Still some turbulence ahead for Qantas shares

Even Warren Buffett's airline investments are down this year

ROGER MONTGOMERY

Over the years, airlines have generally produced poor returns: for this alone I have long chastised those who even entertain the idea of purchasing shares in airlines.

Yet Qantas always has its fans. Earlier this week there was another new buy call on Qantas as Bank of America Merrill Lynch recommended the stock on the back of higher airfares and the prospect of capital returns.

What about the wonderful Qantas turnaround, some might ask: actually, Qantas shares are trading where they were about 11 years ago and Virgin's shares are 90 per cent lower than where they were 11 years ago.

In addition, accounting standards allow big differences between reported profits and "economic" profits in the sector.

Of course, stockmarkets have short memories and investors instead look to the six-fold jump in Qantas's shares since January 2014 as reason to think airlines have changed their spots.

One of the inescapable issues for airlines is the need to fund new aircraft to remain fresh, efficient and competitive. The problem is that airline accounting doesn't do a great job of reflecting the true cost of running the airline and replacing the planes.

The depreciation expense in the profit-and-loss statement is based on the historical cost of an aircraft that could be more than 15 years old and if the depreciation change were instead replaced with an equally creative "provision-for-replacement of aircraft" charge, the expense on the profit-and-loss statement would be much larger and the accounting profit could quickly turn into a loss.

Another way to test whether any real money is being made is to look past the reported accounting profits to the cash flows.

In Qantas's case, the company has also been reporting strong cash flows in recent years.

In 2014, the year the company wrote down the value of its international fleet by $2.6 billion, Qantas reported a $2.8bn headline loss and a $640 million underlying loss. However, the operating cash flow amounted to just over $1bn.

Fast forward to 2017 and while reported profit had grown to $852m, cash flow from operations grew to $2.7bn. And since 2014, the share price is up over six-fold.

So, what gives? Have airlines suddenly become high-quality businesses that we should hope to own for the long term? Or is there something the strong cash flow isn't reflecting?

As an aside, Warren Buffett has previously been on the record pointing out that had he been at Kitty Hawk in 1903 when Orville Wright took off for his maiden voyage, he hoped that he would have had the presence of mind, for the benefit of all future capitalists, to have shot him down. This is due to the tremendous aggregate losses airlines have accumulated over decades.

Qantas shares are trading where they were about 11 years ago

Those losses are a function of airlines being incredibly capital and labour-intensive, and there's the small matter of some competitors having access to cheaper fuel thanks to ties to royal families or supportive governments.

Yet only back in January, Buffett's flagship investment company Berkshire Hathaway had airlines: the share portfolio, led by Ted Weschler and Todd Combs, owned a $US11bn stake in United Airlines, Delta Airlines, Southwest and American Airlines. All are lower since the start of the year.

So back to the original question; have airlines become compelling investment opportunities?

No. Here's why.

First, while the company's cash flows look great, they have benefited in recent years from generally declining oil prices.

In July 2008, West Texas Intermediate crude oil traded at $US147 a barrel. By February 2016, the oil price had fallen to less than $US26. But since then oil has almost tripled to over $US70 and analysts at UBS now believe Qantas could be hit with a $700m negative shift in fuel costs from FY18 levels to the current spot price.

And while the impact might be offset by an expected 10 per cent increase in domestic revenue, there's the matter of $400m a year in cash tax payments starting in the 2019 financial year.

In addition to benefiting from cheaper fuel, cash flows have also been boosted by a strategy that has allowed the fleet to age.

As I said earlier, the most expensive part of running an airline is replacing old, cheap planes with newer and more expensive models. Airlines cannot escape this capital expenditure lest passengers jump to competing airlines with fancier entertainment offerings and more comfortable seats, bars and beds.

You can call it a disciplined approach to capital spending or you could say the board might prefer to see the share price go up now, maximise share price-related incentives for current management and leave the reality of replacing planes to the next CEO.

On that matter, having served as CEO for almost a decade, it's time to wonder whether Alan Joyce will stick around through the next potentially more challenging period, or perhaps leave that job to Alison Webster, who runs Qantas International.

Whichever way you spin it, investment bank UBS notes Qantas's "fleet age has increased from 7.7 years in 2015 to a current 10.2 years". They also note that the fleet is now older than the last peak of nine years in 2007.

According to the same report, Qantas has introduced just nine new aircraft or 3.7 per cent of group seat capacity over the last three years and so a minimum of $1.4bn a year will be required to maintain a constant fleet age, with an additional $300m spend on the non-aircraft asset base making $1.7bn.

That matches depreciation, but depreciation is based on historical costs so it is still probably undercooking how much is needed to keep the fleet fresh, new and competitive.

And that means future cash flows might not look as good as recent numbers suggest. You cannot escape being an airline, you will have to eventually replace planes and keep in mind even Buffett's airline investments are not going so well this year.

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Don't be fooled by risky super 'cash' products

ELIZABETH MORAN

In the scramble for customers, some fund managers and superannuation providers are taking on additional risk, investing in a range of assets and deeming them "cash" when clearly they are not.

Though I watch cash investments closely, it was a shock to see a recent piece in *The Australian* exposing the practice of classifying asset-backed and mortgage-backed securities, commercial bonds, hybrids, credit default swaps, loans and other credit instruments as "cash".

Put simply, this practice makes some funds more risky than they look. According to the OECD, Australian superannuation funds are already some of the most risky in the developed world, investing some of the highest percentages in shares at 51 per cent and offsetting some of the risk with high cash holdings of 17 per cent.

But what we know is that in some cases — even among the biggest and best known funds — the cash isn't really cash.

We need some clarity about who the culprits are, how widespread the practice is and how APRA propose to remedy the situation and ensure future compliance. Super funds are desperately underweight in what is known as the bonds and bills asset class and joint last of 34 OECD countries with Poland, holding an allocation of just 10 per cent.

Without the need to think about providing long-term retirement funding and instead being driven by short-term returns, Australian superannuation funds take on too much risk. It's the members of the fund — not necessarily financially savvy — who take the risk. They largely rely on superannuation institutions to do the right thing, make the best decisions on their behalf.

The same issue confronts private investors reacting to advertisements for so-called cash rates which on closer inspection turn out to be a mixture of cash and products which can be quite a distance from what might be usually considered as cash such as first mortgage income.

Unfortunately, the main and perhaps only qualification members seek is returns, compelling domestic super funds to invest a greater proportion in the highest yielding but highest risk assets, shares. Moreover, despite these issues cash remains low — in fact official rates remain stuck fast at 1.5 per cent.

Dangerous territory. Just ask someone who retired just prior to the GFC and had their "comfortable" retirement decimated by a major market dislocation.

Superannuation asset allocation needs to change over an investor's life cycle and become much more defensive near and into retirement. Providers should be increasing allocations to defensive assets, rather than exposing unsuspecting member funds to additional risk and notional higher returns to attract more members.

One last thing: investors who are unwittingly in these cash-like products might take heed of APRA's definition of cash under Superannuation Reporting Standard (SRS) 530 Investments, which states that "cash" represents cash on hand and demand deposits, as well as cash equivalents. "Cash equivalents represent short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value".

That cannot be said of hybrids — the highest risk asset on the list of "cash equivalents". They are not short term even if acquired within a year to first call, as there is no guarantee of conversion or redemption and in fact some are perpetual instruments with no repayment obligations. They are certainly not highly liquid. Instead, they are at times illiquid and at risk of significant changes in value of up to 30 per cent if you take the GFC as an example.

Cash is cash on hand — at call — money you or your fund manager can get at immediately. Anything else does not qualify.

Don't be fooled.

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How to choose an 'exceptional' accountant

JAMES GERRARD

For many investors this is the time of the year when they look forward to a tax refund. That is, once you have an accountant to do your annual accounts. There is so much attention paid to choosing advisers but very little paid to choosing accountants.

Here's a few key things that you need to know, particularly for 2018.

If you don't have an accountant or are considering changing accountants this year, there are a few things to consider.

Accountants can be victims of their own success. As they progress through their career, happy clients refer more clients and eventually the accountant can't keep up without more support. Where you may have started years ago solely dealing with your accountant, you may find that you're now primarily dealing with an underling with only the occasional interaction with your beloved accountant. So make sure your accountant has capacity to take on your work, and has good processes and systems in place so you won't be pushed off to someone else at a later stage. Ask how many clients they have.

Timothy Ricardo, certified practising accountant with Ricardo Accounting, says there's a small trick that usually works to get your accountant to personally do your tax return.

"It's simple: book the appointment and physically go in to your accountant's office to do your tax return," Mr Ricardo says.

"If not, the chances are much higher that it will be done by a junior. Even if it costs more, it's usually worth the expense to get in front of the senior accountant to prepare your tax return."

Technology can have a big bearing on accounting costs. The tech-savvy accountant will set up data feeds from your investment account or self-managed super fund into their accounting software. The old-school accountant will manually input hundreds of transactions to do what the tech-savvy accountant managed to do in less than five minutes, with a click on a mouse. Take a guess which accountant is probably going to end up giving you the larger bill?

The main checks are as follows:

- Is your accountant a certified practising accountant or chartered accountant? To become a CPA or CA, in addition to an accounting degree you require three years' industry experience, passing an in-depth curriculum and undertaking an intensive mentoring program. Contrast this to the minimum requirement of becoming a registered tax agent; an accounting diploma and two years' relevant experience.
- There has been pressure on accounting fees over the past five years as more digital and outsourced accounting firms appear. Ask your accountant if they offshore any aspect of your taxation work. If so, ask what controls and measures they have in place to protect your information.
- Ask what the accountants lodgement rate is with the ATO. If an accountant does not lodge at least 85 per cent of all statements and tax returns on time, the ATO can remove their lodgement extension concession.
- Be wary of the high fees charged by instant tax refund firms. Although you will get your tax refund on the spot, they will usually charge a percentage of your refund in fees in addition to your normal tax return costs.

If you're due for a refund on your individual tax return, get it done once the accountant has received all the data in a pre-filling report, which may be later in July or even August depending on the data sources feeding in. If you have additional tax to pay, delay lodgement until closer to the due date, which is October 31 for individuals, or May 15 if you use an accountant, but only if the accountant has a good lodgement history and has the lodgement extension concession.

As you can see, it pays to be patient and not to get your tax return done at the start of July.

Ricardo says "the first mistake accountants and clients make is to lodge the tax return too early. Accountants receive information from the Australian Taxation Office in what's known as a pre-filling report.

"The report contains information compiled from various sources on things like bank account interest, share dividends and investment distributions. The data can be automatically imported into the accountant's tax return software. However; the issue is that it takes time for this data to flow through.

"For those eager to lodge their tax returns early, the accountant must manually input data provided by the client ... and if it does not match the eventual data that appears in the pre-filling report, the chance of getting audited go up exponentially."

When you do get your tax return done for the 2017-18 financial year, keep in mind that each year there is a "red button issue". This year be careful about laundry deductions. Ricardo says: "The ATO have flagged that they're keeping an eye on laundry deduction this year. If you don't have a uniform or wear protective clothing, don't claim laundry deductions. If you do claim, you're likely to get some attention from the ATO."

The difference between having an average accountant versus an exceptional one should not be underestimated. Not only will it potentially result in better tax outcomes, but you will enjoy less stress and hassle. The good accountant will be on top of things, making the tax process as painless as it can be from start to finish.

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