

OPPORTUNITY STOCKS

In times of low growth, advisers may find it difficult to spot the companies that will deliver, writes Jeremy Chunn. Several experts offer their insights.

Australians love shares, but for the past four years it's been hard to keep the flame burning. The sharemarket has been bucking about like a nag at a rodeo, popping above 5000 every so often only to lose its stamina and conk out for another siesta. It's been a lousy time to make money, and a huge pile of cash is waiting in the wings.

What is an adviser to do...

Australia is in a low-growth period. The Reserve Bank of Australia in September revised growth to 2.25 per cent from 2.5 per cent. But lower interest rates will support equities, and companies that can "re-invent themselves" to suit the economic climate may prove valuable, says Johan Carlberg, principal and portfolio manager at Alphinity Investment Management.

"To just wait for the cycle to improve is probably not going to work," he says. "Things going forward are likely to be a bit different."

Attractive companies are those with low volatility in earnings, higher profitability in terms of return on equity and cash flows which are well aligned with earnings results, he says. Investors should look across a business cycle and take care not to extrapolate strong earnings which may be part of an incomplete cycle. Industries experiencing structural change will be harder to read, he says. "Some companies have been under pressure from a cyclical downturn, and at the same time there's a structural [downturn] going on."

Advisers looking for yield should check a company's dividend history and capacity to grow dividends and be wary of stocks where the yield appears to be high because the share price is in decline for some serious reason, Carlberg says.

Weather report

"Quite clearly we are looking at low global growth prospects," says ST Wong, portfolio manager for Prime Value Asset Management. "This has an implication for the major miners." Large diversified miners that have reduced costs and capital expenditure will be well placed to improve profitability when things pick up, and it always pays to bear in mind that BHP Billiton and Rio Tinto alone account for nearly 10 per cent of the Australian sharemarket.

"From a portfolio theme perspective, and focusing on China softening, if you can focus on what the individual companies are doing, there could be value in some of the diversified miners in the next 12 or 24 months," Wong says. "A lot of negatives seem to have been baked into share prices of the diversified miners."

As the Reserve Bank is expected to extend its loose monetary policy, Wong says a pick-up in demand for housing may see business conditions improve for companies linked to construction. "This is quite

From left: Johan Carlberg, principal of Alphinity Investment Management; S.T. Wong of Prime Value Asset Management; Jon Reilly, CIO, Implemented Portfolios.

early in the sense that we haven't seen any signs of life of any significance in the housing market, but we will be looking for indicators as far as housing starts are concerned," he says.

Central banks have been "in the driver's seat" of the world economy, Wong says, providing liquidity by keeping rates low and encouraging investors to seek better returns elsewhere. Australia has attracted a lot of foreign investment, and "liquidity impacts the markets", he says. When some of that money was withdrawn in the June quarter, when the US Federal Reserve suggested its policy of quantitative easing might slowly come to an end, the Australian dollar and sharemarket took a hit. "It's kind of an emerging market phenomenon," Wong says. As central banks reverse easy monetary policies, companies that show value now will look like even better buys.

Instant diversification

Jon Reilly's clients are financial advisers who recognise stock picking may not be their core expertise. He admits it isn't his forte either. "We don't get involved in a stock-picking decision at all," says Reilly, chief investment officer at Implemented Portfolios, which constructs five investment funds, each containing different allocations to exchange traded funds (ETFs) over Australian equities.

ETFs are funds of shares constructed to replicate various indices, sectors or strategies. There are about 80 ETFs traded on the Australian Securities Exchange.

"We spend our time on long-term forecasting," Reilly says. "We have a view markets are generally quite efficient in the short term, but over longer periods there are asset classes or sectors which become under- or overpriced."

The ETFs within the five programs are reweighted accordingly. Australian equities exposure is through four ETFs: S&P/ASX50; S&P/

ASX200 Financials ex-REITs; S&P/ASX Resources; and ASX Small Ordinaries (stocks between the top 100 and 300). Implemented Portfolios has more than 400 clients and \$250 million under management. About two-thirds of funds are from self-managed super funds.

Holdings of Australian equities vary between zero and 20 per cent for the conservative profile program and 85 per cent for the growth profile. Australian investors are notoriously biased towards domestic stocks, but the message from setting the downside at zero exposure is they are risky.

"It's an important philosophical point for us," Reilly says. "If we're not getting compensated to take risk in an asset class, why do it?"

Know the score

AltaVista Research values ETFs over Australian equities to find its own measure of expected return, which it calls an ALTAR score (for AltaVista long-term annual return). The score is essentially an aggregate measure of the intrinsic value of each constituent stock in the ETF. Its calculation uses return on equity and forward price to book value over seven years of data, which it says takes into account the business cycle.

"Our research process certainly isn't a qualitative view," says Michael Turner, head of sales and corporate development at AltaVista. "We think that's a completely irrelevant way of looking at an ETF."

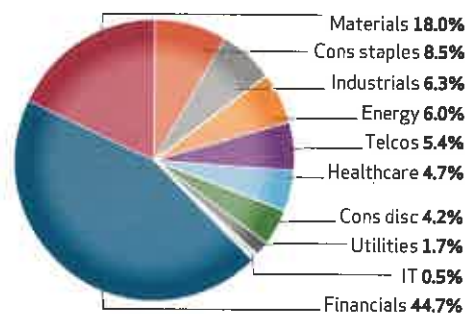
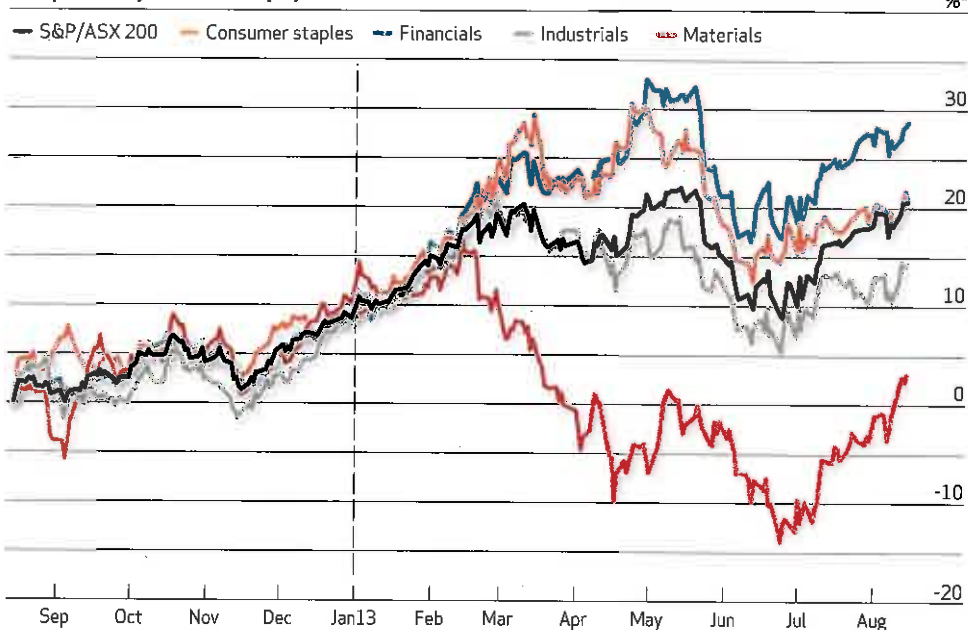
The company rates ETFs this way, then constructs model portfolios using strategic asset allocation or technical asset allocation methods. It offers three model portfolios for Australian equities.

"There is still an innate ability for people to ignore the fundamentals of investments, and we like to think we offer a bit of rationale around investment selection," says Turner. "Despite their lack of uptake, ETFs offer an amazing way for advisers to access the market."



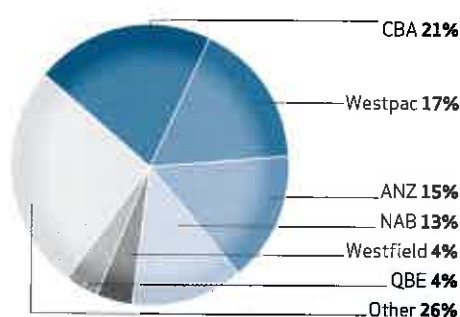
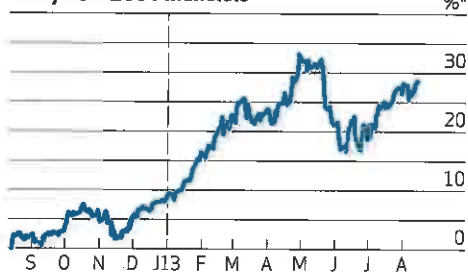
Picking winners

Comparative performance (%)



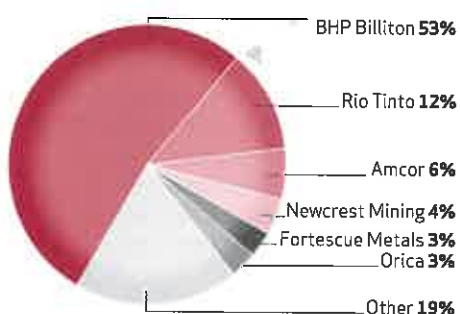
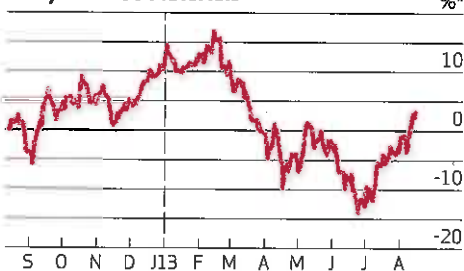
Gainers	Linc Energy	202 50%
	BlueScope Steel	128 10%
	M2 Telecommunications	97 07%
	JB Hi-Fi	94 62%
	Henderson Group	94 27%
Losers	Australian Infrastructure Fund	-93 14%
	Discovery Metals	-88 35%
	Sundance Resources	-77 50%
	Emeco Holdings	-77 25%
	Boart Longyear	-76 02%

S&P/ASX 200 Financials



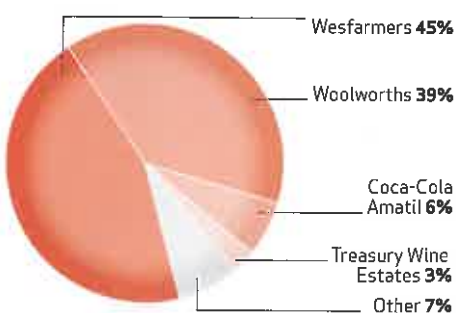
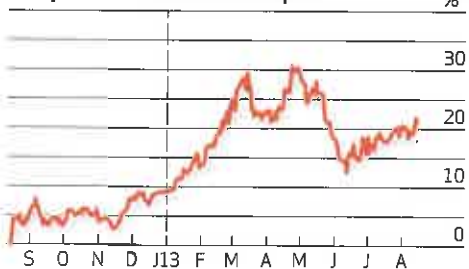
Gainers	Henderson Group	94 27%
	Macquarie Group	72 03%
	Magellan Financial	67 85%
	Platinum Asset Management	64 12%
	IAG	55 51%
Losers	FKP Property Group	-36 69%
	Westfield Retail Trust	-2 81%
	Investa Office Fund	0 70%
	GPT Group	2 53%
	CFS Retail Property Trust	4 80%

S&P/ASX 200 Materials



Gainers	BlueScope Steel	128 10%
	Amcor	46 70%
	Fletcher Building	44 16%
	DuluxGroup	32 84%
	Arrium Limited	31 19%
Losers	Discovery Metals	-88 35%
	Sundance Resources	-77 50%
	Perseus Mining	-72 99%
	Silver Lake Resources	-67 98%
	Mirabela Nickel	-60 00%

S&P/ASX 200 Consumer staples



Gainers	Wesfarmers	9 05%
	Woolworths	5 50%
	GrainCorp	2 99%
	Treasury Wine Estates	0 62%
	Goodman Fielder	0 18%
Losers	Coca-Cola Amatil	-0 70%

*Share price movement for 12 months to August 15, 2013. Source: Bloomberg

A direct approach

Advisers who make direct stock picks will always feel better if their views line up with commentators in the investment industry. "Heading into results season we would expect the key areas of positive earnings surprise to come from stocks which do not heavily rely on the economy to drive earnings growth," says Ed Prendergast, a fund manager with Pengana Capital. "Sectors such as healthcare and telecommunications are likely to feature strongly in this environment, aiding stocks such as Vision Eye Institute and Capitol Health and the smaller telcos such as M2 Telecommunications, Amcom and Vocus."

Prendergast says things might get rocky for retail and media companies. Despite interest rate cuts since late 2011, consumers are not spending freely. And a fall in the Australian dollar has driven up the cost of imports, which could affect retailers' margins. "Discretionary retailers such as Myer [and] David Jones will struggle to maintain positive earnings momentum," he says.

"Media spend is often a derivative of consumer sentiment, and many stocks in that sector are facing increased competition from online alternatives. Fairfax Media, Ten Group and APN [News & Media] are all vulnerable," he says.

Prendergast also isn't holding out much hope for mining services in the short term. "Stocks such as Monadelphous, NRW, United Group will likely be the source of ongoing earnings disappointment."

Small and mighty

More than 2000 companies are listed on the ASX and some of your clients probably think you should know the financial details of each one intimately. But there's no hope in hell of that. That's why active fund managers stand out in the small caps field, which is typically defined as the 101st to 300th companies by market capitalisation on the ASX. (Mid caps are the 51st to 100th in size, and micro caps are outside the top 300.)

Managers can do well against the benchmark by finding quality, which is possible, and avoiding surprises, which is impossible.

"There are a lot of potential blow-ups in the [small caps] universe," says Lonsec senior investment analyst Steven Sweeney. A good example is McMillan Shakespeare, which dropped 58 per cent after Kevin Rudd proposed the fringe benefits tax change which could destroy its long-term prospects.

Small cap funds which have been underweight resources companies have fared better than average, Sweeney says, and some

names in the media and retail sectors have been best avoided.

Returns of small cap managed funds diverge from the index of the 199 companies which make the benchmark much more than balanced funds versus the S&P/ASX 200, because volatility levels of share prices of small caps are much higher.

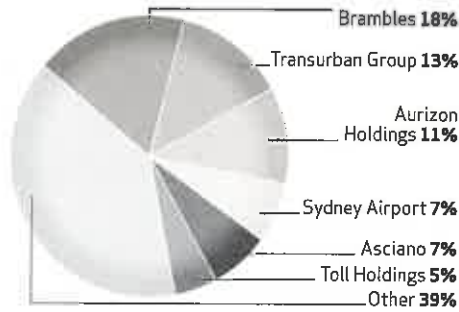
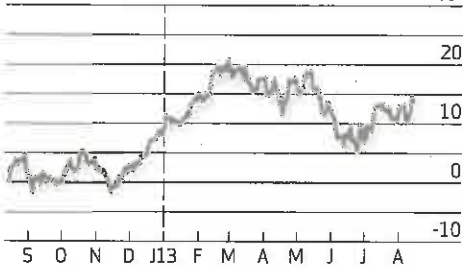
Serious money can be made and lost and a good fund will earn its fees.

"The peer group for Lonsec's active managers is significantly ahead of the benchmark," Sweeney says, singling out Hyperion Asset Management, Celeste Funds Management and Schroders for a mention. (Schroders Microcap Fund invests outside the top 250 companies.)

Sweeney recommends using small caps to complement an existing Australian equities exposure; between 5 and 10 per cent of allocations to local shares should be enough. "It's a higher risk, higher reward segment," he says. There are times when markets are challenged and small caps will suffer, however, and "they will feel the sell-off more than the large-cap managers". He says Hyperion is about a 20-stock portfolio, so its skill is in picking 1 in 10 winning stocks from the pool. More conservative funds might cap holdings of one stock at 2 per cent, so a fund will have at least 50 companies. ▣

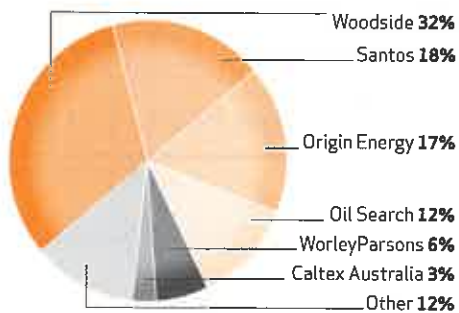
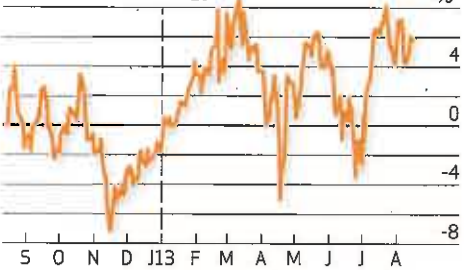
Picking winners

S&P/ASX 200 Industrials %*



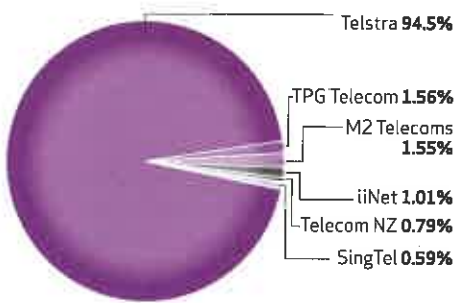
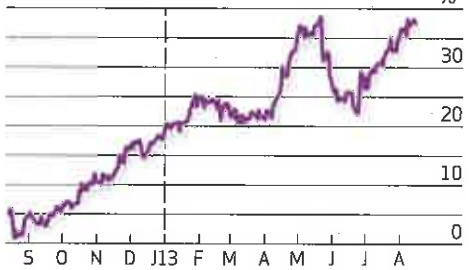
Gainers	Macquarie Atlas Roads	75.56%
	CSR	57.14%
	Seek	45.74%
	Brambles	43.58%
	GWA Group	33.33%
Losers	Australian Infrastructure Fund	-93.14%
	Emeco Holdings	-77.25%
	Boart Longyear	-76.02%
	Ausdrill	-58.96%
	NRW Holdings	-57.77%

S&P/ASX 200 Energy %*



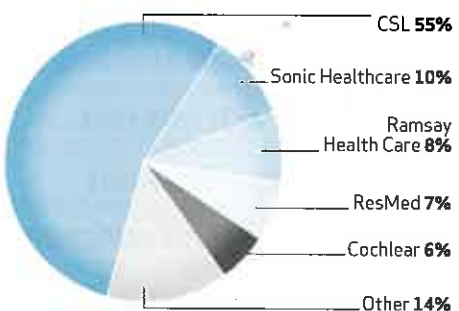
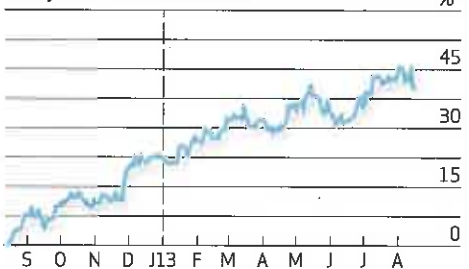
Gainers	Linc Energy	202.50%
	Karoon Gas	27.99%
	Caltex Australia	24.66%
	Santos	22.74%
	Oil Search	15.71%
Losers	Coalspur Mines	-58.71%
	Maverick	-54.67%
	Paladin	-48.41%
	Whitehaven Coal	-46.58%
	Buru Energy	-42.90%

S&P/ASX 200 Telecommunications %*



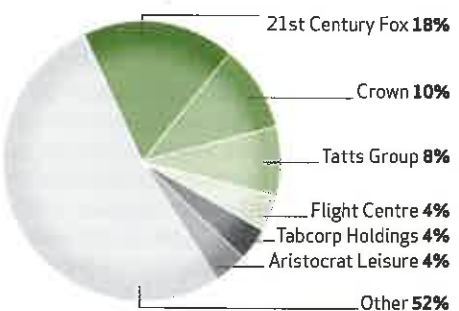
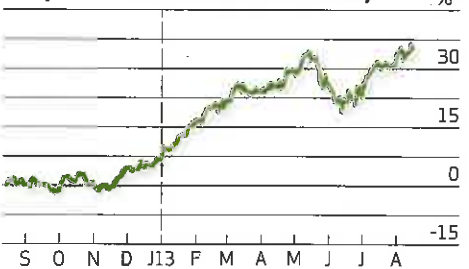
Gainers	M2 Telecommunications	97.65%
	TPG Telecom	88.66%
	iiNet	43.31%
	Telstra	33.16%
	SingTel	27.06%
Losers	Telecom NZ	-6.13%

S&P/ASX 200 Healthcare %*



Gainers	Primary Health Care	61.49%
	CSL	58.63%
	Ramsay Health Care	55.39%
	ResMed	54.91%
	Ansell	29.07%
Losers	Acrux	-18.52%
	Cochlear	-9.18%
	Sirtex	-1.07%

S&P/ASX 200 Consumer discretionary %*



Gainers	JB Hi-Fi	94.72%
	Flight Centre	92.54%
	The Reject Shop	83.26%
	21st Century Fox	78.19%
	Aristocrat Leisure	72.49%
Losers	Fleetwood Corp	-68.25%
	Billabong	-58.25%
	APN News & Media	-45.83%
	Echo Entertainment	-38.04%
	G.U.D. Holdings	-30.55%

*Share price movement for 12 months to August 15, 2013. Source: Bloomberg