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HD **Share sizzle going to a simmer**

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Investor returns have been spectacular for the past two years. But fund managers say the new financial year won't burn so brightly, writes John Collett.

The past two calendar years have been particularly rewarding for share investors, with Australian and global shares producing double-digit annual returns. Australian shares, including dividends, returned more than 20 per cent for each of 2012 and 2013. International shares returned 14 per cent in 2012 and 48 per cent in 2013.

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The better-performing fund managers have been able to add returns over and above those of the market. Usually, the better-performing funds invest in Australia's record profit-producing big banks and under-invest in the struggling resources sector. However, they have also been able to find plenty of companies outside the financial services sector that have done well.

The better performers share some common features - they invest in well-run companies that tend to have low debt and continue to do well almost regardless of economic conditions.

Nowhere has this been better demonstrated than with fund manager Perpetual. Four of Perpetual's funds are among the top-10-performing Australian share funds ranked by three-year returns. Among global share funds, the better performers have mostly been those invested in multinationals, whether listed in New York, London or Switzerland, that own well-known brands.

Australian shares

Smallco Investment Management's Broadcap Fund takes line honours in Australian shares. Morningstar data shows that over the three years to April 30, it has produced an annual average return of 26.51 per cent. That compares with a total return from the Australian sharemarket over the corresponding period of just over 9 per cent - an outperformance of the market of more than 17 percentage points.

The Broadcap fund holds 20 to 30 stocks and up to 40 per cent of the fund can be invested in smaller companies. Andrew Hokin, senior portfolio manager for the Broadcap fund, says good performers for the fund over the past three years include online job search **company** Seek, fund manager Magellan Financial **Group** and Rupert Murdoch's entertainment **company**, 21st Century Fox.

The Perpetual Wholesale Ethical SRI fund is in second place with an average annual return over the three years of just under 18 per cent.

"SRI" stands for socially responsible investing and shows investors can invest with a conscience and still produce very good returns. The manager first applies a negative screen to knock out companies involved in industries such as tobacco, alcohol and gaming, among others. Most miners are excluded either for environmental reasons or because they are involved in particular mining activities such as uranium (if more than 5 per cent of revenue) or coal seam gas. About 150 stocks make it through the screening, with about 40 to 50 stocks selected from those on investment merit.

A common theme running through the top performers, including this fund, is under-investment in the struggling resources sector. About 30 per cent of the portfolio is smaller companies - those outside the 300 largest companies. Nathan Parkin, portfolio manager of the fund, says good performers over the past three years include the personal injury litigator Slater & Gordon, Bega **Cheese** and Freedom Foods, which produces "health and wellness" foods.

In third spot is Investors Mutual's Wholesale Industrial Share Fund. Investors Mutual is the boutique fund manager founded by Anton Tagliaferro. The Industrial Share Fund is the manager's flagship fund. "We are a 'value' fund manager," says Tagliaferro. He says the investment philosophy focuses on companies with strong competitive advantage, recurring earnings and capable management.

"In the last three years we focused our portfolio on companies that our research shows could grow their earnings and dividends despite the very mixed economic conditions around the world," he says. Companies that have done well include packaging **company**Amcor, CSL, Telstra and Energy Developments.

Global shares

Magellan Global Fund is the top-performing international share fund with an average annual return over the three years to April 30 this year of 23.55 per cent.

Sydney-based Magellan was established by Hamish Douglass and Chris Mackay in 2006. The flagship Global Fund was launched in mid-2007. It was tough time to launch a global equities fund, as sharemarkets were collapsing everywhere in the lead-up to what would become the global financial crisis.

"We did not have a lot of inflows but held our nerve ... and investors have done well to stick to us," says Frank Casarotti, general manager of distribution at Magellan. He says the fund holds about 25 high-quality companies. They are mostly multinationals with well-known brands such as eBay, Microsoft and Nestle. It also includes the British supermarket chain Tesco. Magellan Financial **Group** is listed on the Australian sharemarket with a market capitalisation of about $2 **billion**.

IFP Global Franchise is another fund to do very well from investing in companies with global brands. Macquarie Professional Series offers the London-based Global Franchise Fund to Australian investors.

The fund is managed by international shares investor Hassan Elmasry. The fund is unconstrained in how it invests and holds between 20 and 40 stocks. Over the three years to April 30 the fund has returned 19.44 per cent to take second place in the global shares category.

Adrian Stewart, head of distribution and marketing at Macquarie Investment Management, says the companies held in the portfolio usually have a **brand**, patent or licence - something that is hard for competitors to replicate. Good performers for the fund include US-listed Mondelez International, which owns brands including Cadbury and Toblerone. The fund's investors have also done well from Novartis AG, the Swiss and US-listed pharmaceuticals **company**, and from the health, hygiene and home products maker Reckitt Benckiser.

PM Capital's Absolute Performance Fund is in third spot with an average annual return over the three years of 17.79 per cent.

The Sydney manager, founded by Paul Moore in 1998, is still playing the recovery in real estate prices in Las Vegas. PM Capital is repeating the strategy applied in Las Vegas to Spain and Ireland. Las Vegas was the centre of the crash in US house prices that triggered the global financial crisis. Moore has been investing in US banks, benefiting from the housing recovery there.

"What happened in the US is being replayed in Europe with a two-year lag," Moore says. US house prices hit bottom about three years ago and the trough in prices in Europe was the second half of last year, he says.

The Absolute Performance Fund has positions in London-listed bank Lloyds and in Dutch bank ING. The fund also has investments in pooled vehicles that **buy** "distressed" in Europe.

Moore's "gut instinct" is that rents will go up 50 per cent in Ireland and parts of continental Europe. Real estate prices will rise. He says that in some ways ING is like the Commonwealth Bank and Westpac 15 years ago. The Australian big banks' shares have gone from book value to more than two times book value over that time, and Moore believes the same could happen to ING.

Tougher times ahead

Investors have enjoyed bumper returns for the past two years, but fund managers expect returns to moderate this year.

International fund managers surveyed by AMP Capital said they were cautious for the outlook for this year.

"Their concerns are based around the risks they see to the global economy, including the ongoing crisis in Ukraine, the end of quantitative easing [money printing] by central banks and questions over the direction of **China**'s economy," says Anthony Fasso, chief executive, international, at AMP Capital.

Managers of Australian share funds are also more cautious, as opportunities are harder to find and the economy faces head winds. The big banks have had a terrific run as investors chase divided yields of about 7 per cent after franking credits. The big banks have probably contributed more than half of the performance of the market, after adding in their dividends. Three of the big four's share prices are trading at record highs.

"At the moment it is hard to find much that we would describe as value, and certainly the opportunities are nothing like they were even 12 months ago, let alone two years ago," says Smallco investment manager Andrew Hokin.

There is also uncertainty over the likely strength of domestic consumption. Hokin has a bias to Australian-listed companies with offshore exposures and is holding higher-than-normal levels of cash.

The Australian sharemarket is reasonably fully priced, says Perpetual portfolio manager Nathan Parkin. "It is harder to find value today than it was. We could **buy** fast-growing businesses at 10 times PE [share price-to-earnings ratio], [but] we cannot do that any more, as the opportunity has exhausted itself."

Fund manager top picks

Andrew Hokin, Smallco

● Sirtex (SRX). Cancer treatments. "Sales of $100 **million** and profit of $20 **million**."

● Seek (SEK). Online job ads, education and training. "Its international businesses are still at early stages and improving."

● Henderson (HGG). British-based pan-European asset management. "Its retail inflows have improved enormously over the past 12 months."

Nathan Parkin, Perpetual

● Reckon (RKN). Financial management software. "Profitable, little debt and 5 per cent cash yield fully franked."

● Freedom Foods (FNP). Specialised foods. "They have expanded the **business** well."

● Bega **Cheese** (BGA). **Dairy** products. "It has delivered good profits and management is first-class."

Anton Tagliaferro, Investors Mutual

● Recall (REC). Global document storage. "Generates great cash flow and will grow earnings."

● Pact **Group** (PGH). Packaging. "Recent listing and extremely well-managed."

● Ansell. (ANN) Gloves and condoms. "Well-positioned to continue to grow through acquisitions and new products."

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