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Weekly Review

RESEARCH

– Issue – 7 Oct. 2016

A cholesterol killer decades in the making could be a game changer for CSL.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 6 OCTOBER 2016

A billion reasons to love CSL's new drug

Acute Coronary Syndrome doesn't sound very pleasant, and it isn't. This umbrella term covers a range of symptoms that occur when blood flow to the heart is suddenly blocked. Whether this leads to a little chest pain or a full-blown heart attack, it's a big problem: your heart tissue is dying.

Key Points

- ***CSL-112 could add US$1bn to NPAT***
- ***Large market; Low probability of success***
- ***Results positive so far but late stage failure is common***

CSL (CSL) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$106.52	6%	Medium	Med–High

BUY Below $80.00 | HOLD | SELL Above $150.00

$106.52

ACS causes more than 2.5 million hospitalisations in the USA each year and nearly half-a-million deaths. In fact, it's the world's leading cause of death. The American Heart Association estimates that ACS costs America alone more than US$150bn a year, with more than half of that due to patients needing to go to hospital multiple times.

ACS is typically caused by a narrowing of the arteries, which itself is due to a build up of 'plaque' on the edges – a hardened cake mix of fat, calcium and cholesterol.

You may recall from science class that there are two types of cholesterol. 'Bad' cholesterol causes plaque, but the other, well-behaved type of cholesterol – so called HDL cholesterol – is the crime fighter of the body's arteries, sweeping away bad cholesterol and reducing your risk of heart disease.

More than a decade ago, CSL realised that the blood plasma leftover from making its antibody products was loaded with this 'good' cholesterol and set about purifying the active component.

Faster acting

Dubbed 'CSL-112', early research suggested that when it was injected into patients, it would flush out bad cholesterol from their bodies, dissolve life-threatening plaques and reduce the overall chance of heart attack.

CSL-112 appears to work much faster than existing cholesterol-lowering drugs, which are slow-acting and so offer little benefit in the weeks following a heart attack – right when a patient needs them most.

Historically, CSL has focused on therapies that treat people suffering from rare illnesses. In olive-sizing terms, the market for CSL's haemophilia and antibody products is small and medium, respectively. The market for CSL-112 would be super-colossal.

For context, the current cohort of cholesterol-lowering drugs, known as 'statins', is led by Lipitor. Over its 20-year history,

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Lipitor was the world's best-selling drug and generated more than US$140bn in sales for its owner, US-based Pfizer.

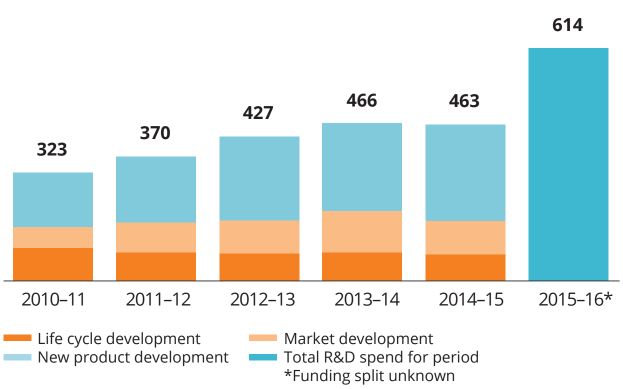
With this in mind, it's no surprise that chief executive Paul Perreault thinks that CSL-112 'will just be transformational for the company' if the product makes it to commercialisation.

A very big if

A couple of years ago we described how CSL-112 was beginning **the second phase of the clinical trial process**. The research involved 1,200 patients globally and monitored the effect of multiple administrations of CSL-112.

The study was completed in April and the results are to be presented to the American Heart Association during its next session on November 12–16, though CSL may make an announcement earlier.

Chart 1: R&D investment (US$ millions)



Source: R&D presentation 2015, company reports

Be warned: CSL's share price movement that day will probably look a lot like the **EKG** of someone having a heart attack, so you should prepare yourself mentally. A lot hangs on these results.

If the study fails to show a significant effect, CSL will have wasted years of research and a good $70m in Phase 2 clinical trial costs. If the result is positive, it will mean the company is likely to proceed with the final leg of the approval process – the infamous Phase 3 clinical trial.

A Phase 3 clinical trial for CSL-112 will require 12–15,000 patients – 10 times as many as necessary for Phase 2 – and may take four years to complete. At the lower end of expectations, it will cost US$250m but may cost as much as half-a-billion. And, still, there's no guarantee it will be successful and result in a marketable product.

No news is good news

When it comes to clinical trials, failure is the norm. It's worth noting that products similar to CSL-112 that were designed to raise the amount of good cholesterol in the blood have failed in late stages of development.

In 2012, Swiss-based Roche ended development of an HDL cholesterol-boosting drug part way through its Phase 3 trial after it became apparent that it wasn't having a significant effect. This followed 13 years' worth of Phase 1 and 2 trials that all pointed in the right direction.

And in 2006, another drug that increased levels of good cholesterol in the body, known as Torcetrapib, had its Phase 3 trial cut short by Pfizer when participants started dying unexpectedly.

Just three days prior to the cancellation, Pfizer's chief called it 'one of the most important compounds of our generation,' which shows how quickly the tide can turn. Pfizer had spent US$800m developing Torcetrapib before it was abandoned.

Even for CSL, things have ended badly at the last turn. In 2007, CSL's Phase 2 clinical trial of its previous cholesterol-fighting candidate – CSL-111 – was aborted early due to the development of liver abnormalities in a number of patients.

It's encouraging that the CSL-112 trial didn't end ahead of schedule due to safety concerns, though that still doesn't mean the result will be enough to justify the enormous time and expense necessary for Phase 3.

> **There's a wide range of outcomes when valuing blockbuster drug candidates, which is one reason we've been reluctant to sell CSL despite its seemingly high valuation.**

How to value hope

Though it's a long shot, we can't ignore CSL-112's potential. Citigroup research estimates that the therapy could add around US$1.0bn to net profit within five years of launch.

That seems reasonable – if not conservative – given that the current market for cholesterol-lowering drugs is around US$30bn a year and the margins on CSL-112 would be mouthwatering because CSL would manufacture it using the waste portion of its existing plasma supply.

Taking CSL's current forward price-earnings ratio of 27, an extra billion in net profit might mean another US$27bn added to the company's market cap – or $77 per share.

But let's not get ahead of ourselves. Between 2005 and 2015, some 9,985 clinical trial 'phase transitions' were **registered with the US regulator**. Only around a quarter of the drugs related to cardiovascular disease that were in Phase 2 clinical trials proceeded to Phase 3, and – even then – around half of those in Phase 3 failed to reach commercialisation. With these grain-of-salt statistics to work with, CSL-112 may only have a 1-in-8 chance of success.

That means we need to multiply our imaginary US$27bn by the totally hypothetical 1-in-8 chance of it working out, which gives us a valuation of about US$3.4bn.

However, because the Phase 3 results won't be ready until around 2021, and it could take another few years to really ramp up sales, we need to discount that US$3.4bn back to today's dollars – the result being that CSL-112 is worth about US$1.5–2.0bn at this stage of the game, or around $5.00 per share. If next month's Phase 2 results are positive, that valuation would at least triple.

As you can see, there's a wide range of outcomes when valuing blockbuster drug candidates, which is one reason we've been reluctant to sell CSL despite its seemingly high valuation.

And this says nothing of the extra juice that can be squeezed from the company's current product lineup, nor other novel treatments CSL is working on. In 2016, CSL's research and development (R&D) spending increased 32% to $614m thanks to several therapies reaching more costly, late-stage clinical trials – and if the news for CSL-112 is positive, that number will get a lot bigger in coming years.

Management expects net profit to rise 11% in 2017, while earnings per share are likely to grow slightly faster due to the company's ongoing share buyback. The stock has more than tripled in the five years since our **initial Buy recommendation** and – with a clean balance sheet, several competitive advantages and significant growth potential – we continue to recommend you **HOLD**.

Staff members may own securities mentioned in this article.

Pricing power and the decision to incorporate social media into its core product show why iSentia is a very good business.

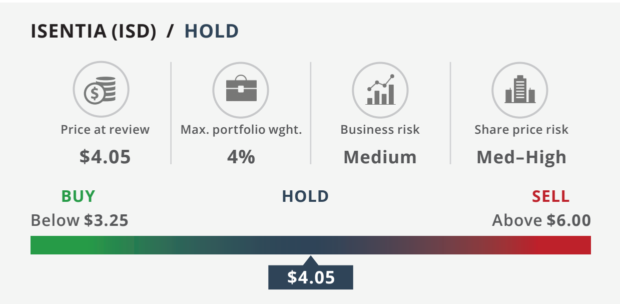
BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 5 OCTOBER 2016

iSentia's social skills

We were hoping for bad news from iSentia when it reported its 2016 result in late August. We didn't get it. Contrary to the concerns we raised in ***Risks rising for iSentia*** in July, management confirmed the company would report strong earnings growth in 2017 and laid out its '2020 strategy'. As a result, the stock has risen 16% since then (and around 30% since the August low).

Key Points

- ***Pricing power evident in 2016 year***
- ***Incorporating social media into core product a wise move***
- ***More growth to come from 2020 strategy***



What surprised us – and the market – was iSentia's apparent pricing power. Late in the 2016 financial year the media monitoring and analysis company implemented a 10% price increase, larger than the usual annual 4–5%. Admittedly this partly reflected iSentia passing on higher content costs, as it signed a new licensing agreement with the media industry in April.

But, according to management, there was no discernible effect on client 'churn', which remains around 1% of revenue (but 5% of client numbers, implying iSentia's large company clients are 'stickier'). In other words, clients took the price rise on the chin rather than cancelling their subscriptions.

This is often a sign of a great business, although price rises and pricing power are not necessarily the same thing. Occasionally companies push pricing too hard, which allows competitors to gain a foothold (we're looking at you, **Woolworths**).

Chart 1 shows iSentia's average revenue per client in Australia and New Zealand (including spending on add-on services). iSentia's success at boosting client spend might one day encourage the price-conscious among them to try smaller and less-expensive competitors such as Meltwater. But it's not happening yet.

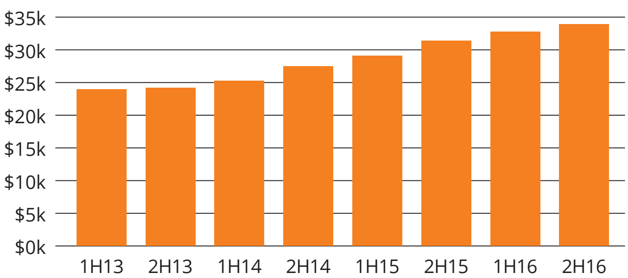
Selling confidence

At a recent management briefing we attended, iSentia responded to the competitive threat with: 'We sell confidence'. Only iSentia has the scale and resources to pay people to sit in rooms listening to television and radio broadcasts. The company's clients subscribe because they don't want media content missed.

If you're in the marketing or public relations department of a top 100 company – and iSentia counts 87 of the companies in the S&P/ASX 100 index as clients – then the average annual $34,000 cost of subscribing to iSentia's services isn't significant. It's virtually an essential service.

The company is also taking steps to 'widen the moat'. At the results presentation, management announced that its social media monitoring product would become available to all clients this financial year. So rather than social media monitoring being a stand-alone product that incurs an additional fee, it will be bundled in with mainstream media monitoring.

Chart 1: Average revenue per client (Aust. and NZ)



Source: Company reports

This makes sense for two reasons. First, social media is likely to become a much larger part of the media monitoring industry over time; to separate mainstream and social media monitoring looks like a false distinction. And second, it will help differentiate iSentia's full-service approach from the less comprehensive service offered by competitors.

All this should help cement iSentia's already strong pricing power. But what about our other concern from **iSentia's unfriendly trends**: that the ongoing decline

> **"While Quadrant sold out of iSentia in August 2015, there's no sign of disappointment yet. Quite the contrary.**

in the volume of content from print media sources was a risk to revenue?

Risks lower

Here the risk seems lower than expected. iSentia has invested significant time in pushing its clients on to fixed fee subscriptions. It's been very successful, with fixed fee subscriptions rising from less than 40% of domestic revenue in December 2014 to 78% of revenue recently. Management expects fixed-fee subscriptions might eventually hit 85% of revenue.

You can see iSentia's 2016 results in Table 1. But it was management's confidence in the future that explained why the share price jumped in the aftermath.

Table 1: iSentia result 2016

YEAR TO 30 JUNE	2016	2015	+/(–) (%)
REVENUE ($M)	156.0	127.3	23
EBITDA ($M)	51.0	42.5	20
NPAT# ($M)	31.1	26.5	17
EPS# (C)	15.6	13.3	17
DPS* (C)	8.13	6.9	18
FRANKING (%)	77	0	N/a

*** Final dividend 4.43 cents, 100% franked, ex date 5 Sep**
 # before the amortisation of acquired intangibles

iSentia forecast that both revenue and earnings before interest, tax, depreciation and amortisation (EBITDA) would grow in the 'low to mid-teens' in the 2017 financial year. With the help of the 10% price increase – and further earnings growth from the 2015 acquisition of King Content – that implies EBITDA will be $57m–59m. In earnings per share terms, this equates to a forecast of around 19 cents (before the amortisation of acquired intangibles).

Companies with a private equity heritage have an unfortunate habit of disappointing the market soon after the private equity firm has sold its stake. While Quadrant sold out of iSentia in August 2015, there's no sign of disappointment yet. Quite the contrary.

Management announced its '2020 strategy' with the 2016 results, which aims to deliver 'strong revenue and earnings per share growth' for the three years beyond 2017. The media intelligence market is forecast to grow 6% a year over the next five years, driven by social media, so there are some helpful tailwinds.

Double trouble?

Management's 2020 strategy identifies around $200m of incremental revenue opportunities. As iSentia's 2016 revenues were $156m, a more-than-doubling seems optimistic, although presumably it includes revenue targeted beyond 2020.

One of the largest revenue opportunities management has identified is King Content which, despite our **initial scepticism**, seems to be exceeding expectations under iSentia's ownership. Nevertheless, content marketing is a lower margin and more competitive business than iSentia's core media monitoring service.

On top of this, management aims to increase Asian revenues to 40% of the company's total (from 24% currently). With existing operations in China, Singapore, Malaysia, Thailand, Indonesia, Philippines, Hong Kong, Vietnam, as well as the recently acquired South Korea, this is probably the more attractive growth opportunity. Expect more acquisitions in Asia.

Summing up, iSentia might have significant revenue growth potential, but it's likely to be at lower margins. Given that – and despite the high quality of its core business – the stock isn't particularly cheap.

While iSentia should report earnings per share of about 19 cents this year, that's inflated by a low tax rate. On an enterprise value to EBITDA basis, which removes the effect of tax, the stock is trading on 15 times, which is certainly a premium multiple. The 3% free cash flow yield doesn't scream value either.

iSentia is a great business, but the stock isn't sufficiently attractive at current prices. It's clear that we've been too conservative, though, so we're lifting our price guide to Buy up to $3.25 and Sell above $6.00. We'll continue to hope for an opportunity but the recommendation is **HOLD** for now.

Staff members may own securities mentioned in this article.

Its share price keeps rising, but we're not ready to wave goodbye to this fast-growing serviced office provider.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 4 OCTOBER 2016

Sticking with Servcorp

Almost 50 different articles by no fewer than five different analysts. That's the sum of our coverage of serviced office provider Servcorp in the 11 years since we **first recommended the stock** in 2005 at $2.60. The stock doubled in its first year following that recommendation, before giving it all back (and more) in the global financial crisis and rising almost fourfold since, to today's record high of $8.19.

Key Points

- ***Quality company growing quickly***
- ***USA still making losses***
- ***Increasing price guide***

SERVCORP (SRV) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$8.19	5%	Med–High	High

BUY Below $6.50 — HOLD — SELL Above $11.00

$8.19

Through all that, we've never said Sell – and we're not about to start now.

Premium quality

Servcorp's business is a fairly easy one to understand. The company rents floors in some of the world's most prestigious office buildings on long-term leases, divides up the space and then sub-lets it to tenants for a monthly fee. In return, tenants get plush meeting rooms, a receptionist, full IT support, and – last but not least – a fancy address.

It's a simple formula and one that Servcorp has perfected. From the moment they sign a lease, a team will fit-out the office using similar layout, fittings and IT equipment to the other 150 floors that are located in 22 countries around the world (see Chart 1). It's the office equivalent of your computer's copy and paste function.

Despite the cookie-cutter approach, Servcorp's interior design is luxurious and, along with its premium locations and support, this allows the company to attract higher quality tenants than the cash-poor tech start-ups that many of its competitors covet.

Position of strength

The benefit of attracting these higher quality tenants – apart from the fact they tend to stay in business for longer – is that you can make more money.

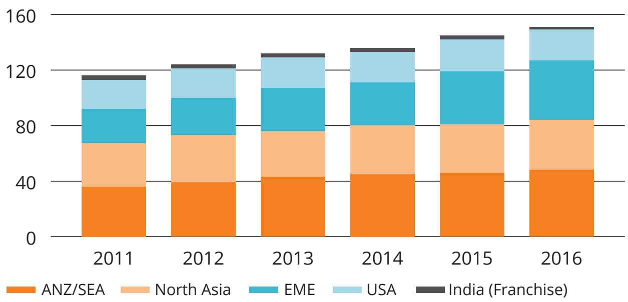
In the 2016 financial year, Servcorp's earnings before interest, tax, depreciation and amortisation margin of 22% was higher than industry giant Regus at 16% or the 3% that venture capital darling WeWork disclosed in a **recently leaked letter**.

In a competitive and cyclical industry such as Servcorp's, where demand will rise and fall along with the worldwide economy, earning a bit more than competitors allows more room to cut costs to maintain occupancy when things go bad.

A like-for-like story

A key metric to follow with Servcorp are its like-for-like figures, which measure only the performance of floors open in both the current and previous financial year.

Chart 1: Total floors



Source: Company reports

New floors will typically take 12–18 months to become profitable as the company incurs the cost of leasing the property from day one but it needs fitting out and, even after that, its sales team starts with occupancy at zero. New floor losses, which amounted to just under $8m in 2016, can't be ignored, but management has a great track record of turning these losses into profits. The like-for-like figures, meanwhile, provide a better indication of how the mature business is travelling.

In 2016, like-for-like occupancy fell 2 percentage points to 77% after two years of reporting like-for-like occupancy of 79%. Total occupancy for the company also fell to 75% from 76%. Occupancy is a major driver of profit growth as

> “Whilst the fall in occupancy isn't a good look, it didn't appear to hurt much in the last financial year.

it dictates revenue which, with a high fixed cost base, will mostly flow straight through to profit.

Whilst the fall in occupancy isn't a good look, it didn't appear to hurt much in the last financial year. In a sign that Servcorp was able to charge higher rents, like-for-like profit before tax actually increased 37% to $57m.

What's happening in the world?

More than 80% of Servcorp's revenue comes from outside Australia and New Zealand, making it a truly global business (Table 1).

Table 1: Geographic breakdown

($M)		2013	2014	2015	2016
ANZ/SEA	Revenue	75	79	81	87
	NPBT	13	11	9	12
NORTH ASIA	Revenue	69	78	89	105
	NPBT	11	12	18	21
EME	Revenue	43	59	73	93
	NPBT	5	11	16	19
USA	Revenue	12	19	25	35
	NPBT	(6)	(3)	(5)	(4)
TOTAL	Revenue	200	234	269	321
	NPBT	24	31	37	48

Out of all its locations, the biggest problem is the USA, which is still yet to report a full-year profit since opening its first floor in 2010.

While the 66% decline in the total loss to $3.8m and revenue growth of 42% are encouraging, occupancy still trails the rest of the business.

With the division now more than 5 years old and many of its floors mature, we were hoping for better news. We will be eager to hear more information about what the company expects to do with the US at its upcoming AGM.

Staying put

Servcorp expects to open at least four new floors in 2017 and, with only token external debt and almost $100m in cash, it's well placed to take advantage of further opportunities.

Management's guidance is for another year of double-digit profit growth, with profit before tax expected to rise 15% to $56m, which should lead to earnings per share of around 46–47 cents. The company expects to keep dividends steady at 22 cents per share for the third year in a row, pushing the payout ratio down from 54% to 49%. This is a company focused on growth.

The guidance puts Servcorp on a forward price-earnings ratio of 18, or closer to 15 if you strip out the cash balance. That's not expensive for such a high-quality business that offers excellent long-term growth prospects although, given its cyclicality, we'd need a greater margin of safety before upgrading again. Our price guide, though, has been left behind by the company's growth and we're bumping up our Buy price to $6.50 (from $5) and our Sell price to $11.00 (from $8). **HOLD**.

We're delighted to expand our coverage of listed investment companies.

BY MITCHELL SNEDDON • INTELLIGENT INVESTOR • 3 OCTOBER 2016

Expanding our LIC coverage

Listed investment companies (LICs) can make terrific investments. They can give an investor exposure to a broad range of companies, sectors and regions while only needing to hold a handful of stocks. They can be a great set and forget investment, if there is such a thing these days. And they can also give the savvy investor an opportunity to buy at a discount to increase their potential returns.

Key Points

- ***Expanding LIC coverage***
- ***Prefer LICs trading at discounts to NTA***
- ***Two LICs added to Buy list***

LICs

COMPANY NAME	ASX CODE	RECO.
BAILADOR TECHNOLOGY INVESTMENTS	BTI	Hold
BKI INVESTMENT COMPANY	BKI	Hold
HUNTER HALL GLOBAL VALUE	HHV	Hold
MAGELLAN FLAGSHIP FUND	MFF	Hold
PERPETUAL EQUITY INVESTMENT COMPANY	PIC	Buy
PM CAPITAL ASIAN OPPORTUNITIES FUND	PAF	Buy
THORNEY OPPORTUNITIES	TOP	Hold

So we're delighted to expand our coverage of LICs, and in this review we're going to set out the list of stocks we plan to cover (in addition to *Intelligent Investor*'s current coverage of **Australian Foundation Investment Company**, **Argo Investments**, **PM Capital Global Opportunities Fund** and **Templeton Global Growth Fund**).

Closed-ended

The key feature of LICs – compared to other forms of funds – is that they are 'closed-ended' rather than 'open-ended'. This means that if you want to invest in them, you need to buy shares in them from other investors (rather than apply for units to be issued to you as you would with an 'open-ended' managed fund).

This means that the price you pay can be disconnected from the underlying value of the fund (as measured by net tangible assets, or 'NTA'). For value investors that's obviously an attractive feature, but investors should be careful not to just select the LIC with the deepest discount to NTA because, more often than not, the discount will persist.

Care also needs to be taken with the NTA figure itself, because it might have changed since it was last reported. If the market has fallen since the latest NTA update, then a fund's NTA is also likely to have fallen, thereby increasing any premium or reducing any discount (and vice versa if the market has risen).

So some adjustment may need to be made. You can do this crudely by assuming NTA has changed along with the market, or more precisely by considering the movements of the LIC's largest holdings (although bear in mind that they might have changed). The more an LIC positions its portfolio differently to the market (which is generally what we like to see) the more you'll want to take the latter approach.

Thankfully, though, LICs are getting better at reporting, with a number of the ones below reporting weekly NTA updates and one of them even reporting daily.

Discount to NTA

All things being equal, we like to see a discount that's sufficient to make up for an LIC's charges. So if you expect your investments to return 8% and an LIC charges 1% a year, then you're losing one eighth of your return – that is 12.5% – and you'll want to buy the LIC at a discount of this amount to get you back to square.

We may be prepared to relax this a little where we particularly like an LIC's management and think they should outperform over time. (See our special report – ***An in-depth look at LICs*** – for more about valuing LICs, but note that the report is eight years old so the specific recommendations no longer apply.)

Note also that this is what we'd generally need to see clear value in an LIC – compared to making direct investments yourself – and therefore to make it an outright Buy. If you don't want to pick your own investments then you will have to bear some costs, so it would make sense to only discount an LIC's NTA by enough to overcome any extra costs above what a low-cost index tracker might charge. This lower hurdle may bring some of our better Hold recommendations into range, and we'll try to point this out where appropriate.

Our LIC coverage list will change over time depending on where opportunities can be found. There will at times be some noticeable absences. **WAM Capital**, for example, is not on the list as it has traded at an excessive premium for

> **Over time we'll write full reports on all LICs listed below and hopefully conduct interviews with their managers.**

a long time. That's not to say you can't make money from it, but as value investors we are looking for a disconnect between price and value and we're unlikely to find that any time soon in WAM Capital.

Over time we'll write full reports on all LICs listed below and hopefully conduct interviews with their managers. In the meantime, here are some brief summaries to get us started.

PM Capital Asian Opportunities Fund (PAF)

Even though its options have now expired, PM Capital Asian Opportunities Fund continues to trade at a substantial discount to its net tangible assets (NTA) – currently 16% based on pre-tax NTA, which it reports weekly.

PAF gives you a portfolio of Asia-focused businesses. This might sound obvious but portfolio manager Kevin Bertoli is constantly trying to remind people of it: you are not just buying 'emerging markets'; you are buying a portfolio of businesses.

Table 1: PAF top ten positions at 31 Aug 16

POSITION	GEOGRAPHIC EXPOSURE
51JOB	China
DONACO	Thailand
HSBC	Hong Kong / International
BAIDU	China
SINOPEC KANTONS	Hong Kong / China
TURQUOISE HILL RESOURCES	International
ZHAOPIN	China
MGM CHINA	Macau
PAX GLOBAL	Hong Kong / China
CARLSBERG BREWERY MALAYSIA	Malaysia

Source: Company reports

Bets on the consumer services sector have worked out nicely for PAF recently, including its exposure to gaming. Bertoli noted recently that visitor numbers had been increasing in Macau, which will have contributed to a near-doubling of two of PAF's larger investments, Wynn Macau and MGM China, since January. He has a four to five-year time horizon and thinks earnings for these companies could increase significantly.

PAF follows the same strategy as PM Capital's unlisted Asia managed fund, which Bertoli also manages and which has returned 15.5% a year since inception in 2008 (after fees). That compares to only 7.1% for its benchmark, the MSCI Asia (ex-Japan) Index.

PAF incurs a management fee of 1% plus a performance fee of 15% of any outperformance over its benchmark. To compensate, for this, however, investors are getting a 16% discount to pre-tax NTA and a 13% discount to post-tax NTA.

With capable management, PAF offers an attractive means of getting exposure to a portfolio of Asia-focused businesses. Note, however, that the stock is fairly illiquid, so patience may be required when acquiring stock. If a discount to NTA is part of your investment case (as it is here), then you need to make sure you don't compromise on that discount. **BUY**.

Hunter Hall Global Value (HHV)

Currently trading at a 6% discount to pre-tax NTA and sitting level with post-tax NTA, HHV has a portfolio of global stocks (including Australian) that has run away from its global competitors of late.

The cause of the recent outperformance has been the portfolio's exposure to Australian gold producers, which makes us wary, particularly since its previously hefty discount has narrowed. As we explained in ***The truth about gold stocks***, success in this area has more to do with luck than skill.

The gold exposure reflects HHV's bearish view of the world.

'The expectation of rising US interest rates is one of the most anticipated events in the history of financial markets, yet we continue to see violent moves in the US market as the prospects of this reality waxes and wanes on a daily basis. As a contrarian investor HHV seeks to exploit irrational market behaviour and, with a cash stockpile in excess of 20%, we are well positioned to do so. At the same time we maintain solid exposure to the gold price as a hedge against the inherent fragility of financial markets following almost a decade of quantitative easing,' explains deputy chief investment officer Jonathan Rabinovitz.

> **As long-term investors, we welcome periods of volatility as it gives us an opportunity where we can to add to existing holdings of those businesses that we like.**

HHV also promotes itself as ethical and it's the only LIC that does. So if you want to invest in LICs ethically and you agree with HHV about what that entails, then this LIC might still be worth a look despite its relatively narrow discount – particularly if you have a bearish outlook about markets. For most people, though, we'd say the stock is a **HOLD**.

Bailador Technology Investments (BTI)

Bailador Technology Investments is an LIC that invests in unlisted technology companies focused primarily on 'cloud technology' and 'software as a service'. Co-founded by **Trade Me** chairman David Kirk and private equity investor Paul Wilson, the LIC isn't interested in startups, but invests in the 'expansion phase' of businesses. This means it invests in businesses with established revenue streams that are in need of fresh capital to expand.

BTI takes board representation in its investments and contributes its strategic expertise as well as its wide network of connections. Although listed in Australia, BTI's investments are spread across the globe, including its largest investment, Siteminder, a provider of hotel room management systems, which just opened an office in Ireland.

'We have nine investments in our portfolio of well-established technology companies. Our companies are all growing fast and most have extensive international operations. All up our companies employ over 800 people and 58% of their revenue comes from international markets,' says David Kirk.

BTI gives investors an opportunity to access private equity investments but beware – the immaturity of its investments and the fast-changing IT landscape makes it high risk. BTI is currently trading at a 2.8% discount to post tax NTA and a discount of 9.4% pre-tax. Note, however, that there is some subjectivity over the valuation of its investments because all of them are unlisted. **HOLD**.

BKI Investment Company (BKI)

BKI belongs in the same league as the likes of AFIC and Argo, offering diversification among Australian equities, with incredibly low fees, lower even than those charged by most exchange traded funds.

Last week BKI said that, as from November 1, it would switch from being internally managed, where it pays no management fee and employs its own analysts, to an external management arrangement.

This goes against the grain somewhat. As LICs grow bigger it typically makes sense for them to switch the other way. In this case, however, we think it makes sense. BKI is still relatively small (at just below $1bn) and the idea is that outsourcing its management will enable it to get the benefit of an expanded analyst team, while keeping its management expense ratio close to its incredibly low current levels of around 0.16%.

The new management company will be called Contact Asset Management and will be operated by BKI's current chief executive Tom Millner and portfolio manager Will Culbert. Together they will own 80% of Contact, with **Soul Pattinson** owning the remaining 20%. BKI will pay a flat management fee to Contact of a lowly 0.1% of its total assets, with no performance fee.

Reflecting on the portfolio Millner said: 'BKI has been listed for almost 13 years now and has been providing shareholders with an increasing income stream of fully franked dividends and capital growth. While there are some challenges in the economy, we believe the BKI portfolio is well placed to continue to capture income we can pass onto our shareholders. As long-term investors, we welcome periods of volatility as it gives us an opportunity where we can to add to existing holdings of those businesses that we like. We are constantly looking for businesses that offer an attractive and sustainable yield, are well managed, appropriately geared, have a favourable earnings outlook and are appropriately priced.'

Worthy sentiments and, with the current share price standing at a discount to NTA of close to 2% pre-tax and close to a 5% premium post-tax, we recommend you **HOLD**.

Perpetual Equity Investment Company (PIC)

Perpetual Equity Investment Company invests predominantly in Australian listed securities, with 'typically a mid-cap bias', together with 'opportunistic allocations to global listed securities'. Exposure to overseas stocks is capped at 25%, as is exposure to cash, deposits and senior debt.

As the name suggests, the fund is managed by **Perpetual** and specifically by Vince Pezzulo, a senior portfolio manager at Perpetual who is the manager for 70% of its industrial share strategy. Perpetual has a team of six portfolio managers and 12 equities analysts and we have a high regard for its value

> "The portfolio is highly concentrated and has a focus on quality.

investing approach, which has delivered success over many years. Perpetual charges a fee of 1% of net assets each year.

Seeing little value in either 'the yield trade and the very long duration stocks (high PE)', PIC is currently positioned defensively. 'All of our investments have good balance sheets and will be able to navigate their way through any market turmoil,' says Pezzulo confidently.

The largest investments in Australia currently include **Woolworths**, **Suncorp**, **Sky Network Television**, **BlueScope Steel** and **GrainCorp** and at 31 August these comprised 35% of the portfolio's value. The largest overseas holdings are Royal Philips, Icon plc (a Dublin-based global contract research business) and Bank of America, which together account for a further 19%.

Table 2: PIC top six positions at 31 Aug 16

POSITION	GEOGRAPHIC EXPOSURE
WOOLWORTHS	Australia
SUNCORP	Australia
ROYAL PHILIPS	International
SKY NETWORK TV	New Zealand
ICON	International
REALOGY	USA / International

Source: Company reports

No doubt reflecting the difficulty in finding decent businesses at attractive prices at the moment, the fund was 23% in cash at the end of August, meaning that cash and the above investments comprised 77% of the portfolio's value at that date.

PIC no longer has any options overhanging its ordinary shares, which currently trade at a discount of 10% to pre-tax NTA (which it reports daily) and a discount of 9% to post-tax NTA. That's perhaps not quite enough to discount the 1% in annual fees, but we're willing to make allowance for Perpetual's disciplined value investing approach and great track record. With a discount at least in the high single digits, we rate PIC a **BUY**.

Magellan Flagship Fund (MFF)

Not to be mistaken with all of the other Magellan managed funds, this LIC is solely managed by Chris Mackay. He can make use of the research conducted by the investment team at Magellan Financial Group but the buck begins and ends with him.

The portfolio is highly concentrated and has a focus on quality. As he has often explained in his monthly reports, Mackay is reluctant to move into lesser quality businesses to chase short-term returns. He strongly prefers to hold the best quality businesses he can find at any given point in time.

MFF's long-term performance is fair, but it lost around 3% (pre-tax) in the year to August, compared to the MSCI World Index's gain of 1%, with its exposure to financial stocks weighing it down. At the end of August, the fund's top five holdings were Visa, Home Depot, Lowe's, Mastercard and Wells Fargo, which between them comprised half the portfolio's value.

The stock currently trades at a discount of around 12% to its pre-tax NTA and close to par with its post-tax NTA, although these figures move to a discount of around 5% and a premium of around 9% respectively after accounting for option dilution. **HOLD**.

Thorney Opportunities (TOP)

Thorney Opportunities is similar to Bailador Technology Investments, not when it comes to the companies it invests in, but in the way it gives the everyday investor access to something they otherwise would not have and that is a well-regarded activist investor fighting to unlock value.

Thorney is managed by Alex Waislitz who is known for unlocking value in companies in a number of ways. The portfolio is incredibly concentrated with fewer than 10 holdings to its name. In the past year that handful of names has performed well. Among the stocks held are AMA Group, Service Stream and Diversa.

Two weeks ago I sat down with Waislitz and discussed other possible opportunities still within the portfolio. After the video Waislitz stuck around to discuss the outlook for the rest of the portfolio as well (**click here** to be see the video).

The stock currently trades at a discount of around 4% to its pre-tax NTA and a discount of half a percent post-tax. **HOLD**.

Staff members may own securities mentioned in this article.

Australia's big four banks are among the most profitable on earth. This is how they do it.

BY GAURAV SODHI • INTELLIGENT INVESTOR • 4 OCTOBER 2016

Why Australian banks earn so much profit

It is a well-worn argument: Australia's Big Four banks are over-earning and the proof is in their profits. The unsophisticated simply point to the profit number and declare it too large, ignoring the big pile of capital it takes to generate a big pile of profits.

Even if we take a more nuanced approach to measure bank profits – return on equity (ROE) – it seems self-evident that Australian banks over-earn.

ROEs for Australian banks range from over 16% for **CBA** down to 12% for **ANZ**. CBA's ROE is one of the highest in the world and even ANZ, considered the bad boy of Aussie banking, is better than decent.

In comparison, Bank of America (NYSE:BAC) earns less than 6%, Wells Fargo (NYSE:WFC), a key Buffett holding, earns less than 12%; Lloyds (LSE:LLOY) earns 4%. In the rich world, only Canadian banks come close to Australian level returns on equity and they too, operate a cosy oligopoly.

Proof, some say, that banks needs more competition. That might be true but high ROEs alone aren't enough to make the case.

ROE is made of two metrics, the return on assets (ROA) and the amount of leverage carried by banks. Australian banks earn ROA of about 1%, maybe a little higher than most international peers but nothing that screams outright theft.

The key to higher ROE isn't higher interest margins or scandalous fees but the liberal use of leverage. Aussie banks earn more because they are more leveraged than international peers.

Does that make them inherently riskier? Not necessarily.

A key feature of Australian banks is the high proportion of loans made to the residential mortgage sector. Mortgages account for about 60% of CBA's loan book at the top end and about 40% of ANZ's at the bottom. Nowhere else in the world are banks as heavily exposed to residential property.

Less capital needs to be put aside against a relatively safe asset like residential property and higher property prices mean that this is a reliable source – perhaps the sole source – of credit growth. This could be a source of risk in future but, for now at least, residential property is the cash cow of the banking sector.

Because Aussie banks have such large mortgage books they can afford to be more leveraged than just about any bank anywhere. And it is leverage, not scandalous charges, that is the true source of bank profits.

Myer upgraded

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 5 OCT 2016

MYER (MYR) / SPECULATIVE BUY

Price at review	Max. portfolio wght.	BUY Below $1.25	HOLD	SELL Above $1.80
$1.18	3%	$1.18		

With all the 'mid-season sale' signs around Sydney's Pitt Street Mall lately, it looks like retail is going through one of its regular rough patches. In fact we said 'the first quarter of 2017 looks like a difficult one' when reviewing Myer, the department store company, in ***Myer: Result 2016*** last month.

We usually encourage buying on bad news, but poor market sentiment runs a close second. While Myer's turnaround will be lengthy and the stock remains speculative, there's a decent probability that profit growth beyond 2017 will be stronger than the market expects. With the stock trading on an enterprise value to operating profit before interest, tax, depreciation and amortisation multiple of under five times, you're not paying for much upside. **SPECULATIVE BUY**.

Staff members may own securities mentioned in this article.

Do II portfolios offer good value?

With II's advent of the SMAs as a way of effectively investing in either, or both of the portfolios you now manage with actual cash, it got me thinking about the inherent current value of the portfolios. Do the current portfolios represent "good value" at this stage of the investment cycle particularly given we are 7 years into a bull market (at least in the US)? I note that quite a few fund managers (Geoff Wilson and Steve Johnson to name two) are holding between 25% and 35% cash and many commentators seem concerned about property and shares being at the very least being fully valued. So: (1) are the portfolios good value at the moment? (2) If you were starting afresh would the same stocks, with the same percentages, be chosen to be in the portfolios and would you consider holding more cash than they currently do? (3) Which do you think would be the better placed portfolio to weather an Australian recession?

4 Oct 2016 – **James Carlisle**: Great questions. On the whole my aim is to keep the portfolios pretty close to fully invested for the reasons given in **this article**. The trouble with holding cash is that over the long term it has been shown to underperform shares (and other real assets) and for good reason. If cash outperformed the real economy, the latter would eventually be unable to generate the money to pay the interest on it. I'm confident that over 100 years the Aussie sharemarket will outperform cash from where it is now, and I'm confident that both the II portfolios will do likewise; and if you think shares will outperform over 100 years, then the odds favour them over periods of 1 year, or even 1 minute. So it seems to me that by holding cash (as an investment, rather than money needed for spending and emergencies) you are to some degree trying to time the market. I don't rate my chances of doing that, so I simply try to ensure that when the market makes its upwards moves, 'I am caught with my pants up'.

Of course if we ever think a stock offers lower expected returns than cash, then we'll say sell it and sell it from the portfolios. So to answer your first question, yes, I think they are good value at the moment, compared with the alternatives. That's not to say they haven't offered better value and won't do so in future, but I don't think that's something we or anyone else can predict.

As to your second question, the aim of portfolio management is to have your money invested in the most undervalued stocks you can find at any point in time, subject to having an acceptable degree of diversification and not incurring too much cost from trading too much. The latter point does introduce a degree of friction, so that the portfolio will never look exactly as it might if we were starting again from day one, but that will always be the case with any portfolio. If you compare the portfolio with our recommendations and price guides, though, then you'll see that it generally comprises stocks that are Buys, or close to our Buy prices. There are some that we're letting run a bit further than that, but these are generally at the higher end of the spectrum, where our price guides are perhaps more likely to lag a little. So the stocks and weightings are a little different to what I'd pick now, but only by a little and the difference is likely to be lost in the wash – I would not be confident that a portfolio picked today would necessarily beat the ones we've already got. Also, as explained above, we wouldn't hold more or less cash if we started today.

I can't really provide an answer to question three. Of course there's quite a lot of overlap – the main differences being that the Equity Income Portfolio holds some banks and property trusts (ie ALE and HPI), whereas the Grown holds a few more speculative, growthy situations, like iCarAsia (which is looking highly speculative but not very growthy at the moment!), Nanosonics, Amaysim, Fleetwood and Hansen. On the face of it, then, the Growth Portfolio carries more risk, but I'm not sure you can stretch that to saying it's less likely to do well in a recession. Those are individual stocks and they could power along while more mainstream situations like banks and property trusts falter.

Agriculture sector

I know you get the Agricultural stocks question every now and then. Would it be possible to ask for a sector review - it would be informative to know your thoughts on the fundamentals and reasons why not to go into the sector (if you think it lacklustre). Surely it's time again? I am particularly interested in the fundamentals and value behind Nufarm (NUF).

5 Oct 2016 – **Gaurav Sodhi**: Ag is hard. Cycles are typically short because prices influence production and supply decisions with short lead times (unlike mining) so the opportunity to profit from cycles is lower in the sector. There are those who think there is a structural change in demand but there is ample room to lift supply so I'm not a price bull over time. We're unlikely to cover the sector in any detail simply because it isnt prospective enough. Nufarm is one of the better businesses in the sector and has some undeveloped property that might be worth something but, again, doesnt look cheap or interesting enough to allocate research time at this stage.