MAKER OF BESPOKE FUNDS

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The Australian

Fund manager Hugh MacNally advises on options in the present investment climate.

Hugh MacNally always wanted to run a funds management business with a bespoke approach: a hands-on service for people, funds and charities who wanted an individually managed account. Starting as an analyst in 1984, McNally moved up through funds management circles that included a four-year stint as manager of investments at Permanent Trustee, where he had oversight of investment of more than $900 million. With colleague Bill Gregerson, he founded Private Portfolio Managers in 1995, an Australian equities manager with $300 million under management. MacNally is responsible for the management of portfolios and the analysis of investment opportunities.

"We've had the same executives and senior management team for 13 years, which must be something of a record in this industry," he says.

"From the beginning we have sought to deliver tailored Australian equities portfolios that take into account someone's particular tax situation, to maximise after tax returns. Over time our tax effective approach has proven attractive to charities and other not-for-profit organisations, as well as super funds -- two areas [in which] we are seeking to expand."

How would you describe the fund?

We aim to identify companies and industries where there are favourable strategic characteristics and the prospect of long-term growth. The portfolios are concentrated in 20 to 25 stocks. The focus is on company and industry research rather than trading, which helps limit tax and keep the costs down. Each portfolio is managed as a separate entity and through this we can manage the tax position of each entity to best advantage.

What are your fees?

Our management fee is 1 per cent a year (plus GST) of assets under management and this has been constant since we started, despite the upward drift of fees, which are now sometimes close to 2 per cent and also include performance fees.

How do you view the main themes that will dominate the market in the next 12 months?

We are seeing the interplay of an economy that has only recently started to turn down, and a market that has been falling very rapidly for over 15 months. At some stage the market will start to look through the bad numbers that are coming out. In a number of industries this has already occurred and there are some great opportunities emerging.

Then there is an interesting interplay in the major banks between the bad debt cycle and the margin expansion that they are achieving. This industry has a lot of the characteristics we look for, including a low level of competition after the departure of most of the foreign banks and non-bank lenders, leading, we feel, to a long period of high margins and growth (after the bad debt cycle has passed).

A third theme that this difficult period has thrown up is a watershed for change in a number of industries -- shifts that result from companies and individuals focusing more sharply on costs and accountabilities. An example is the movement from traditional media to online, where costs are low and results are more accountable. Many of the companies in this area have done very well during these tough times.

Where do you see the market heading in the next 12 months?

I'd like to paraphrase the great contrarian investor John Templeton. 'I never ask if the market is going up or down. I don't know, and besides it doesn't matter. Forty years of experience have taught me you can make money without ever knowing which way the market is going.'
For instance, if we relied on our view of the market direction to make investments, we probably wouldn't have invested heavily in Origin Energy, which is up nearly 50 per cent - the mirror image of the market return.

How do you value companies?

Our approach is a combination of quantitative analysis of companies and analysis of industry structure. Quantitatively, we look at a company's price to earnings ratio (the PE), cashflow, financial structure and dividend yield as the basic starting point.

We ask: does this company have the building blocks we are looking for?

The second part is strategic: looking at the structure of the industry and the company's positioning within that industry. We do a lot of analysis of strengths and weaknesses vis-a-vis customers and suppliers. We are looking for companies that dominate. A good example is results that Woolworths has been able to produce over a long period of time through the domination of its suppliers. We build up the strategic picture by talking to companies in the industry, visiting their managements and competitors.

We allow some latitude in the quantitative characteristics depending on the company's strategic positioning. Although we won't buy when the numbers are excessive; this particularly applies to financial structure, where we are a hard marker.
Are you increasing or decreasing your cash position?

Decreasing generally: there are more attractive investments around than there were a year ago.

Is this climate good for your type offund?

Definitely. Our strategy has proven itself over a series of down cycles and the recent market falls are no exception. In a relative sense we have beaten the market by nearly 14 per cent in the past 12 months: that ranks us second among our peers in a period which has been tremendously difficult for all managers. We are seeing some very attractive situations developing and are confident we can continue outperforming for our investors.

What has your performance been like since inception?

For more than 13 years, from December 1995 to February 2009, our average return has been 11 per cent per annum, versus the All Ordinaries Accumulation Index's 7.2 per cent. We've also beaten the index over one, three, five and 10 years by a substantial margin.

In Australia, what sectors and stocks do you like most?

There has been a range of very beneficial changes to the structure of a number of industries. Retail banking has seen the effective departure of much competition; this is wonderful for them and very profitable once we're past the bad debt cycle.

Other structural changes include the emergence of the online advertising model as the new successful medium: REA Group and Seek are a couple of examples. Pay TV could also be put in that category with stocks such as Consolidated Media and Austar well positioned.

What do you think of the banks and financial services sector?

Just dealing with the banks, our view is as above. In general, if a financial stock has survived the last year without sovereign help, it is probably in a relatively strong position. In this sense we have a positive view of, say, insurer QBE, which has an enviable record of growth over many years and is well placed to take advantage of hardening insurance rates and the difficulties of its competitors.

Do you hold any miners?

It is not the most important holding in our portfolios, as the cyclical nature is not an attractive characteristic. We like BHP's position on the cost curve and the structure of the iron ore industry in particular.

The other area of interest is upstream gas stocks, but we don't really hold much outside these.

Do you hold any small caps?

We hold a number of small caps. Often due to the size of the Australian economy, the companies in the forefront of changes in industries are themselves small. An example is Patrick Limited, the company that changed the Australian ports (and a lot else): at the time the company was capitalised at less than $200million. It is an important area to look for great companies.

What stocks have been the best performers for you so far?

Over the long-term Woolworths, Patrick Corporation, medical device maker ResMed, Origin Energy and Melbourne IT.

Various stocks have taken a beating in recent months. Has that enticed you to buy up?

Yes. For example, the banks, QBE, Melbourne IT, online publisher REA Group and mining service companies.