EQUITY

STANDING UP FOR SHAREHOLDERS

OCTOBER 2017
VOL 31 #9

STRATEGIES FOR SELECTING SMALL CAPS

08
Hidden opportunities in the software sector

11
Investing in innovation – the dawn of an exciting new asset class

17
Insights from the company monitor: Qantas

Australian Shareholders' Association

RRP $10
www.australianshareholders.com.au

EQUITY

STANDING UP FOR SHAREHOLDERS

October 2017
Vol 31 #9

FEATURES THIS MONTH

04 Strategies for selecting small caps

When Dean Fergie selects stocks in the small cap space (ex ASX200) he does not focus on value as he finds 'value' to be one of the most confused, overused, misleading and irrelevant factors with respect to share-market opportunities. Dean outlines his processes for selecting stocks that will deliver a significant positive overall return over time.

08 Hidden opportunities in the software sector

The largest IT company listed on the ASX is Computershare which arguably could be classified as a financial. As a result it's a sector that is largely ignored by Australian investors. IT is the fastest growing sector globally and this is likely to be the case for years to come.

17 Insights from the company monitor: Qantas

Qantas is without doubt one of the most widely known companies listed on the ASX. Nearly everyone has flown with either Qantas or its subsidiary, Jetstar. It is indeed a household name. Some love the airline and are very loyal passengers. Others dislike it intensely.

06 Bank bashing: our national sport

07 The importance of getting CGT relief right

10 Five steps to choosing a managed fund

11 Investing in innovation – the dawn of an exciting new asset class

12 Record keeping tax tips

13 Exchange Traded Funds: Managing risk

14 Metcash AGM report

15 Brickbats and Bouquets

16 Upcoming AGMs

18 ASIC reports on how investors decide to invest in IPOs

19 News desk

20 Victoria report

Australian Shareholders' Association

BOARD OF DIRECTORS
Diana D'Ambra BCom MCom FCA MAICD, Chairman
Geoffrey Bowd BCom MCom
Alison Buxton BCom (Marketing), GAICD
David Fletcher BAcc CA GAICD
Allan Goldin BA BLaw
Don Hyatt BAppSc DipEd M Ed MACE
Stephen Mayne BCom GAICD

NATIONAL OFFICE
Judith Fox
CEO

Fiona Balzer
Policy & Advocacy Manager

Sarina Devi
Administration Officer

Silvana Eccles
National Operations Manager

Kristy Wan
Web Content & Social Media Coordinator

STATE BRANCHES

ACT Edward Patching	act@asa.asn.au
NSW Richard McDonald	nsw@asa.asn.au
QLD Bryan Moore	qld@asa.asn.au
SA Kevin Parken	sa@asa.asn.au
VIC Don Hyatt	vic@asa.asn.au
WA Barry Nunn	wa@asa.asn.au

EQUITY EDITOR
Silvana Eccles equity@asa.asn.au

CONTACT DETAILS

TELEPHONE 1300 368 448
02 9252 4244

FAX 02 9252 4966

ADDRESS Suite 1A, Level 2
20 Loftus Street
Sydney NSW 2000
GPO Box 359
Sydney NSW 2001

ABN 40 000 625 669

EMAIL share@asa.asn.au

WEBSITE www.asa.asn.au
www.australianshareholders.com.au

DISCLAIMER
This material in EQUITY is provided for information only. No responsibility or any form of contractual, tortious or other liability is accepted for decisions made on the basis of the information contained herein. Nothing in EQUITY is intended or should be interpreted as being investment advice. Investment advice can only be obtained from persons who are licensed in accordance with the Corporations Act. Views expressed in articles in EQUITY do not necessarily reflect ASA policy. The ASA does not endorse or favour any specific commercial product or company. The ASA is often able to negotiate discounts or benefits for ASA members however the inclusion of discounts or advertisements in EQUITY, on the ASA website or within other ASA communications does not constitute an endorsement for the products, services or companies mentioned.

COPYRIGHT
All material published in EQUITY is copyright. Reproduction in whole or in part is not permitted without written authority from the Editor.
All graphs for the AGM and BIG Reports derive from Morningstar. Any correspondence regarding matters covered in this magazine should be addressed to the Editor.

FROM THE CEO

By Judith Fox

At the time of writing this column, retail shareholders were wondering if anything can be salvaged for them with the announcement of the proposed sale of Network Ten to CBS Corporation. Throughout the saga of Network Ten being put first into administration and then receivership, the ASA has been heavily involved in seeking to ensure there is something on the table for small investors. Our mission is to stand up for shareholders and that is exactly what we have been doing.

This has been a tale with many twists. In June, Network Ten announced it had gone into voluntary administration. In light of the advice from guarantors Mr Murdoch, Mr Gordon and Mr Packer that they would no longer guarantee a key loan, the board told investors it had "no choice" but to appoint administrators KordaMentha, given the risk of insolvency.

We were surprised that the Network Ten directors chose to appoint voluntary administrators when the ASX announcement by the company on 14 June clearly set out the progress which had been made on a number of fronts. It was not clear to us the precise reason for the board's decision to appoint a voluntary administrator so quickly. Given the conflicts of interests at play, we wrote to ASIC noting we would be concerned if minority shareholders were being oppressed.

Mr Murdoch and Mr Gordon advised that they were forming a joint venture to propose a restructure to repay Ten's existing loan. The ASA met with the administrators to encourage them to work diligently to preserve and maximise shareholder value and to conduct an orderly process, which focused on maximising competitive tension and valuation.

In July, CBA, the largest secured creditor, appointed PPB Advisory as receivers of Network Ten. Network Ten's share register consists of approximately 17,000 retail shareholders. The ASA met with PPB Advisory to press upon them the urgency of working toward delivering some residual return for shareholders.

On 28 August, CBS Corporation confirmed it had entered into a binding transaction document to acquire the business and assets of Network Ten. It appears that shareholders will receive no compensation for their shares being taken over by CBS. ASA is unhappy that the retail shareholders will not receive any part of the sale proceeds. We called on the Australian Government to seek a revised offer from CBS Corporation, one that includes compensation to the existing shareholders. The takeover needs approval from Australia's Foreign Investment Review Board.

Meanwhile, we have also been publicly putting forward the views of shareholders with regards to CBA. The allegations by AUSTRAC are serious and suggest there are significant cultural issues at CBA. We were pleased to see the CBA board respond in a timely fashion and cut the short-term incentives of the CEO and senior executives. More significantly, the board recognised its shared accountability and elected to have director fees reduced. The announcement of the succession planning underway for the CEO role was also welcome, as was the use of the board's power to adjust remuneration outcomes for former executives. The ASA would like to see more boards use such powers as appropriate.

ASA is supportive of class actions in general, but notes that this one depends on the legal arguments as to whether the disclosure of the AUSTRAC investigations was 'material' in 2015. CBA is now facing multiple legal proceedings and investigations, including by APRA, and shareholders want to see these completed in a timely fashion.

Finally, it is with sadness that I advise that Samantha Clark has departed ASA. Her consistently professional, calm, helpful and efficient approach has been the subject of much praise from members and we will all miss her. She has taken up a great opportunity in a new role, where she will be able to expand her capabilities and develop new skills and we wish her well in this next chapter. E

Strategies for selecting small caps

By Dean Fergie Director & Portfolio Manager at Cyan Investment Management

One reason regularly quoted to buy a certain stock is because it offers 'good value'. It is certainly an easy (and lazy) argument for stockbrokers to recommend a company. When I select stocks in the small cap space (ex ASX200) I do not focus on value as I find 'value' to be one of the most confused, overused, misleading and irrelevant factors with respect to share-market opportunities. I don't think readers specifically want to find 'value', they simply want to invest in stocks that will deliver a significant positive overall return over time (capital growth and income, but mostly capital growth) with minimal to moderate risk.

What I will try to convey are a number of clear, logical and achievable processes, ideas and practices that will assist in discovering and profiting from small cap opportunities in the Australian market.

Coming briefly back to traditional 'value'. It is easy to find. Any investor with a financial data source and rudimentary excel skills has the capacity to sort the universe looking for 'value criteria'; a low PE (ignoring the negatives); a high dividend yield and perhaps, if they're feeling a little creative; an attractive EV/EBITDA ratio or a discounted Price/NTA ratio.

Unfortunately this type of analysis, albeit fundamentally correct in many cases, is fraught with danger.

Looking for value invariably focuses the spotlight on the discounted stocks in the share-market: the oversold; the ignored; the disliked, distrusted and disappointed sectors of the market. Think of it as the discount or 'sin bin' end of the market.

As a wise friend and mentor many years ago once told me, "Good stocks aren't cheap and cheap stocks aren't good".

Efficient market hypothesis (EMH) states that stock market efficiency causes existing share prices to always incorporate and reflect all relevant information. So the value end of the market is reflecting all the negative current sentiment. So in its essence, it can often mean that "the crap has floated to the top".

I've run a screen on the cheapest stocks in the market (on a prospective PE basis and dividend yield) and their respective 1 year performance. On this simplistic measure, the average fall over for the cheapest 10 stocks over the past 12 months has been -45% for the high yielders and -12.5% for the low PE stocks.

Company	FY1 P/E (Majority EPS), Mean	Price % Change, 52-Wk
Shine Corporate Ltd	5.1	-48.2
Resolute Mining Limited	5.2	-27.5
Prime Media Group Limited	5.4	22.6
Vita Group Limited	5.5	-70.2
Godfreys Group Ltd	5.8	-25.7
Fortescue Metals Group Limited	5.8	27.0
BPS Technology Ltd	6.8	-16.2
Villa World Ltd	7.0	2.3
Thorn Group Ltd	7.4	0.8
Avjennings Ltd	7.4	13.7
		Ave. -12.2

Company	Dividend Yield (%), Current	Price % Change, 52-Wk
IPE Ltd	32.4	-37.0
PS&C Ltd	23.4	-39.7
Reverse Corp Limited	13.5	-40.8
Vita Group Limited	13.5	-70.2
Countplus Ltd	13.5	-42.9
CSG Limited	12.7	-50.5
K2 Asset Management Holdings Ltd	11.4	-45.0
China Dairy Corp Ltd	10.6	-54.3
Traditional Therapy Clinics Ltd	10.3	-38.9
Capral Limited	9.6	-31.6
		Ave. -45.1

Buying stocks because they offer 'good value' is simply a strategy one would only employ if they wished to reduce a capital gains tax bill!

So let's look at it a different way and throw the whole 'value' idea out the window. If we accept EMH then how do we best find those stocks that are likely to make you money?

Distilling our investment process into a simplified form, we aim to find (and invest) in companies that are likely to perform better than market expectations. If this occurs, regardless of 'value', these share prices almost invariably rise over time.

So here are eight tips outside the basic financial investment fundamentals that I believe will help guide you to creating a well-positioned, defensive and profitable portfolio at the smaller end of the market.

Follow the momentum. We rarely buy stocks that are falling in price. More often than not (see EMH) falling share prices indicate there are integral problems or structural challenges with the company or the industry in which the business operates. Don't be afraid of buying a stock if it's cresting a record high. As a rule at we do not buy stocks if they've fallen to a record low and rarely buy into shares that are in a downward trend. It sounds simplistic, and in many ways it is, but this simple rule has saved us from countless historical losing positions. The only time we overlook this rule is when there has been a material change to a business; new management team, a

capital raising providing a growth catalyst, an attractive acquisition, or a competitor misstep.

Investigate (and invest) in what you understand. We never invest in biotechnology businesses or any business that we cannot understand. We avoid biotech because we don't have scientific backgrounds and do not understand the technology, science or have grasp of the opportunity or the industry, Fortunately (for us), there are no more than a handful of these businesses that have performed anywhere close to their initial promises and expectations. We also avoid the resources sector because we are not confident in predicting the macro-economic drivers of underlying commodity prices. All this is not to say significant returns cannot be generated from investing in these industries. Just be humble enough to recognize what you feel you can understand and have some hope of predicting.

Utilise anecdotal evidence. One of the advantages of investing in the Australian stock market is that you can be close to the action and have the ability to experience first-hand the performance of certain businesses. For instance one of the most successful businesses for us recently has been the payments processing technology company, Afterpay (ASX:APT). Both in store and online it has been evident that this business is gaining significant traction in the retail space. Our anecdotal evidence (friends and family using and recommending the Afterpay system) has further strengthened our positive view of the performance of the company, in addition to the information that has been released to the ASX. Whether it's in the retail space, financial services, infrastructure, food, healthcare or real estate, don't discount the value of your own experiences with listed companies.

Relentlessly follow cash flow. "*Revenue is Vanity. Profit is Sanity. Cash is Reality.*" Without doubt the most valuable financial report released by companies to investors is the cash flow statement. Even better, are the quarterly 4C statements, for companies that are required to report them (typically for newer loss making businesses where more than half of the entity's tangible assets are in cash). The cash flow statement gives complete transparency as to revenue run rate, company expenses and cash backing. They can be a clear indication as the true cash profitability of a business, or for those in earlier stages of their lifecycle, if or when a company might be required to raise capital. The cash flow statement is the very first thing we look at in a company's financial report.

Beware the Executive Chairman. We find there's a fine balance between a healthy level of company ownership by management and too much. Often that manifests itself in the title of Executive Chairman. If an individual owns a high percentage of the company then that influence should be mitigated by an independent and non-executive chairman. The EC role tends to shout the word, "Minority Shareholder".

Be dynamic. It is nice in theory to buy shares at their lowest price and sell them at the very top. We all seem to have one friend or colleague that does that regularly. The fact is that it's impossible to get anywhere close to that over a cycle. We aim, over time, to buy parcels of shares as we become increasingly confident in a business and sell them either as the price increases or be we lose confidence in a company. Over a 2 year holding period we will make regular changes to our target weightings of any specific company relative to our overall portfolio. For instance we bought into Bellamys (BAL:ASX) at listing at $1, saw it rise to over $15 and sold out the last of our stock at $8.30. Over that 18 month holding period we changed our weighting in the company on more than 30 occasions. Of course not all those trades were profitable but over time we did well for our clients. Think of an investment like sailing a yacht, even if you set off in the correct direction, you always need to be vigilantly watching for changed conditions and always need to trimming the sails and altering your course.

Understand the conflicts of interest in broker research. Here's how the system works. If an analyst puts a 'Buy' on a company it has the following consequences:

- A 'Buy' rating potentially appeals to every client, those that own the stock and those that don't. Hence the broking house is more likely to write more business in the stock with a 'Buy' rating.
- It keeps the company happy.
- It encourages the company to engage the broking house in corporate services.

If an analyst puts a 'Sell' on a company it:

- Is only of interest to owners of that stock (unless it can be shorted). Hence the 'Sell' recommendation is likely to only generate limited business.
- Often upsets existing holders of the stock (who don't want to see a negative view being circulated).
- Upsets the company itself which is therefore less likely to engage the house in further corporate work.

So the moral of the story is, although sometime the content is an excellent source of information, pretty much ignore analyst recommendations (and sometimes even the valuations).

Have humility and never cross your fingers. Invariably investments fail to perform to expectations. Certainly one of the aspects of stock-market investing that we believe private investors do most poorly is selling. Whenever a business or company disappoints us we immediately take action to sell our position in that company, REGARDLESS OF PRICE. There are over 2000 companies listed on the exchange and we never feel that we need to be backing companies that disappoint. Just as you would never return to a restaurant that served you a bad meal we never return to disappointing businesses. It takes a certain self-assurance to admit you're wrong and take a loss, but this is a crucial part of the process. The philosophy of "I'll cross my fingers and hope this gets better over time" is one reason why part-time investors' portfolios do not perform as well as they should. Don't be scared about booking an immediate loss when something goes wrong. Believe me, things usually get worse. And from a taxation perspective, a realised capital loss holds more value than an unrealised loss.

So investing in the small end of the market is not easy. There are no algorithms or systems or rules or gurus or books that can guarantee you winning. It's not a part-time job. It takes common sense and humility and confidence and hard work. Good luck.