

Quarterly **Review of funds**

Hot stocks are getting harder to pick

Australian equities

Peter Wells

The resumption of more normal market conditions might be welcomed by investors who have been buffeted by 12 months or more of volatility, but gains will be harder to come by from here.

While broader systemic and economic concerns pounded shares on the way down and the alleviation of those worries prompted the broader market to rally, investors expect it is now time for stock-specific news to come to the fore. It is, as they say, a stock-picker's market.

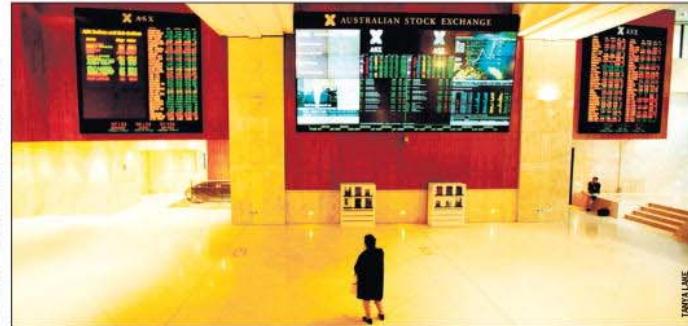
The S&P/ASX 200 Index rose 19.9 per cent in the September quarter – its biggest quarterly leap since the index was created in 1992. The broader All Ordinaries index rose 20.05 per cent in the same period for its best quarterly performance since a 27.4 per cent rise in the September quarter of 1987.

The average return for Australian long-only funds in the September quarter was 22.3 per cent, says Mercer Consulting.

Ranking first out of 112 funds in the three-month period with a 32.4 per cent return was the Continuum Aggressive fund, which also made its first appearance in the Mercer tables. Placed 112th with a return of 16.5 per cent was JM Asset Management-TPS Growth.

Australian shares managed to string together two consecutive quarters of gains but in doing so have pulled the market back to roughly the same level it was a year ago, just before global sharemarkets took a turn for the worse.

But for all the woe at the time, fund managers appear to be sitting



Stock selection is critical. Differences in valuation are not as great as they were.

pretty a year on. In the 12 months to September 30, the S&P/ASX 200 edged 3.11 per cent higher.

This compares with the median return for long-only fund managers of 13 per cent.

Out in front over the year is the UBS Australian Share fund, with a return of 25.7 per cent. MIR Investment Value was last (102nd) with a loss of 3.3 per cent. MIR and Challenger Select Australian Share are the only two funds with negative performances over the past year, Mercer says.

UBS was ranked sixth during the September quarter with a return of 25.7 per cent.

UBS's head of Australian equities, Simon Shields, says the year to September was one of two halves.

How they rank

Best performing long-only Australian share funds in the September quarter (%)	
Continuum Aggressive	32.4
UBS Australian Equity HALO	32.2
Orbis/SM Australian Equity Fund	32.0
Legg Mason Australian Value Equity	31.5
Dimensional Australian Value	29.6
UBS Australian Share Fund	27.5
Schroder Australian Equity Opportunities	27.2
Schroder Australian Equity	27.0
Concord Capital Australian Equities	27.0
Hyperion Australian Growth	26.6

SOURCE: MERCER CONSULTING

During the downturn the fund "had enough exposure to those defensive companies that people were seeking protection in".

Such stocks, labelled "expensive defensives", were then shunned

from March onwards as glimmers of hope began to appear in markets and the economy, and investors jumped into stocks with greater leverage to an improving economy that had been beaten to cheap levels.

Tide turns in the pursuit of value

Small caps

Brendon Lau

Small cap fund managers had little problem outperforming the benchmark in the September quarter, although microcap managers got an edge over their peers this time around.

Investment firm Mercer says microcap funds that invest outside the S&P/ASX 300 Index turned in the best performance with an average return of 32.4 per cent for the period, compared with their counterparts that invest outside the top 100 and top 50 indices.

These small cap funds turned in gains of 26.3 per cent and 24.7 per cent, respectively, while the S&P/ASX Small Ordinaries gained 21.8 per cent.

In the June quarter, all three classes underperformed the Small Ordinaries, as most small cap fund managers were initially reluctant to believe that the market had finally turned after months of panic selling.

But microcap fund managers may have had an unfair advantage in recent months, says Noel Webster, portfolio manager for BT Wholesale MicroCap Opportunities – the top-rated fund for the quarter with a return of 47.7 per cent.

"The money takes a while to make it down to the microcap end of the market after the market recovers.

So you tend to find there are a lot of stocks down there that got missed [as the market rebounded]," says Webster. "We typically try to avoid being thematic."

"I think [our outperformance] is probably due to our disciplined approach and style to pick high-quality businesses that have genuine earnings."

Stocks that helped lift the fund to the top of the league table include luxury brand retailer Orotan Group, RCG Corporation (owner of The Athlete's Foot sports chain), and accounting software distributor Reckon.

However, anticipating a trend can also prove to be very rewarding, notes Macquarie Funds Management portfolio manager Neil Carter. The Macquarie Australian Microcap fund took second place with 44.5 per cent return in the three months to September but was ranked No. 1 over a nine-month and one-year period.

"We have been deliberately exposing ourselves to importers that would benefit from the strong Aussie dollar," says Carter. "We had anticipated that coming through."

These importers include household and beauty products supplier McPherson's and women's apparel retailer Specialty Fashion Group.

"We also had some good stories in the resources area, like Galaxy Resources, which is one of the

Small funds, big return



leading lithium plays in the world. Lithium is one of the ways you can get exposure to electric cars and the whole thematic of batteries," he says.

"The final thing that differentiates us from the retail investor is placements."

"There have been some good money-making opportunities here and we have access to all the capital raisings, whereas the retail investor normally only has access to a relatively small portion of those."

While Carter believes larger companies have generally raised sufficient capital, he is anticipating a lot more raisings in the smaller end of the market over the next 12 months.

"We are engaged in what I call a relentless pursuit of value. When something moves up into more than 12 or 13 times [price-earnings ratio], we recycle that cash and spin down to low P/E stocks," says Carter.

"This will ensure the portfolio is trading at a healthy discount to the market."

Challenges of reinvestment

From page 1

Planners say any decision about the use of geared funds will depend on an investor's view on the direction of markets, and their inclinations on risk.

Leslie does not recommend gearing levels of more than 50 per cent, and suggests a lower level for those nearing retirement.

While median returns for hedge funds might look appealing, there is far greater variation across returns, risk and strategies, compared with equities.

Investing in hedge funds is less about timing and more about understanding the strategy and skill of the manager. For example, long-biased equity funds using little short selling tend to have performance which is positively tied to rising equity markets. Yet many market-neutral funds – those with no net

Small companies are more leveraged to the overall market than large cap share funds.

Symon Parish

market exposure – tend to perform better in volatile markets and underperform when markets rally.

Fortitude Capital managing director John Corr says investors should seek funds which are true to their strategy and have demonstrated they can genuinely "hedge" against losses in a downturn.

"Because many hedge funds are

"In every sector there were stocks that were very good-quality companies that the market had marked down too much, and a good example of that is Westfarmers," Shields says.

Having raced past 4900 points in mid-October, the market has since pulled back and is experiencing what some describe as a consolidation phase around 4700.

AMP Capital Investors thinks the cyclical rally still has some way to run, while Credit Suisse takes a similar line and considers the economic recovery hasn't been priced into industrial stocks as fully as it has for banks.

Although the market looks "moderately attractive by historical standards", the opportunity to ride on the coat-tails of the economic recovery has largely gone, Shields says.

"There are still opportunities, but they are much less stark than what they were. There is much less dispersion between cheap stocks and expensive stocks now than there has been at any time over the past 12 months," he says.

"It's not clear-cut like it was and the differences in valuation are nowhere near as great as what they were, either. Stock selection is going to be the key now that the macro-economic differences are much less."

Companies that Shields thinks have very strong outlooks include retailers David Jones, Billabong, transport companies Toll and Qantas, News Corp in media and James Hardie in building materials.

Among financial stocks he likes Commonwealth Bank of Australia and also Axa, which has since become the subject of an \$11 billion takeover offer from AMP.

pitched at sophisticated [self-managed super fund] investors, they don't need the same level of disclosure and all the usual protections for retail investors may not apply," Parish says.

Other strong fund performers include small cap funds. While the strong run in small caps is expected to moderate, few are predicting a nosedive in performance, given that the outlook for small companies is linked to the general economy.

Parish says small companies are more leveraged to the overall market than large cap share funds. "If market keeps going up then small caps are not overvalued, but if it goes down they will fall by more." He retains a slight overweight to the sector.

Higher yields on debt and bond funds has seen the popularity of these lift in recent months, although funds with a high exposure to mortgage-backed securities or complex debt have lost over the year.

Leslie recommends a portfolio allocation of up to 15 per cent in fixed interest or bond funds, while Boubouras says corporate investment grade corporate bonds represent a strong opportunity with yields of more than 2 per cent above the cash rate.

While pure high-grade bond funds can deliver modest low-volatility returns for conservative investors, some financial planners note other debt funds mix a range of securities with risks which can be difficult to understand.

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