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Five Aussie stocks riding high on a softer dollar

RICHARD HEMMING

The Australian dollar is always a wild ride, but never more so than now, when predicting its moves is harder than anticipating what's going to come out of the US President's Twitter account.

The two are not unrelated because, relatively speaking, the Australian economy is small and remains resources-based, which means it is dependent on global economic growth, which is showing signs of stalling against the backdrop of the US-China trade war, stoked in no small way by one Donald Trump.

Not helping is an iron ore price in freefall, having dropped sharply recently on global growth fears, plus the recommencement of production of the giant Brazilian miner Vale following the collapse a dam and the loss of 250 lives. Iron ore and coal are Australia's biggest exports, representing almost 40 per cent in value terms.

Also consider the 38 per cent devaluation of the dollar when compared to the US dollar over the past eight years, since its record level of about $US1.10 in May 2011 to where it trades today at just below US68c.

Any company that earns money from offshore markets and translates that back into Australian dollars is on a winner.

But you don't invest on the basis of currency unless you're George Soros, who in 1992 made $US1bn by betting that the British pound would go down. He could well be going the other way if he thinks Brexit will fail.

I work on the assumption of eliminating the currency effect to establish what are the "real" or "underlying" earnings. In fact, this is why companies often cite sales result comparisons with prior periods on a constant currency basis.

There is a consensus that the dollar is headed for more weakness. For companies, the amount of hedging they have taken on board will be important. If a company hedges its foreign exposure, then it's possible that any change in gross profit margins in dollar terms will not happen for as long as a year (assuming exchange rates remain at current levels) when it has to roll over those hedges.

Currency is complicated and it's important to remember that unless you are a Soros, don't invest on the basis of currency. Having said that, here are five companies that stand to benefit from a lower-for-longer Australian dollar.

Austal (ASB) $4.19

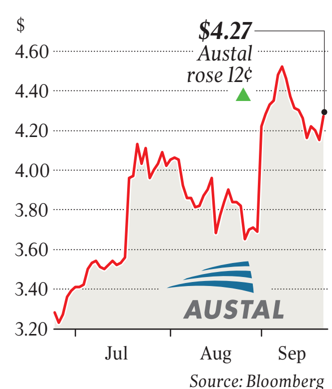
Austal is a global designer and builder of ships. The main shipyards are in Western Australia and the US. It designs and manufactures defence and commercial ships. It specialises in twin-hulled aluminium ships and ferries. The shipbuilder has the bulk of its contracts in US dollars and has made the correct decision to raise US dollar debt and carry cash on the Australian side to offset currency risk.

Evolution Mining (EVN) $4.68

This company has diversified goldmining operations in Australia and is the country's second-largest producer of the yellow metal. It's easy to forget, but US dollar-denominated gold had a big shakeout after reaching a high in the latter half of 2011 of about $US1900 an ounce to lows of close to $US1000 an ounce in the following four years. The Australian-dollar gold price has been kind to surviving producers such as Evolution Mining and Northern Star, as has their ability to mop up cheap but profitable mines. It's clear that this domestic consolidation has come to an end for the time being.

Afterpay Touch (APT) $32.25

Afterpay is a buy-now, pay-later credit provider, operating in Australia with a growing presence in the US and has recently entered the UK market. The domestic market is important, but the key to this highly successful stock is the US and, fortunately, where it is kicking goals. In FY19, sales of products using Afterpay (also known as gross merchant value, or GMV) were up 140 per cent on FY18 to $5.25bn, with Australia and New Zealand doubling to $4.31bn, while the US went from



$14.2m in FY18 to $927.5m. Management reiterated its FY22 target of exceeding $20bn a year in GMV. This is almost four times its FY19 level and is principally based on US growth.

Nearmap (NEA) $2.55

Nearmap is an Australian export success story. It provides instantly accessible, frequently updated, high-resolution aerial imagery taken from light aircraft. Its intellectual property lies in its camera and software technology. The company has a user-based subscription model that provides an annuity-style income stream. A wide range of industries are serviced, including architecture and engineering, construction, government, insurance, property, rail, roofing and solar. It currently operates in the Australian and US markets and is looking to expand.

Catapult (CAT) $1.33

The company is leveraged to the growing need for winning strategies in sport. The fast-growing sports analytics technology company has made a big mark on the world stage. We spot a buying opportunity following a fall in the share price and a capital raising: the FY19 result showed that investors are cottoning on, boosting its share price by 20 per cent on the day of the announcement.

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Don't assume rates will go to zero

If world tensions ease, they might just start to rise again

ROGER MONTGOMERY

I recently attended a lunch, hosted by National Australia Bank, with the assistant governor of the Reserve Bank, Guy Debelle. Perhaps the most interesting takeaway from that lunch wasn't anything Debelle said. It was the commonality of the questions being asked by attendees. Everyone wanted to know when rates were going to zero. Nobody asked "if" they would.

Experience tells me that when everyone in the market is pointing in the same direction, that trade is done, and it's time to turn around and look the other way.

I generally agree with the thesis that ageing demographics are producing a slower rate of global growth and that the advent of technology has reduced capital intensity, generating a lower demand for money.

While reduced capital intensity demands less money, the resultant market valuations demand more. Consequently, productive endeavours are displaced by speculative ones.

There is little question that lower interest rates are required to keep companies investing and people employed. But when low rates spur investment in technology that replaces labour, rates have to drop even further.

Central banks find themselves caught between a rock and a hard place. So rates may indeed stay very low but it's dangerous to assume they will.

If you are an equity investor, low rates are manna from heaven. The way rate reductions work through the present value calculation, they have a materially larger positive impact on those companies that earn nothing today but hope to earn a great deal in the distant future.

However, the simple reality is that not all companies can win, even when billions of dollars have been thrown at them to disrupt legacy business models.

I have written here about Uber, Tesla, Peloton and WeWork. All of these companies will cease to exist whether rates are low or high. If rates remain low, the flaws in their models, changes in their competitive landscapes and overreaching will produce undesirable outcomes for their investors. If rates stop going down and start rising, the boil will be lanced much faster. (We should point out that the US Federal Reserve earlier this week snipped interest rates for the second time this year when it brought its benchmark rate down 0.25 percentage points to 1.75 per cent.)

But I return to the question of whether it's wise to assume rates will stay lower for longer. Global bond yields have indeed tracked the direction of global growth and, while the global economy does appear to be fragile, financial conditions have eased significantly, some indicators are moving off their lows, US household spending has demonstrated resilience and China is stimulating its domestic economy to offset the Trump-induced challenges for its external economy.

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You only have to believe that the trade tensions between the US and China will remain but not escalate and that a hard Brexit is unlikely, and suddenly the economic outlook is not so dire and bond rates could rise.

Donald Trump and Xi Jinping are incentivised to avoid escalation of trade tensions. Trump wants to be seen positively by the stockmarket, which will improve his chances of re-election. Meanwhile China wants to ease the pressure on its external economy. A hard Brexit looks politically impossible, which might mean another referendum. The winds have already changed in Britain where the number of people opposing Brexit has increased significantly since 2017.

Less than two weeks ago, bond yields jumped on the realisation that the US and China would direct trade negotiators to meet again in October. Since then, US 10-year bonds have risen from their lows of 1.43 per cent.

While indicators such as the US ISM Manufacturing Index — a coincident indicator for 10-year bond yields — remain weak and suggest it's too early to announce the bottom in the global industrial cycle, there are some positive signs emerging.

As stated earlier, US household spending is doing OK, as is the service sector across the world. Indeed, services are doing much better than manufacturing. Thank cheap money funding start-ups for that. Meanwhile, some leading proprietary global economic indicators have paused their slide and are slightly above lows.

Importantly, with global financial conditions relaxing significantly, it suggests that global growth could indeed bounce and take everyone by surprise.

Of course, if that happens you can expect bond yields to rise. It would also be positive for equities. When everyone is zigging, it may be worth zagging.

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

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Do legwork on SMSF diversity or wait for taxman to come knocking

JAMES GERRARD

If your self-managed super fund has a large holding in a single asset you may come under review by the ATO in its latest crackdown.

It is expected about 17,000 SMSF trustees who are at risk of breaching the Superannuation Industry Supervision Regulations (1994) will receive an ATO letter. But what exactly are the rules around SMSF diversification?

As the name implies, self-managed superannuation funds allow the trustees to enjoy a higher level of flexibility compared to retail and industry funds. SMSFs can make purchases of gold, artwork, wine and physical property as long as they are within certain rules, with a significant one being the sole-purpose test. This states that a super fund is maintained for the purpose of providing a benefit to members upon their retirement or to their dependants in the event of death before retirement.

If the SMSF trustees decide that holding the majority of funds in a single asset is in line with the sole-purpose test, is that allowed?

Mark Wilkinson, superannuation partner at accounting firm BDO, says: "SMSFs have to consider diversification, but they don't necessarily have to be diverse. It depends on where in the life cycle the SMSF members are. There is nothing wrong for a person in their mid-30s to make an investment in a single property and broaden into more investments as they approach retirement. But regardless of age, you need to consider the risks.

"Will the property perform the way we want it to? Will there be special levies or other repair costs that the SMSF will have to meet? Is property a suitable asset to invest in? What if I need liquidity, how easy will it be to sell? There are a whole range of issues to consider, and it's up to the trustee to determine whether it's appropriate or not to narrow the investments down to a single holding."

But one thing that is required for SMSFs is to create and regularly review an investment strategy document. Under 4.09 of the SIS Regulations (1994), diversification, risk, return and liquidity need to be considered and reviewed.

Wilkinson says: "People need to realise that the fund is there to support disability and retirement of the members. Think about the health of members, and when they are going to retire. Will they take a lump sum versus a pension, and through that prism, determine the appropriate mix of investments. For example, if a member is going to retire in two years and take a lump sum, holding a large portion of the SMSF in an illiquid asset may not be appropriate."

In a letter to trustees, the ATO states: "Our records indicate that your self-managed super fund investment strategy may hold 90 per cent or more of its funds in one asset, or a single asset class ... You could also be liable for an administrative penalty of $4200 if your investment strategy fails to meet these requirements ... We will also be writing directly to the auditor of your fund to notify them of our concerns. You should be aware that if your auditor identifies that you have failed to rectify any noncompliance with the requirements listed above, this could result in the imposition of the above mentioned penalties."

Wilkinson believes the ATO is targeting SMSFs with undiversified property exposures. Clients with large holdings in cash or shares, on the whole, are not being sent the letter. Wilkinson says: "The ATO is watching interest rates going down, which may lead to another increase in property prices. This may encourage property developers and spruikers that have previously been around in the market promoting everyday Australians to set up SMSFs to re-emerge. The ATO may be firing a warning shot that those type of arrangements will come under close scrutiny."

Sydney buyers' agent Kitty Parker from Kitty & Miles says: "I'm advising clients to be wary of targeted unethical advertising. Many of these dodgy campaigns suggest mum-and-dad investors are eligible for off-the-plan property purchasing within a SMSF as they are a married couple. While there is a grain of truth to this idea, the risk of such ill-advised investing could cost your everyday family their future financial security."

In terms of SMSFs meeting the investment strategy requirements, Wilkinson says: "It is fair to say that probably a reasonable number of SMSFs don't have an appropriate investment strategy in place, or may have never reviewed it. They may have downloaded a pro forma from the internet and what I think trustees should do, especially if they have the letter from the ATO, is to seek professional advice and review their existing strategy to ensure that it is appropriate."

The key takeout from this is to have a properly considered investment strategy and review it on a regular basis. You will not get a penalty for contravening the diversification rules if you have the investment strategy in place, have considered the risks and have minutes to show you have reviewed it on an ongoing basis.

James Gerrard is the principal of financial planning firm FinancialAdvisor.com.au

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