AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive

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Meetings with Management

A key part of our investment process is meeting with the management teams of companies at least once every six months where we hold a significant long or short position in the Aurora Dividend Income Trust and the Property Buy – Write Income Trust. Generally we seek to meet with management teams just after they have released their semi-annual profit results and at other times during the year when we have specific issues or concerns that we feel need to be addressed. The content and tone of these meetings varies widely depending on the nature of the company and how far the results that the management team has delivered deviates from our expectations.

As it is reporting season we have been very busy over the month meeting with management teams from both large (***BHP*** and ***CSL***) to small (***Investa Office Fund***) companies. In this piece we are looking to shed some light on the role that these meetings play in the investment process.

Why Meet with Management Teams?

The efficient market hypothesis states that it is impossible to "beat the market" because stock market efficiency causes existing share prices to always incorporate and reflect all relevant information. If we believed this to be true, it would be a waste of time for anyone in the market to meet with CEOs and CFOs, as we could learn nothing that was not already incorporated into the company's current share price. Whilst this theory sounds elegant, in practice markets are inefficient due to the influence of human emotions and indeed robotic trading algorithms. As investors we want to capture higher investment returns from selling over-valued companies and buying those that are undervalued.

The press sometimes paints the additional access to management that institutional investors have over casual mum and dad investors as being unfair or bordering on inside information. In practice, these management meetings don't provide us with inside information, but rather are used by the analyst as additional pieces to build up a *mosaic of information* to determine the underlying value of a company.

In the past some of the most useful information on a company has been obtained not from the management itself, but rather from meetings with that company's direct competitors and clients. Often a company may be a little coy when asked the more difficult questions about issues facing their business, but that same company may enthusiastically discuss problems facing their listed competitors, such as lost contracts. Similarly in 2013 the management teams at RIO and BHP were discussing their plans to significantly cut their cost base by reducing their reliance on contractors and indeed renegotiate existing contracts. Coming out of these meetings it was clear that there was a disconnect between the guidance being given by the suppliers (***Downer, United Group*** and ***Leighton***) and their customers (***BHP*** and ***RIO***).

See the Colour of their Eyes

Further when meeting with management teams you are also looking to gauge management's response and body language when they are answering difficult questions ranging from refinancing debt to achieving stated profit guidance targets which look excessively optimistic. By purchasing securities listed on the ASX we are effectively entrusting our clients' capital to the management teams of various companies and must therefore trust that these management teams are going to act in the best interests of our clients. For example a few years ago I met with management of Lihir Gold (now part of **Newcrest**) to question them about their meagre dividend payout policy, despite ounces of gold finally starting to flow out of the mine on Lihir Island. Management at the company (former engineers) said that returns for shareholders would not increase, but rather they were going to invest the profits in building a new mine in war-torn Côte d'Ivoire, which would involve the building of a 100km rail line through the jungle. From this meeting it was clear that management's first instinct as former engineers was to build beautiful mines, rather than reward the owners of the company!

As we took the view that our clients' interests would be better served by receiving dividends now, rather than potentially investing that cash flow in a new, quite risky development, the position was sold shortly after the meeting. Similarly we left a meeting with a company's CFO last year with the view that there was a disconnect between the profits outlook presented to us and the structural headwinds from deteriorating conditions in the company's industry and sold the position shortly after.

Give and Take

It would be wrong to think that these meetings are mostly adversarial competitions for information between analysts and management teams. From the perspective of the company these meetings can be a forum for the CEO to float potential acquisitions changes in strategy or capital management initiatives to their major shareholders. The advantage of doing this behind closed doors is that a company can avoid the potential embarrassment or loss of goodwill that comes with presenting an acquisition with a dilutive equity raising to a hostile group of institutional shareholders, some of which may decline to support it.

Recent Meetings of Note

In the meeting with ***Investa Office Trust*** the focus was not so much on the recent profit result that was quite solid, but rather in understanding the future of this trust. The near term returns from owning this high quality trust are more likely to come from a potential wind-up or takeover rather than operating performance or leasing success.

Similarly, when we met with ***BHP's*** CEO, after discussing the company's cost cutting program and capital expenditure plans, most of the discussion involved understanding the sustainability of the company's dividend (currently over 7% fully franked). Furthermore as we are very interested in franking in our Dividend Income Trust, any discussion with BHP always involves plans to access the company's franking account balance. In the case of BHP, the large outstanding franking credit balance can be viewed as an A$15 billion 0% interest rate loan to the government by BHP shareholders. Even the most patriotic Australian would not want to be a long term low cost lender to the government and would prefer to see a cheque for these tax credits.

At Aurora we own long positions and also short stocks, so it is important to understand the companies where we have large short positions. Accordingly we met with ***CSL*** last week not so much to gain insight into the company's blood therapy products, but rather to better understand the loss-making flu business acquired recently from Novartis. This acquisition created the second largest influenza vaccine business with 20% revenue share globally yet is expected to lose money and be earnings per share dilutive until 2019.

With ***Federation Centres*** the focus of the meeting was not so much on the result and the $3.1 billion shopping centre development pipeline, but rather on the Novion merger especially with the recent and somewhat surprising change of CEO. The key here was to understand how the CEO was going to mesh the different cultures of Federation (necessarily entrepreneurial after emerging from the near-death Centro experience) and Novion (coming out of the process driven Commonwealth Bank) and what this means for shareholder returns.

One of the benefits of having your portfolio managed professionally is that the portfolio is constructed and managed by individuals whose sole focus is to select and blend equities into a portfolio designed to deliver higher returns with lower volatility. Another advantage of institutional management is that many doors get opened for Research to ask questions of senior management in investee companies.

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Aurora Funds Management Limited is a fully owned subsidiary of ASX listed, Keybridge Capital (ASX Code: KBC). Aurora is a boutique investment manager that was established in 2003, and has established a long track record of producing risk adjusted returns for retail, institutional and high net worth investors. The investment strategies are offered through both ASX listed investment vehicles and managed funds. They aim to deliver income whilst also managing the risks associated in investing in Australian and global equities.

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- **Aurora Dividend Income Trust (Managed Fund) (ASX code: AOD)**
- **Aurora Absolute Return Fund (ASX code: ABW)**
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