

Australian Research Trip, January 2011

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Executive Summary

- Australia is China's mine
- Chinese Stimulus programs in 2008/2009 have caused a raw materials supply side bottleneck
- Inflation has been contained by a strong A\$, but the cost of living is high
- Superannuation schemes drive the savings and investment markets, with A\$1.2trn in AUM
- Australian equity markets look "cheap" relative to their historical P/E ratings, and commodity price falls are being discounted

Introduction

Edward travelled to Sydney and Melbourne between the 26th January and 7th February 2011, and met with fund managers, economists and analysts from 16 different investment management groups.

This report is split into three parts: General/Macro thoughts, Australian markets, Investment Conclusions.

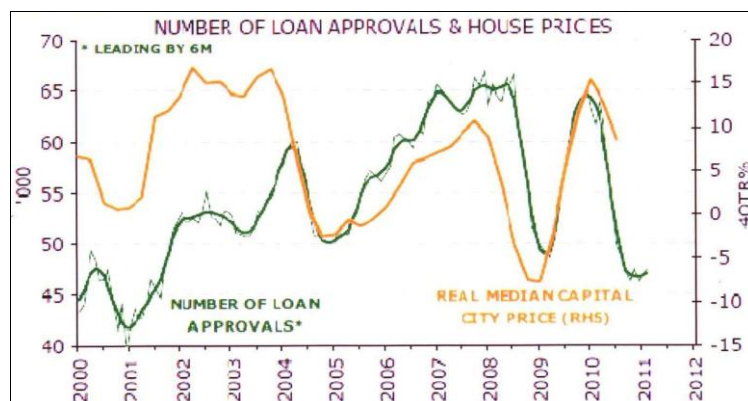
Part 1: Macro Thoughts

For an Australian newspaper editor, the outside world exists in order to:

- Buy Auzzie resources
- Provide a poor comparison to the superior Auzzie (economy)
- Buy more Auzzie resources

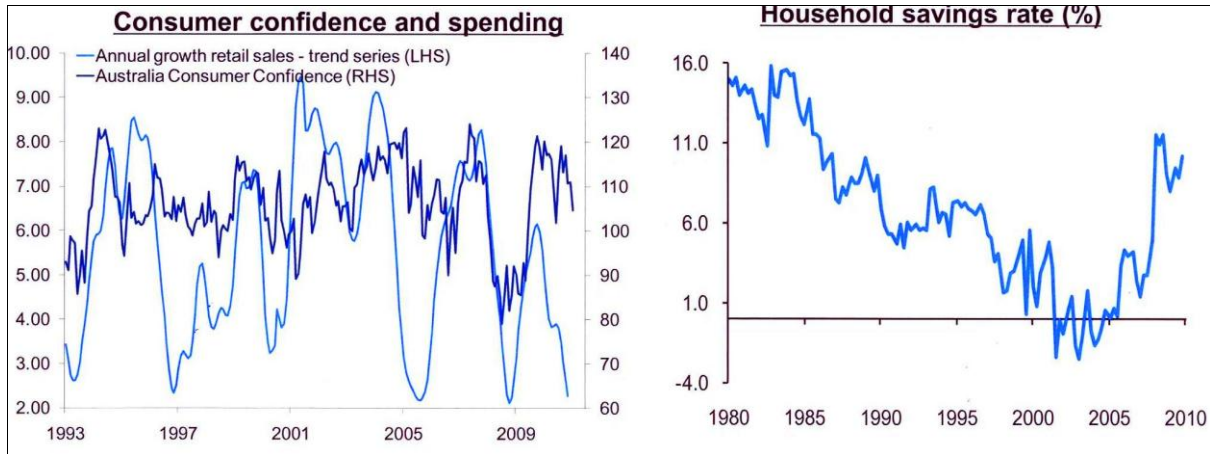
Even though the Queen's portrait adorns their banknotes, Australia seems oddly inward looking; News is overwhelmingly domestically focussed, with column inches dedicated to the housing market and anything to do with the mining industry.

You could argue that Australians have good reasons for confidence; whilst the G7 economies floundered in the "GFC" (nothing to do with fried chicken), the Australian economy contracted for a mere one quarter before forging ahead. House-prices are amongst the most expensive in the world, and although prices fell 5% in the "Great Financial Crisis", they subsequently bounced by some 15% to the end of 2010.



Australian loan approvals and percentage house price movements. Source: Insync Fund Managers

Yet these figures mask what is really a two tier economy; a mining industry printing money and a retail market staving off recession. Rising interest rates are dampening the property market (as shown in the falling mortgage lending in the chart above) and retail spending growth is falling as household savings rates rise.

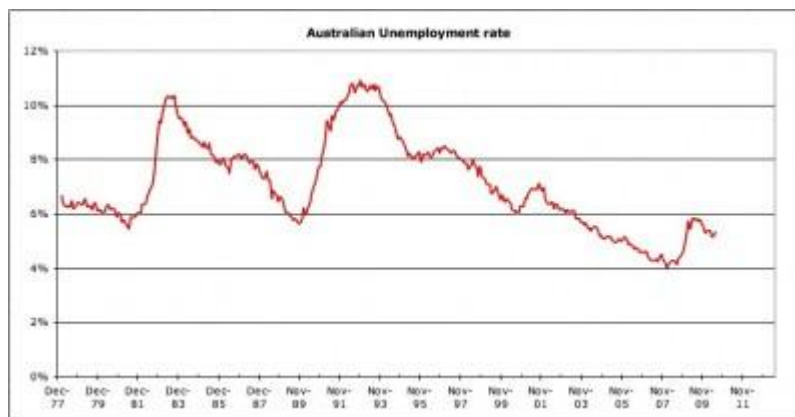


Australian consumer confidence and savings rate. Source: ABS, Colonial First State

So what is happening here? The answer, known to every Shane and Sheila on the street, is that the extraordinary (stimulus package) demand from China has pushed Australia's capacity to produce raw materials to the limit. There are ships queuing outside the West Coast ports to meet freight trains running 24 hours a day delivering Coal from Queensland's open cast mines to China, India and Japan. This, combined with global supply side pressures, has relentlessly driven up the prices of raw materials and both resources companies and their employees are flush with cash.

I was told that a hairdresser can take a job driving a truck up and down an open cast mine in the Northern Territories and can expect to earn A\$150,000 to A\$200,000 per annum. This is for a four week on, four week off cruise, and although there is little to spend hard cash on near the coalface (aside from the traditional frontiersman's pastimes of wine, women and song), this windfall capital has rapidly found its way into house prices and the local economy back home.

Unemployment is at historic lows despite high levels of immigration (the Australian workforce is reputed to have risen by 2% in Q4 2010) and the Australian dollar has risen 30% to reach parity with the US Dollar. This currency move has largely contained inflation over the last year or so.



Source: www.datadiary.com.au

Rob Mead, CFA of PIMCO's Sydney office suggested that the sweet spot for Australia is an annual Chinese GDP growth rate of 7-8%. Any higher than this and the supply side struggles to cope causing inflationary distortions and waste. Any lower and commodity prices would fall, leading to rising unemployment, a falling A\$, rising inflation, and falling house prices. He notes that 95% of all mortgages are at floating rate, but thinks that house prices would have to fall by 25-30% to trigger a US style banking crisis within the four major Australian banks.

Many investment professionals fear a currency correction, however Mr Mead was more sanguine. He points out that although Australian consumers are amongst the most leveraged in the world, the government and corporate sector are both in a sound fiscal position. He feels that the effect of the "carry trade" (where investors borrow a low yielding currency in order to purchase a higher yielding currency) could keep the A\$ overvalued (on Purchasing Power Parity terms by an estimated 30%) for extended periods of time.

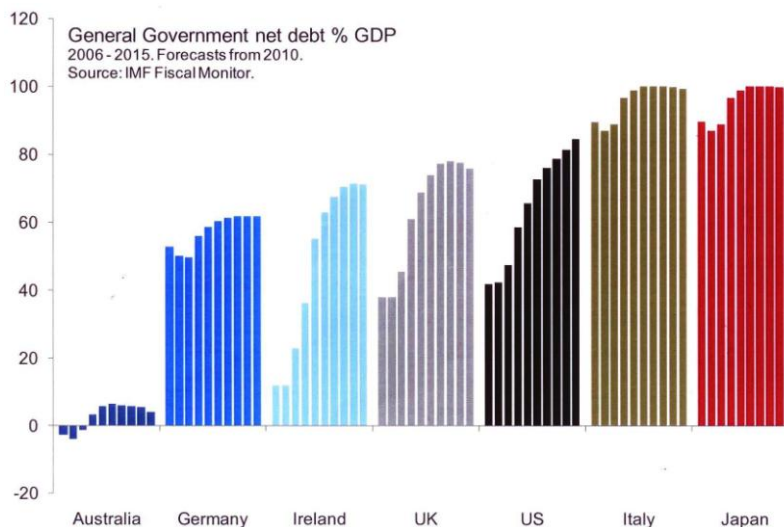
The Australian government recently tried to impose a "resource tax" on mining companies in order to put aside some of the windfall mining profits for future generations. These companies responded with an intense media campaign against this tax, and the motion was subsequently withdrawn. Australia is one of the cheapest nations in which to extract resources, and the mining companies (themselves major political contributors) have significant political clout. Interestingly Australia does have a "Future Fund" into which tax revenues are paid, however this is actually a fund to meet civil service pension obligations!

In summary, Australia is a risk-on, risk-off sort of place. If China continues to grow strongly, then Australians will continue to reap the benefits of super-normal profits. If not, then they will be vulnerable to a global slowdown.

Part 2: Australian Markets

Investment professionals in Sydney (who read the FT) are quick to point out the deficiencies of their local market: the top 9 companies in the ASX index account for 65% of its value, and the vast majority of capital is managed to an "index+" benchmark. That said, the market is said to be very efficient, and the four largest banks in Australia now rank amongst the world's top 10. The Australian equity market is currently 40% held by foreign investors.

These same banks are heavily reliant upon wholesale funding from foreign lenders (remember northern rock?) to the tune of around 130% of deposits. During the "GFC", national banks were quickly backed by the Australian government which, seen as a safe creditor with comparatively low net debt for a developed nation, meant that they easily attracted cash looking for a safe haven.



Source: Colonial First State

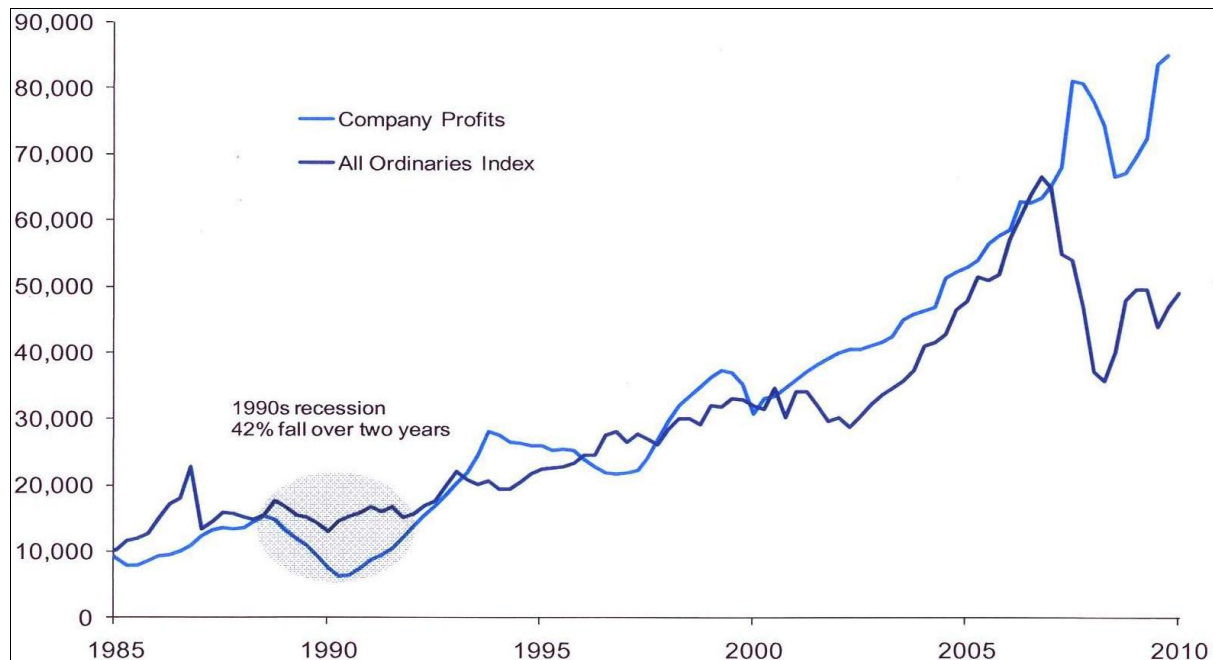
The banks have tried to address their dependence on wholesale funding by offering retail interest rates of up to 7% (NB prime mortgage rates are at 8%) while at the same time reducing business lending. These banks traded sideways in 2010 as the market punished their declining margins on increasing volumes.

The combined profits of the resource companies, BHP and Rio Tinto, were equivalent to 4.5% of Australian GDP in 2010. Despite roaring share prices, they have been consistently de-rated from the "growth" companies of 10 years ago trading at 20* earnings to "value" companies today trading at 10* forecast earnings. The market appears to be discounting significantly lower commodities prices in the next 2-3 years, as new supply comes online in Australia, China and Mongolia.

The last significant part of the market are the retailers, Woolworths and Wesfarmers. These firms occupy a position of near oligopoly given their stranglehold on city centre retail real estate. Combine this effect with that of high import duties on foreign goods (10-20%), and living in Australia becomes very expensive!

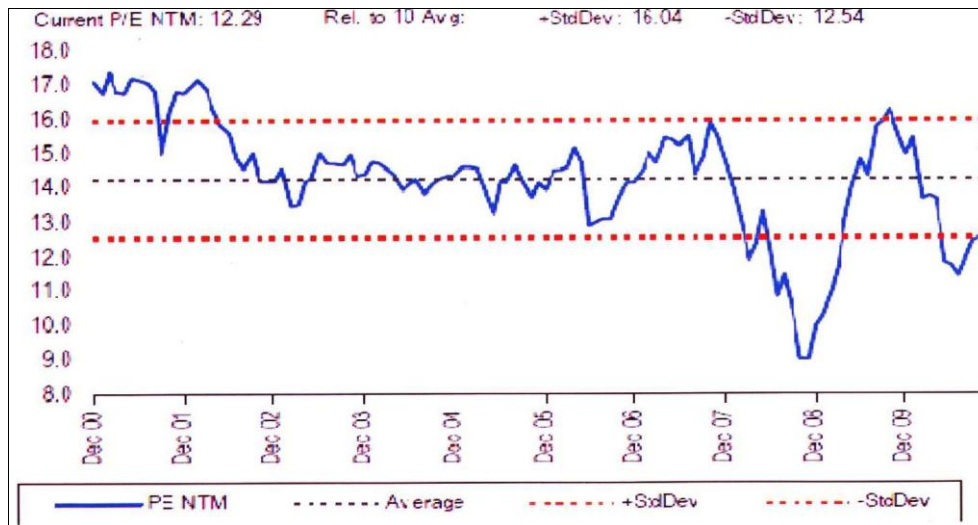
The cost of basics (shampoo, toothpaste etc) is around 1.5 to 2 times the equivalent cost in London. Coffee retails for around A\$4 = £2.80 and Beer is typically A\$9 = £6 for not quite a pint. However the days of easy profits for Woolworths and Wesfarmers may be drawing to an end, as out of town supermarkets, led by ALDO, are starting to encircle the cities. I was excited to pass the county's first Costco on the outskirts of Melbourne.

The de-rating of the mining industry in particular has caused the share price and projected earnings of the Australian market to diverge, as shown in the charts below:



Source: ABS, Bloomberg, Colonial First State

Australian P/E ratios are towards the bottom of their historical range:



The high rates of return from cash mean that investors have little incentive to take risk with their savings. However, by law 9% of annual earnings are paid into superannuation schemes (pensions), which typically follow a 70:30 equity:fixed interest asset allocation, and make up a pool totalling A\$1.2trn. The equity allocation is overwhelmingly domestic, probably because Australian equities have been on a 30 year bull run and anyone investing outside of Australia in the last year or so has been severely punished by a strengthening A\$. In addition, tax credits on domestic stock dividends can almost double the income yield paid to domestic shareholders.

The structure of the investment community is shaped by this "super" money, which is controlled within three types of structure:

1. Around 1/3 of the "super" savings are held in institutional pension schemes, whose fund choices are tightly monitored against benchmarks via investment consultants (Mercer etc). Fees are very low at 30-40bps, or even 2-3bps for an index tracking mandate. Increasingly, the big Superannuation funds are taking investment staff in-house in order to cut costs.
2. The next 1/3 of these savings are run via Independent Financial Advisors who typically invest in managed domestic funds, again to tight benchmarks. Much use is made of platforms to manage this capital, for example Macquarie's COIN platform.
3. The last 1/3 is self-invested. The costs of doing this means that the minimum size is around \$300,000. Australians are typically risk-hungry investors and they have been richly rewarded for taking risk in the past. There seems to be a slightly gung-ho approach to risk taking, evidenced by the startling volatility and high ratings of the smaller capitalisation mining stocks.

The corporate bond market is far less developed or liquid than the equity market. REITs are an important part of the market, and "hybrid" bonds (like convertibles without the call option but with multiple/flexible put dates) have also been popular.

Part 3: Investment Conclusions

Investing in domestic Australian funds carries uncertain (withholding) tax implications. There are a few funds set up for the international investor, although none that I saw had UK reporting status.

If Australia is a risk on/ risk off investment, then it currently looks attractive relative to its historical price. It has the attraction of being linked to Chinese growth and yet indifferent (in the short term) to the profitability of that growth. To me, the large cap mining industry looks more attractive than consumer discretionary companies or the banks.

The A\$ is more than 2 standard deviations away from its long term average value, although investing at 5.5% institutional cash rates versus 0.5% in the US/UK is an attractive carry trade. If one invests in Australia to capture "risk on", then it doesn't make much sense to hedge the currency.

Commodity supply out of Australia is currently very constrained by both current production capacity and Infrastructure. Future supply is significant, however as Stuart Connell of JPMAM points out it is that which is available today that matters to spot prices (see appendix for full meeting writeup). Perhaps this argues for being long via the futures markets rather than via companies?

Appendix: Meeting Note with Stuart Connell of JPM Asset Management 31 Jan 2011

Stuart co-managed the \$9bn JPM Natural resources fund with Ian Henderson in London, before recently moving back to his native Melbourne. Here he is continuing to work with the Natural resources team in London, and has taken on some Asian mandates along a similar vein including the "Leaders Strategy", a large cap version of the JPM Natural Resources fund.

Thurleigh do not currently own any of the above funds.

Investment Views

Stuart's primary message was that you need to think of resources in terms of volume. The percentage growth rate of the global economy sets the volume of commodities that need to be dug up each year, *however each year this amount starts from a higher base*. This means that we are stuck with the problem of compounding; the volume of commodities required to satisfy last year's 3% GDP growth will not be enough to satisfy this year's 3% GDP growth.

Add to this the very real problem that quality and quantity of new finds is decreasing. Average Copper recovery from ore 10 years ago was 1.6%; now it is nearer 1.2%. This doesn't sound like a big difference, but in fact it means that you have to dig up 33% more of the stuff to achieve the same volume of processed copper.

Stuart believes that the super-spike is still to come, the supply problems are just that bad. This assumes that the world continues to muddle along.

When I suggested that there has already been a large amount of capital invested and that supply should come on in the next few years, Stuart countered that new supply is always coming on at some point in the future, but the issue we face is what is available today!

The large-cap resources companies are a call on commodities prices; Stuart feels that 90-95% of price movements will go straight to the bottom line. The majority of the industry sells product at spot and there is very little use of the futures markets to hedge. However, analysts tend to only update their price assumptions before reporting dates, so there may be a disconnect (as now) between forecast sales and reality.

JPM Natural Resources Fund

The JPM Natural Resources portfolio is divided 50:50 between mid/large- cap companies and smaller companies (usually pre-production mining projects). The portfolio is also spread:

1/3 Base Metals

1/3 Energy

1/3 Precious Metals

This latter part of the portfolio represents a long tail of smaller of mining companies where the fund will take a significant (10%) stake in the company. This clearly leaves them open to liquidity risk: in the GFC they underperformed by 15% as they sold proportional slices of all stock, including the small cap names. There was compensation in the subsequent bounce back.

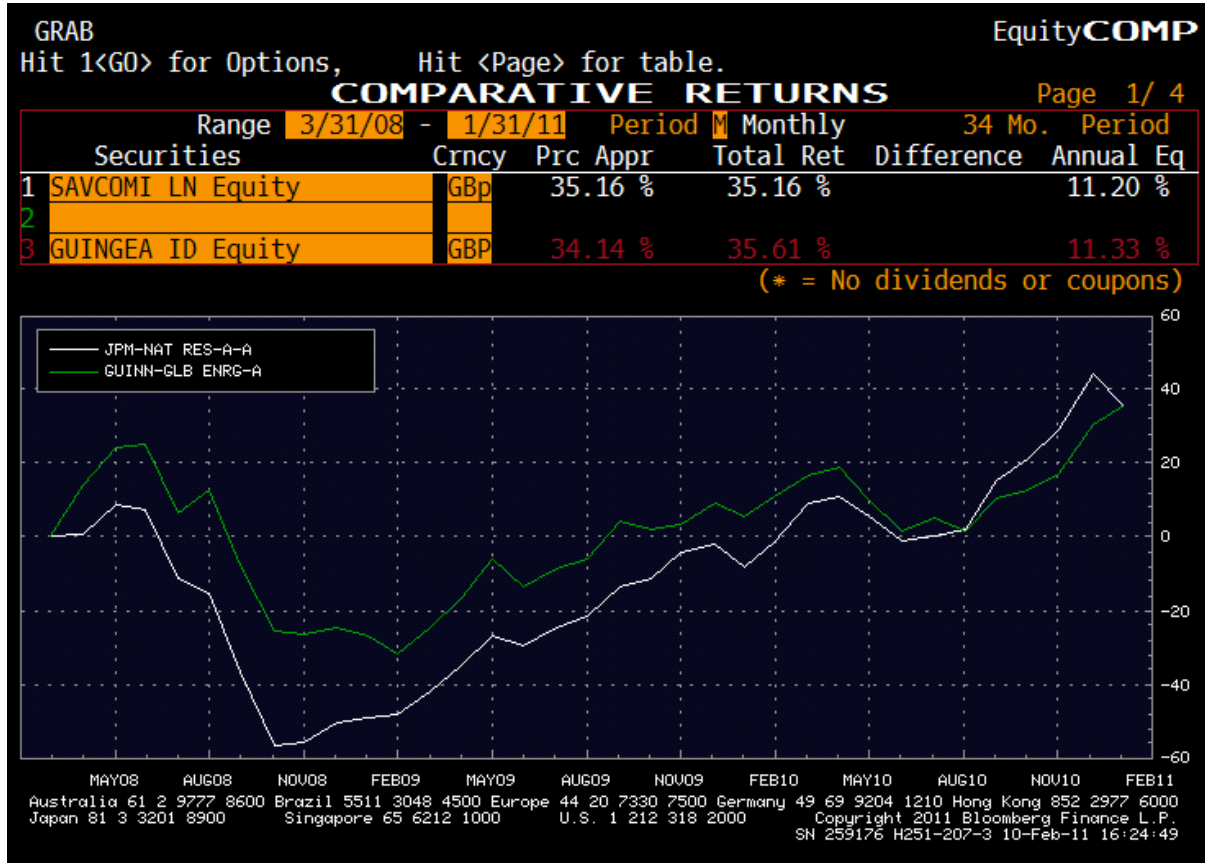
Stuart spends his time meeting with the management of the c.280 companies in the portfolio as well as any new entrants into the space. His team uses brokers numbers / models as the basic information on any resources company and uses the management meetings to test the assumptions made.

Given the number of positions in the portfolio, they diversify away the risk of company management simply giving false information. However there is a perennial tendency to overestimate the speed of development and the scale of un-mined deposits. This is often because funding will rest upon these assumptions, and margins of error are always such that optimism can be revised down.

We talked about gold: Stuart thinks that the cost of production will double over the next few years. There is more gold out of the ground than in the ground, and it is becoming harder and harder to mine the existing deposits. Having said that, they have reduced their weighting from 45% of the precious

metals bucket to 25% today on a tactical basis. Price over cost of marginal production is high enough that it could easily fall back.

The performance versus the Guinness Global Energy fund (which Thurleigh owns) is shown below:



Source: Bloomberg