AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

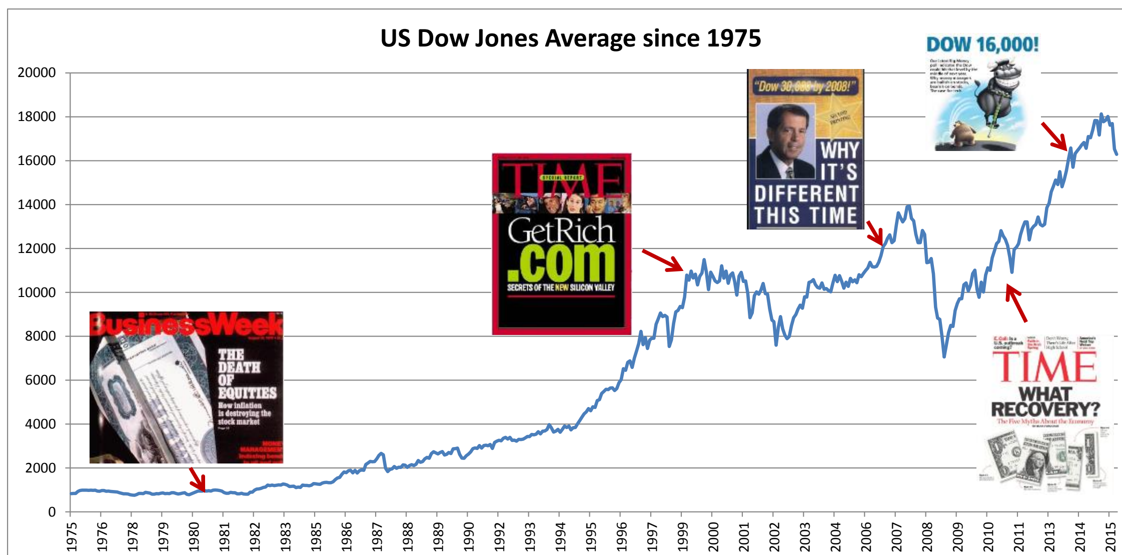
By Hugh Dive — 23rd October 2015

Losing Money in the Market

Notwithstanding the weakness in the global markets over the past eight months, investors globally have had a good run over the last six years with the US's Dow Jones up 160% since 2009 and the ASX200 up 67%. However it is very rare to ever be enjoying market conditions where you can have a great degree of confidence as to the future direction of the share market, as it is the uncertainty of returns that gives rise to the return premium that equities have enjoyed over bonds and cash over the long term. Indeed over the past week we have seen headlines in the financial press with the title "*Two Significant Flags signal the Bull Run is getting close to the Peak*" and "*Kerr Neilson sees value in Epic Sell-Off*". As the equity markets have only seen a modest increase this week, surely these statements can't both be true.

In the spirit of investing in uncertain times, in this piece we are going to look at seven reasons that have caused both individual and institutional investors (including the author of this piece) to lose money in the market when making investment decisions.

1. **Chasing overvalued markets.** The close cousin of panic selling at the bottom, is the feverish buying at the top of the boom. Most investors can recall top-selling pre-GFC books written by investment gurus with titles like *"Dow, 30,000 by 2008" Why It's Different This Time".* This book had the misfortune of being published just before the US index more than halved to 6,000. During even the most exuberant of markets, investors will be able to find market experts giving reasons why valuations can go even higher. In 2000 investors were told that "*clicks per eyeball*" is a more important metric to use in valuing a company, rather than free cash flow per share. During this period I had friends that were making large profits trading internet companies where they only thing that they knew about the business was the company's three letter stock ticker on the Toronto Stock Exchange. As an equity analyst with years of training I found this particularly galling.



2. **Does the company have Sustainable Earnings or a sucession of One-off Fees?** The GFC exposed investors and their advisers that invested in complex products and companies that were reliant on short-term debt and one-off fees to generate earnings, or the appearance of earnings. Similarly during housing booms, Property

Trusts are able to boost earnings with development profits or by selling re-zoned industrial property to residential developers at a premium to its book value. When market conditions change, these earnings tend to evaporate, thus investors should only pay a low multiple for these profits.

3. **Panic selling of investments.** Despite the doom and gloom heralded in the financial press such as the infamous headline in the chart above which predicted the "*Death of Equities*" just prior to a 15 year bull run in the sharemarket, when the clouds are the darkest, this can be the time to actually be buying quality stocks with sustainable businesses. In January 2009, CBA was under a significant degree of pressure after Storm Financial collapsed along with other high-profile companies such and Babcock and Brown and ABC Learning which caused the stock to hit $24. This proved to be a very small part of the business and CBA has returned 203% since then even after the 2015 capital raising (or 296% including dividends).

4. **Buying "cheap" companies that are facing significant negative structural challenges** because sometimes companies are cheap for a reason. Often we get asked "*why don't you buy company X – it is yielding 12% ?*" Invariably this is down to a high trailing yield (i.e. last year's dividend divided by the share price) and future dividends are often significantly weaker than what was paid in the past.

   We look to short sell companies with issues, as the issues almost always go on for longer and are worse than even the most pessimistic initial estimates. Past examples of this have been the slow erosion of Metcash's share of the grocery market, IAG's foray into the UK motor insurance market and Worley Parson's attempts to adapt their business to a market with minimal appetitie for large-scale engineering projects. In golfing terms this is the equivalent to being in the rough and hitting blind over the trees onto the green, rather than chipping back onto the fairway.

5. **Asset rich, but cash poor.** This point refers to companies that have a large asset backing, often with a NTA per share (net tangible assets or a company's assets minus liabilities and non-cash intagible assets such goodwill and patents) higher than its market value. In theory, investors could liquidate the company's assets, pay off its debts and then receive more than the current share price back in cash. However with companies such as BlueScope and Arrium that trade below their asset backing; the value of a second hand steel mill that a forced seller can realise would certainly be much less than its value on the balance sheet. Similarly timber company Gunns' vast land bank ultimately counted for little when a rising AUD dramatically reduced woodchip sales to Japan and the company's debt load became unsustainable.

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6. **Owning companies with excessive gearing,** particularly when associated with any of the above factors. A company adds debt (or even an investor by gearing their purchase of a stock) to magnify the returns on funds invested. The downside is that higher leverage adds an additional level of risk to a company, as greater portions of company earnings go to cover the interest bills of the increasingly nervous lenders. As we saw with Gunns in 2012, high leverage gives companies fewer options when business conditions deteriorate. There have been many circumstances were companies have been forced to sell quality assets at low prices just to keep their bankers at bay. Arrium is in this very situation at the moment and is looking to sell its most profitable division, global mining consumables.

7. **Anchoring** refers to the investing tendency to rely on the first piece of information offered when making decisions. In this case an investor may say "*I bought Babcock & Brown for $15 in May 2008 and it has declined and I know the business looks like it is in trouble, but I will wait till it gets back to $15 before I sell it*". Here the investor anchors their decision based on a number, rather than a valuation based on the prospects for the business going forward.

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