

# Quarterly review

September 2015



## Market environment

Volatility increased sharply during the quarter, with falls across all share markets - ASX 200 -8.0%, S&P 500 -6.9%, Germany's DAX -11.7% and the Shanghai Composite Index -28.6% (!)

These returns reflected concerns about the slowing pace of Chinese growth (and ramifications around the globe) coupled with the potential fallout from higher U.S. rates, flagged by the Federal Reserve as likely by the end of the year.

The initial trigger was the sharp fall in the Chinese share market combined with the same government's decision in August to devalue its currency by some 3% against the US dollar. Both events were seen as evidence that the Chinese economy was slowing more sharply than previously anticipated.

This also precipitated a fall in many commodities to which Australia is leveraged (eg. iron ore and oil) which was reflected in turn in the share prices of some of our largest resource/energy stocks (Santos being the most impacted). Having said this, it is important to keep in mind that the Chinese stock market is far from a proxy for the Chinese economy with the economy in fact becoming better balanced as it transitions from investment lead to consumption driven growth.

Outside of global concerns, domestically higher capital requirements and a strengthening of controls around lending for direct property investment saw the major banks fall significantly over the quarter.

Our portfolio fell as well but, as a result of being underweight resources/energy and financials in general, combined with the outperformance of our smaller cap stocks, significantly less than the market itself.

## Portfolio activity

In the last quarter, we added the following stocks:

- **Bursons** (a consolidator in the domestic automotive aftermarket parts market, Bursons has been a major wholesaler to mechanics around Australia but, following the acquisition of Metcash Auto (Autobarn, ABS and Midas amongst other brands), it now has the opportunity to sell product through the retail and chain workshop segments of the market);
- **Billabong** (this once loved and recently maligned Australian surfwear brand has undergone a thorough and aggressive restructure led by a well credentialled MD, Neil Fiske, following the stock nearly falling into receivership a few years ago. Billabong has streamlined its business, stabilised its revenue base and regained its focus. We see the "turn around" as being in its early days);
- **Greencross** (a pet care retailer (namely "Petbarn") and provider of veterinary services across Australia, which we held previously and sold (at a profit) and which, following a fall in price, recent management changes and a refocussing of the business, stands to benefit from the still highly resilient pet care market);
- **TPG Telecom** (following its takeover of iiNet, TPG is now the 2nd largest telco in Australia, as measured by internet subscribers. Backed by excellent management, TPG is well placed to not only leverage its brand but also its high quality infrastructure, as the NBN rollout gathers pace); and
- **Yowie** (an international confectionery distributor of the old Cadbury's product, Yowie, owing to patent protection, has little competition in the prime US market for the next couple of years, with its popularity evidenced by recent "all stores" rollout agreements with WalMart and Safeway).



In addition, we also added to holdings in **Challenger** (where regulatory change continues to move in its favour), **Infomedia** (pre its FY15 result which whilst solid has since highlighted further capital expenditure), **Slater and Gordon** (where we believe the stock has been oversold due to overblown market concerns and hedge fund short selling) and **Veda** (now the subject of takeover bid).

As is always the case some stocks did not live up to expectations or reached a price which we think overvalues the underlying company, accordingly during the quarter we removed the following:

- **Credit Corp** (at a profit, with sale occasioned by slow progress in the US and a full price for the stock capturing those future underlying opportunities);
- **JB HiFi** (despite solid dividends and making a small profit, JBH made way for better ideas within the portfolio, given the tough local environment for consumer electronic retailers, reliant on importing, where product is becoming more expensive, owing to the Australian dollar depreciation);

- **Tox Holdings** (although believing the company to be “best of breed”, our investment thesis has depended upon a pick-up in infrastructure, which was to be a hallmark of the (previous) Abbott government, but this has not come to pass. As such Tox has not been able to seamlessly transition its earnings from its resources/energy bias as we had hoped); and
- **Flexigroup** and **G8 Education** (we have been long term investors in these companies however concerns around recent management decision making, exacerbated by unexpected changes in management ranks and a growing lack of transparency (some of our key investment criteria) forced our hand).

During the quarter, we also reduced our position in **Australian Careers Network** (at a profit and to reduce the risks around any changes to government regulations), **CSL** (at a profit) and **Telstra** (following issues with a mooted Philippines expansion).

## Commentary

From an overall perspective, although there were several causes for the market to take a step back in the quarter, there are still many reasons to remain positive about the foreseeable future:

- monetary policies of almost all central banks remain highly accommodative for global growth;
- any US Federal Reserve rate hike will not occur unless growth is entrenched (2016 looking likelier);
- share prices (having fallen nearly 10%) now represent better value, all things being equal; and
- a softening in Chinese data, albeit expected, could still encourage fiscal or monetary stimulus by the People's Bank of China, to “smooth” the slowdown trajectory.

Against this backdrop, we continue to favour investments which exhibit the following:

- exposure to US Dollar earnings, which we believe will continue its strength as other countries pursue “beggar thy neighbour”<sup>1</sup> economic policies;
- secular stories where the success of the company is not intrinsically tied to variations in global or domestic economic growth; and
- companies whom we believe hold a significant point of difference or are directly exposed to earnings tailwinds such as a first mover advantage, an aging population or a growing demand niche.

1. a “beggar thy neighbour” economic policy is one whereby one country attempts to remedy its economic problems by means that tend to worsen the economic problems of other countries e.g. a country aiming to depreciate i.e. reduce the value of its currency to make it more competitive than another country.

Please note that the information in this publication is for general use only. We would be pleased to talk with you in regard to your particular circumstances should you wish to explore any particular aspect further. Any tax planning matters should be discussed with your accountant before proceeding.

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## Our Quote for the Quarter

*“Discovery consists of seeing what everybody has seen and thinking what nobody has thought.”*

Albert Szent-Gyorgyi, Nobel Prize Winning Physiologist