Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

- **When SMSF members head for the exit** *Julie Steed*
- **Court defends super death benefits from bankruptcy** *Liam Shorte*
- **US shares at new highs, but what about Australia?** *Ashley Owen*
- **The future has arrived in Australia** *Rudi Filapek-Vandyck*
- **Behind the headline profit number** *Hugh Dive*
- **What to look for in a profitable turnaround** *Mark East*

When SMSF members head for the exit

Julie Steed

Establishment and growth of SMSFs receives plenty of coverage in the media, but relatively little attention is paid to the other end of the SMSF life cycle – when an SMSF is no longer appropriate for one or more of its members. ATO data shows about 1,000 SMSFs are wound up each month.

The increasing number of Australians living with dementia and Alzheimer's has encouraged some SMSF members to look at alternatives and there are circumstances where SMSF members may need an exit strategy. The three main alternatives are:

- rollover to a retail or industry fund
- convert to a Small APRA Fund (SAF), as discussed previously in Cuffelinks here.
- pay benefits to members and close it down.

More on these choices later.

Why do some trustees wind up their SMSF?

It is important to consider the attitudes and abilities of the remaining SMSF members if one or more members die or are no longer able to be a trustee, perhaps due to declining physical or mental health. Will the surviving members want to continue the fund? Do they have the necessary skills, time and interest levels?

An exit strategy may also be needed due to the fund's investments. Does the fund have illiquid or indivisible assets that may affect its ability to make benefit payments?

The following 'Ds' are all trigger events that may lead to the need for an exit strategy:

Death and disability: The payment of a death or disability benefit is an important issue if indivisible or illiquid assets are involved, or if there are unique assets the family unit wishes to retain.

Dementia: If an SMSF trustee loses mental capacity they are legally unable to continue in the role of trustee and therefore unable to be a member of an SMSF. However, there are no legal issues with a person who lacks mental capacity being a member of a retail fund or a SAF.

Disinterest: Loss of interest can be a driving factor for many SMSF trustees who are skilled and committed at the outset but may become less interested and able as they age.

Divorce: When couples in an SMSF separate it is often highly desirable for each member to make their own future super arrangements. Running an SMSF with trustees who are not on good terms is difficult at best and often impossible. Additionally, if a family law split is being made from the SMSF, it is possible to take advantage of the capital gains tax (CGT) exemptions when moving one of the parties to a SAF or a new SMSF. However, this is generally not available if the family law split is paid to a retail fund.

Departed residents: If an SMSF member becomes a non-resident, it can be difficult for the SMSF to retain its eligibility for concessional tax treatment. There are generally no issues for departed members in retail funds. SAFs can also have non-resident members, however the members can generally not contribute.

Disqualified persons: A disqualified person is either an undischarged bankrupt or someone who has been convicted of an offence involving dishonesty. A disqualified person cannot legally be a trustee and is therefore unable to be an SMSF member. There are no issues with a disqualified person being a member of a retail fund or a SAF.

The three exit strategies have different tax outcomes, different abilities to retain private assets and different administrative requirements.

1. Rolling over to a retail or industry fund

Rolling over to a retail or industry fund is a CGT event. Any gains will be realised and tax payable. If capital losses exist, they cannot be carried forward. If members are in pension phase this may not be an issue, however it may be a significant cost if the fund is still in accumulation phase.

The range of investment options may also be a significant factor. It is important to compare the SMSF's existing investments with those available in a new fund. If the SMSF has assets that cannot be accepted, how do the members feel about disposing of the assets? This may be an issue if the SMSF has real property, collectables or shares in private companies. If the SMSF has a residential apartment on the Gold Coast, the SMSF members may be perfectly comfortable in selling the property to facilitate a move to a retail fund. However, if it's a property that SMSF members are running the family business from, its sale may be highly undesirable.

For members who commenced a pension before 1 January 2015, any Centrelink deeming exemption will be lost if the pension is rolled over to a new fund. This may result in a reduction in age pension.

2. Converting to a small APRA fund

A SAF is an SMSF with a professional licensed trustee. The professional trustee manages the fund for the benefit of the members and is responsible for all of the fund's compliance, regulatory reporting, and administration.

This conversion can avoid CGT entirely. The existing trustees simply retire and appoint the professional trustee. The fund (the tax paying entity) continues uninterrupted and does not dispose of any assets; there is simply a change in trustee.

Moving to a SAF may also help members who wish to retain unique investments. Different SAF trustees will have their own rules in respect of allowable assets, however a SAF will be far more likely to accept a unique asset than a retail or industry fund. Provided that the total fund investments are relatively diversified, it is common for SAFs to allow holdings of real property, private company shares and collectables.

Importantly, converting an SMSF to a SAF does not have any implications for the grandfathering of Centrelink deeming on pensions.

3. Paying benefits and closing the SMSF

If the members have met a condition of release it is possible to simply pay the member benefits and wind-up the SMSF. Sufficient funds will be retained for wind-up costs and taxes and a final return will be lodged.

Naturally, the member needs to compare the tax-effective environment of superannuation with other forms of investments. This decision is often balanced with the expense of running an SMSF that has been paying a pension for many years and now has a relatively low account balance.

There may also be Centrelink implications of cashing benefits from an SMSF.

An exit strategy may not be something that SMSF members think about often, but there are a number of instances in which one may be required. Taking steps to identify the potential trigger events and available strategies will assist members to better achieve their retirement goals, even when things don't go to plan.

Julie Steed is Senior Technical Services Manager at Australian Executor Trustees. This article is general information and does not consider the circumstances of any individual.

Court defends super death benefits from bankruptcy

Liam Shorte

Protection from creditors is an unsung benefit of superannuation. Life does not always go according to Plan A.

I keep hammering it into my small business clients in particular that, while they may be passionate about their business and absolutely certain that it will succeed, they need to have a Plan B. Things can go wrong no matter how hard they work.

Superannuation is that Plan B in many cases. By putting a portion of profits away each year into super, they can minimise their tax obligations, save for retirement and protect some of their hard-earned wealth from unforeseen circumstances like a business collapse.

I always give the example of a client who had a successful software business who listened to me and put funds away in super yearly despite not wholly trusting the system. A dodgy overseas firm copied and made minor changes to his software and sold it for 10% of his price, thereby decimating his profits. He could lose everything, as the ensuing defence of his patents in court cases is wiping out his personal finances and those of his company. Even if he wins, they could just keep their assets overseas and he has no chance of recovering costs and damages. If he loses, they could chase his assets to recover their costs. The one thing protected is his superannuation, which will provide a decent, if slightly less comfortable, retirement.

The recent case of Trustees of the Property of Morris (Bankrupt) v Morris (Bankrupt) [2016] FCA 846 shows what happens when superannuation, bankruptcy and the payment of death benefits intersect.

Background

Ms Morris became bankrupt 3-4 months after her husband, Mr Foreman, died. Mr Foreman held two policies with two different superannuation funds: AustSafe Super and Plum Super.

After becoming bankrupt, Ms Morris received three separate payments. Plum Super made a life insurance payment of $311,865.95, which is not controversial, as section 116(2)(d)(ii) of the Act provides that divisible property does not extend to life assurance policy proceeds of a bankrupt, or their spouse, received on or after the date of bankruptcy.

What was 'controversial' was AustSafe Super's payment of $45,392.48 and Plum Super's payment of $67,240.27. Both funds made these payments to the bankrupt under discretionary powers, as Mr Foreman had not nominated any dependents or beneficiaries.

Ms Morris's bankruptcy trustees applied to court in respect of these payments, arguing that the superannuation monies received by the bankrupt were after-acquired property that vested in them (as bankruptcy trustees) and was therefore divisible among the bankrupt estate's creditors.

I am not a lawyer so I will not go into details of the argument but there is a good blog on the subject by Bryce Figot of DBA Lawyers – see more here and the actual case decision here.

In summary

Justice Logan held that prior to the superannuation fund trustees' exercising their discretion in favour of Ms Morris, she had no interest in either fund. However, on this favourable decision, an interest was then created in the superannuation funds, and therefore these payments (totalling $112,632.75) made to Ms Morris (after bankruptcy) were held to be captured by s116(2)(d)(iii) and s116(2)(d)(iv) of the Act. Consequently, the bankruptcy trustees were unsuccessful with their application and Ms Morris retained the money.

So superannuation death benefits received by the bankrupt were protected from bankruptcy trustees.

I have not seen any previous guidance or authorities about the meaning and effect of the above sections of the Act. The decision seems to be consistent with the intention of legislation to protect and preserve benefits in respect of retirement for both members of funds as well as their spouses and dependants.

If you or your spouse are in business, or in a highly litigious profession, or high-risk investors, then talk to an advisor about your Plan B.

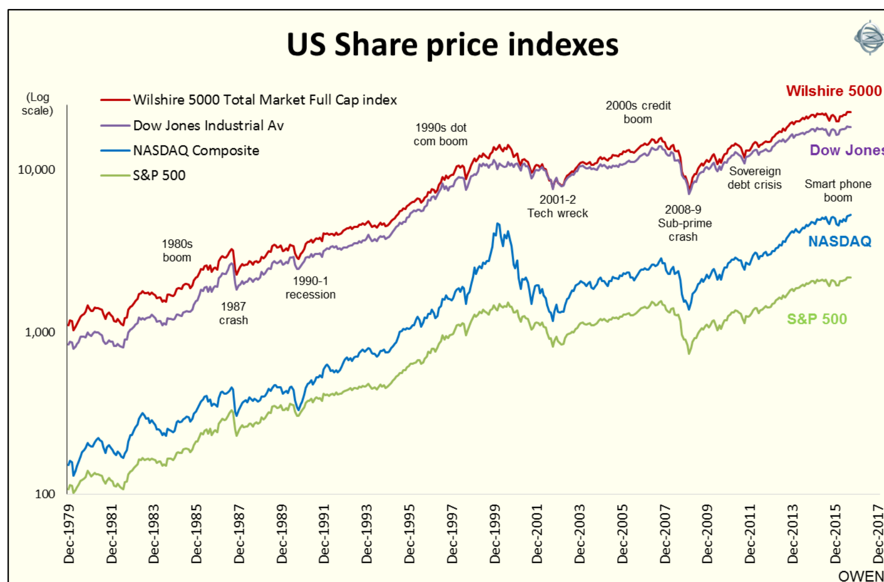
Liam Shorte is a specialist SMSF advisor and Director of Verante Financial Planning. This article contains general information only and does not address the circumstances of any individual. You should seek professional personal financial advice before acting.

US shares at new highs, but what about Australia?

Ashley Owen

US share prices have been doing well this year. The broad market indexes have reached new all-time highs, finally topping their previous peaks at the top of the 1990s 'dot com' boom and the 2000s credit boom.

The chart below shows four of the main US market indexes over the past four decades.



This shows that the current boom is not confined to just a few 'hot stocks', but enjoyed by the whole market. The Dow Jones Industrial Average measures the prices of just 30 of the largest stocks including Apple, Microsoft, IBM, McDonalds, Coca-Cola and Disney. The S&P 500 index covers 500 large and mid-sized companies, and the Wilshire 5000 index covers 5000 companies including thousands of small and micro stocks. The NASDAQ composite is heavily weighted toward technology companies.

The stock market boom in the US has been driven by two main factors: low interest rates and the global smart phone revolution. However, the US Federal Reserve turned off the 'QE' tap in 2014 and started raising interest rates in December 2015. The US government has also been tightening fiscal policy in recent years with progressively lower budget deficits. So the boom is overcoming the twin headwinds of tightening monetary and fiscal policies.

The main driving force has been the global technology revolution. The smart phone is changing how billions of people in virtually every country on the planet go about their daily lives. New technology is also revolutionising how businesses operate, from cloud computing to inventory management to accounting.

All of this requires new hardware and software. Factory workers in low wage countries build the hardware out of rocks dug up from quarries like Australia. But the real money is in the know-how and software and those come mostly from American companies. The American economy may be struggling to get back to normal growth but American companies are leading the global technology revolution.

Australian versus US shares over the long term

US shares have beaten Australian shares handsomely over the past five years despite Australia enjoying stronger economic growth and population growth.

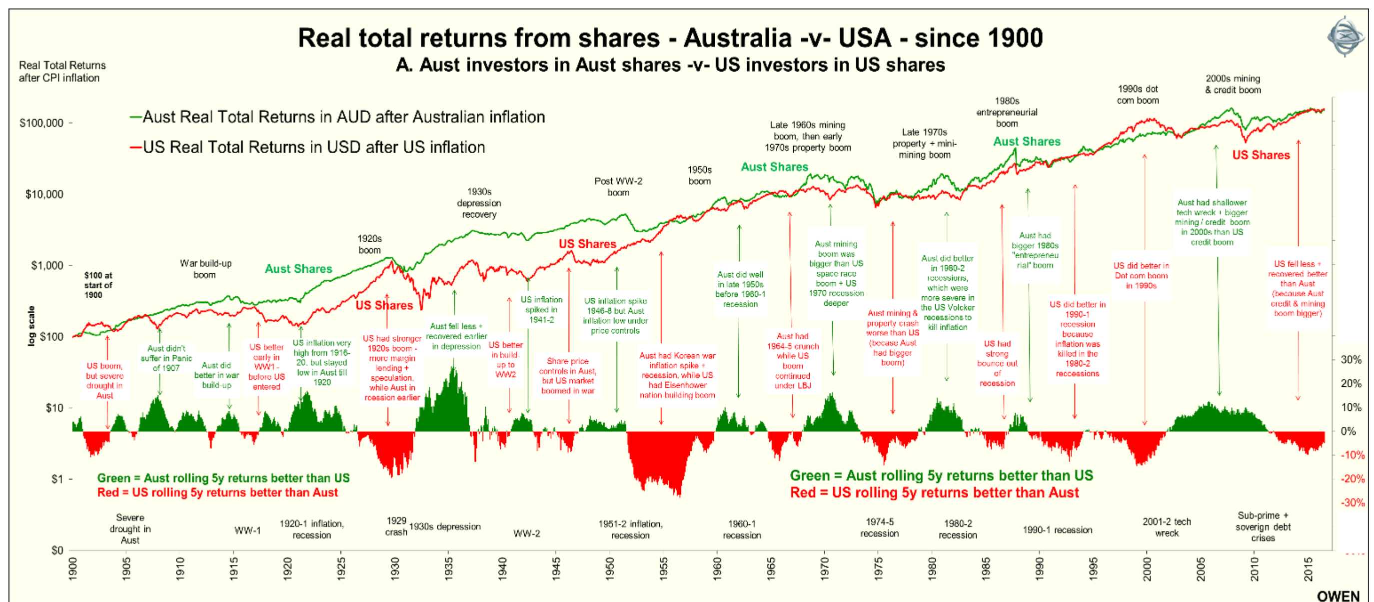
US S&P500 Price Index is 40% above its 2007 high. With dividends it is 70% above. Total Return series after US inflation is 48% above 2007 highs. But the Australian All Ords Price Index is still 18% below 2007 highs. With dividends it is 20% above, but the Total Return series after local inflation is still 2% below peak (these numbers are to end September 2016).

A better comparison is an Australian investor in Australian shares after Australian inflation versus the same Australian investor in US shares after Australian inflation. Then US shares Total Returns less Australian inflation is +66% since 2007 highs versus -2% for Australian shares. The difference is currency effect of falling AUD and higher inflation here than in the US. Investors tend to ignore inflation when comparing long-term performance.

Here is the longer term picture.

Both markets have returned average real total returns (including dividends and after CPI inflation) of 6.5% per year since 1900. While the real total returns have been the same, the components of returns have been different. Australian shares have delivered higher nominal price growth and higher dividend yields than US shares, but these benefits have been neutralised by Australia's higher inflation rate, so the net real total returns after inflation have been the same in both markets.

The two markets have also followed different paths along the way. The next chart shows the accumulated real total returns from both markets – green for Australia and red for the US.



The lower section shows when Australia was winning (positive green bars) and when the US was winning (negative red bars). Both markets have risen in global booms and then fallen in the global busts, but Australia and the US have taken turns in having bigger booms and busts.

Starting from the right side of the chart we see that Australia had a bigger 2000s boom than the US, and so it suffered worse in the 2008 bust. On the other hand, the US had a much bigger 'dot com' boom in the late 1990s, so it had a more severe 'tech wreck' in 2001 and 2002. Australia had a much bigger mid 1980s 'entrepreneurial' boom (Bond, Skase, Herscue, Elliott, Connell and the rest), and so it had further to fall in the 1987 crash. And so it goes back through history.

The fact that the US market has been winning in recent years is more a reflection of our bigger 2000s boom and our bigger bust in the GFC. Australia and the US both had a credit boom in the 2000s but Australia also had a mining boom that crashed as well, and it is still recovering.

So it is America's turn, and we are seeing it already with the US clearly leading the global technology boom.

Ashley Owen is Chief Investment Officer at independent advisory firm Stanford Brown and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities.

The future has arrived in Australia

Rudi Filapek-Vandyck

There's a mind-numbing multitude of changes taking place around the world today. Focusing solely on new technologies is more than sufficient to back up that opening statement. I am not even including climate change, refugees, social inequality, demographics or the many side-effects from ultra-low interest rates and bond yields.

Viewed through an economic lens, most changes are still in early days of development. Their true impact will only be felt in 5-10 years' time. But societies have started to pay attention. It's why buzzwords like 'sharing economy', 'fintech' and 'disruptors' are common in the vocabulary of investors and economists, and even of politicians.

My eBook published last year, "*Change. Investing in a Low Growth World*", draws a comparison with the roaring and fabulous 1920s, the last time such a whirlwind of innovations and technological breakthroughs re-shaped global society. If my comparison proves accurate, we haven't even seen the full tip of the iceberg of future transformations yet.

ASX transformation

Collectively, new technologies and 'disruptors' are already making their presence felt. By opening up monopolies, breaking down market barriers, lifting transparency for consumers and commoditising popular goods and services, there's already a good argument that all this partially explains today's lack of economic growth. It may also be causing a lack of inflation, low growth in wages and poor genuine, sustainable corporate profit growth across developed economies.

In Australia, where a relatively small population in a vast geographic space has facilitated duopolies dominating markets, the arrival of new business models and challengers has been an important co-contributor to why the ASX20 has significantly underperformed the broader share market since late 2012.

So far not so good for Australian share market investors. It's easy to feel excluded with companies including Facebook, Alphabet, Tesla, Apple and Alibaba contributing to the feel-good factor in US equity markets. Unbeknownst to many, the Australian share market is going through major transformation, and modern day explosions in innovation and capital-light business models sit at the coal face of it.

Raging bull market downstairs

The ASX20 price index is close to the same level it was in February 2013. This means no net returns from holding a basket of shares with Wesfarmers, Telstra, BHP Billiton, the banks et cetera in it, other than dividend payouts and franking, over a period extending more than 3.5 years.

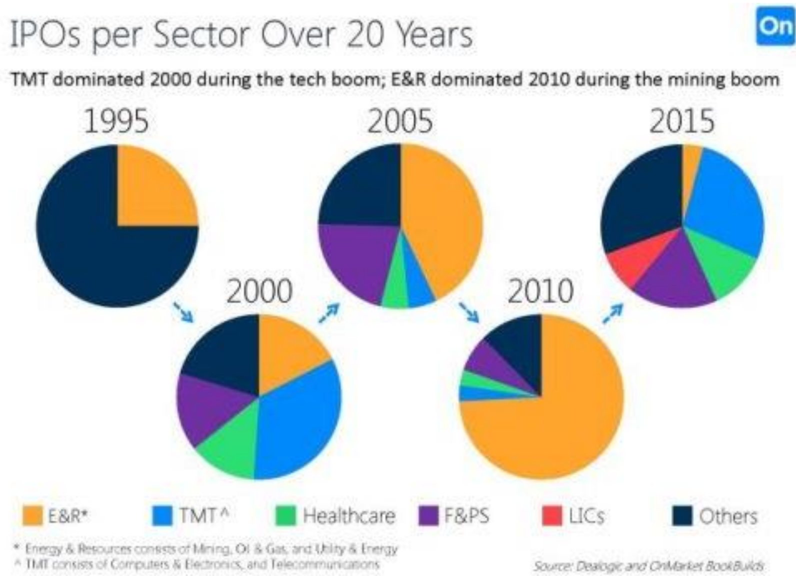
Over that same period, the All Ordinaries index, comprising of 500 mostly mid and small cap stocks in addition to the Top 20, appreciated by nearly 12%. Still not a fabulous result, given the S&P500 in the US added 43%, but nevertheless a world away from the moribund and sorry state at the top of the Australian stock market.

No double guessing as to why many a focus has descended outside the Top 20 in Australia, including from funds managers previously specialised in large cap blue chips. This looks like the ideal environment to introduce new ASX-listings.

According to data from OnMarket Bookbuilds, not only are fresh IPO numbers on the rise, so is their average size and their popularity among investors. There's sufficient evidence for the latter in the observation the average first day-of-trading performance for all 24 IPOs on the ASX in Q3 this year is +28.2% (average gain at 4pm on the first day of trading on the ASX). There's a trend to IPO more foreign companies on the ASX, as well as more new listings originating from private equiteers. Note to us all: private equity IPOs do not turn into mud by default, as long as the owners remain on board with a substantial stake in the equity.

Technology rules among IPOs

The transformation of the ASX, as shown in the 20-year overview below, has expanded the exchange with many new technology, healthcare and finance & professional services companies. In 2016 to date, half of all IPOs consisted of technology and finance companies with many of the latter carrying the label 'fintech'. Gone are the days when the majority of new listings comprised of mining, energy and mining services providers. That is so 2005-2010!



Australian investors do not only see the ugly side from today's technological transformation disrupting or challenging the corporate heavyweights. They do not by default have to venture overseas to seek exposure to new challengers and innovators; they can stay here at home, at the ASX.

It goes without saying, irrespective of current popularity and average past performances, new ASX listings are not a risk-free, guaranteed money printing option. Some IPOs cause shareholders severe headaches, if not significant capital losses. Once the initial euphoria post public listing ebbs away, there is no guarantee investors stay on board or join in. Most of these freshly minted ASX-additions are young, unknown and they still have a lot to prove.

Don't ignore the future

As a daily observer and analyst of financial markets and of global macro-economic developments, I do believe new IPOs over the past two years have enriched the local stock exchange overall, and investors should definitely pay attention because in between the many newbies of today might be the next REA, ResMed or Carsales.

Below are ten newbies from the 2014-2016 harvest who, on my assessment, have shown enough substance to suggest a future success story might be in the making. Investors should always conduct their own research and consider their risk appetite.

Ten ASX-Newbies worth investors' attention

Name	ASX-code	Listing	Price	26/09/16
iSentia	ISD	May-14	$2.04	$3.85
Speedcast	SDA	Jul-14	$1.96	$3.99
Aconex	ACX	Nov-14	$1.90	$6.70
Catapult	CAT	Nov-14	$0.55	$3.55
oOh!media	OML	Nov-14	$1.93	$4.92
Appen	APX	Dec-14	$0.50	$3.29
Link	LNK	Oct-15	$6.37	$8.34
MYOB	MYO	May-15	$3.65	$3.76
Class	CL1	Dec-15	$1.00	$4.02
WiseTech	WTC	Apr-16	$3.35	$5.37

Brief intro:

iSentia: media intelligence offered as Software as a Service (SaaS), expanding into Asia
Speedcast International: network and satellite communications services worldwide, headquartered in Hong Kong
Catapult Group: wearable athlete tracking and analytics solutions
oOh!media: out-of-home advertising services, increasingly digital
Appen: speech technology and search services for international technology customers
Link Administration: back office administration services to companies and financial services providers in Australia
MYOB: desktop accountancy software, migrating into the cloud
Class: cloud-based services for SMSF trustees, their accountants and their advisors
WiseTech Global: cloud-based software solutions for the logistics industry, worldwide

If you do intend to look into some of the potential new stars of the future, the list above could be a good starting point.

Rudi Filapek-Vandyck is Editor of FNArena. His book, "Change. Investing in a Low Growth World", is available via Amazon or any online book platform. This article is general information and does not consider the circumstances of any individual.

Behind the headline profit number

Hugh Dive

The CEOs of the big four banks were grilled by the House of Representatives' Standing Committee on Economics last week. The committee wanted to know why Australian banks have higher returns on equity (13.8% ROE) and profits than those in other Western countries and whether it is due to their market power.

This appears to be both an exercise in political point-scoring and data mining. I strongly doubt it would be in the national interest if Australian banks generated the returns of the European banks (4% ROE excluding Deutsche Bank). Weak returns limit internal capital generation and increase financial precariousness and thus the risk of taxpayer-funded bailouts. Indeed, in a more comparable and similarly structured banking market such as Canada (ROE 14.8%) has five dominant trading banks (CIBC, Royal Bank of Canada, Toronto Dominion, Bank of Montreal & the Bank of Nova Scotia) in a highly regulated market. Shareholders could make the case that the Australian bank CEOs are not trying hard enough to generate profit!

This article examines the different measures of corporate profitability for listed companies, looking beyond the billion dollar headline figures.

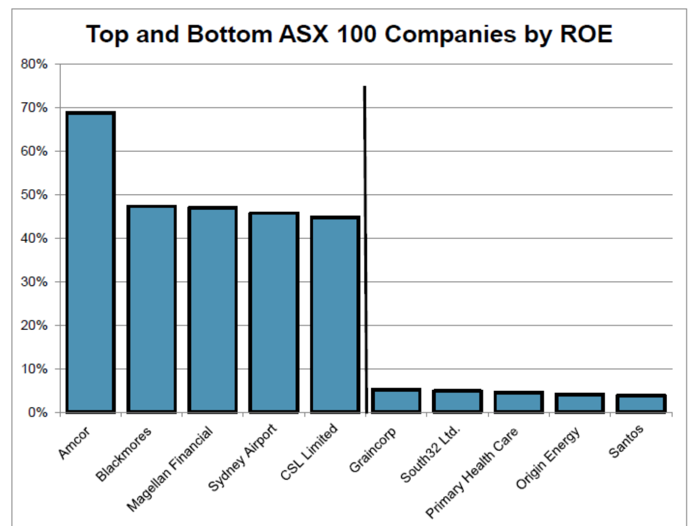
Measures of profitability

As a fund manager, the $29 billion of raw profit made by Australian banks over the past year does not mean much by itself. I look at the underlying earnings per share (EPS) that my unitholders receive from that profit. We also look at growth in EPS, as a company's profits can often grow substantially when they make an acquisition, but if that acquisition is funded by issuing a large number of additional shares, profit per share might not actually grow. For example, telecommunications company TPG reported a sensational 60% increase in underlying profit this year after the acquisition of iiNet. However, earnings per share grew at a much lower rate after TPG issued additional shares to fund the purchase.

Additionally, at a company level, we look at measures such as return on assets, equity and profit margins, which can be better measures of how efficient a company's management is utilising the capital or assets belonging to shareholders in generating the annual profits.

Return on equity

Return on equity (ROE) looks at the profit generated by the equity that the owners have contributed to establish the business. ROE is calculated by dividing a company's profit by the money shareholders have invested in it. This investment by shareholders includes both the original capital given by shareholders in the Initial Public Offering (IPO) plus retained earnings. Retained earnings are the profits kept by the company in excess of dividends and are used to fund capital expenditure to either maintain or grow the company. Companies with high ROE typically require little in the way of dilutive equity raisings from shareholders to run their business, or may be financed primarily from debt rather than shareholder equity.



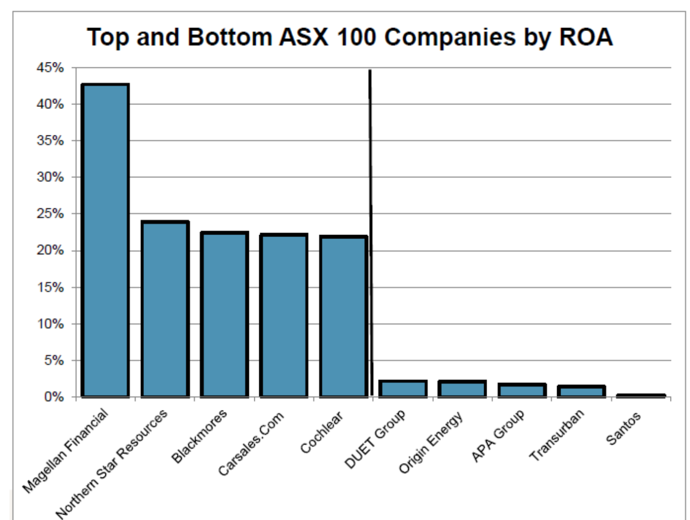
The above chart shows the top and bottom five companies in the S&P/ASX100 as ranked by ROE. The top ROE earners contain a packaging company (Amcor), a vitamin company (Blackmores), a fund manager (Magellan), a highly geared utility (Sydney Airport) and a healthcare company (CSL).

The common factor in these businesses is minimal ongoing capital expenditure to run the company. Bringing up the rear are a range of capital-heavy businesses that required a large amount of initial capital to start the business and large capital injections from shareholders to maintain their assets and finance ongoing activities. This sub-set includes energy companies (Santos and Origin), a miner (S32) and a grain handler (Graincorp).

Return on assets

Return on assets (ROA) differs from ROE, as it measures the return a company makes on its total assets. This measure accounts for both the equity and the debt used to purchase the assets that generate profits.

The chart on the right shows the top and bottom companies in the S&P/ASX100 ranked by ROA. Companies generating a high ROA generally have minimal to no debt such as Magellan, Carsales.com or very low debt such as CSL and Cochlear. Here the factor driving profits in internet and healthcare companies is generally a smart idea (online real estate listing replacing paper) or a piece of medical research, rather than expensive tangible assets such as steel mills or airplanes bought with capital raised from both shareholders and lenders.

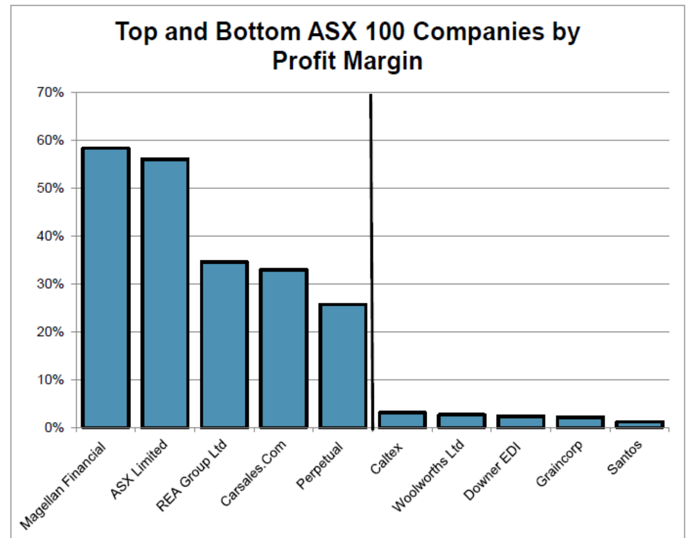


Similarly fund managers (Magellan) enjoy significant operating leverage, as once the fixed cost of fund distribution, office rent and fund manager salaries are covered, each additional dollar of revenue is almost pure profit that requires minimal capital. Gold miner Northern Star sneaks onto this list due to the combination of high global gold prices and a low capital intensive business model.

Alternatively, companies that have a low return on assets typically require expensive hard assets to generate profit. These assets range from utilities (Transurban, DUET and APA) and energy companies (Santos and Origin). Typically hard asset companies such as Qantas, BlueScope and Boral appear on the list of the bottom ROA companies, but these are all currently enjoying their cyclical time in the sun due to company-specific factors.

Profit margin

Profit margin is calculated by dividing operating profits by revenues and measures the percentage of each dollar a company makes that results in profit to shareholders. Typically, low-margin businesses operate in highly competitive mature industries. The absolute profit margin is not what analysts will look at, but rather the change from year to year, as a declining profit margin may indicate stress and could point to future declines in profits.



The chart on the right shows how companies generating the highest profit margins are monopolies (ASX), fund managers enjoying the operating leverage (Magellan and Perpetual) or internet companies (REA and Carsales.com).

Low profit-margin companies characteristically receive large revenues, but operate in intensely competitive industries such as petrol retailing (Caltex), engineering (Downer) and staples retailing (Woolworths). Graincorp makes this list due to lower grain exports and a relatively poor east coast wheat harvest. Companies with low profit margins are forced to concentrate closely on preventing them from slipping further, as a small change in those margins is likely to have a significant impact on the profit that can be distributed to shareholders.

While the banks deliver large absolute profits and make big headlines, they are not among the most profitable S&P/ASX100 companies in terms of profit margins and returns on assets. The Commonwealth Banks's 45,129 employees produced a $7.8 billion profit in 2016, but this represented a ROE of 16.5% and a profit or net interest margin of only 2.07% on assets of $933 billion.

Hugh Dive is Senior Portfolio Manager at Aurora Funds Management.

What to look for in a profitable turnaround

Mark East

We are always on the lookout for opportunities we believe the market has missed, misdiagnosed or underappreciated. One type of stock that falls into this category is the 'turnaround'. It can be defined in various ways, but in essence it involves a change from a poor quality company to a good one. This does not necessarily mean a company whose improvement relies on the economic cycle, such as a building stock benefiting from a housing construction boom. Instead, I mean corporate change that is more structural and enduring.

The upside

Turnarounds can be very rewarding for investors. Often the share price of a turnaround stock will reflect low expectations, extrapolating its difficult past without comprehending what it could possibly become. A successful turnaround can give rise to a double play. Firstly, the company materially improves profits, often dramatically so; and secondly, this leads to a turnaround in investors' perceptions, leading to a re-rating of the company's

shares as the improvement proves sustainable and profits offer potential growth. This double play compounds returns for the shareholder, with for example a doubling of earnings and a doubling of the PE giving rise to a four-bagger (a rise in share price of four times).

In addition to the potential outsized returns, turnarounds can also offer diversification benefits. Turnarounds represent upside that is generally stock-specific, and as a result, performance has limited correlation with the rest of the market. The ups and downs of a turnaround stock will generally depend more on what is going on within the company than in the broader market.

The downside

On the other hand, turnarounds come with significant risk. A turnaround may not actually succeed as planned, it may waste considerable resources in its attempt, and underlying profitability may continue to deteriorate. In fact, this scenario is not uncommon and is best explained by Warren Buffett's quip that "turnarounds seldom turn". For this reason, turnarounds can become value traps, with the failure to turn further evidence of the company's poor quality, justifying its lowly valuation.

There can often be a fine line between success and failure in any turnaround situation. That said, there are a number of attributes to look out for in identifying a potential turnaround success. In broad terms, one should consider what has been holding the company back, whether it can be changed, and as the turnaround strategy progresses, tangible signs of progress.

Sometimes they do turn

The first and perhaps most important attribute to look out for is the existence of a strong underlying business or assets that will allow the company to rise above its problems. One of Buffett's greatest all-time trades was actually a turnaround situation called GEICO. The company is a US car insurer with a low-cost, direct-to-consumer model that allows it to price policies cheaper and earn decent margins. However, at the time of Buffett's original purchase in 1975, it was facing near bankruptcy due to over-expansion, ill-disciplined underwriting, price controls in certain states it operated in, and an undercapitalised balance sheet. With a new CEO leading the charge, the company raised capital and embarked on a dramatic turnaround focused on reining in the expansion, returning underwriting discipline, and exiting operations in regulated and unprofitable states. From a position from which Buffett admitted there was a reasonable probability of losing his entire investment, GEICO slowly turned around and eventually made Buffett a mint (which it still does).

The key to the success was the strong underlying business that had lost its way, but was capable of re-finding its funk. It is much easier for a business with good bones to turnaround.

The rarity of operational turnarounds

It is also possible for an operational turnaround to succeed in making a fundamentally bad business good. However, structural reasons may make it nigh on impossible. As evidence, there are a large number of businesses forever trying to turnaround, with classic examples being CSR, AMP, Spotless and Primary Health Care. There are few that change fundamentally for the better.

One that has is Amcor. For a long time the company struggled in the largely commoditised packaging industry, and reflecting this, its share price barely budged for decades. A decade ago, new CEO Ken McKenzie started out on a turnaround strategy that involved divesting low-returning businesses, scaling up more profitable ones via acquisitions that also consolidated relevant markets, plant rationalisation, and instilling a sales discipline that focused on margin rather than volume. Perhaps owing to its inglorious past, it took the market some time to recognise the change, but those who did have enjoyed strong investment returns since.

Leveraging valuable assets

Amcor's strategy was text-book for a turnaround for a structurally challenged company, one that we see echoed in the turnaround currently being undertaken at Treasury Wine Estates by CEO Mike Clark. And in contrast to Amcor, Treasury has some valuable brands to work with.

In fact, as in the case of GEICO, most companies that can successfully execute a turnaround have something valuable to work with. For example, Coles' turnaround under Wesfarmers ownership starting in 2008 had the benefit of Coles' large existing store network, with as many stores as Woolworths, and sufficient scale through a meaningful sales base. New management came in, revived store formats, loudly marketed lower prices, and

grew customer numbers and sales strongly, helped out of course by an accommodative competitor in Woolworths.

Likewise, Caltex owned a very profitable fuel distribution business that was able to shine through once it reduced its low-returning and volatile oil refinery business; and TPG Telecom had an existing network and a decent customer base as it moved from loss-making to very profitable through scale-building acquisitions that also consolidated the broadband market.

What to look for

The examples suggest characteristics to look for in identifying when a turnaround might succeed:

- a new CEO, often from outside of the company, carrying none of the company's historical baggage and who can drive the turnaround strategy
- a corporate restructuring, generally aimed at growing the higher-quality businesses, and exiting unprofitable ones
- industry rationalisation, particularly as part of an attempt to beef up profitable businesses, with the added benefit of improving the industry structure
- an accommodative industry, in which a struggling company is allowed to re-emerge, or where an industry as one works towards higher pricing and therefore profitability
- a recapitalisation, with the effect of addressing an over-leveraged balance sheet, which affords the financial flexibility to get through any difficulties and allows investment in growth areas.

Conclusion

Turnarounds offer the opportunity to invest in quality that may not be readily apparent to most other investors, a scenario that generally presents value upside. Turnarounds, however, come with considerable risk, and it pays to stay close to the company in question. At BAEP, we invest where we have high levels of conviction. We will usually wait for genuine evidence that a turnaround is turning, most often through the company's reported financials. Head fakes are common in this game. We're happy to give up the first 20% or so if it means greater certainty. Generally, this still leaves plenty of upside as the market slowly starts to look at what the company may become.

Mark East is Chief Investment Officer of Bennelong Australian Equity Partners (BAEP). This article is general information and does not consider the circumstances of any individual.

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