AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive

29th April 2016

Avoiding Torpedo Stocks

Last week ***McGrath*** (ASX: MEA), an integrated residential real estate services company (that we don't own) saw a 31% decline in its share price after the company downgraded estimates for future earnings. This was very painful for investors in this recently listed company, but for us, it was not particularly surprising.

In this piece we are going to look at the mechanisms we use to filter out companies that have a higher probability of future issues to reduce heartache. This exercise is based on the concept that removing a few "losers" from the long only portfolio is more consistently beneficial to a portfolio's performance than focusing on picking the next Aconex (up 207% in the last year). As we can also short stocks this process is also a component of what we use to identify "torpedo" stocks. Also like most investors I am somewhat irrationally loss averse[1] in that I strongly prefer avoiding losses to acquiring gains, even when the probability weighted outcome is the same. One of the mechanisms we use to filter out noise and narrow down our investment universe is our quality filter model (QFM).

In developing the model we reviewed corporate failures in Australia over the last decade looking for contributing factors which lead to the disaster. Across the corporate graveyard it became evident that many companies exhibited similar characteristics that contributed to their demise.

These factors including an excessive amount of debt, rapid growth through acquisitions, poor corporate governance, significant changes in government regulations and the impact of disruptive new technologies as being major causes of failures. These factors became the framework for the QFM.

The below table details a range of companies that have failed the various QFM factors and a few currently listed companies that exhibit some similar undesirable characteristics.

	Leverage	Growth	Governance	Regulation	Technology
ABC Learning		💣	💣		
Allco Financial Grp	💣	💣	💣		
Babcock & Brown	💣	💣	💣		
Timbercorp	💣	💣		💣	
Gunns	💣		💣	💣	
Slater & Gordon				💣	💣
Spotless		💣	💣		💣

Avoiding Losers

[1] See KAHNEMAN, Daniel, and Amos TVERSKY, 1979. *Prospect Theory: An Analysis of Decision under Risk*. *Econometrica*, **47**(2), 263–292.

The underlying theme is that history has shown that it is easier to add alpha to a portfolio by avoiding torpedoes than by picking winners! Far too often the emphasis when investing in equities is on 'picking winners'. This occurs as it is far more exciting for fund managers to tell investors about how smart they were picking Magellan Financial (1,545% over the last 5 years); as opposed to how the manager avoided Slater + Gordon (down 95% over the past year). When looking at the two decisions with the benefit of hindsight, the former tends to show off the brilliance of the portfolio manager. Whilst the latter in 2016 seems like a pretty obvious choice, but one year ago Slater and Gordon had a market capitalisation of $1.5 billion after sucessfully completing a $890 million capital raising at $6.37!

Key Factors

- **Financial Leverage**: Here we look at the gearing controlling for the nature of the business (i.e. utilities like ***Transurban*** can 'safely' have more debt than a highly cyclical stock with variable earning and thus a variable ability to meet interest payments), the interest coverage and the company's debt maturity profile. Highly geared companies like ***Santos*** score poorly on this measure.
- **Rate of expansion**: We look at whether the company is growing and consider the quality of the growth, in particular whether the acquisitions are value accretive or destructive? ***Boral***'s Asian plasterboard acquisition is an example of value destructive growth. Similarly ***Slater and Gordon***'s UK expansion led to the company accumulating over $1.2 billion dollars in assets and intangibles yet generated little in the way of returns.
- **Corporate Governance**: Over time poor governance and disclosure can be a leading indicator for poor financial outcomes for investors. If a company's disclosure is poor whilst things are going well, it can be hard for an analyst to pick up clues in their financial accounts when conditions begin to deteriorate. In this measure we also look at shareholder returns versus executive compensation and executive share ownership. ***Myer*** scores poorly on this measure due to excessive pay compared to weak shareholder returns over three and five year periods.
- **Regulatory Risk**: Here we look at both the current level of government regulation being applied to the businesses industry and the potential for the government to increase regulation. AMP scored poorly due to increasing government regulation. Companies that score well in this measure are generally those where the government has little interest in their activities such as office trusts like ***Investa Office*** or packaging companies such as ***Amcor***.
- **Technological & Operating Risk**: The risks we are primarily looking for is the risk of technological obsolesce of the company's business. Even the best managed company in an industry facing structural weakness, cannot fight those declines. Twenty years ago selling and repairing type-writers or renting DVD movies were lucrative businesses that are now of zero economic value. Across our investment universe we see ***Seven West Media***'s magazine and free to air television businesses as having a large degree of technological risk from online magazines of Mamamia and direct streaming services Netflix.

Our Take

Every equity investor from time to time will face issues in the stocks in their portfolio. Indeed Warren Buffett, one of the most successful investors of all time has not been immune from owning stocks with issues, the most prominent one being his investment in 1962 of a New England-based textile company called Berkshire Hathaway. Here after twenty years of losses and the mills losing market share to Asian textile companies with lower cost structures; Berkshire Hathaway's cotton mills were shut down in 1985 leaving only its name to the sprawling multinational conglomerate holding company. We see that investing is more a grinding game of cricket scoring singles, rather than spectacular sixes. The quality filter model is a defensive measure trying to avoid mistakes, and focus our investing research attention on companies less likely to experience problems or stress in the future.

Hugh Dive CFA
Senior Portfolio Manager

AURORA FUNDS MANAGEMENT

Aurora is the issuer of the:

- **Aurora Dividend Income Trust (Managed Fund) (ASX code: AOD)**
- **Aurora Absolute Return Fund (ASX code: ABW)**
- **Aurora Fortitude Absolute Return Fund**
- **Aurora Global Income Trust (ASX code: AIB)**
- **Aurora Property Buy-Write Income Trust (ASX code: AUP)**
- **HHY Fund (ASX code: HHY)**

AURORA FUNDS MANAGEMENT

Level 4, 1 Alfred Street, Sydney NSW 2000
PO Box R1695, Royal Exchange NSW 1225
Telephone: +61 2 9080 2377
Visit:
Email:

Disclaimer: The above information is commentary only. It is not intended to be, nor should it be construed as, investment advice. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. Before making any investment decision you need to consider (with your financial adviser) your particular investment needs, objectives and circumstances. For further information please visit www.aurorafunds.com.au.