

# THE AUSTRALIAN Business

WITH THE WALL STREET JOURNAL.

June 24, 2009 01:48am AEST

## Cautious investor: OC Funds Management

Katherine Jimenez | June 24, 2009

Article from: *The Australian*

**THE duration and severity of the cycle of bad and doubtful debt for the main Australian banks will be one of the key factors setting the course for local investments during the next 12 months.**

"The main issue for banks now is how severe the bad-debt cycle could become," OC Funds Management portfolio manager James Casey says. "The peak of the bad-debt cycle is typically six months after the trough in gross domestic product growth. So if you believe that GDP troughed in the second quarter of 2009, we should begin to see improvement in the cycle by second half (of) 2010."

The other key themes are "the speed of recovery in China and other emerging countries which will influence commodity prices and resource company earnings", the recovery of the Australian economy and the effect this will have on domestically focused businesses.

OC Funds is a privately owned Melbourne-based manager, established in 2000, which has \$70 million in funds under management. It recently changed its name from Opus Capital after weathering an unfortunate likeness with the moniker of collapsed stockbroker Opus Prime. There is no connection between the two.

Casey says the initial focus of the fund manager was on small companies, but in 2005 it diversified, launching the OC200 Fund, a balanced portfolio of investments in high-quality Australian companies. The OC200 fund was opened to the public for the first time last year. Its benchmark is the S&P/ASX 200 Accumulation Index.

"Since inception, the fund has provided investors with a return of 6.8 per cent per annum v the benchmark return of 3.3 per cent," Casey says. "So the fund has outperformed the market by around 3.5 per cent on average every year after all fees."

In the year to May 31, the fund's performance was minus 24.3 per cent against the S&P/ASX 200 Accumulation Index's minus 28.9 per cent.

### What is your investment philosophy?

Our overriding aim is to protect investors' capital. We seek to protect capital by avoiding large losses and avoid making serious investment errors. The fund will not invest in companies that are not profitable, do not pay dividends or fail to achieve a significant return on equity of at least 10 per cent. I do not see the OC200 Fund as having a particular growth or value bias; it has more of a quality bias. We focus on investing in quality businesses with sound prospects and conservative capital structures that are available at reasonable prices. Our larger holdings will typically be in businesses that are easy to understand and have a relatively predictable earnings stream, which are simpler to value.

### Where will markets head in the next year?

We believe the equity market will trend higher during the next 12 months. Despite the recent improvement, we believe there is scope for share prices to move higher. The prospective price-to-earnings ratio for the Australian market is at present about 13.5 times based on estimates for the 2010 financial year. This compares with a long-term average of about 14.5 times. So we believe there remains some upside on a valuation basis. This is especially so given the present low-interest-rate environment, with the dividend yield of the market at about 4.7 per cent v short-term interest rates of just 3 per cent.

### How do you value companies?

Due to our focus on risk avoidance and capital preservation, we apply what we call a two-dimensional valuation process. For this we calculate a standard base-case valuation, and in addition we construct a low-case valuation to provide a worst-case scenario for a stock's possible price outcome. This provides a valuation range for a potential investment and gives us clear guidelines as to the opportunity and, more importantly, the risk of the investment. It also indicates the prices at which we should consider buying and selling the investment.

The techniques used to value companies will vary depending on the business-model dynamics and the nature of the earnings stream. The techniques we use to value companies may include capitalisation of earnings, discounted cashflows

and comparable valuation analysis.

### **In Australia, what sectors and stocks do you like most? What stocks are you buying?**

Recently, several capital raisings have given us the opportunity to acquire shares in companies at discounted prices. The capital raised also significantly improves the companies' financial positions. Examples of recent discounted capital raisings we have taken advantage of include ANZ, QBE Insurance Group and Westfield Holdings. These additions mean we are overweight in the financial sector.

We were underweight in the resource sector for most of last year.

However, we believe the recent recovery in commodity prices has seen prospects for the mining sector improve and we have increased our positions in BHP and Rio Tinto.

### **Have you changed your strategy and weighting in the past six months? If so, how?**

Because valuations have changed and prospects for growth have changed we have skewed our portfolio away from high-quality defensive stocks towards high-quality cyclical stocks.

### **Do you have a cap on the number of shares you hold in a company?**

The fund will typically hold between 20 and 40 companies. Until recently, we had been particularly selective about the companies we invested in, and as a result the number of holdings was reduced to about 25 stocks. However, recent capital raisings and the strengthening of corporate balance sheets have seen the number of stocks held by the fund increase to about 30.

### **How did you get into investment management?**

I have worked in financial markets for almost 20 years. Most of my career has been spent within the research department of leading investment banks. As a research analyst, I covered a variety of sectors and analysed numerous companies in a great deal of depth. Some of the companies I have followed have been tremendously successful, such as Woolworths, and others no longer exist. This experience has provided me with a strong platform for my present role.

### **What was your first investment?**

My first investment was in a mining company called Pan Australia Mining in the mid-1980s. The company had a very successful goldmine at Mt Leyshon in Queensland.

I bought the stock at \$1.50 and sold it at \$6 a relatively short time later. So my first investment was a four bagger.

### **What was your first investment mistake?**

Taking the proceeds from my gain on Pan Australia and investing into some smaller, less successful mining exploration companies. This not only eliminated my initial gain, it also extinguished my capital. However, the experience provided an extremely valuable lesson about speculative trading v long-term investing.

### **Who or what company do you admire in your industry?**

Along with many investors, I have a great admiration for the results Woolworths has been able to achieve. Woolworths was a company that was essentially on its knees in the late 80s; its supermarkets were in a poor state and underperforming their peers, and its Big W business was losing a significant amount of money.

With high-calibre chief executives such as Paul Simons and Roger Corbett, the business rapidly expanded its store base and revenues and, perhaps more significantly, dramatically lowered its costs.

This transformation has had a major effect on its profitability, return on investment and returns to shareholders.

Woolworths remains a great Australian success story. It also demonstrates what can be achieved with the right management team.

### **FOUR HOT TIPS**

**DO** your own homework and analysis. Don't rely on others.

**BE** wary of companies with excessive debt.

**REMAIN** humble. If the facts change, change your mind.

**MOST** important, understand the price you are paying to invest. If you pay too much for a business, even a high-quality business, your returns will be compromised from the start.

*All times are EST. © MarketWatch, Inc. 2008. All rights reserved. Subject to the Terms of Use. Designed and powered by Dow Jones Client Solutions. MarketWatch, the MarketWatch logo, BigCharts and the BigCharts logo are registered trademarks of MarketWatch, Inc. Dow Jones is the registered trademark of Dow Jones & Company, Inc. Intraday data delayed at least 15 minutes. "Intraday data is provided by Interactive Data Real Time Services and subject to the Term of Use." FXQuoteTM provided by GTIS, an Interactive Data Company "Historical and current end-of-day data provided by Interactive Data Pricing and Reference Data". FTSE (Footsie) is a trade mark of the London Stock Exchange and the Financial Times and is used by FTSE International under license.*