DIVIDEND DETECTIVE

Orica no fizzer for patient investors

Orica
ASX CODE: ORI
SECURITY PRICE: $21.04
INDUSTRY: Mining services
FORECAST DISTRIBUTION: 95c per share, 40 per cent franked

DARREN KATZ

The outlook for explosives company Orica has fizzled as the mining slump hits earnings.

The company recently disappointed the market with a below-expectations interim profit result. But despite those challenges, a pretty solid dividend yield is underpinning its shares.

Orica is transforming its operations in an effort to become more resilient. And it should benefit from both a falling dollar and a potential infrastructure-spending surge in Europe. This makes the stock a solid option for patient income investors.

Orica is the world's largest supplier of commercial explosives to the mining and infrastructure market. It operates in over 50 countries and has a 28 per cent global market share.

The mining services segment includes the manufacture and supply of commercial explosives and blasting systems to the mining, quarrying, construction and exploration industries.

The segment also includes the provision of ground support services in mining and tunnelling. Orica recently offloaded its chemicals business.

But like many other service providers, the mining downturn has hit hard. Orica's CEO recently described market conditions as "unquestionably difficult". Global markets are volatile, so Orica isn't providing a 2015 profit guidance.

The tough conditions have affected earnings. In May, Orica announced a 3 per cent fall in first-half net profit to $211 million, revenue flat at $2.8 billion.

But it's not all gloom and doom. Orica's new challenge is to build earnings resilience in the downturn. It is taking action with a "transformation program" that includes cost-cutting and contract renegotiations. This program is starting to gain traction.

Orica should also benefit from a fall in the dollar at some point and we expect it to benefit from infrastructure rollout in Europe. The company's balance sheet is also in good shape, with gearing falling from 36.5 per cent to 29.4 per cent in the first half.

Orica declared an interim dividend of 40c per share, franked to 14c per share. It is forecast to pay a total full-year dividend of 95c per share, around 40 per cent franked, which gives a healthy 4.5 per cent yield.

At $21.04, Orica is trading slightly above our forecast value of $18.07 but remains an option for income-focused investors.

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Picking a fund manager

The choice really boils down to 'active' and 'passive'

WILL HAMILTON

Robert Shiller shared the Nobel Prize for Economics in 2013 with Eugene Fama, whose views directly contradicted his AP

What's the ideal type of fund manager? And how does a private investor choose between the many brands and styles available? Indeed we might ask, is any one style the right style?

The Nobel Prize for Economics was shared in 2013 by two professors with opposing views.

The first was Eugene Fama, who gave us the modern efficient markets theory that share prices incorporate all available information and there are no mispricings to exploit.

The second, Robert Shiller, believes efficient markets "make little sense". He draws on behavioural science to show the human errors involved in market pricing as investors misperceive and overreact to information.

Both these positions, contradictory as they were, were seen by the Nobel prize committee as "the right approach".

The division of views on how you might approach markets is also plainly seen in the current debate over which approach to adopt toward asset management.

In looking at active management, it is important to differentiate between "index like" — a broad portfolio built around the index and the sectors it makes up — and "conviction" — a portfolio of stocks where the fund manager makes investment decisions based on a company's fundamentals and price.

They don't buy simply because they believe the price is going up or sell because they believe the price is going down.

Passive or index investing adjusts a portfolio's weightings based on what has occurred in the past, conviction investing is forward looking towards a business's potential.

More sophisticated investors want exposure to stock specific risk and are looking towards conviction based funds for risk based assets, therefore introducing idiosyncratic risk into their portfolios.

Once a decision has been made to look at exposure to market risk, the natural extension is to look at idiosyncratic risk. That is where funds with high active share, high tracking error and therefore idiosyncratic risk have been more likely to outperform.

A conviction value manager believes that the stock market is not always efficient or rational and that the underlying value of a security is distinguishable from its daily market price.

Their view is that inefficiencies in markets can be caused by short termism of many participants and/or the tendency of many investors to hug indices.

The skill in assessing a high conviction manager lies in identifying their stock picking ability as idiosyncratic risk becomes their friend, conviction managers therefore strive to be different from the crowd, aligning with Professor Shiller. In Magnus Angenfelt's book *The World's 99 Greatest Investors*, he looks at how the efficient market hypothesis assumes shares are always traded at their correct value, therefore by definition no shares sold are undervalued and no shares bought are overvalued. In other words, Professor Fama's view that you can never deliver a better return than the market.

Angenfelt argues this is at odds with the view of professional investors, the best of which have beaten the market year after year for an average of 25 years and usually with less risk.

Angenfelt argues further that the sums involved are too great to be dismissed as a statistical residual, as the market is not efficient and investors need to seek out those managers that are "outliers".

The big question therefore becomes how to select a conviction manager. In selecting a manager you are leveraging the stock-picking skill of that team.

While quantitative data is available a strong qualitative assessment is necessary.

The vital importance of knowing and being comfortable with a management team — as well as the mandate, and their previous experience in navigating volatile markets, while ensuring the process and philosophy of the fund — has not changed.

This is crucial, especially in times of market underperformance when investors want reassurance a manager has used their mandate correctly.

It's generally expected that conviction funds should be able to mitigate risks better than index aware funds.

When assessing a manager you must ask:

- Does the team have ownership in the fund?
- Can the fund manager properly ensure incentives are very much aligned with the investor?
- Are there size constraints on the fund?
- Does the fund have the ability to hold cash?

Fees often come up in the active versus passive debate.

What is important to ensure as an investor you are not paying active fees for passive management?

Even the Nobel prize cannot resolve the active versus passive debate, and there is a role for both.

On the active side of the argument too many so called active managers are operating close to the index and in assessing the risk component of a fund idiosyncratic risk combined with high active share and high tracking error can be your friend.

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Trust me, you need to get your death benefits in order

MONICA RULE

Putting plans in place on how to distribute your superannuation savings upon your death is equally as important as planning how to use your superannuation savings while you are alive. Not many people spend much thought on estate planning because it is one of those things we tend to put off until "later". But no one wants to leave a big mess for our family to resolve when we're gone.

Take for example, a badly worded self-managed superannuation fund trust deed that provides for the payment of death benefit, payment of a reversionary pension and allows a binding death benefit nomination to be made.

Our sample trust deed states that a binding death benefit nomination (BDBN) must be made in an approved form, yet there is no approved form attached to the schedule of the trust deed, which means, regardless of what form the members end up using, the nomination will not be binding.

Another mistake made in trust deeds is where certain words are not clearly defined. Examples are the words "spouse" and "member". Does a spouse include a de facto spouse or is it only a married spouse? What will happen if the surviving member is in a de facto relationship with the deceased member — is a death benefit payable to the de facto spouse? What about a person who is drawing a pension from the SMSF? Is this person included as "member" or is it only the members in the accumulation phase that are considered to be members of the SMSF? Does this mean, the member accessing a pension may not be able to make a binding death benefit nomination? These are all questions the trust deed must answer.

I recently attended the SMSF Association's National Conference in Melbourne, where lawyers Scott Hay-Bartlem and Clinton Jackson from Cooper Grace Ward Lawyers role-played a scenario where a husband and wife were members of their SMSF. The husband made a binding death benefit nomination leaving his superannuation entitlements to three sons from his previous marriage. The husband was in receipt of a reversionary pension at the time of his death.

Both Mr Hay-Bartlem and Mr Jackson convincingly argued their cases where one acted as the lawyer for the surviving wife who would receive the reversionary pension from the SMSF, and the other acted for the three sons who would receive the death benefit of their deceased father's super entitlements. Both presented compelling cases for their "clients".

Which should take precedence? Is it the death benefit payment to the sons or the continuation of the reversionary pension to the wife? It all depends on the wording in the trust deed, binding nomination and the product disclosure statement of the pension (if there is one).

In the role-play, it was decided that as the reversionary pension continued to be paid to the surviving spouse after the death of the husband, there is no death benefit payable. Therefore the deceased sons were not entitled to their father's superannuation savings regardless of the binding death benefit nomination.

Make sure your documents are drafted by someone who is a superannuation specialist and has experience in the superannuation dispute matters. People who have children from previous marriages who have started new relationships should be particularly careful they have everything in order.

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Bond market uncertainty a sign it's time to fix rates

DON STAMMER

Bond markets in Europe are stressed. And it's affecting the US and Australia. Investors should allow for further lively — and likely disruptive — times in bond markets, here and abroad, in coming months.

Five weeks ago, yields on government bonds in many countries were at their lowest levels ever. In Europe, US$3 trillion of government bonds were priced with negative nominal yields.

Investors, and not all of them central banks, were prepared to pay to lend money to the German, Swiss and Austrian governments.

But on May 7 there was a dramatic sell-off in the German bond market, traditionally lauded for its stability. The yield on 10-year bonds — German government bonds — went from their April low of 0.05 per cent to a brief peak of 0.78 per cent.

Concerns spread to other bond markets, including in the US and Australia. In Australia, 10-year yields have risen by more than half a percentage point from their April lows. There is, of course, an inverse relationship of bond yields and bond prices — and the longer-dated the bond the greater the inverse move in market prices.

There's still no agreement on what caused the sell-off in European bonds.

In my thinking, it's an early sign of an emerging view that the global economy, which has been in the doldrums, is now close to an important turning point that delivers better growth.

Here's a list of how analysts and traders have explained the jump in bond yields:

- Some blame "technical issues", associated with a temporary shortage of buyers as some big investment funds switched from conventional bonds to inflation-linked bonds.
- Others point to the recent changes in bank regulation, which have constrained the activity of "market makers" in bond markets.
- Investors are starting to prepare for the level of bond yields that's likely from August next year, after the European Central Bank completes its program of bond purchases of 60 billion euros a month.
- The business outlook in Europe is not now as gloomy as investors had earlier expected. Though many problems have to be faced, the consensus forecast for economic growth in the eurozone this year has been raised to 1.5 per cent, pushing bond yields higher.
- Also, bond investors may have gone too far in their earlier expectations for sustained deflation in Europe.

Perhaps triggered by the rebound in oil prices, bond investors are again allowing for (mild) inflation.

If, as I expect, further signs emerge over coming months of an early pick-up in global growth, bond markets could turn decidedly bearish.

Yields on medium-dated and long-dated bonds will likely increase relative to yields on short-dated bonds, which are anchored — other than in the US — by the prospect of cash rates remaining unchanged for some time. Perhaps it's time for bond investors to consider favouring shorter-dated bonds, floating rate notes or cash, relative to their holding longer-dated bonds. And investors in

> Borrowers might consider locking in some fixed-rate debt while term rates remain relatively low

bond funds might favour absolute return funds in preference to funds that focus on outperforming the average returns the market is delivering (which may well be negative).

Borrowers might consider locking in some fixed-rate debt while term rates remain relatively low. To date, the mood swing in bond markets has had relatively little effect on share markets. It's prudent, I believe, to allow that forthcoming increases in bond yields will hurt investor confidence — and initially reduce share prices. However, if bonds sell off because of an upgrade in global growth, which would raise expectations for company earnings, share markets might soon rebound.

There's also the point Nick Nelson, a European equity strategist for UBS, makes that "equities hate deflation so if bond markets are moving away from deflation that should be constructive (for shares)".

The fractured confidence in the bond market is a reminder, too that the US Fed will be skating on thin ice when it begins to "normalise" its US cash rate without, it hopes, unsettling the US bond market.

Don Stammer chairs QV Equities, is a director of IPE, and is an adviser to the Third Link Growth Fund and Altius Asset Management. The views expressed are his alone.

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