian 10-year bonds also tempt, with 2.4 per cent yields in a world of low or negative interest rates.

The key to whether the dollar can power higher and commodities can levitate above their lows rests in the hands of seven men in Beijing. The Politburo Standing Committee, the apex of Chinese policymaking, has decided it's time to stimulate growth again, if lending data from March are any indication. The injection of cash pulsing through the arteries of China's economy is great news for commodities producers, at least for the moment. The easy money is fuelling a wave of euphoria in the property market and a surge in speculative futures trading.

To be sure, Australia would not be immune if China's rapid debt build-up causes the Asian giant to stumble. But there's more to ties with China than selling dirt.

**SEVEN STOCKS WITH UPSIDE FROM DOWN UNDER**

| Company | Recent price | 52 week high-low | Market value ($bn) | Dividend yield | Services provided |
|---|---|---|---|---|---|
| Aurizon Holdings (AZJ) | $A4.41 | $5.69-$3.35 | $9.1 | 6.9% | Rail freight operator, coal haulage |
| Bellamy's Australia (BAL) | 10.80 | $16.50-$3.36 | $1.0 | 0.5% | Organic baby formula maker |
| BHP Billiton (BHP) | $27.66 | $49.71 – 18.46 | $69.8 | 2.3% | World's largest iron ore miner |
| Blackmores (BKL) | $A169.67 | $A222.90 – 67.50 | $2.9 | 2.8% | Vitamin maker |
| Capilano Honey (CZZ) | 23.15 | $23.92-11.50 | $0.2 | 2.3% | Honey supplier |
| Rio Tinto (RIO) | $30.50 | $47.37 – 21.89 | $57.1 | 7.0% | Iron ore miner |
| South32 (S32) | $A1.57 | $A2.45 – 0.87 | $A8.3 | - | Miner |

Source: Barron's

Despite popular perception, mining accounts for less than 10 per cent of Australia's economy, with consumption accounting for about 70 per cent.

Rate cuts are supporting retail sales and property construction. China's fast growth in services is a source of demand for Australian agriculture, wine, tourism, and education.

The true believers say the task of urbanising and developing China's inner provinces should sustain demand for commodities — a positive for the dollar over the long term.

A long-term driver of demand will be China's ambition to construct a new Silk Road through the "One Belt, One Road" initiative linking the Middle Kingdom to Europe via Central Asia.

While aggressive chequebook diplomacy will buttress China's growing geopolitical influence, it also provides an outlet for the excess capacity that haunts many industries, such as steel and cement. Indeed, the waning of the mining investment boom in recent years underscored the need for a more diversified economy.

Whereas Australians used to lament the so-called tyranny of

The hunt for yield could draw foreign money into Australian bonds

distance from markets in Britain, the Lucky Country is well positioned to profit from its proximity to Asia's fast-growing economies.

The transition from "mining to dining" is underscored by the huge gains in stocks of companies such as organic baby formula producer Bellamy's Australia, vitamin maker Blackmores and Capilano.

Concerned with food safety issues and contamination of infant formula, many Chinese look to Australia for organic food or simply for food not grown in polluted air and soil.

All three stocks look like good long-term bets, but investors may want to wait for a pullback before buying.

The weak dollar also fired up tourism, with record numbers of Chinese visiting Australia.

Education is also booming, as Asia's middle classes send their children to Australian universities.

Despite Australia's revolving door of prime ministers over recent years, the world's 12th-largest economy looks like an island of policy coherence and competence compared with the high farce among debt-burdened major economies seemingly trapped in the vise-like grip of unconventional policy.

Australia's 3 per cent annual growth outpaces most advanced economies, while unemployment is back below 6 per cent.

The hunt for yield could draw foreign money into Australian bonds, thereby supporting the local currency.

Australian stocks are also experiencing renewed foreign interest, thanks to yields of about 5 per cent. At the Credit Suisse Asian investment conference held in April, attendees voted Australia one of their favoured markets in Asia.

The broker's Australian strategy team came away from Hong Kong feeling comfortable with its commodities exposure, with BHP, Rio Tinto, South 32 and rail operator Aurizon Holdings among their favoured stocks.

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# Another way to make money from property

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SHARES

Global returns and interest rates are so low that in Denmark borrowers are finding their mortgage balances are declining, even without making payments, because interest rates are negative. Elsewhere, high-quality companies are trading at eye-watering multiples. In private equity, too much money is chasing too few opportunities, and meanwhile investors are happy to buy property that is yielding barely more than bank interest despite the higher risk profile.

In such an environment, it is next to impossible to find high-quality businesses that are still cheap compared with our estimate of their value. But one of those companies is REA Group (ASX: REA), which has just reported a 20 per cent increase in revenue in the third quarter. In fact 3Q16 revenues were reported by the company at $147m, which was up 20 per cent year on year.

Investors could be forgiven for feeling slightly anxious on the back of the news coming out of Australia's real estate market. In the space of a few days we have had:

The revelations of dubious real estate financing, as mortgage brokers reportedly put foreign buyers with poor documentation through to the major banks;

Reports of large falls in apartment prices in Melbourne, and;

Reports from McGrath Limited (ASX: MEA) of listing volumes declining by about 25 per cent in some areas of Sydney.

However, REA's revenues are primarily driven by the sales of premier/highlight listings on the realestate.com.au website, and data that records listing volumes can be used as a proxy for where said revenues are headed.

While nationwide listings are down since the end of December as per the seasonal trend, on a year-on-year basis, considerable growth is observed. And in a market where listings volumes have been under pressure, REA's revenues have grown more than 50 per cent on the back of price increases and changes in the volume of premier ads (i.e. 'mix shift'). This resilience — a function of pricing power — is an attractive quality to owners of the business.

For the nine months to the end of March 2016, group revenues rose 20 per cent year on year to $461m. This result was partly boosted by the consolidation into the accounts of the acquisition of the iProperty Group announced November 4, 2015 at $4 a share. Operating expenditure of $69m had risen 21 per cent year on year, which was not a surprise to the market, and so EBITDA rose by 18 per cent year on year to $77m.

Of the $6bn spent on marketing properties in Australia each year, real estate agents collect about 86 per cent and REA Group's realestate.com.au website collects just 5 per cent (with the rest of the pie being split between traditional media and competitors).

My investment thesis is partly reliant on the idea that real estate agents do not deliver 86 per cent of the value in a real estate transaction and that real-estate.com.au delivers more than 5 per cent.

The change in the equation — in favour of REA Group — will be initially effected by a change in the willingness of vendors to accept higher prices for advertising on realestate.com.au but not higher charges from real estate agents. The second phase of the change in the equation will be that realestate.com.au's higher prices will eat into the total spend of the vendor such that vendors will insist on lower fees from the agents.

As an investor, I was pleased that REA introduced a price rise from July in the range of 10 per cent to 15 per cent, which beat some analysts' expectations and confirms the pricing power of the model as well as reinforcing our thesis of being able to ultimately take a larger share of the total real estate market pie.

Encouragingly, REA also confirmed that despite investing aggressively, further EBITDA (earnings before interest tax depreciation and amortisation) margin expansion in the fourth quarter should be expected because marketing costs will be lower then.

The company also announced that the US business Move Inc is now EBITDA positive.

The REA valuation is currently $65 (against about $54.70 now) this compares with analysts we know who have price target/valuations between: $52.19 and $56.50.

The implication is that if we are right, not only could we make more money for our investors but it could happen quickly if the rest of the analyst community rerates the company.

The downside risk is that even though we expect the company to make more money in a property market downturn — because more properties will be listed and for longer — sentiment towards REA Group's share price could turn negative

Disclosure: The REA Group is a subsidiary of News Corp, owner of *The Australian*

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# Investors question hedge fund fees, returns

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Australian investors are regularly encouraged to diversify their holdings and look for alternative asset classes beyond the familiar options of shares and cash.

But the woes plaguing one alternative asset class long favoured by the ultra-wealthy — hedge funds — are a timely reminder that not all alternatives are created equal.

Hedge funds are known for taking big risks and reaping the rewards. Investment styles vary and can include making illiquid investments, short-term trading of equities or computer-generated strategies. Many hedge funds borrow money, amplifying the gains (or losses) of their strategies and bets.

The rewards can be handsome. During 2015, five hedge fund bosses were paid more than $US1 billion each, even though about half of all hedge funds lost money over the same period, an industry survey in the US found.

Clients are often asked to pay through the nose. A common fee structure is known as "two and twenty" — 2 per cent of assets under management and 20 per cent of performance every year.

But with markets proving choppy over the first few months of this year, institutional investors have been starting to question whether they can get returns that are just as good or even better for a lower cost elsewhere.

Outflows have been rising. Investors took back a net $US15bn in the March quarter, the biggest withdrawals since 2009, according to a specialist hedge fund research house.

Here are some of the high-profile names in the US who have recently questioned the appeal of hedge funds:

- Legendary investor Warren Buffett recently launched a tirade against a broad class of active managers and consultants, criticising both their performance and their fees. The Berkshire Hathaway chairman told his annual meeting of a bet he had made with hedge fund Protege Partners that their fund of funds could not beat a Vanguard S&P500 index fund over a decade. The investment of the hedge fund — which initiated the bet — has a cumulative return of 21.9 per cent since 2008, while the index fund managed 65.7 per cent.
- Insurance giants AIG and MetLife both reported falls in first-quarter operating income and partly blamed the performance of their investments in hedge funds. With interest rates staying negligible for years, insurers have been looking for better returns on capital. But both companies now plan to move money out of hedge funds — AIG expects to halve its exposure by the end of 2017, while MetLife is set to slash its holdings by two-thirds in about two years.

Investors have raised concerns that the funds' performance isn't worth the fees, but that's not the only worry. As some funds make investments in illiquid assets, it can be difficult for clients to get their money back as quickly as they'd like. US regulator the Securities and Exchange Commission has been investigating this issue, as well as the question of how the fund managers value illiquid holdings.

- A bad bet by billionaire Bill Ackman's Pershing Square on Valeant Pharmaceuticals has also received considerable coverage in the US financial media, as the drug maker's stock tumbled almost 90 per cent over the past year after accusations of fraudulent accounting.

Some upstarts are claiming to provide lower-cost alternatives, with asset managers saying they can use quantitative models to select, for example, a basket of stocks with low volatility. Smart hedge funds have even started offering low-cost alternatives to their main funds to retain hesitant clients.

Automation more broadly poses a challenge to the labour-intensive work of security selection. Analytics tool Kensho — in which investment banking giant Goldman Sachs has taken a stake — uses big data and artificial intelligence to provide information about market patterns that would have previously taken well-paid bankers days to complete. Hedge funds will also face questions about how to justify their costs when computers can offer insights and replace some work done by humans.

Plenty of large institutions are still sticking with their hedge fund investments for now. But the funds are facing a chorus of criticism that is difficult to ignore.