December 2020

# Top 3 stocks for 3 years

Fifteen stocks to help you protect and grow your portfolio

INTELLIGENT INVESTOR

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## About Us

With a 20-year track record of beating the market, clear and straightforward language, and an 'open book' approach to stock research and analysis, *Intelligent Investor* offers actionable, reliable recommendations on ASX-listed stocks.

In 2014, *Intelligent Investor* became a part of the InvestSMART family, extending our expertise to even more Australian investors seeking quality analysis and advice.

## About the author

John Addis founded *Intelligent Investor* in 1998. Having returned as the editor of *Intelligent Investor* after selling the business in 2004, John now gets to indulge his favourite interests: the shape and form of words; investing psychology; the odd, fascinating and frustrating world of macroeconomics; and great stock opportunities.

## Important information



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# Part 1
# Top 3 stocks for 3 years

**Part competition, part education and always lots of fun, here's the round-up from our fifth 'Top 3 for 3' contest.**

**JOHN ADDIS** • First published online 30 Nov 2020

The top 3 for 3 competition, the first iteration of which started in 2008, was always intended as a bit of fun. Why? Because its central tenet – that choosing just three stocks and holding them for three years, with no averaging down, no profit-taking and no switching – is utterly unrealistic.

### Table 1: Previous contests

| CONTEST | | | II AVG TOTAL RETURN | ALL ORDS ACCUM. INDEX |
|---|---|---|---|---|
| 2005–08 | Selections | Results | (4%) | (8%) |
| 2008–11 | Selections | Results | 69% | 39% |
| 2011–14 | Selections | Results | 58% | 43% |
| 2014–17 | Selections | Results | 55% | 25% |
| 2017–20 | Selections | | 20% | 24% |

The inspiration came from all the new year media articles that ask assorted luminaries to nominate their top picks for the year ahead. Being deeply uncomfortable about picking a solitary stock, and even more so about holding for only a year, we usually declined media invitations. Eventually, they stopped asking.

Not wanting to be killjoys, we came up with our own version of the same thing – with fewer shortcomings but the same capacity to embarrass, as you'll soon discover.

None of us would ever recommend a portfolio containing just three stocks; nor would we recommend a holding period of just three years. But the silly season gave us our excuse. The opportunity to reveal to members a little more about our investing predilections (there is no obligation to include stocks that we formally cover) was an added bonus.

### Table 2: Stock performance

| COMPANY | RETURN |
|---|---|
| Frontier Digital (FDV) | 184% |
| iCar Asia (ICQ) | 128% |
| Wesfarmers/Coles (WES/COL) | 75% |
| Trade Me (TME) | 52% |
| TPG (TPG) | 46% |
| Academies Aust (AKG) | 28% |
| Class (CL1) | 23% |
| **All Ords Accumulation Index** | **24%** |
| **II Average** | **22%** |
| United Overseas (UOS) | 21% |
| Virtus Health (VRT) | 18% |
| News Corp (NWS) | 17% |
| 360 Capital (TGP) | (7%) |
| FSA (FSA) | (16%) |
| Redflex (RDF) | (17%) |
| Thorn Group (TGA) | (59%) |
| amaysim (AYS) | (62%) |
| MMA Offshore (MRM) | (86%) |

The results that follow shouldn't therefore be taken too seriously. If you are to judge us – as you should – our model portfolios are a better guide, not just because they overcome the limitations of this competition but also because they remove the incentives the rules encourage.

With a three-stock portfolio, a three year holding period and a desire to win, there's every temptation for an analyst to chance their arm, not that everyone does.

In the results from our **2014 competition**, which delivered a return more than twice that of the market, that temptation was largely resisted, with picks including **ResMed**, **Computershare**, **Trade Me** and **Perpetual**.

But three years later, in the competition most recently closed, a little more risk was taken with more stocks members may not have heard of. No doubt that adds interest, but it also may have contributed to a greater variance in results – as detailed in Table 2.

Unfortunately this most recent competition is also the first in five where we haven't beaten the index. Picking small, volatile stocks had to hurt eventually and this period was it.

At the close of the last competition in 2017, the top performer – **Hansen** – returned 136% and the worst – **Techniche** – fell 38%. At the close of this competition, Frontier Digital rose 184% while MMA Offshore plummeted 86%. In 2017, there were two stocks that suffered negative returns but this time around there were six.

### Table 3: Analyst rankings

| ANALYST | TOTAL RETURN |
|---|---|
| James Carlisle | 75% |
| Nathan Bell* | 67% |
| James Greenhalgh | 48% |
| Graham Witcomb | 18% |
| Alex Hughes | 7% |
| Mickey Mordech* | (3%) |
| Gaurav Sodhi | (55%) |

***Only in the competition for two years**

It is tempting to think this is due to a decline in the quality of the companies selected but is again more likely due to the nature of the beast. These companies are inherently more volatile. Some years these stocks will collectively perform far better than the benchmark index and at other times will perform far worse.

The same is true of the individual analysts' portfolios (see Table 3). It's notable, for example, that James Carlisle who topped this year's contest came second from bottom in the last one, and that Gaurav Sodhi, who came bottom in this one was the victor last time around.

It's the nature of investing that we have good spells and bad, and this is amplified by the three-stock limit and the inability to correct mistakes by adjusting the holdings.

With that in mind, let's hear from the analysts themselves about the performance of their selections. In Part 2, we'll then reveal their picks for the next contest.

## James Carlisle

### Carlisle's Crackers

| STOCK (ASX CODE) | PRICE AT 23/11/17 | PRICE AT 20/11/20 | DIVS | TOTAL AT 20/11/20 | TOTAL RETURN |
|---|---|---|---|---|---|
| Trade Me (TME) | $4.23 | $6.06 | $0.38 | $6.44 | 52% |
| TPG (TPG) | $5.71 | $7.71 | $0.60 | $8.31 | 46% |
| iCar Asia (ICQ) | $0.18 | $0.41 | $0.00 | $0.41 | 128% |
| **Average** | | | | | **75%** |

We can only imagine what might have been with **Trade Me**, **taken over** at $6.06 in May 2019 for a gain of 52%. But with **REA** and **Carsales** almost doubling since that deal was agreed and **Seek** rising a bit over 50%, who knows what Trade Me might be worth now. As we **wrote at the time**, Trade Me was being stolen from us just as it was getting interesting – and it still smarts a bit.

**iCar Asia** has almost trebled since then, although its gain for the contest is a more muted 128%. It has also attracted a bid, although in this case it's still in its early stages and, at 50 cents, is at a higher price than the shares currently trade.

This one's also bittersweet because, after averaging down and ending up with too much of it, I was shaken out in April last year after it had recovered from a sharp fall. I've missed out on a double since then, but it's been a valuable reminder of the difficulties of small-cap investing and of the importance of keeping weightings low.

There's less information around with small caps, so you're always wondering if the market knows more than you do. That can lead to panicked decisions – particularly if you're overexposed. The moral, for me at least, is to stick to simple, high-quality businesses, which are less likely to throw up surprises – and not to get greedy.

To complete the trifecta, **TPG Telecom** has also been involved in M&A, with its merger with Vodafone **finally going through in July**. It had been touch and go for a while, with the ACCC trying to block the creation of the only real prospect for a serious competitor to Telstra and Optus. Eventually, **sanity prevailed**.

## Nathan Bell

### Bell's Bangers*

| STOCK (ASX CODE) | PRICE AT 23/11/17 | PRICE AT 20/11/20 | DIVS | TOTAL AT 20/11/20 | TOTAL RETURN |
|---|---|---|---|---|---|
| **Frontier Digital (FDV)** | $0.50 | $1.42 | $0.00 | $1.42 | 184% |
| **Class (CL1)** | $1.77 | $2.08 | $0.10 | $2.18 | 23% |
| **360 Capital (TGP)** | $0.97 | $0.81 | $0.09 | $0.90 | (7%) |
| **Average** | | | | | **67%** |

*** Only in competition for two years**

I've been a shareholder in **Frontier Digital Ventures** (FDV) since it listed in 2016. FDV is typical of many great performing stocks, where not much happens for a long time and then huge returns come very quickly.

The company had been flying under the radar but several positive developments this year have attracted a few respectable local fund managers to the share register. First, FDV's South American competitor waved the white flag, agreeing to buy FDV's share of the combined business over the next three years.

Behind the deal was global Internet juggernaut Naspers, based in South Africa. Naspers owns the 70% of Zameen (Pakistan's equivalent of realestate.com.au and the jewel in FDV's portfolio) that FDV doesn't own.

With most of its portfolio companies now turning a profit, FDV itself is now profitable. It was this that attracted fund managers to the register and I expect more will soon follow. This company is still in its infancy, which is why it's my number one pick in the next three-for-three competition as well as the top performer from the competition just finished.

The sleepy share price of **360 Capital** belies management's furious activity this year. New funds have been launched, including several listed on the ASX and more senior executives with excellent track records have joined the company. Both moves have helped diversify the business and reduced the reliance on the chief executive and largest shareholder, Tony Pitt.

It's hard to believe that the share price is trading below the company's net asset value when so much value has been added through the funds management business. This surely isn't reflected in the company's accounting value, which is growing through an intelligent share buyback.

360 Capital is one company that would have benefited from a deep, Covid-induced recession. The company is loaded with cash and Pitt is both contrarian and conservative. A property market collapse would have been a great buying opportunity. Instead, lower rates and government stimulus kept things moving. But I'm still backing Pitt to find some bargains.

As with FDV, I eventually expect the market to take notice. 360 Capital pays close to a 5% dividend yield, which is decent compensation while we wait.

SMSF company **Class** is another highly profitable business with a share price that had gone to sleep after the market dumped it for faster-growing technology and software stocks. Now that the potential growth in the company's new family trust product has been better understood, the price has rebounded from its lows.

Assuming some decent growth in this new product over time, fair value could lie somewhere between three and four dollars a share. With new management, a host of senior executive hires, a fortress balance sheet, a highly profitable software business and good growth prospects, it's a key holding in our portfolios.

## Gaurav Sodhi

### Sodhi's Stockpile

| STOCK (ASX CODE) | PRICE AT 23/11/17 | PRICE AT 20/11/20 | DIVS | TOTAL AT 20/11/20 | TOTAL RETURN |
|---|---|---|---|---|---|
| **Redflex (RDF)** | $0.51 | $0.42 | $0.00 | $0.42 | (17%) |
| **MMA Offshore (MRM)** | $0.24 | $0.03 | $0.00 | $0.03 | (86%) |
| **amaysim (AYS)** | $1.95 | $0.74 | $0.00 | $0.74 | (62%) |
| **Average** | | | | | **(55%)** |

This competition reminds me of playing poker without any money. For me at least, it has ended with similar results; excessive risk taken without reprieve. The disaster hasn't wiped out my win from 2017 but it's knocked a good hole in it.

Each of my picks from 2017 came with neat investment cases. I had thought that locking up the investment for three years would be a benefit. As the results make clear, it wasn't.

First there is **MMA Offshore**, down 86%. This was a business back from the brink with new management, a fresh board and a slimmed-down asset base. I thought that, with a new fleet of ships, decent utilisation rates and a cyclical recovery, MMA could generate enough cash to survive. The shares were so cheap that's all it needed to do. This decade's second oil price crash put an end to that. This is a business unlikely to survive.

**Amaysim** looked so promising in 2017. It had raised margins, was taking market share and had the lowest costs in the industry. There were early signs of stronger competition but I didn't think it would last. Mobile had long been an organised oligopoly and amaysim was sure to be taken over if it didn't work out. Well, it didn't work out. Unprecedented competition disrupted the industry and slashed margins for everyone, including amaysim. It was ultimately taken over by Optus, but at half the price I thought three years ago.

Red light camera maker **Redflex** was faring quite well before the pandemic. Unsurprisingly, empty streets hurt a business that takes a cut of infringements and is reliant on governments' willingness to fine its own citizens.

The last three years has coincided with a big shift in my own investment philosophy. I'm less interested in price and more interested in management ability, hidden quality or unrecognised insight. This competition demands more. Leaving your stocks alone for three years means you need to pursue quality. My stocks selections for the next three years reflect that.

## Graham Witcomb

### Witcomb's Winners

| STOCK (ASX CODE) | PRICE AT 23/11/17 | PRICE AT 20/11/20 | DIVS | TOTAL AT 20/11/20 | TOTAL RETURN |
|---|---|---|---|---|---|
| **FSA (FSA)** | $1.48 | $1.04 | $0.21 | $1.25 | (16%) |
| **Virtus Health (VRT)** | $5.23 | $5.54 | $0.62 | $6.16 | 18% |
| **Trade Me (TME)** | $4.23 | $6.06 | $0.38 | $6.44 | 52% |
| **Average** | | | | | **18%** |

James has already covered TradeMe so I'll hone in on my other two picks, **FSA** and **Virtus Health**.

FSA has been the biggest surprise over the past three years. When we initially **upgraded the stock** in February 2016, we saw it as a 'canoe salesman in the Sahara'. We figured it would plod along most years but, when a crisis arrived, it would benefit significantly by providing bankruptcy and debt agreement services to people in financial distress.

In theory, today's world should be the stuff of dreams for FSA management. Yet the number of debt agreements arranged this year fell 5% and bankruptcy agreements were down 20%. Pre-tax profit, meanwhile, rose a paltry 1%. That's a sign fewer people are in financial hardship.

The problem has been two-fold: Changes to the Bankruptcy Act – which took effect last June –

reduced the time borrowers have to repay their debt under a debt agreement from five years to three. This resulted in more creditors rejecting debt agreements due to the lower rates of return.

What's more, the current crisis has been so severe that it prompted significant Government intervention. People didn't have to default on their loans because they were allowed to defer payments, while many lower-income earners ended up with more cash in their pocket than usual due to the various stimulus packages.

FSA teaches many lessons. For one thing, betting against the economy is an uphill battle, even in bad times. Today's governments step in and prevent normal market functioning – something good for those that have lost their jobs but bad for providers of bankruptcy services. It seems FSA's dream world isn't one where unemployment rockets and the economy freezes up, but one with bumps moderate enough to cause an increase in financial distress but not enough to cause governments to jump in.

The other lesson is the importance of dividends. The share price itself is down 31% over the past three years but the overall fall was reduced to 16% due to consistent, fully-franked dividends along the way. Dividends often get overlooked, especially by new investors who prefer to focus on the booms and busts in share prices. FSA is a reminder that a steady dividend can make up for losses elsewhere.

IVF provider Virtus Health has fared better than I expected this year but has still been disappointing overall. With its expensive discretionary services, Virtus generally moves in sync with the economy. This year was never going to be pretty.

When we first upgraded the stock several years ago and I added it to my Top 3 for 3, we warned that margins were likely to come down over time. There was pricing pressure from a new set of low-cost providers but we believed growth in cycle numbers would pick up the slack due to mothers delaying childrearing and increasing rates of infertility in the population.

We were right on the margin front: the company's operating margin has fallen from 19% to 16% over the past three years, but cycle growth has been terrible. Revenue has been flat and operating profits down 10%. This year, that's understandable, but the last two years were also poor. Our expectations for industry-wide cycle growth were probably too optimistic.

It's therefore surprising that the stock hasn't fallen more, although it could be supported by hopes that the pandemic is pushing cycle numbers into future periods and a boom is just around the corner. That's possible, although IVF can't be delayed as long as other services, given the nature of infertility. We suspect the years ahead will see more margin compression and modest growth.

## Mickey Mordech

### Mordech's Monsters*

| STOCK (ASX CODE) | PRICE AT 23/11/18 | PRICE AT 20/11/20 | DIVS | TOTAL AT 20/11/20 | TOTAL RETURN |
|---|---|---|---|---|---|
| **United Overseas (UOS)** | $0.68 | $0.78 | $0.045 | $0.83 | 21% |
| **Class (CL1)** | $1.77 | $2.08 | $0.10 | $2.18 | 23% |
| **Thorn Group (TGA)** | $0.53 | $0.17 | $0.075 | $0.25 | (54%) |
| **Average** | | | | | **(3%)** |

*** Only in competition for two years**

When I look back on my picks from two years ago, two mistakes jump out at me. For one, I'd never put 33% of my net worth in a stock as low-quality and risky as **Thorn**. Why I did that for this competition I can't fully explain, although the prospect of a rapid turnaround and a huge re-rating no doubt had something to do with it.

Two, one of my favourite stocks at the time was **Audinate** – which I owned – but I decided to go with **Class** instead, despite the fact I've never owned it and it was probably a little pricey, judging by today's price guide.

Picking Audinate instead would have delivered 30% in aggregate performance but thanks to a deteriorating business model and a bit of bad luck – management turning down a takeover offer for the equipment finance business just before the pandemic was probably the lowlight – Thorn is what brought me undone.

Funnily enough, Thorn recently paid a 7.5 cent special dividend and may have as much as 30 cents in cash coming through over the next 12 months as it winds up Radio Rentals, so another year could do some good. I'll concede defeat though, given management has shown its interests are at odds with minority shareholders.

On the plus side, I'm happy with the way Malaysian property developer **United Overseas** performed, especially given that its commercial and hotel properties were hit by the pandemic.

## Tables from the departed

Over the last three years we've brought on two staff and unfortunately lost two, James Greenhalgh (JG) and Alex Hughes (Hughesy). Their picks are listed below. Tomorrow, we'll have the three stocks for the next three years from each of your analysts.

### Greenhalgh's Gems

| STOCK (ASX CODE) | PRICE AT 23/11/17 | PRICE AT 20/11/20 | DIVS | TOTAL AT 20/11/20 | TOTAL RETURN |
|---|---|---|---|---|---|
| Trade Me (TME) | $4.23 | $6.06 | $0.38 | $6.44 | 52% |
| News Corp (NWS) | $21.04 | $23.99 | $0.71 | $24.70 | 17% |
| Wesfarmers/ Coles (WES/COL) | $42.89 | $67.26 | $7.64 | $74.90 | 75% |
| **Average** | | | | | **48%** |

### Hughesy's Hits

| STOCK (ASX CODE) | PRICE AT 23/11/17 | PRICE AT 20/11/20 | DIVS | TOTAL AT 20/11/20 | TOTAL RETURN |
|---|---|---|---|---|---|
| Academies Aust (AKG) | $0.33 | $0.34 | $0.08 | $0.42 | 28% |
| Thorn Group (TGA) | $0.60 | $0.17 | $0.075 | $0.25 | (59%) |
| Trade Me (TME) | $4.23 | $6.06 | $0.38 | $6.44 | 52% |
| **Average** | | | | | **7%** |

# Part 2
# Top 3 stocks for 3 years

**Here, the team pick their top three stocks for the next three years.**

**JOHN ADDIS** • First published online 30 Nov 2020

After reviewing the performance of the last contest, it's time to launch the new one. Yes, despite getting a drenching last time around, we're heading back to the well with a few lessons learned.

Before getting into the 2020-2023 picks, please note that these selections were made on 20 Nov 2020, 11 days prior to publication. Since then, prices have generally risen, although so has the index. The timing merely reflects the time taken to pull everything together – prices were taken on the day analysts submitted their selections.

Tracking and reporting on performance for this competition takes some time and our publishing schedule has been a bit hectic lately, not least due to a couple of new Buy recommendations, in **Omni Bridgeway** and **Aussie Broadband**.

## Nathan Bell

### Bell's Bangers

| COMPANY | PRICE @ 20/11/20 |
|---|---|
| Moelis (MOE) | 4.42 |
| Experience Co (EXP) | 0.24 |
| Frontier Digital Ventures (FDV) | 1.42 |

I could easily pick the same three stocks as I did for the last competition, but to make it more interesting I'm replacing **Class** and **360 Capital** with two Ideas Lab stocks, **Moelis** and **Experience Co**, and keeping FDV.

Buying Moelis today is like buying **Macquarie Group** decades ago. It's full of entrepreneurial individuals that want to share in the value they create, through corporate deal-making and funds management, by owning shares in the business.

Were it not for the high staff ownership making the stock illiquid, this company might well be in our portfolios. Next time the market has a decent fall we'll try and take advantage of the panic selling to build a position.

The share price remains more than 30% below its high of nearly $7, but over time the share price should increase as the company grows in size and stature. The balance sheet is in excellent shape and, as with 360 Capital, a deeper recession might have created more distressed sellers on which the company could pounce.

Despite that, I'm still backing a smart group of hard-working, intelligent people to sniff out great investment ideas. The result, I expect, will be gradually increasing earnings in a safe and intelligent manner.

Experience Co's share price fell to almost three cents during the COVID-panic. Debt was high and new CEO John O'Sullivan was forced to shut down skydiving locations around Australia and New Zealand.

With support from the company's lenders, O'Sullivan has done an excellent job selling non-skydiving businesses, drastically improving the balance sheet to a net cash position (excluding asset financed debt linked to the company's assets, which aren't in peril). Almost all the company's locations have reopened, which is why the share price has increased to 24 cents.

With Experience Co breaking even, there are no longer any financial issues. Now it's a matter of waiting until more people throw themselves out of a plane. The impending opening of the Queensland border will be a huge help, as will the return of foreign visitors.

The stock should be worth at least 50-60 cents in a normal environment but could be worth materially more than that if O'Sullivan can find some attractive bolt-on acquisitions and open a few new locations.

**Disclosure: Nathan owns stock in Frontier Digital Ventures, Audinate, Experience Co and Moelis.**

## Gaurav Sodhi

### Sodhi's Stockpile

| COMPANY | PRICE @ 20/11/20 |
|---|---|
| RPM Global (RUL) | 1.14 |
| Infratil (IFT) | 5.33 |
| Globe (GLB) | 2.27 |

After my failures in the last competition, where I focussed on low price, high risk companies, this time I'm going with quality first and foremost.

**RPM Global** is a stock that's been on and off our buy list for years. It's a chunky holding in my personal portfolio and retains unrecognised potential.

I'm also adding a more recent upgrade, **Infratil**. As we've **noted in reviews**, the quality and growth in CDC has not been recognised by the market. This was also the case with **NextDC** and **Macquarie Telecom** for a while and we're confident the market will recognise Infratil eventually. Let's hope it's in the next three years.

My last pick is a wild card and comes from my friend and former boss, Greg Hoffman. **Globe** is a skating brand that is a little tired but ably run by founding brothers. Within the business, however, they have started new brands that have found their own niche; FXD and Impala, in particular, have an attractive niche audience and are growing strongly. That growth is just starting to filter into Globe's numbers.

Like my other two picks, this is a business where the market's narrative runs shy of reality. More than a superficially cheap price, that dislocation is where opportunity lies.

**Disclosure: Gaurav owns stock in Infratil, Globe, RPM Global, Australian Ethical and EML.**

## James Carlisle

### Carlisle's Crackers

| COMPANY | PRICE @ 20/11/20 |
|---|---|
| Audinate (AD8) | 7.21 |
| Altium (ALU) | 36.07 |
| Webjet (WEB) | 5.27 |

Top of my list for new picks is **Audinate**. Rarely does one get the opportunity to invest in the dominant player in a nascent, fast-growing, winner-takes-all market. I think Audinate may be one such opportunity. The hard part is to work out what it might be worth. Gaurav did a **good job of that** last year, based on current estimates of market size.

There are good reasons, though, for thinking that the eventual market might be a lot bigger than currently believed, mainly because people have a hard time imagining new use cases for improved technologies like this.

We can already see something similar unfolding in mobile phones, internet search, accounting software and online classifieds, to name a few examples. Audinate's ultimate market won't be as big as any of those, but it's a fair bet it'll be bigger than currently envisaged.

The same arguments could also be made about my other two choices: **Altium** and **Webjet**. Having (very nearly) achieved dominance of the market for printed circuit board (PCB) design software, Altium is now working towards transforming the industry.

As electronic products get smaller and more sophisticated, PCB designers need to collaborate more closely with mechanical designers and pay greater heed to the availability and performance of different components. Altium is proposing to create a cloud platform where these different elements can be brought together.

If it's successful, this will add considerable value to all parties, enhancing Altium's margins and entrenching its position. And all that in a market with excellent long-term growth prospects.

Management believes this could mean earnings before interest, tax, depreciation and amortisation (EBITDA) of US$154m–213m in 2025. The middle of that range could mean earnings per share of about A$1.25, against which the stock is priced on a multiple in the high twenties. At that point, one might own a stock with an entrenched and lucrative position in a fast-growing market.

We'd want it a bit cheaper before upgrading it again to Buy, but it's a solid Hold and I'm very happy to include it in this competition.

Due to the pandemic, Webjet is obviously in a different position to these stocks in the short term. However, in the longer term there are similarities. At its **recent AGM**, management reiterated its aspiration to become the world's largest bed bank and I expect increasing economies of scale and improving technology should help it add plenty of value by distributing hotel inventory in a convenient and cost-effective fashion.

It's a lot further from dominance than Audinate and Altium – it's only No.2 at the moment, with its 4% pre-pandemic market share dwarfed by the 13% of Hotelbeds – and it first has to get past the pandemic. But it's also much cheaper, on a multiple of 18 times the 28 cent consensus earnings forecast for 2023. The forecasts that go into that forecast, though, range between 10 and 40 cents, which neatly describes the risk in the stock.

**Disclosure: James owns stock in Altium, Audinate, Webjet, Frontier Digital, Australian Ethical and United Overseas.**

## Graham Witcomb

### Witcomb's Winners

| COMPANY | PRICE @ 20/11/20 |
|---|---|
| FSA Group (FSA) | 1.06 |
| Sonic Healthcare (SHL) | 33.83 |
| Tabcorp (TAH) | 4.07 |

Hopefully, this isn't a case of 'Fool me once, shame on you, fool me twice, shame on me'. I'm going to throw my worst performer over the past three years, **FSA Group**, back into the ring for my next three.

It still has many of the qualities I liked when I picked it last time: high returns on capital, an able and honest owner-manager and a dominant market share. Only now we get the biggest financial catastrophe of the past few decades along with it.

In theory (I'm growing to hate that phrase), as the pandemic settles and the government cools its stimulus, banks again push for loan repayments, and/or unemployment stays high, FSA should catch the tailwind it missed during the worst of the pandemic due to outside intervention.

I fully acknowledge (now) that government intervention will have a significant impact on FSA's returns over the next little while, and who knows what they will do next. But I couldn't consider myself a shareholder focused on the long term if I didn't ride out the current mess and look ahead.

**Sonic Healthcare** is my next pick. We **upgraded the stock** in March when it hit $21 and it is up nearly 60% since then. But it still doesn't look particularly expensive.

Few companies are better placed to benefit from the pandemic over the next year than Sonic, Australia's largest pathology network (and the largest in four other countries, too). Another round of lockdowns could reduce demand for discretionary testing but there's plenty more COVID-19 testing to be had, which should cause an above-average year of profitability in 2021. I also like Sonic's resilient growth strategy of aggregating clinics into its network to benefit from economies of scale.

The company is well managed, has a solid balance sheet and a price-earnings ratio of only 20 if you look a couple of years out (even lower if you look at 2021's elevated earnings). I don't expect it to shoot the lights out but it should do well.

My final pick goes to **Tabcorp**. I could very well have gone with **Gentrack** or **Clinuvel**, but something tells me FSA is more than enough speculative component for a three-stock portfolio.

Tabcorp, on the other hand, is a solid business that sums up Warren Buffett's advice to 'buy businesses that even a ham sandwich could run, because sooner or later one will'. With Tabcorp, that theory has been tested.

However, with the chairman and chief executive resigning a few months back, and a recent capital raising firming up the balance sheet, I think the company is better positioned than ever, with a duopoly in the retail wagering industry and a financial powerhouse in its lotteries monopoly.

There's a good chance that Tabcorp will emerge from the pandemic in a stronger position, too. We expect some weaker competitors to close shop and there are many advantages to more concentrated market shares, such as the potential for a reduction in marketing expenses, which skyrocketed over the past few years. Punters are flocking online, too, which generates higher margins and should boost Tabcorp's return on capital.

With current management out the door, good growth prospects and a 5% free cash flow yield, Tabcorp is another stock where a little patience over the next three years could produce some decent returns.

**Disclosure: Graham owns stock in FSA Group, Sonic and Tabcorp.**

## Mickey Mordech

### Mordech's Monsters

| COMPANY | PRICE @ 20/11/20 |
|---|---|
| EML Payments (EML) | 3.62 |
| Australian Ethical (AEF) | 4.85 |
| United Overseas (UOS) | 0.76 |

The lesson from the last competition is probably to keep it simple and pick the three stocks I'd personally invest in today at today's prices.

In my opinion, **EML Payments** may be one of the best businesses on the ASX. Once it establishes a payment program it keeps customers forever, effectively locking in a royalty on the growth of its digital partners. As partners invest in marketing to grow their own business, EML clips the ticket. The business therefore requires no capital of its own to grow.

It's also well managed by chief Tom Cregan who has proven himself an adept capital allocator, having grown the share price from 12 cents to $3.62. Despite that, I think the company is still poorly understood and underappreciated. Some commentators still refer to EML as a mall gift card business, despite the fact malls make up less than 20% of revenue now.

Trading on 40-50 times 2021 earnings, I'm expecting rapid earnings growth as its programs recover from the pandemic, the full effect of the PFS acquisition takes hold and the company uses its cash hoard to make new acquisitions.

**Australian Ethical** is another stock trading on a high multiple – around 70 times forward earnings – but chief executive John McMurdo **recently said** he's hoping for a five-fold increase in funds under management (FUM) by 2025. This is a stock where next year's multiple is meaningless.

The company is leveraging its market-leading brand in the ethical space, growing FUM organically at the rate of 25-30% a year. Those growth rates don't look unsustainable. We're still in the early innings of the shift to ethical investing and regular superannuation contributions make up a good chunk of that growth. Great fund performance doesn't hurt either.

FUM growth may even accelerate. As the company ramps up its sales and marketing efforts, large institutional mandate wins become an increasing possibility. The penetration of advisor networks will play more of a role over time, too, while the launch of new listed products is another option at the company's disposal. Acquiring smaller rivals in the ethical space might be attractive, too.

Thus far massive growth in FUM is yet to manifest in profits as the investment in sales and marketing comes at the same time as the company is slashing fees. But as Australian Ethical reaches maturity, cost growth should taper off, the revenue margin should stabilise, and operating leverage will begin to work its magic.

I almost went with **Vista Group** for my third pick but it's in the midst of a challenging turnaround. Instead, I've decided to take a safer option in the form of

**United Overseas Australia**. It probably doesn't have as much upside over three years but I'd expect it to churn out an acceptable result given it's trading at just 75% of (understated) net asset value. It also balances out my other choices which are vulnerable to shrinking multiples.

The company thrives in times of distress, having swooped on bargains during the GFC and Asian Financial crisis. The pandemic has brought about falling property prices in Malaysia and UOS is sitting on an enormous cash pile. Management's track record is phenomenal and I'm hoping they'll find some opportunities to put that money to work.

**Disclosure: Mickey owns stock in Audinate, EML, Australian Ethical and United Overseas.**