31 Jul 2019

InvestSMART Ethical Share Fund

Monthly update

PERFORMANCE TO 31 JUL 2019 (AFTER FEES)	1 MTH	3 MTHS	6 MTHS	1 YR	S. I.
InvestSMART Ethical Share Fund	1.9%	N/A	N/A	N/A	0.7%
S&P ASX 200 Accumulation Index	2.9%	N/A	N/A	N/A	4.3%

'Opportunity is missed by most people because it is dressed in overalls and looks like work.
– Thomas Edison

'Investment returns are never guaranteed, but by investing in line with my values, I know I won't regret my choices.'
– Seth Goldman

'A safe investment is an investment whose dangers are not at that moment apparent.'
– Lord Bauer

All eyes were on the central banks this month with the US Federal Reserve reducing the official interest rate for the first time in a decade to 2.25%. The RBA acted earlier in the month, reducing Australia's official interest rate to just 1%.

While these moves have helped calm markets, including Australia's highly indebted housing market, we don't expect history will be kind to those who've thrown the kitchen sink at the economy in the name of growth.

Recessions are the market's healthiest way of purging bad behaviour and eliminating poor businesses. This ensures that savers and investors earn a decent return for taking risks to improve productivity. Mild but regular recessions also help prevent risky behaviour from compounding to extremes that put the financial system at risk, as we saw during the GFC.

Central banks have all but declared that recessions are no longer acceptable and can be avoided with low interest rates and extreme measures such as quantitative easing. For investors that have lived through various cycles and don't believe in the invincibility of some well-paid academics that have never managed money for a living, this creates a treacherous backdrop.

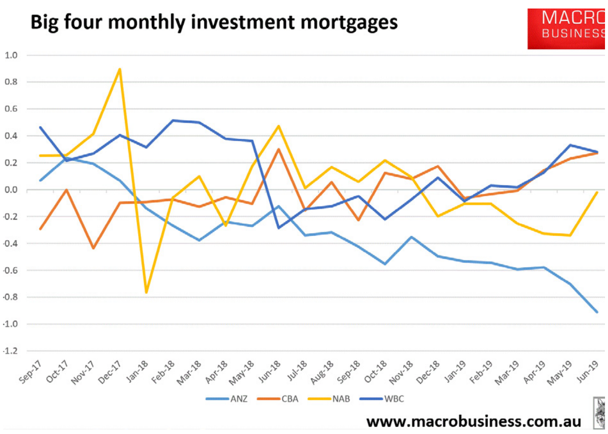
While it makes it harder to find great opportunities, our job is to follow William Arthur Ward's advice; 'The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails.'

This means not taking large risks, sticking to quality, backing intelligent entrepreneurs with skin in the game and waiting patiently for opportunities. As we know from experience, that combination will eventually provide material outperformance.

Aussie housing market

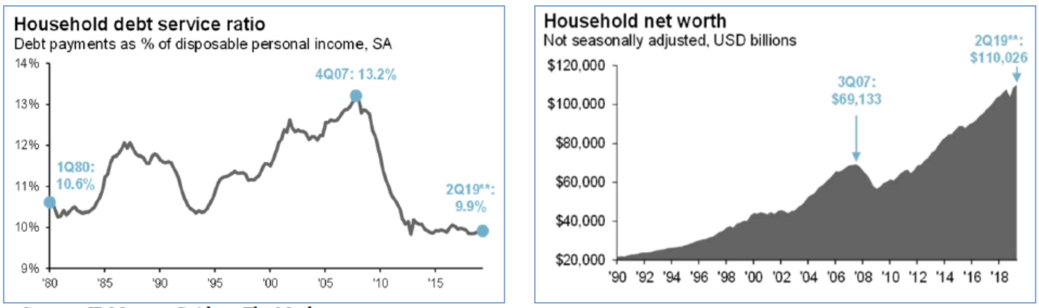
While Australia often has an unhealthy obsession with property, its importance to the economy can't be underestimated. Although housing prices have started ticking up, recent results from Domain and REA Group suggest it reflects a shortage of properties rather than another property boom. Investors set marginal property prices, and so far they're conspicuous by their absence (see Chart 1).

Chart 1



Despite the RBA's and Scott Morrison's attempts to encourage people to take on more debt, it seems Australians are tapped out. Woolworths Holdings, a South African company that acquired David Jones five years

Chart 2



Source: JP Morgan Guide to The Markets

ago, has just written off $437m of its $2bn investment blaming it on a 'retail recession' in Australia. While it also reflects the decline of department stores, we expect you'll hear more stories like these over the next few years as many Australians focus on reducing debt. A drastic fall in construction jobs won't help.

While Australia has its challenges, the US economy is in reasonable shape (see Chart 2 – last two charts side by side in the article). Household debt repayments are low, and the US housing market has barely recovered to levels consistent with the troughs of previous cycles.

Lastly, while the market is currently herding into stocks offering perceived safety or rapid revenue growth, at some point the momentum will shift to stocks offering more value (see Chart 3).

While the major Australian indexes have been exceptionally strong this calendar year, the performance has been dominated by Australia's biggest stocks due to a combination of investors chasing yield and high iron ore prices.

Most of the rest of the market has been left behind, particularly smaller companies that aren't sharing the spotlight with rapidly growing technology stocks. That's left our portfolio with a bunch of names that offer plenty of potential when Mr Market focuses more on valuation.

Portfolio – Resmed

When we added **Resmed** to the portfolio we would've been happy to earn 10% per year over a long period, as increasing obesity and poor health increase the number of patients suffering sleep apnoea. After announcing its latest results, the share price is now up 14% since our purchase.

The results were good, but not great. While there's potential in its shift to more digital and home care services, at best success will take time.

Chart 3

Resmed's stock price is a microcosm of the market more generally, where expensive stocks keep getting more expensive while cheap stocks like CYBG mentioned below keep getting cheaper.

In the short-term price-to-earnings ratios (PERs) are only limited by the market's imagination, but eventually they're more closely tied to operating performance i.e. we can't expect higher and higher PERs to keep delivering such high returns.

Frontier Digital Ventures

Frontier Digital Ventures also reported an excellent set of numbers. Its largest investment, a 30% stake in Zameen – Pakistan's version of realestate.com.au – continues to grow rapidly. Revenue increased 120% in local currency in the first half of this year compared to a year earlier producing the company's inaugural profit at the EBITDA (earnings before interest, tax, depreciation and amortisation) level.

Next year is a pivotal year for Zameen and Frontier Digital. Assuming revenue continues to grow rapidly, Zameen should produce its first free cashflow as profits take off. Once online classifieds businesses have clear market leadership and are profitable, they require very little reinvestment as network effects grow stronger and increase the barriers to entry.

What Zameen's management decide to with the company's cash will be a test of Frontier's model of backing local management with minority shareholdings. With so many respected and experienced industry veterans involved in different capacities with the company we expect a good outcome that could eventually lead to Zameen listing via an IPO.

Clydesdale Bank

Clydesdale remains in the sin bin after reporting numbers at the low end of guidance. We weren't expecting good numbers, but more sell side analysts have been slashing their valuations to a range of $3 to $4. Management stuck with its full year guidance, but there's a clear risk of falling short. Particularly if UK prime minister Boris Johnson pursues a hard Brexit.

While writing this update, I received a question from an investor, questioning why we would own Clydesdale (and Link Services and Unibail Rodamco Westfield – see below) when their share prices are falling and their respective futures look so bleak.

In a portfolio of over 20 stocks we'll always have some doing well, some doing poorly and a bunch doing nothing. Usually even the great investors only get 60% of calls right, but I'd also point out the three stocks haven't been in the portfolio long, and we buy stocks with a three to five-year view.

You also can't have good news and cheap share prices. It's one or the other. And it's our long-term approach and ability to suffer through and take advantage of bad news that gives us an edge over the market.

"NEXT YEAR IS A PIVOTAL YEAR FOR ZAMEEN AND FRONTIER DIGITAL. ASSUMING REVENUE CONTINUES TO GROW RAPIDLY, ZAMEEN SHOULD PRODUCE ITS FIRST FREE CASHFLOW AS PROFITS TAKE OFF.

Unfortunately, that means owning some stocks whose share prices go down, either temporarily or permanently, which is why so few people ever get rich on the sharemarket. They simply can't stomach share prices falling. Recalling Mike Tyson, who said everyone has a plan until they get punched in the face, many people pretend to be long term investors until they bail at the first sign of problems.

Admittedly, the performance of the fund has been poor recently. But I believe that's been due to a lack of fresh ideas, which we're busy fixing as you can see from the new stocks being covered on the Intelligent Investor website.

The operating trends for these three companies are currently poor, but that's why they're potentially cheap. Duffy's strategy at Clydesdale will take a couple of years to impact profitability and an ugly Brexit and recession could make things much worse for Clydesdale before they get better.

But at 0.5x book value and a strategy that should produce a 10% return on equity in two to three years at the very least (management is targeting 12% or more), which would put the shares on a forecast dividend yield of 10% in 2022 based on the current share price, for now we're hanging on. As always, we reserve the right to change our mind at any time.

Lastly, it's important not to get frustrated following one or two poor performing stocks. Even if Clydesdale's share price halved from here, it would only cost the portfolio around 1.5%. Yet if the share prices of Frontier Digital and 360 Capital doubled over the next few years, it would add 8%. It's easy to get gloomy, but as Benjamin Graham warned, 'To be an investor you must be a believer in a better tomorrow.'

Unibail-Rodamco-Westfield

Make no mistake, the retail property industry is facing its biggest test since Victor Gruen, an Austrian-born architect who emigrated to the US, designed the first outdoor suburban shopping plaza near Detroit in 1954. Lower prices for many goods and services, rapid growth in online shopping, and high rents are conspiring to send many retailers bankrupt.

The Lowy family, which started building the Westfield empire over 50 years ago, saw the writing on the wall and sold its flagship stores to French shopping centre owner **Unibail** last year. Unibail's share price has fallen by a third over the past year after announcing a major profit downgrade. In the short term we're not expecting much good news, as the trends mentioned above are only gaining strength. But Unibail is adapting.

The company's latest half-year result provides plenty for bulls and bears. The company has sold €3.2bn of property at a premium to book value to reduce debt and is now half way through its list of sale candidates totalling €6bn.

While we take the massive gap between the company's net tangible asset value (NAV) and share price with a grain of salt – if NAV were reliable the entire portfolio should be sold to realise a profit of over 50% – it does provide a margin of safety against lower property values. This would happen if vacancies increase, lease rates fall and/or interest rates increased. We note NAV fell slightly in the half year result.

We currently estimate that flagship stores, like the huge Westfield centres that dominate the CBD's of Sydney and Melbourne, for example, constitute 85% of the company's portfolio. But that figure should increase over time as lower quality centres are sold and the company's €10.9bn development pipeline takes shape.

This is extremely important, as the recent performance of Unibail's flagship stores has been good, while the rest are struggling and will be hard to sell at a premium. For the first half ending in June, for example, net income increased in 2.2% in the US but the figure was 5.5% for flagship stores. The UK was also a sore point, with sales falling 6.3% mainly due to Westfield London.

The sooner the company jettisons its lower quality stores across the globe the better, and conditions may not get better than right now while interest rates are low, and credit is flowing easily.

Management highlighted the 'strong impact of the deliveries of the Tesla Model 3'. Sales across the Continental European portfolio would've only grown 2.9% without them, compared to the 4.9% reported.

On the plus side, it shows Unibail is adapting by introducing new retailers. Tesla stores are also bound to attract inquisitive shoppers. But on the flipside, you don't buy Tesla's every week or every month. Perhaps in future we'll see many more auto companies selling their wares, like Range Rover does in Westfield Bondi Junction.

Management has reduced its development pipeline by 10%, is building more office and residential property and signing up many new retailers to replace obsolete offerings. It appears to be doing a decent job of transitioning the business, but life isn't going to get any easier. Management increased its forecast annual distribution by €0.30 to €12.10 to €12.30 for a current yield over 8%, but it was only due to cheaper borrowing costs.

Only those with premium property have a chance of avoiding the fate of UK shopping centre owner and victim Intu. Its share price fell 30% after reporting an 18% fall in rental income, as its lower quality assets and high debt levels magnified the problems.

Over time property values in major cities will increase and landlords like Unibail have more options to redevelop shopping space than many doomsdayers predict. But the transition is not without risk and will be bumpy. We expect Unibail to survive and prosper given its first-class property portfolio.

Portfolio allocation

ASSET ALLOCATION

Sector	Weighting
Cash	27.6%
Industrials	14.6%
Information Technology	14.5%
Communication Services	13.1%
Financials	10.2%
Real Estate	7.3%
Health Care	6.9%
Consumer Discretionary	3.9%
Consumer Staples	1.9%

TOP 5 HOLDINGS

Security	Weighting
Frontier Digital Ventures (FDV)	4.2%
Carsales.Com (CAR)	4.1%
360 Capital Group (TGP)	3.9%
Audinate Group (AD8)	3.6%
Unibail-Rodamco-Westfield (URW)	3.4%

Performance numbers exclude franking, after investment and admin fees; excludes brokerage. All yield figures include franking. All performance figures, graphs and diagrams are as at 31 Jul 2019. Performance figures are based on the portfolio's previous investment structure, a Separately Managed Account (SMA). This portfolio is now offered as a Professionally Managed Account (PMA), as of 1 November 2018. The underlying securities remain the same between the SMA and PMA structures. The inception date refers to the SMA. Please see the Investment Menu for full PMA fee details.

Skin In The Game podcast

Join portfolio managers Nathan Bell and Alex Hughes weekly as they discuss stocks, economics, their respective portfolios and much more.

InvestSMART Group Limited (INV)

was founded in 1999 and is a leading Australian digital wealth advisor which has over 32,000 clients and over $1.4B in assets under advice. InvestSMART's goal is to provide quality advice and low cost investment products, free from the jargon and complexities so commonly found in the finance industry, to help you meet your financial aspirations.

The Portfolio

The InvestSMART Ethical Share Fund is a concentrated portfolio of 10 – 35 Australian-listed stocks. The Fund invests in a diversified selection of Australian companies that produce growing, sustainable profits at low risk of interruption from the increasing threats associated with Environmental, Social and Governance (ESG) factors and financial criteria to achieve medium to long-term capital growth. This is available as a listed fund (ASX code: INES)or as a separate account through the PMA.

Investment objective

The Portfolio's investment objective is to produce a sustainable income yield above that of the S&P/ASX 200 Accumulation Index.

Why the InvestSMART Ethical Share Fund?

Australia has one of the world's most stable and highest returning share markets and is often considered a safe-haven by investors. Using a negative screen, the InvestSMART Ethical Share Fund protect against increasing risk from threats from environmental, social and governance (ESG) factors. As value investors, producing safe and attractive returns in the stock market means sticking to a disciplined and repeatable process. We do this by waiting patiently for overreactions in share prices, so we can buy at comfortable discounts to intrinsic value.

Who manages the investment?

Nathan Bell, has over 20 years of experience in portfolio management and research and is supported by our Investment Committee, chaired by Paul Clitheroe. Before returning to InvestSMART in 2018 as Portfolio Manager, he was the Research Director at our sister company, Intelligent Investor for nine years which included over four years as Portfolio Manager and being a member of the Compliance Committee. Nathan has a Bachelor of Economics and subsequently completed a Graduate Diploma of Applied Investment and Management. Nathan is a CFA Charterholder.

Key Details

INVESTMENT CATEGORY
A portfolio of individually-selected Australian Equities

INVESTMENT STYLE
Active Stock Selection, Value Investing Approach

BENCHMARK
S&P/ASX 200 Accumulation Index

INCEPTION DATE
1 July 2019 for the PMA
12 June 2019 for the Listed Fund

SUGGESTED INVESTMENT TIMEFRAME
5+ years

NUMBER OF SECURITIES / STOCKS
10 - 35 stocks

INVESTMENT FEE
0.97% p.a.

PERFORMANCE FEE
N/A

MINIMUM INITIAL INVESTMENT
$25,000 for the PMA
$1 for the Listed Fund

PORTFOLIO MANAGER
Nathan Bell, CFA

Important information

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