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INSIGHTS

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A discussion of the Risks for Index Funds and their heavy exposure to the Banking Sector by Hugh MacNally, PPM CIO and Founder

Australia's Achilles Heel?

This article follows an earlier article in the May PPM Insights Index Funds - the untold risks. It points to the concentration of risk in two industries; resources and banking, both of which are themselves risky and asks the question, what would happen if the GFC style banking crisis were repeated in Australia?

To recap, the Australian equities market is very poorly diversified with two industries, finance and resources representing 50% of the ASX300 (a common index fund basis) and the top 10 stocks representing 42% of the total capitalisation, a very high proportion. The concentration is higher than most developed country markets. The arguments for index or "passive" investment has been that the no manager beats their benchmark consistently.

Does investing in a mechanical and simplistic fashion produce better returns at acceptable risk?

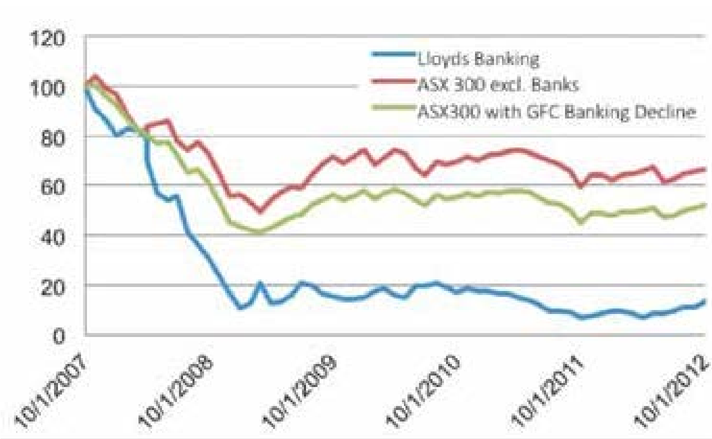
We are used to seeing resource stocks move in a volatile fashion, BHP dropped from $50 to $15 and Rio from $140 to $40. They tend to bounce back again when circumstances change as we have seen in the last year. However, in industries like banking, the other big sector in the Australian market, when there is a crisis of the magnitude of the GFC exposed banks go down and stay down with the share prices not recovering to previous levels for a generation.

So, what would be the effect on the Australian index funds of a GFC style event in the Australian banks?

The graph below represents what would happen if the current composition of the market suffered a major crisis. For the purposes of this exercise we have used the movements of Lloyds Banking Group as representative. Lloyds business is not vastly different to the four large Australian banks; during the GFC it lost 90% of its value.

Shown in the green is what would have happened to the ASX300 if the Australian Banks had declined as Lloyds did during the GFC. For most of the time the index would have been 15% lower and would have been 50% off the previous five years.

ASX300 With Banks in GFC Decline



It could be argued that this is a trivial exercise, it is what happens when you reduce 27% of a portfolio to near zero. What we would point out is that banking crises are not uncommon and their effects are long lasting. In my career, so far, as an investment manager there have been three.

Of course banking is a critical industry in any economy and as a result is both supported by government in a crisis and also heavily regulated, but essentially at its core it borrows short and lends long and on that mismatch lies its weakness. While government regulators will do anything to maintain the integrity of depositor's assets, depositors being a protected species (to do otherwise would be disastrous and involve the breakdown of an economy). The equity holders on the other hand will generally lose all or nearly all their money. Governments may step in and provided capital to keep the institution operational, as in the case of Lloyds, or not, as in the case of Lehman Brothers in the US. Either way the original equity holder's investment is largely gone. My point is that the value of these companies is far more brittle than for the wider market.

This we feel is the risk inherent in index funds; they do not make any judgements about risk in the sense of the companies' underlying financial, business and pricing risk. The substantial inflow into index funds in Australian, as there has been globally, makes the market quite illiquid as a large proportion of investors are all doing the same thing. Where an index carries these risks to excess through its composition, its lack of diversification, the investor carries them as well. You can manage risk but you can't manage performance, perhaps a bit of the former is better than singular focus on the latter.

Whether the Australian banks navigate the risks inherent in their asset concentration, their high leverage and the level of indebtedness of their customers, only time will tell, but do I want to mechanically put 27% of my portfolio in this sector? The answer to that is, no.

A discussion by Ian Hardy, Portfolio Manager of Private Portfolio Managers

Disruptor or Beneficiary?

A discussion with Qube Managing Director, Maurice James

There has been much market talk about the potential effect of Amazon entering the Australian market and the impact this might have on retail sales, industrial real estate, transport and logistics and the supply chain generally.

In the investment community Qube Holdings Limited (QUB) has been mentioned as a potential beneficiary. Qube's Managing Director Maurice James recently presented to a PPM luncheon forum and discussed both Qube's strategy and his perspective on Amazon's announced entry to Australia.

Efficient and effective transport and logistics channels have a significant impact on productivity, competitiveness and profitability. Free trade and the relatively recent growth of internet sales have both relied on advances in how we move goods around the world and across the city, so that they arrive reliably and safely.

Consequently, the importance of port services and logistics to the Australian economy cannot be underestimated. At Private Portfolio Managers, we have spent considerable time and effort, over many years, understanding the transport sector generally, Qube's predecessor companies in particular and Qube Holdings. In this process we have watched with interest the growth and expansion of Qube. Recently, this has been this has been focused on observing Qube's very strategic and deliberate approach to the emerging Moorebank Intermodal project as well as their recent acquisition of a 50% interest in the Patricks Ports business, where much of the current management team were originally employed.

The luncheon with Mr James fortuitously, as it transpired, coincided with the recent Qube equity raising of some $350 million, part of which will be used to begin development of warehousing in the new Moorebank Intermodal Park.

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Mr James explained the history of the 243 hectare site at Moorebank and how it will be the largest intermodal freight facility in Australia. The development includes an import- export rail terminal connected to the container store docking terminals at Port Botany via the Southern Sydney Freight Line. The import- export terminal will be capable of handling more than 1 million containers per annum. An interstate terminal will also be developed connected to the national rail network capable of handling 500,000 containers per year of freight from regional areas and to Melbourne and Brisbane. Qube will be the owner and operator of both terminals. The site is large enough to accommodate the two terminals and up to 850,000 square metres of warehousing. Qube has all the development and asset management rights. Mr James noted that whilst the plans of Amazon are yet to be revealed he did not believe it would have significant impact on their operations as many other participants in the retail sector continue to invest in efficient warehouse and inventory management solutions.

Additionally, Mr James gave an overview of Qubes other major operating divisions, Ports and Bulk and Logistics. Ports and Bulk has a heritage stretching back 150 years, and with facilities in all Australian capital cities and cargo facilities in a further 24 regional ports, is pre-eminent in its field. Operations consist of on – wharf and port precinct facilities, providing break- bulk services, refrigerated transport, customs and quarantine clearance and heavy haul transport amongst others and as a consequence can service customer needs across a broad mix of industries and critical logistic chains.

Qube Logistics is made up of some 15 intermodal facilities across Australia providing, road and rail transport, warehousing and distribution, container parks and related services. Qube uses 90 plus locomotives, 900 + wagons, 300 lifting machines and in excess of 900 prime movers and can combine them as an integrated solution or tailor them to meet individual client needs. Over the last four years, Qube Logistics has extensively developed and expanded its logistics portfolio and is now Australia's single biggest provider of logistic services.

Given the importance of moving goods into and out of Australia and the development of the Moorebank Intermodal Park facility, we will continue to closely monitor and maintain our dialogue with this important and growing company and assess their reactiveness to Amazon when it plans are revealed in substance.

Updated PPM website

You may have noticed in July that we launched an updated and new look PPM website – still at the same address www.ppmfunds.com

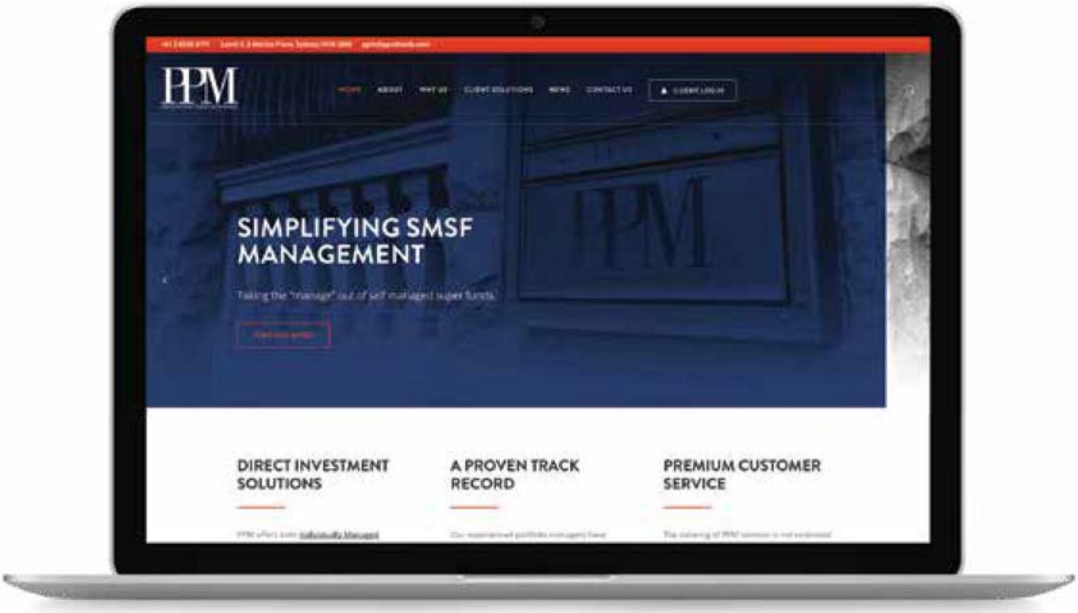
Our goal for the updated website was to make it faster and easier to navigate on mobiles, tablets as well as desk top computers.

Most of all, we wanted to help you, our clients, get to know us better by making it easier to find the information you need.

The PPM login is unchanged and remains a secure and client only access to your Portfolio information. There is no need to change your passwords or bookmarks.

Please, have a look around the site and let us know any feedback you may have at ppm@ppmfunds.com

Enjoy!



For further information about PPM's services, please contact either Sally Humphris or Adam Griffiths on 1800 463 359 or email ppm@ppmfunds.com.

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