# Caught out: judge's ruling on short attack may embarrass super funds

JAMES KIRBY
WEALTH EDITOR

Big super funds that finance short-selling — especially industry funds that strive to take the higher ground in ethical investing — must surely be wincing at a remarkable story in the courts this week surrounding one of the nastier "short attacks" we have ever seen in Australia.

In principle, shorting keeps the sharemarket healthy. It spots weakness and, at its best, forces companies to clean up their act. (Shorting is where an investor borrows stock for a fee, then waits for the stock to drop, sells the stock for a much cheaper price, returns the stock to the super fund and pockets the profit).

But how short funds actually work in practice is another matter altogether: a court judgment this week would seem to confirm our worst fears about shorts and how they operate in practice.

Many investors don't like their super funds lending to shorters because they worry it can be unethical: they find it hard to see why their own super fund wants to finance an activity that can be trying to "short" the very same shares they probably own.

For example, it is beyond doubt our major super funds over the last year would have been holding JB Hi-Fi while also lending to shorts who were betting the JB Hi-Fi share price would fall (JB Hi-Fi has been consistently among the most shorted stocks in the market).

There has always been rumours that short-sellers play various tricks: using media leaks as part of shorting campaigns, exaggerating weaknesses of the target to maximise profits, etc. But we now have a window into what can be a decidedly unsavoury business after a plucky decision by Rural Funds Management to take its enemy — a US short-selling specialist called Bonitas Research — to court.

Rural Funds management CEO David Bryant woke up one morning last August to find the Texas-based short fund had issued a damning report on the Australian business, branding it as "worthless".

Now in our volatile and overheated sharemarket, a report like that spreads like wildfire and other investors don't wait around to see if Bonitas has played by the rules or not — many investors simply sold out.

Rural Funds endured a 42 per cent fall in its share price in the aftermath of the report release.

Why? Because Australia has been a short-sellers paradise since the original attacker, Glaucus, came in some years ago and made a fortune with a masterpiece short attack on sandalwood plantation group TFS and followed it with an even bigger trophy, the Blue Sky group. In both cases, the companies literally crumbled and Glaucus made a fortune.

In fact, there has always been shorting in the local market, generally as part of long/short strategies at leading funds that use the big super funds to supply stock for a fee.

At any given time, there are hundreds of stocks being shorted — over the last week among the top 10 most shorted were JB Hi-Fi, the Inghams group and tech favourite Nearmap.

The most shorted stock in the entire market is miner Galaxy Resources, with nearly a fifth of its entire market capitalisation held by shorts.

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Nowadays Glaucus has many imitators: in fact, Bonitas CEO Matthew Wiechert was a co-founder of Glaucus. (You may have seen Wiechert in The China Hustle, a terrific documentary about fraud in China in which Wiechert did some useful investigative work.) But Wiechert's plan for Rural Funds Management has not gone quite so smoothly.

On Wednesday, Justice David Hammerschlag in the NSW Supreme Court gave Bonitas a beating around the ears that was something to behold.

Hammerschlag said the Bonitas report on Rural Funds was "materially misleading" and then he hit them between the eyes with this: "They (Bonitas) never took the trouble to check with or inquire as to any material which they broadcast … I have no difficulty in concluding that they did not care whether what they were saying was false."

So it turns out that apart from the issues highlighted in that last statement from Hammerschlag, the self-described "activist short-seller" released a scathing report to start a short attack on an ASX-listed company, then instantly bunkered down in Texas.

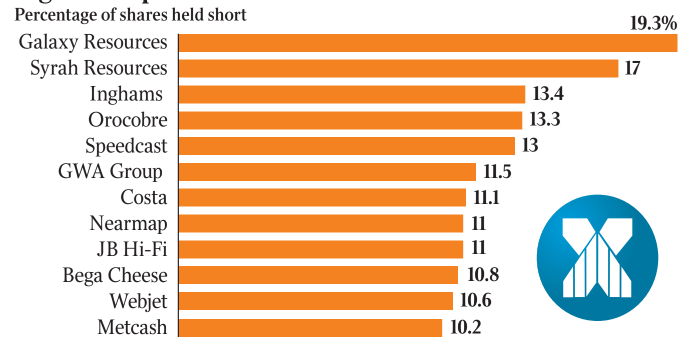
As a precautionary measure, Bonitas fired off an email to their Australian target that revealed the Bonitas researchers had never visited Australia and they were sure the laws of the US would protect them should Rural Funds be so presumptuous as to try to defend itself.

Bonitas kept blazing away after the legal loss this week, suggesting the court judgment was "procedurally and substantively infirm".

Meanwhile, Rural Funds' share price — at $2.05 — has recovered to a point close to where it was the day Bonitas launched its attack.

Hammerschlag will announce his decision on damages in the case on March 6. That decision won't just be news in our market, it will be read by ever short-selling outfit around the world.

If the Rural Funds exercise ends up costing Bonitas big money in damages, it will change the numbers for anyone considering a short attack on Australian companies. Or, to be precise it will change how shorters behave in our market — and that would be no bad thing.




# Star picks from profit season

There are sectors and stocks to watch for earnings

ROGER MONTGOMERY

The reporting season is now under way amid bush fires and a coronavirus pandemic.

The environment is ripe for more surprises than we have seen, perhaps since the global financial crisis. And that's before we add in the fact that the ASX 200 industrial index, excluding financials, is trading on a record multiple of 28.5 times earnings — even higher than before the GFC. With valuations generally stretched, the potential impact on prices from profit and outlook surprises could have a greater impact on investors' portfolios than at any time since the GFC.

Over the past few days we saw the first batch of results, which brought solid returns from market leaders such as CBA and CSL, but there is a long way to go before we get a full picture of the results season — we won't have a complete picture until March.

Among the banks, CBA presented a decline in half-on-half profits of 4 per cent and an unchanged dividend.

In the days ahead, Bendigo Bank will report its half-yearly results, while Westpac, ANZ and NAB will release quarterly numbers and/or pillar III statements. We don't expect many big surprises, with underlying conditions remaining tough and the outlook expected to remain subdued.

With national household credit growth — both housing and personal — declining, the reporting season for the banks is likely to continue the trends of increasing pressure on revenue growth and declining net interest margins.

Costs will continue to grow as increases in compliance and regulatory costs more than offset efficiency savings in the core operating cost base. Delinquencies have been increasing slowly for a while, despite bad debt provisions remaining at cyclical lows. Bad debt provisions should present a headwind to profit growth.

The backdrop for the reporting season is soft: the raw national retail sales figures reveal a soft Australian retail sector.

December raw retail sales grew 2.4 per cent annualised and, while this has been portrayed as solid, it is in fact a decline on November's 3.4 per cent and October's 2.7 per cent.

Non-discretionary food, which drives 30 per cent of retail sales, rose an annualised 3.8 per cent in November. However, in December growth slumped by nearly half to just 2 per cent annualised.

Important for retailers of course is volume, and retail sales volume growth reversed in the September quarter for the first time since the 1991 recession. While December growth improved marginally, the annualised growth rate is zero.

With the coronavirus drama in China, businesses with fast inventory turnover could be most at risk if they are unable to source from alternatives suppliers to China.

With retail sales slowing, and annualised personal credit growth deeply negative as consumers pay down debt, I generally expect soft results from retailers and very cautious outlook statements from listed retailers.

Some retailers have already downgraded, including Super Retail, Mosaic Brands (formerly Noni B), Beacon Lighting, PAS Group and Kogan.com.

Keep in mind that despite additional stimulus from tax cuts and interest rate reductions, plus recently improved capital city house prices, the banks say households have chosen to pay down debt rather than consume.

While risks obviously exist, our small-cap team have run the ruler over the retailers and currently prefer Adairs, City Chic and Premier in the retail space.

In the resources sector, the miners should report generally positive results for the December half as it coincided, for example, with a period of relative strength in iron ore. The strong expected earnings should help major miners BHP, Rio and Fortescue continue with near record dividends.

The outlook for resources may not be as rosy, as resource companies face the uncertainty of China's slowdown. China is, by far, the dominant consumer of iron ore at over 70 per cent of global supply, so any slowdown can have a significantly negative impact on short and medium-term prices.

In technology, where expectations are built on growth and the demonstration of scale, reporting season is viewed closely for validation of those growth forecasts. Investors have been willing to trade losses and lower profits today for faster growth in the future. Stocks that deliver the former without the latter will be punished, while faster than expected growth will be cheered.

Market valuations for technology companies have strengthened, particularly in areas where structural global growth is evident such as in payments, cloud and AI toolsets.

US earnings season for mega-cap technology companies such as Microsoft, Alphabet and Amazon as well as others in the tech "food chain" have demonstrated continued strong growth and I expect those trends to also be experienced by companies here in Australia, including Next DC, Appen, Megaport and EML Payments.

Locally, expect further evidence that some fintechs are growing fast at the expense of the big banks (albeit not huge expense), and taking advantage of demand for personal and business finance where the banks are withdrawing. Also, we expect continued growth where innovation is disrupting traditional or conventional revenue models, such as the buy-now-pay-later space.

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

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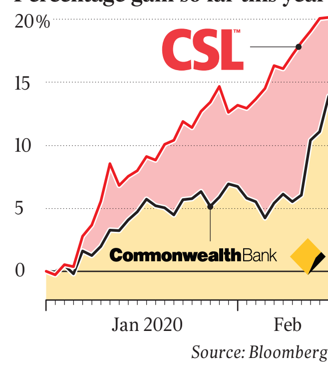
Percentage gain so far this year




# THE COACH

**I am extremely concerned about my exposure to the sharemarket. Is now the right time to be invested in shares?**

In a volatile market it is often difficult to stay on track with your investment strategy.

If you are investing for the long term, you may do more damage trying to time your exit and entry to the market. Investors who park their assets in cash often fail to recognise the time to get back in the market.

If you are worrying about your money, your appetite for risk may have changed. It could be your time frame for investing is now shorter, your circumstances have changed or there has been a change in market outlook. Assess if your change is permanent or a response to short-term factors such as markets volatility or valuation.

If your investment time frame has changed, do you have the time for your investments to recover through the cycle? All markets run in cycles, some are short-term corrections, some are medium-term business cycles of three to five years and others can be long-term secular swings of 20 years. Make sure your portfolio can weather a cycle and ensure you have sufficient time to allow your portfolio to recover.

Assess the quality of the assets within your portfolio. If they are direct equities, consider the short and longer-term prospects of the company.

If you invest in managed funds, ensure you are comfortable with the investment approach of the managers. Monitor where they invest, assess if they have been true to their philosophy and invested where they said they would.

Diversify your portfolio into a range of sectors, companies and regions. Consider how concentrated your portfolio is to the Australian market and particular sectors such as banking.

Recognise that market volatility can create attractive opportunities. A stockmarket correction can be a good time to invest in equities, but do not presume a "hot" stock that falls in value is now cheap and will recover.

Over the long term, equity risk is usually rewarded. Empirical studies have shown the value in long-term compounding returns and the benefits of investing regularly in a portfolio regardless of whether markets are rising or falling. The best way to navigate a choppy market is to have a good long-term plan and a well-diversified portfolio. But sticking to the fundamentals is sometimes easier said than done. Seek advice from a qualified professional.

**How do I determine my investment risk profile?**

A risk profile is an assessment of your willingness and ability to take risk with your portfolio. The process of risk-profiling builds a framework to determine what investment asset classes you should consider and avoid.

Your risk profile is built upon three primary considerations — tolerance for risk, risk you would be required to take to generate sufficient return and your capacity for risk.

Risk tolerance is the level of risk you feel comfortable with. As we get older it is common for our tolerance for risk to diminish. A risk tolerance questionnaire will identify your responses to a range of scenarios which will include your level of experience as an investor, your understanding of investment markets, your confidence in making investment decisions and how you feel when markets rise and fall.

Risk required is the level of investment risk you would need to take to achieve your goals. If you require a return of 6 per cent long term to achieve your objective, you will need exposure to growth assets to achieve the goal.

You can apply different risk profiles based on your specific financial goals.

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# Hybrids are popular for their cashflows — but be aware of the risks

TONY KAYE

Interest rates are already at record lows, and there's the strong prospect of further easings in monetary policy this year as central banks around the world endeavour to stimulate economic growth.

For investors, and particularly retirees reliant on stable income streams, the challenge of securing and maintaining reliable cash flows will be exacerbated by even lower interest rates.

So, the biggest conundrum for many investors will be sourcing investment returns that deliver income without increasing exposure to excessive capital risk.

One alternative investment option on the table is hybrids, which pay regular fixed or floating interest payments to investors, generally on a quarterly basis.

Australia's major banks, other financial institutions, and even some corporations have been active in rolling out hybrid issues over many years, because they use them as a way of meeting their regulatory obligations to have minimum levels of capital available on their balance sheets to cover potential financial shocks.

More than $5bn of new hybrid issues hit the Australian Securities Exchange last year, taking the total number of listed hybrid issues to 54, worth a combined $45.7bn.

The biggest hybrids listings of 2019 were a $1.87bn issue by NAB in March, paying an interest rate of 4.9 per cent, a $1.65bn issue by Commonwealth Bank in November, paying a rate of 3.93 per cent, and a $905.5m issue by Macquarie Group, also in March, paying a rate of 5.04 per cent.

On the surface, especially given the fact that Australia's major banks make up the bulk of the issues that can be invested in, hybrids could be construed as a safe investment avenue to capture regular income payments.

Yet, it's very important for investors to understand what's beneath the hybrids surface and the capital risks they may entail in the future. To do that, the first point to realise is that hybrids is an umbrella term used to describe an array of highly complex products that blend fixed income and equity characteristics. Unlike other fixed-income securities, instead of paying a lump sum principal payment at maturity, investors' capital is instead usually converted into the underlying shares of the issuer at a specified conversion date.

**Conversion risk:** Hybrids investors take on the risk that share price volatility near the date of the conversion into equity could significantly affect the value of the hybrid security. Most hybrids are structured to allow the issuer to force a conversion to shares at its discretion, irrespective of the initial prescribed maturity date.

If the issuer's share price has fallen at the conversion date since the time of the initial investment, investors will in effect take a capital loss.

**Deferral risk**: Another factor with hybrids is deferral risk, whereby issuers can choose to indefinitely defer making interest payments.

**Liquidation risk:** Furthermore, in terms of recouping funds in the advent of a company default and subsequent liquidation, hybrids rank below senior and subordinated debt (bonds), although investors do have priority over common stock holders.

**Interest rate risk:** There is also interest rate risk in hybrids, which exists for holders of both fixed and floating rate payment hybrid securities.

For fixed rate hybrids, the inverse price/interest rate relationship will mean that when rates rise, prices fall; and when rates fall, prices rise. The level of interest rate sensitivity will depend on the duration of the security.

**Liquidity risk:** For some hybrid security holders who wish to sell, a lack of market liquidity means they may find it difficult to find a buyer willing to pay a high enough price, or in a stressed market scenario may not be able to redeem their capital.

In short, hybrids may be considered to be defensive, but their attached equity components and other inherent risks, some of them quite substantial, must be understood clearly. They represent one way of stretching for yield, but for some they could become a yield stretch too far if equity market conditions worsen. In past market downturns, because of their inbuilt equity characteristics, hybrids have often been poor performers for investors.

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