Ripe for the picking:
Overseas stocks to buy now

SPECIAL REPORT | PUBLISHED OCTOBER 2012
Dear Intelligent Investor,

You know the pitch: ‘Representing just 2% of the world’s stockmarket capitalisation, those invested only
in Australian stocks are missing out on 98% of the world’s opportunities.’

We never much went for the marketing spiel. Investors that stayed home also missed out on 98% of
the world’s stockmarket blowups, bankruptcies and frauds. The ultimate goal is the same as ever: to build
and maintain a portfolio of 10–20 underpriced securities, diversified in risks.

In the Australian market, the rule of law and local experience fall in your favour. An investor too focused
on ensuring they have an adequate weighting to Bangladesh and Peru, or to biodiesel and nanotech, is one
not concentrating enough on price.

That’s not to deny the strength of the counter-arguments, as long as one abides by the rule to only ever
own underpriced securities.

Australia lacks global brands and many important industries are simply non-existent here. If one can
purchase shares in Coca-Cola, Berkshire Hathaway or AB Inbev at reasonable prices—as this report argues
you can—you’re buying into industries and brand names unavailable locally. The cheap shares come with
more diversifying power, too.

Furthermore, assuming you have the discipline to buy only underpriced shares, the argument that
international investing offers more opportunities carries more force.

W-8BEN form aside (a Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding, not
a new strain of bird flu), it’s never been easier, either. Lower brokerage rates should encourage more international
investment. [See page 26 for a beginner’s guide to establishing a broking account that permits international investing.]

Still, the conventional arguments don’t fully explain why your analytical team has become more interested in
international investing recently. Instead, unconventional reasons—ones specific to the times—carry more weight.

First, the tailwinds that have boosted the Australian economy and its stockmarket over the past decade
may be about to experience a change in direction.

Australia has been a huge beneficiary of a Chinese infrastructure spending boom—one that looks
unsustainable. Some of your analysts are also convinced Australia has a house price bubble. All are concerned
about high levels of consumer debt and a (still) high dollar. Moreover, these risks are linked. Should one
materialise, others become more likely.

Meanwhile, the door opened by the high dollar and aftermath of the GFC remains ajar. Twelve or more
years ago, when the above-mentioned marketing pitch was especially virulent, US stocks were sky high and
Australian blue chips cheap. That’s no longer the case.

While Australian blue chips are cheaper than they were five years ago, they’re not outcasts. Many big US
and European stocks are. That’s the second reason for our interest: International diversification makes more
sense today because it delivers greater diversification and attractive pricing.

If you’re concerned about the economic outlook at home, or looking to
expand your value investing hunting grounds, we suggest you take a closer
look at the stocks outlined in this report.

Please note however that it is not detailed analysis. We’re attracted to
the stocks in this report either because respected value investors have taken
a substantial stake or because we’re familiar with the company through our
personal investments.

We’ve explained what’s to like about the stock, as well as some of the
risks. The rest, as they say, is up to you.

We trust that you gain as much value from this research as we’ve had
pleasure in bringing it to you.

Kind regards,
Nathan Bell
Gareth Brown

Note: All figures are in USD unless otherwise stated.
The Home & Away portfolio

A ready-made portfolio of the finest Australian and international businesses? If that’s what you’re looking for, this is for you.

The best portfolios are like a beautiful garden; they are not planted in an afternoon but carefully planned and lovingly tended.

Perhaps you already know the companies you want to buy. You may also know the price you’re prepared to pay for them. Implicitly, you’re prepared to exercise patience, waiting for the moment in which to strike.

Sometimes, you’ll be able to buy a boot-load of high quality bargains in periods of market panic, filling a whole corner of the garden in the process. At other times, you’ll make a studious purchase of a stock you love, paying a fair rather than cheap price.

Consider the publication of this, our Home & Away portfolio, a selection of top quality Australian and overseas blue chips, as a beautiful garden in the planning stages. It is not an encouragement to rush out and buy all the stocks on the list. The market is not especially cheap after all, although there will be times in the future when it might become so.

What this exercise should do is provoke some serious thinking about how you might build and maintain a portfolio with your own needs and risk profile in mind, focussed on high quality Australian and global businesses.

The structure of the portfolio also makes the point that having a totally local focus—all too common among investors, especially after so many years of plenty—fails the important principle of diversification.

To fill our new portfolio, we first raided our current Buy list for high quality Australian stocks that are quite cheap today—QBE Insurance, ASX, Computershare, ALE Property Group, Brickworks, Origin and Santos were all awarded a place in the portfolio.

These stocks should be at the top of your list if you’re putting together a portfolio today. Then we plucked the highest quality businesses from our Hold list: Woolworths, Sydney Airport, ARB Corporation, CSL, Cochlear, ResMed, InvoCare and News Corp. All have market-leading positions but aren’t currently bargains.

If you’re committed to building your portfolio over a series of years, these might be stocks for your watch list. For those wanting to ‘get invested’ in a hurry, though, we’re convinced these businesses will be bigger, stronger and more profitable a decade from now. Most will pay you a reasonable dividend while you wait.

We’ve also added a generous weighting to the big, international blue chips that are the subject of this special report—McDonald’s, Wal-Mart, Berkshire Hathaway, Coca-Cola, Tesco, Lowe’s, Vivendi and AB InBev.

These multinationals will add a diversity to your portfolio that it might now lack. Plus they will add currency diversification, sharply reducing your portfolio’s reliance on the same Australian economy that dictates your job prospects and the value of your home.

As Australia isn’t particularly blessed with global brand names, they also add much-needed diversification by business-type. Not only are these global businesses of the highest quality, they’re also quite cheap. That makes the case for international diversification doubly attractive today.

Importantly, the Home & Away portfolio is well protected against an Australian economic and/or currency downturn, perhaps one caused by further troubles in China.

Foreign multinationals with genuinely global businesses make up 30% of the portfolio directly, while almost 20% more is invested in Australian stocks with substantial overseas operations, such as QBE, Computershare, CSL, Cochlear, ResMed and News Corp.

You’ll also notice how 20% of the portfolio is held in cash, allowing you to add future bargains when the opportunity arises. Half that cash is in Australian dollars, the remainder US dollars. If you hold a lot of cash, you might seek even more diversification adding other big currencies to the mix.

Finally, a reiteration of the first point: Please do not rush out and buy all the stocks in this portfolio. Buy carefully and, where possible, cheaply. The research in this report makes clear those stocks that we believe offer good value now. Above all, exercise patience.

"These multinationals will add a diversity to your portfolio ... [and] add currency diversification, sharply reducing your portfolio's reliance on [the] Australian economy."
Coca-Cola rediscovers its fizz

It’s not especially cheap but Coca-Cola has all the ingredients of a successful investment, argues Nathan Bell.

Swept up in the Nifty Fifty bubble, Coca Cola’s share price doubled between August 1971 and October 1973. The collapse came swiftly—within a year it had fallen to less than a dollar. Twelve years passed before the company’s share price once again breached $3, on its way to a peak of $86.75 in July 1998 (these figures haven’t been adjusted for the recent 2-for-1 share split, see Chart 1).

Although the price has since fallen almost 15% (after adjusting for the 2-for-1 split), the company still trades on a PER of 20, a reflection of the reliable growth potential of one of the world’s best-known brands. Fifteen years ago, that potential was more than priced in. Now, under chief executive Muhtar Kent, it’s potentially understated, which is what makes it so interesting.

The impact of Kent himself doubles the attraction. One might think that a company with 146,000 employees and sales due to reach $48bn this year might easily resist the exhortations of one man. Not, apparently, if that man is Muhtar Kent (a recent Fortune article).

Kent joined Coca Cola in 1978—taking a hiatus between 1997 and 2004 following a stock-trading incident—and became CEO in July 2008. Since then, he’s reinvigorated the company. Seventy percent of the company’s senior managers have been replaced, revenue last year increased by a third and operating profit rose 20%, largely due to the acquisition of the company’s largest North American bottler. In the four years since he took over, the company’s stock has risen 50%, despite the GFC.

Of Turkish origin, Kent grew up in Thailand, India and Iran, the son of a diplomat. It’s a background not unsuited to a global brand business. In a period when professional managers behave more like administrators, Kent acts like an entrepreneur and tries to instil those qualities in his staff, according to his philosophy of being ‘constructively discontent’.

In the Fortune interview he describes this as being, ‘Not fast enough, not innovative enough, not entrepreneurial enough.’ It is, he says, ‘all about an entrepreneurial mentality. I’ve worked religiously to get that into the company.’ Kent also possesses an instructive grounding in how to run, and not run, the company.

He saw first hand how Doug Ivester sought to maximize Coke’s own profits by strong-arming bottlers to consolidate, and overcharging them for concentrate. The moves alienated bottlers and left them financially strapped. Since rejoining the company as Coke’s head of North Asia, Eurasia, and the Middle East in 2005, Kent’s priorities have been fivefold:

1. Expand geographically

According to BrandZ, Coke is the world’s tenth most valuable brand. Despite it being founded over a century ago, it remains a growth business. In the western world, Coke offers a cheap sugar rush. In developing countries, it’s positioned as an affordable luxury.

Coca-Cola has already built 42 bottling plants in China and is preparing for Chinese sales to more than double. Eventually, they will overtake those in the US and Mexico (see Chart 2). As with Anheuser Busch InBev (see page 10), Coca-Cola offers a low risk way to benefit from emerging market growth. Burma is yet to be conquered and Cuba and North Korea are unlikely to ever be but Coke, available in over 200 countries, is almost everywhere else.

The brand also delivers one of the most sought-after characteristics: pricing power. Do you really want to drink Pepsi to save a few cents? Coca-Cola’s enduring brand and popular taste ensures it is best positioned to take advantage of the huge growth potential in emerging markets. Indeed, Diet Coke recently surpassed Pepsi as the second largest selling soft drink in the US, behind Coke itself.

Kent knows the benefits of the brand. Now he’s busy developing new markets into which the company’s natural advantages can be parlayed into growing profits.
2. Introduce or acquire new brands

Image 1 shows how Coca-Cola doesn’t just sell Coke. The company owns 15 brands, including Fanta, Powerade and the comically named Vitamin Water (a 500ml bottle of water with 23g of sugar). Kent is keen to develop or acquire more, especially as the company’s ability to develop or acquire and distribute new brands to large populations is already proven.

That five of the 15 brands were developed outside the US also augurs well for investors searching for exposure to less mature markets. Coca-Cola’s distribution network and marketing muscle is a formidable competitive advantage.

3. Work closely with independent bottlers

Unlike his predecessors, Kent’s recognises the value of working closely with bottlers. He wants them to be able to afford to invest in their businesses and be rewarded for selling more Coke, something that entails a little short-term pain for long-term gain.

Kent’s riskiest move was acquiring the North American unit of Coca-Cola’s largest bottler in 2010. It made the company far more capital intensive (return on capital has fallen from 18% in 2008 to 11% in 2011) but gives Kent the opportunity to cut costs and prioritise the production and marketing of non-soft drink products that can produce quicker growth (bottlers frequently despair at producing soft drink alternatives, which are more costly to produce and require larger investments).

4. Change the company’s culture

Kent’s long-term vision of doubling sales by 2020 requires a new corporate mindset. This is perhaps Kent’s greatest challenge, but one well-placed observers suggest he can meet. Coke board member Barry Diller says he’s never met ‘anyone so intense’ and Herbert Allen, chief executive of investment bank Allen & Co, says Kent is ‘the best chief executive Coke has had in 25 years.’

Kent is also focused on costs, roaming the office late at night turning off lights. Managers must pay $15 a month if they use their mobiles for personal calls. The same rule applies to the chief executive. There is a deep respect for cash: ‘When you don’t see cash, all sorts of things go wrong,’ says Kent. ‘You overspend as an individual and overspend as a company.’

Barry Diller’s purchase of 2m shares since Kent took the top job suggests he’s making the changes the company needs.

5. Succession planning and financial performance

A highly capable management team offers the company plenty of succession alternatives, including US Coke boss Steve Cahillane and non-US chief Ahmet Bozer (the front runners), Latin American Coke chief José Octavio Reye and US Still Products boss Brian Kelley.

Each has contributed to a highly successful turnaround in Coca Cola’s performance. Since 2008, despite the poor global economy and acquiring the capital intensive US bottling operations that reduced operating profit margins from 26.3% in 2010 to 23.4% in 2012, earnings per share have increased 10.9% annually. And return on equity has only fallen marginally from 28% to a still impressive 27%.

Whilst the bottling acquisition has increased net-debt-to-equity from 20% to 58%, the company’s reliable earnings should easily finance it.

Warren Buffett once remarked to Bill Gates that a ham sandwich could run Coca-Cola. Kent has a full picnic. The company’s performance since he took over points to a smorgasbord of replacements, each capable of adding to shareholder returns.

Valuation

Companies with incredible brands, wide competitive moats, extensive distribution networks and high returns on capital rarely trade at bargain prices. Even when Coca-Cola’s share price fell to below $19 on 5 March 2009, it still traded on a price-to-earnings ratio of 15.

If earnings per share keep growing at around 10% a year, then you should expect total annual returns (capital gains plus dividends—currently) of a similar magnitude. Should the Aussie dollar fall significantly over time, this should increase your returns well into the double digits.

Remember also that whilst Coca-Cola’s stock price has risen 50% since Kent’s appointment, his strategy is orientated to the long term. If ever there was a stock to keep in the bottom drawer for your grandkids, this is probably it.
If you aim to purchase only bargain priced stocks, consider making a small investment now, say 3% of your total stock portfolio, and build on it over time. If you can buy the company on a forecast price-to-earnings ratio of 15, perhaps when PepsiCo is winning the cola war (fortunes between the two rivals are forever swinging back and forth), then consider increasing your stake to 10%.

US Stock | Nathan Bell, CFA

McDonald’s not so secret sauce

McDonald’s remarkably resilient business is built for the times. Nathan Bell explains why it’s worth paying up for this company.

What do Sharon Stone, Shania Twain, Jay Leno and rock star Pink have in common? They all worked at McDonald’s before they were famous. McDonald’s estimates that it has employed one in every eight Americans and even the Queen of England owns a McDonald’s store near Windsor Castle.

The company sells 75 hamburgers per second; its US customers consume one billion pounds of beef per year; and if McDonald’s were a country, including franchisee sales its economy would rank 62nd in the world.

Also, and rather more pertinently for its investors, the company has increased its dividend for 36 consecutive years.

Despite these remarkable statistics and a financial performance that would make Usain Bolt proud (in 2008 Bolt won gold in the 100 metres at Beijing after eating Chicken McNuggets), back in 2003 the company’s stock was less popular than the pickles on its burgers (see Chart 1).

‘At the start of 2003’, according to PBS in America (www.pbs.org/wsw/tvprogram/burgerletter.html), ‘the fast food chain was a mess. Earnings had fallen seven of the last eight quarters and the stock had lost more than half of its value over the past eight months. News articles described the company as a “slow-moving monolith” and pundits dismissed it as a lost cause.’

In a letter to the company, US fund manager Robert Olstein implored management to stop cannibalising existing stores by opening new ones with cash flow that would add more value buying back shares.

Under a new chief executive the company obliged and, in 2011, it returned $6bn to shareholders though dividends and share buybacks. Since 2008, it has consistently produced a return on equity of more than 30%.

Secret sauce

Maccas’ not so secret special sauce is its franchise model. The company itself operates 6,435 stores, roughly 20% of its 33,510 locations worldwide. These provide valuable operational experience for McDonald’s staff, and allow testing of ‘operating standards, marketing concepts and product and pricing strategies’.

Almost 60% of stores operate under a typical 20-year franchise model, where McDonald’s selects and purchases the land for a new store, and requires franchisees to pay ‘rent and royalties based on a percent of sales along with minimum rent payments, and initial fees’. Local franchisees are then able to help McDonald’s adapt its menu and services to suit local tastes and customs.

The remaining 20% of stores operate under affiliate and developmental franchises where fees and rental agreements may vary.
In summary, McDonald’s is best thought of as a property owner and franchisor with a fast food business.

The results of this model speak for themselves. Because franchisees put up most of the capital to fit out new stores, McDonald’s collects a reliable and inflation-resistant revenue stream without requiring large investments. The gobfulls of cash can then be used to pay dividends or buy back shares.

That said we’re comfortable with McDonald’s plans to invest $2.9bn in 2012 to widen its competitive moat.

Half will be used to open 1,300 restaurants, including about 450 restaurants in affiliated and developmental licensee markets, such as Japan and Latin America, where it’s not on the hook for further capital expenditure. At the same time, around 400 locations will be closed, reflecting the company’s fiscal discipline.

The remaining capital will be used to refurbish 2,400 locations worldwide. In Tasmania some refurbished locations have produced a 60% increase in sales.

While McDonald’s is a mature company, sales are still growing as it expands drive-through services (including adding double lanes), increases the number of 24-hour and McCafe locations (around 60% of US locations are open 24 hours a day) and introduces breakfast menus.

‘Love or loathe the food they serve’ says Australian fund manager Coopers Advisors, ‘the fact is “Maccas” remains the most cost effective dining out option for the vast majority of struggling cash-poor families in the Western world today. In a time of austerity and busy lives, where a basket of fresh but uncooked ingredients in the United States costs way more than a McDonalds Extra Value Meal, we think the company’s offering of consistently hot, fresh and tasty fare will continue its dominance for a long time to come.’

**Pickles and sprinkles**

So what could bring our investment undone?

One obvious worry is slowing growth: after rising for many years (see Chart 2), same-store-sales have been flat recently as the downturn has started to bite around the world. Short-term trends such as this don’t worry us too much if a business is built well to provide growth over the longer term.

Competitors are another concern. McDonald’s has many global competitors, such as Burger King and KFC, and there are many more in the US, including Wendy’s, Jack in the Box and Carl’s Jr. All of them are aiming to capture value-conscious customers, and this could lead to lower margins and returns on capital. Mind you, those competitors are probably more scared of McDonald’s than it is of them and we expect Maccas to retain its dominant position. Burger King, for example, has undergone several reincarnations in its struggle to compete.

Another potential problem is management, with former chief operating officer Don Thompson being promoted to chief executive officer earlier this year after Jim Skinner retired. But it’s pleasing to see an internal appointment and we expect a seamless transition.

Possibly the biggest worry of all, though, is that unlike its value meals, McDonald’s doesn’t trade at a bargain price. The stock is trading at much higher prices now than before the global financial crisis, and stands on a forecast price-earnings ratio of 15–16.

But through a combination of rolling out new stores, refurbishing older ones, closing poor performing stores and buying back shares, starting with a 3.4% (unfranked) dividend yield, McDonald’s should be capable of producing total annual shareholder returns in the high single digits.

A fall in the Aussie dollar or a pick up in the global economy would then be the sprinkles on our investment McFlurry.

While Warren Buffett has always favoured Coca-Cola over McDonald’s because of its reliance on the continual promotion of children’s toys related to Hollywood movies (Coke appeals to people of all ages), in an environment where growth is hard to come by McDonald’s seems built for the times.

While many of its competitors go broke or undergo multiple restructurings, McDonald’s has built one of the world’s most enduring franchises.

We suggest starting with a 2–3% portfolio weighting, with a view to raising that to 7% if the price-earnings ratio falls below 14.

Disclosure: The author, Nathan Bell, owns shares in McDonald’s.
Betting on Berkshire Hathaway

Rarely has the gap between Berkshire’s intrinsic and market value been wider. That favours today’s buyer, with or without Buffett at the helm.

Berkshire Hathaway’s track record under Warren Buffett is legendary. Since 1965, Buffett has compounded Berkshire’s book value by 19.8% a year. Not bad for a business based on a textile manufacturer that may well have gone bust without his intervention.

Measured by revenues, Berkshire is the seventh largest business in the Fortune 500, boasting a market capitalisation of $222bn. Yet its share price, as Chart 1 reveals, has increased by just 50% over 16 years (and the company doesn’t pay dividends). Indeed, Berkshire’s current price-to-book value of 1.2 is at a near-record low. Buffett’s halo shines much less brightly these days, which, for potential investors, is a cause for celebration.

Valued at $77bn on 31 December 2011, Table 1 shows Berkshire’s concentrated portfolio of high quality listed securities. The portfolio is filled with global iconic brands, including Coca-Cola (see page 3), IBM, Berkshire’s second largest holding, and American Express. All reflect Buffett’s love of predictable businesses.

### TABLE 1: BERKSHIRE HATHAWAY STOCK PORTFOLIO (31/12/2011)

<table>
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<tr>
<th>COMPANY</th>
<th>SHARES</th>
<th>PERCENTAGE OF COMPANY OWNED</th>
<th>COST* (SM)</th>
<th>MARKET ($M)</th>
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<td>JOHNSON &amp; JOHNSON</td>
<td>31,416,127</td>
<td>1.2</td>
<td>1,880</td>
<td>2,060</td>
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<td>KRAFT FOODS INC</td>
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Buffett has famously avoided technology stocks so his $10.9bn investment in IBM last year was especially notable. Twenty years ago the then low margin hardware manufacturer flirted with bankruptcy but has since reinvented itself as a higher margin IT services company.

But Berkshire is more than a collection of brands. If Buffett likes a business, he buys it. That explains why Berkshire also owns a number of companies outright, from relatively small operations like See’s Candies and Nebraska Furniture Mart to giant utilities such as MidAmerican Energy and BNSF Railway. The latter—a capital intensive railway business—was much criticised at the time of Buffett’s purchase but in 2011 it increased profits by 21%.

According to T2 Partners LLC, between 2002 and 2011 pre-tax earnings per share from these operating companies increased from $1,479 per share to $8,000. In contrast, the value of the securities portfolio has merely doubled.
The large increase in Berkshire’s operating business earnings means we need to value these two components separately, a matter we’ll get to shortly.

Berkshire also has a substantial insurance business, chiefly operating under the brand names Geico, General Re and the Berkshire Reinsurance Group, which insures ‘super cats’, the biggest of the big catastrophe events. No matter what the risk, if the price is right, Berkshire will probably insure it.

This isn’t a matter for great concern. Berkshire generates a billion dollars of free cashflow each month, has a $77bn portfolio of listed securities and around $70bn in cash and fixed interest securities. In the event that one of its insurance companies underestimates the probability of a bad outcome, Berkshire is financially very well positioned to deal with it.

As discussed in our EFY special report Inside the underwriters, Buffett also invests the premiums (or ‘float’ in insurance industry jargon) at high rates of return. This is the secret sauce behind Berkshire’s phenomenal long term growth.

All of which suggests a strange anomaly: If Berkshire is so financially strong, diversified and boasts an incredible track record, why is it trading at a record low valuation?

There are five explanations, with a little bit of truth attributable to each:

1. The possibility of a double-dip recession

Berkshire’s diverse portfolio of businesses makes it a bet on the US economy. And there’s enough evidence to suggest that a double-dip recession is a possibility, if not a probability. But unlike the share prices of US homebuilders, which soared recently as confidence grows that the US housing market has reached a bottom, Berkshire’s stock price has barely budged. Clearly, there’s more to the Berkshire story than the prospect of a US recession but it’s one factor holding down the price.

2. Berkshire’s size means low growth is more likely

Berkshire’s size is making it harder for Buffett to find investments that will have a significant bearing on profits. This isn’t news, though. Buffett has been warning investors for many years that Berkshire will grow more slowly than it has done in the past. Indeed, the company’s stock has yet to surpass the levels reached prior to the GFC. As time passes and Berkshire gets even bigger, that point looms closer, a factor playing on potential investors’ minds.

3. The danger in derivatives

After declaring that derivatives were weapons of mass destruction in the 2003 letter to Berkshire Hathaway shareholders, Buffett copped a lot of flak for Berkshire’s book of credit default swaps and equity index puts. There’s a possibility that regulations surrounding these investments may change, forcing Berkshire to put up more capital. That, though, shouldn’t significantly impair the company’s underlying value.

4. Insurance businesses are on the nose

After last year’s record losses, the share prices of insurers worldwide are in the dumps. Berkshire Reinsurance’s 2010 profit of $176m slumped to a loss of $714m in 2011. But, as discussed in the special report previously mentioned, lower profits are likely to prove temporary for shrewdly managed insurers like Berkshire Hathaway.

5. Life without Buffett

Berkshire will eventually face life without Buffett. This won’t be a revelation to you—we all die. The problem is that even the best possible replacement, and Berkshire has plenty of talented managers and investors—is unlikely to do as good a job as his predecessor. They won’t have Buffett’s Rolodex and fewer favourable deals are likely to come Berkshire’s way with someone else at the helm.

Buffett’s hands-off management style has also encouraged many business owners to sell to Buffett and keep on working. As these owners are rich and many are old, they may not be inclined to hang around under a new manager. Buffett’s departure may well be a signal for their leaving.

But Berkshire won’t fall apart. And, at the current price, you’re being compensated for the risk. There’s also a risk his departure would reduce—that of Buffett staying on too long and making poor decisions.
How cheap is Berkshire?

Berkshire’s current price-to-book ratio is just 1.2, not far from a record low in recent decades. There’s evidence from many sources that Berkshire is cheap.

The first is Buffett himself. He’s said many times that the company’s intrinsic value (of which he never publicly discloses his estimate) is higher than its book value. Moreover, according to Buffett the difference between intrinsic value and book value is growing each year, mainly due to the increase in the value of its fully owned businesses.

The company has also instituted its first ever buyback and now has a permanent program to purchase stock at a price-to-book value ratio of 1.1. Buffett’s statements in the announcement of September 2011, the 2011 annual report and elsewhere leave little doubt that he thinks the stock genuinely cheap at 1.1 times book value. That’s only a little below today’s price.

The second source is more independent. Respected fund manager Whitney Tilson has published his estimate of Berkshire’s value in his presentation. Tilson takes the $98,366 per share value of Berkshire’s total investments at 31 December 2011 and applies a sensible multiple of 10 to his adjusted estimate of pre-tax operating earnings per share of $8,000. Adding these two figures delivers a value of $178,366 for the Berkshire A class shares—44% above the current share price.

After adding $7,000 per share of cash earned this financial year and assuming 8% growth, Tilson’s estimate for 2012 increases to $200,000 per share—49% above the current share price.

To convert that estimate to Berkshire B shares (assuming you want to buy a smaller parcel), divide the figure by 1,500. That’s a value of $133 per share, 49% above the current share price. Whichever way you cut it, Berkshire doesn’t look expensive.

With Charlie Munger, Berkshire boasts two of the greatest allocators of capital of all time, inside owners with a long-term view, a remarkable track record and a pristine balance sheet. Yet its stock almost certainly trades at a discount to the sum of the value of its disparate parts.

There is no premium for great management in Berkshire’s stock price, which affords today’s buyer significant protection even against Buffett’s eventual departure. This formidable combination means you can have up to 10% of your total stock portfolio invested in Berkshire Hathaway, and still sleep very peacefully.

Disclosure: Staff have interests in Berkshire Hathaway, but not the author, Nathan Bell.

US Stock | Nathan Bell, CFA

Lowe’s everyday low price

Like its incredible product selection, Lowe’s offers investors quality at a reasonable price.

I’ve never been handy around the house. I can’t even climb a ladder due to my fear of heights. But while I couldn’t think of anything worse than spending my weekend renovating a kitchen or bathroom, for many professional and DIY handymen and women, home improvement is a way of a life.

Catering to these weekend warriors is Lowe’s Companies Inc, which operates around 1,750 big box home improvement stores that are essentially blue versions of a Bunnings Warehouse. They’re mostly located in the US, with a handful in Canada and Mexico.

Bunnings’ rival Masters, which we looked at in Woolworths’ Masters nails it on 12 Jan 12 (Long Term Buy—$25.62), is a joint venture between Lowe’s and Woolworths. But unlike Woolworths, which primarily leases its sites, Lowe’s owns 89% of its properties and boasts a $22bn property portfolio (including plant and equipment).

The US home improvement market is highly fragmented, but the largest participants are Lowe’s, with an 11% market share, and its archival Home Depot, with 16%. Lowe’s stocks
around 40,000 products in a typical store and over 200,000 online. Although online sales remain miniscule, the company’s power over suppliers enables it to offer cheaper prices than smaller rivals and a much wider assortment of products and services.

On average shoppers spend $63 per trip, but 70% of the company’s revenue comes from repeat customers known as ‘creators’—people that are emotionally attached to their home, which they see as a reflection of their personality. These loyal customers spend thousands on renovation projects that require a broad range of products, from cheap screws and nails to paint, flooring, cabinets and kitchens. A quarter of Lowe’s customers are professionals.

**Makeover**

Professionals and DIY handymen also value advice and inspiration, so Lowe’s must provide a higher level of service than you’d find at Woolworths or Wal-Mart, for example. This helps immunise Lowe’s from the threat of online rivals, though slide 10 of Pershing Square’s analysis (http://bit.ly/Q1y6ZA) suggests that 10% of the company’s products are at high risk of online competition.

Home renovation projects were shelved across the US as the housing market collapsed in 2008. Customers started making fewer trips and spending less on big-ticket items such as fridges and wine chillers. The impact on Lowe’s profitability is obvious (see Chart 1 and Table 1).

Sales have fallen from a peak of $298 per square foot in 2006 to $255 currently, dragging operating margins down from 11.0% to 7.5%. Earnings per share currently stand at 2006 levels.

That’s hardly surprising given new housing starts have collapsed to around 600,000 per year (see Chart 2), well below the 1.2m needed to meet population growth and obsolescence. It’s remarkable then that the floor for Lowe’s return on equity was 9.6% in 2009. Profits should increase dramatically as housing starts rebound towards the average.

Lowe’s price-to-earnings ratio of 21 shows the market has already factored in a rosier future, but there is a thorn in Lowe’s’ side.

Prior to the global financial crisis, Lowe’s same-store-sales growth consistently eclipsed that of Home Depot’s, but that relationship has since been turned on its head (see Chart 3). Home Depot has been reinvigorated by chief executive Francis Blake, and it relies less on discretionary purchases than Lowe’s. Lowe’s has also adopted an everyday low pricing policy like Bunnings and K-Mart, rather than promoting large sales with coupons. As department store operator JCPenney has discovered recently, it takes time for customers to adjust to new pricing policies. Unfortunately for Lowe’s, the anticipated upick in sales has been slow to appear, resulting in a recent profit downgrade.

Lowe’s major problems seem cyclical rather than terminal. While setting long-term earnings targets is often a red flag (often management starts making short-term decisions in order to hit the targets) management has laid out a very clear plan of how it expects to double earnings per share to $3.66 by 2015.

Lowe’s needs to generate 4.5% annual sales growth per year. This hinges on a cyclical recovery in the US housing market, which is slowly getting underway. While the pool of unsold homes in foreclosure—known as the shadow housing market—looms large, there’s plenty of anecdotal evidence that more bidders are showing up at auctions and bidding up prices. The stocks of US homebuilders have doubled over the past year in anticipation of a sustainable recovery.

**Counter-cyclical**

Lowe’s is also increasing the number of private brands it sells, just like Woolworths and Coles in Australia. In addition to its everyday low pricing policy, this should help improve margins, while new store layouts and technology are making the shopping experience more enjoyable and easier. Each store now has around 25 iPhones being used over 30 times a day to order stock, and check on availability and any rebates that might apply.

Chief executive Robert Niblock is very focused on capital allocation. New store rollouts will be cut back to 15 per year, which should allow Lowe’s to repurchase 8-9% of its share count annually. The share count has decreased 17% since 2009. Even if Niblock falls short of his optimistic targets, the share buyback alone suggests you should still do well buying today.

While I may not know the difference between a bradawl and a gimlet, it’s obvious that this company is capable of producing much higher profits when the housing market improves, and
that may be sooner than many think. The company’s property portfolio also helps protect your downside, and should Lowe’s share price fall then the share buyback should add even more value.

Lowe’s share price has rallied recently, so with some decent downside protection and the potential for much higher profits Lowe’s is a Buy for up to 4% of a well-diversified portfolio. That gives you some wiggle room to increase your stake up to 7% should the price-to-earnings ratio fall below 16–17.

Disclosure: The author, Nathan Bell, owns shares in Lowe’s.

For 12 years, the share price has been stuck in a time warp. Finally, this A-1 business is available at an attractive price.

It seems implausible now but Wal-Mart Stores (Walmart), the world’s largest retailer, got caught up in the Internet boom. Walmart’s share price increased 11-fold during the ‘90s, peaking at $67.38 eight days before the dawn of the new millennium (see Chart 1). With earnings per share of $1.25, the company’s price-to-earnings ratio peaked at an inconceivable 54. There really was only one way to go after that.

Walmart’s stores typically resemble a cross between a Big W discount store and a Woolworths supermarket. One can only guess as to what allowed investors to believe Walmart warranted a tech stock valuation—perhaps the company’s unrivalled distribution chain would form the backbone of an online retail revolution?

Either way, it didn’t happen. Twelve years on, and still very much a real world retailer, Walmart’s share price sits at $74.

This rather stark contrast hides a more complex story. Chart 2 shows how, since 2000, Walmart has increased earnings per share at 11.3% per year. Despite the worst recession in 80 years, the company has consistently delivered earnings growth that you could set your watch to.

How is that possible?

Each year, the company serves more than 176m customers through its 10,130 Walmart and Sam’s Club stores (a club membership retailer that competes against Costco) in 27 countries (see Chart 3). Walmart’s 2.2m staff, or ‘associates’ as they’re known, outnumber Adelaide’s population by a factor of two-to-one.

Founder Sam Walton was fanatical about lowering the prices of everyday goods; ‘Buy it low, stack it high, and sell it cheap,’ said Walton. This wasn’t just for effect. Walton dealt directly with suppliers to reduce costs and was an early adopter of technology that helped to drive down prices.

According to Fortune, ‘He shared the real-time data with suppliers to create partnerships that allowed Walmart to exert significant pressure on manufacturers to improve their productivity and become ever more efficient. As Walmart’s influence grew, so did its power to nearly dictate the price, volume, delivery, packaging, and quality of many of its suppliers’ products. The upshot: Walton flipped the supplier-retailer relationship upside down.’

As with Woolworths and Coles in Australia, Walmart’s power over suppliers produces the best deals because it buys in massive quantities. If Walmart were a country, it would be the 23rd largest economy in the world. A typical store might stock over 100,000 products.
As sales grow, Walmart’s bargaining power over suppliers increases, allowing further price cuts. It’s a virtuous cycle that most competitors find impossible to match.

This model produces annual free cashflow that is quite staggering. Since decreasing the number of new store openings in 2008, free cashflow has exploded from $4.4bn in 2008 to $14.2bn in 2011.

Like Woolworths and Costco, Walmart empties its shelves before it has to pay suppliers. This produces ‘negative working capital’. That means suppliers are essentially financing Walmart’s short-term capital needs, freeing up cash to open new stores, revamp existing stores, increase dividends and buy back shares. It’s a powerful competitive advantage.

Walmart is also more robust than Woolworths because it owns most of its properties, rather than having to lease them. That’s why Walmart’s average return on equity of around 22% is more impressive than Woolworths’ 27%. Walmart’s $100bn property portfolio accounts for about half the company’s current market value, which adds to the margin of safety for those investors buying the stock now.

All the indications, from valuation to business metrics, suggest this is a wonderful business. So why is it trading on a price-to-earnings ratio of 16, well below Woolworths’ multiple of 20.

First, as measured by revenue, Walmart is the second largest company on the Fortune 500, behind Exxon Mobil. With 90% of all Americans living within 15 miles of a Walmart store, growth will be slower than it has been in the past (see Chart 4—new store openings).

Second, same-store sales growth in the US has been sluggish. While Walmart is attracting more customers impacted by weak economic growth and high unemployment, consumer spending is likely to remain subdued for many years. Company-wide growth is more likely to come from Walmart’s overseas operations.

The company operates in Mexico under the name Walmex, Asda in the UK, Seiyu in Japan and Best Price in India. Most of these economies offer higher growth than the US, though collectively their profits are significantly lower than those produced in the US (see Chart 4). Should US inflation take off, this provides some currency diversification against the US dollar.

Third, Walmart also faces the growing threat from big online retailers like Ebay and Amazon. According to research firm Forrester, US online sales are expected to reach $279bn by 2015, up from $152bn in 2008. Only 2% of Walmart’s sales are currently made online, which is why it has recently spent $300m acquiring online businesses and encourages customers to pick up their own purchases from stores, thus avoiding delivery costs.

According to a William Blair & Co. study, though, ‘Amazon is the undisputed leader in terms of pricing as its prices are on average 14% lower than Target’s and 9% lower than Walmart’s.’ Walmart’s efforts to adapt are something to watch closely, but generating 55% of sales from grocery items offers a fair bit of protection.

Fourth, Walmart operates a pension plan that’s underfunded by about $650m. That figure sounds as though it should be a concern but as it’s only two weeks of free cashflow, it’s nothing to worry about.

Lastly, the company has made mistakes. It reduced its product range (a move that was sensibly reversed) and according to one website, is sued every two hours. Recent headline-making stories include a class action against the company for gender discrimination and a Mexican bribery scandal. None of these issues, however, impact the company’s underlying value.

Valuation

The June 2011 issue of Value Investor Insight summed up the view of respected US investor Tom Gayner: ‘With its difficult-to-replicate distribution system, international growth opportunities and capacity to buy back stock, Tom Gayner believes the company will continue to grow per-share earnings at double-digit rates. With the shares [then] trading at less than 12x earnings, “I’m as confident as I can be that the stock price will follow suit.”’

Even if earnings per share growth is a more pedestrian 8–9%, should Walmart’s price-to-earnings ratio expand (unlikely if growth slows) and/or the Aussie dollar fall significantly against the US dollar, then the overall return could increase well into the teens. The current 2.0% dividend yield isn’t bad either, at least for an overseas stock.
Of course, there are no guarantees. But few companies are as reliable or predictable as Walmart. Provided you pay less than a multiple of 14–15 times forecast earnings (the equivalent of $70–$75 currently), there’s a strong case for allocating up to 6% of your portfolio to the company.

Anheuser-Busch InBev: Take a long drink

Despite higher commodity costs and a consumer shift towards boutique beer, cider and wine, this company’s leading brands and shrewd owner-management leave it well placed.

In 1989, three Brazilians—Jorge Paulo Lemann, Carlos Alberto Sicupira and Marcel Telles—purchased struggling brewer Cervejaria Brahma for $50m. Ten years later, after cutting the workforce in half and increasing operating profits eight-fold (see their T2 Partners LLC presentation), Brahma acquired local rival Antartica Paulista.

The company was renamed AmBev and by 2000 was the world’s third largest brewer measured by beer volume, behind Anheuser-Busch and Heineken. Not bad for 11 years work. But the rapid program of expansion was not yet over.

In August 2004, European brewer Interbrew, which had grown rapidly through acquisitions itself to overtake AmBev as the world’s third largest global brewer, merged with it. The deal was complicated; A stock swap that turned the Brazilian trio’s initial $50m investment into a 25% stake in the world’s largest brewing company, now named InBev, subsequently valued at over €30bn just two years after the merger.

AB InBev, which we’re about to commend to you, became the world’s largest brewer in November 2008 after InBev swallowed US beer giant Anheuser-Busch for $52bn. With the Busch family selling out, the Brazilian trio became non-executive directors and reportedly have a combined net wealth of over $20bn.

Billion-dollar brands

AB InBev is now a vast, sprawling, beery empire. The company owns a stable of over 200 beer brands, including Stella Artois, Becks and Budweiser, and many other dominant regional brands. Indeed, 14 of its brands deliver over $1bn in estimated retail sales per year. The company also owns a 50 percent share in Grupo Modelo, Mexico’s leading brewer and owner of the global Corona brand, and is the world’s fifth largest consumer products company.

The expansion strategy hasn’t just been well-executed, it’s also precise. Table 1 shows how the company is either the number one or two player in almost all of the world’s largest beer markets.

This is important for two reasons. First, pricing power and profitability in the beer industry requires scale. Without a mix of lean manufacturing operations and an extensive and efficient distribution network, profitability and growth are difficult to achieve. AB InBev has both.

Even so, with the rapid consolidation of the global beer industry over the past decade, which recently saw Foster’s gobbled up by AB InBev’s largest rival, SAB Miller, market share growth will be hard to achieve without acquisitions. AB InBev certainly has an enviable track record in this area.

Keeping costs low is also crucial, especially in mature Western markets where growth in...
beer volumes is falling (US beer sales fell 1.3% in 2011 by volume). It’s tough to compete with dominant players like AB InBev, which enjoy high profit margins, huge marketing budgets and strong returns on capital. Unless you’re a niche operator—like Little Creatures or US-listed company Samuel Adams—able to charge a price premium, competing with the industry’s giants is beyond most brewers.

**TABLE 1: AB-INBEV MARKET SHARE**

<table>
<thead>
<tr>
<th>MARKET</th>
<th>VOLUMES (’000 HL)</th>
<th>MARKET POSITION</th>
<th>MARKET SHARE(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>122,356</td>
<td>1</td>
<td>49</td>
</tr>
<tr>
<td>BRAZIL BEER</td>
<td>76,276</td>
<td>1</td>
<td>69</td>
</tr>
<tr>
<td>CHINA</td>
<td>48,914</td>
<td>3</td>
<td>11</td>
</tr>
<tr>
<td>RUSSIA</td>
<td>16,563</td>
<td>2</td>
<td>16</td>
</tr>
<tr>
<td>ARGENTINA BEER</td>
<td>12,863</td>
<td>1</td>
<td>74</td>
</tr>
<tr>
<td>UK (INCLUDING LBS &amp; IRELAND)</td>
<td>12,696</td>
<td>1</td>
<td>22</td>
</tr>
<tr>
<td>CANADA</td>
<td>11,238</td>
<td>1</td>
<td>42</td>
</tr>
<tr>
<td>UKRAINE</td>
<td>10,456</td>
<td>1</td>
<td>40</td>
</tr>
<tr>
<td>GERMANY, SWITZERLAND AND AUSTRIA</td>
<td>9,244</td>
<td>2</td>
<td>9</td>
</tr>
<tr>
<td>BELGIUM</td>
<td>5,627</td>
<td>1</td>
<td>58</td>
</tr>
</tbody>
</table>

Source: Company website.

Second, whilst Western markets have matured, leading market positions in developing countries do offer growth opportunities. With a 69% share of the beer industry and 18% of the soft drinks market, AB InBev is the undisputed leader in the high growth Brazilian market. In fact, T2 Partners claims the Brazilian premium beer market increased from 2% in 1998 to 5% in 2008, which offers the opportunity for AB InBev to fatten its margins. It also has a strong position in the world’s largest beer market, China.

In the November 2011 edition of Value Investor Insight, US investor Tom Russo explained the extent of the opportunity. ‘In China, for example, Budweiser [an AB InBev brew] already has 35% of the premium import market, which accounts for maybe 4% of the 550m barrels of beer sold each year. Management believes over the next decade the overall Chinese market will hit 1bn barrels per year and that the premium [market] will go to 15%, comparable to most developed markets.’

Russo continues to explain how even merely maintaining its share of premium beer sales in China would see AB InBev’s operating profit increase from around $200m to $3bn in a decade. He continues, ‘That is just one brand in one admittedly giant market, but shows the kind of global opportunity the company has.’

**No one-trick pony**

Elsewhere, AB InBev is the exclusive bottler and distributor of Pepsico’s products in Brazil, and is Pepsico’s largest bottler outside the US. It makes the point: Despite falling beer consumption in mature markets, AB InBev has plenty of growth opportunities.

The third factor playing to the company’s advantage is the Brazilian trio’s legendary focus on cost control, wonderfully captured in an article in The New York Times following Interbrew’s merger with AmBev:

‘The sales force there all drive gray cars because it is the cheapest color,’ said Concepción Moreno, an analyst at the Belgian stock broker Petercam who visited AmBev’s headquarters in Brazil last week. ‘The chief executive and the chief financial officer share the same desk; paper and phone calls are rationed. Cost-cutting is a way of life, not a one-off activity.’

The effect is obvious in Chart 2, depicting the company’s industry-leading profit margins. By way of contrast, SAB Miller’s profit margins are half those of AB InBev’s.

Management is also very focused. After the merger that led to AB InBev, the group embarked on a garage sale of massive proportions. Theme park operator Busch Gardens was sold to The Blackstone Group for $2.7bn while Asian brewer Tsingtao and a can lid manufacturer were also put on the block. The $6.2bn raised helped to reduce the company’s net-debt-to-equity ratio from 136% in 2009 to 85% in 2011. As debt falls, more cash is available for dividend distribution or further acquisitions.

Management, though, are more than just cost-cutters, a fact that slowly became clear to Russo continues to explain how even merely maintaining its share of premium beer sales in China would see AB InBev’s operating profit increase from around $200m to $3bn in a decade. He continues, ‘That is just one brand in one admittedly giant market, but shows the kind of global opportunity the company has.’
Russo, a man previously sceptical of the company’s ability to invest in its brands. As Russo says:

‘I have since [the 2008 acquisition] gained an appreciation for management as much more than mere cost cutters. I saw it first in the way it creatively re-positioned Stella Artois from a bargain-basement brand to one celebrating more of a high-end, fashion-setting image and competing head on worldwide with other European brands such as Heineken and Peroni.’

The company’s marketing skills are paying off. In the recent quarter ending 31 March, volumes of Stella Artois grew more than 23% in the US and more than 70% in Brazil.

What might you expect to pay for such a stable, high quality business with pricing power, shrewd owner-managers and strong positions in developing markets? AB InBev, currently trading on a forecast price-to-earnings ratio of 15 and a 1.9% dividend yield, doesn’t seem especially cheap.

Russo, though, believes the company’s earnings can grow at a low-to-mid-teens annual rate ‘for some time’, which is really what you’re paying for. Even at a growth rate of 9–10%, the company is best thought of as like a premium beer—an affordable luxury.

The share price has rallied sharply recently, so at current prices we’re recommending you start with a portfolio limit of no more than 2% of your total stock portfolio, which would allow you to increase your stake up to 10% should the forecast price-to-earnings ratio fall to 15 and below.

UK Stock | Nathan Bell

Tesco: A great business in tough times

A world-class supermarket business trading on less than 10 times earnings? There’s so much to like about this UK-based international retailer, argues Nathan Bell.

Would you like the chance to buy shares in one of the world’s best retailers at the price Warren Buffett paid?

That’s the agreeable situation you currently face with the United Kingdom-based retailer Tesco. The stock now trades at £3.12, or about 6% lower than the average price the Oracle of Omaha has paid since first buying a stake in 2006.

Tesco is by far and away the UK’s largest retailer and the fourth largest in the world (Walmart—see page 8—is the largest). It’s predominantly a mid-market supermarket chain, with formats in the UK ranging from convenience stores like Tesco Express to large hypermarkets like Tesco Extra, which also sells general merchandise such as apparel and electronics.

Tesco pioneered many initiatives copied by Australian supermarkets. The company’s move into private label in 1993 has been a stunning success; about 40% of its products are now own-brand. Clubcard, Tesco’s loyalty program, as well as being a treasure trove of data, permits targeted, personalised offers to particular customers. And the company has even moved into banking, offering savings accounts, credit cards and insurance.

This innovation helped drive Tesco’s UK market share from 10% in 1990 to 31% today. It now dominates UK grocery sales, sitting well ahead of rivals such as the Walmart-owned Asda and Sainsbury’s. Concentration has increased over time but the UK grocery market remains more competitive than Australia’s, as Chart 1 shows.

The company’s financial track record is equally impressive. Earnings per share have risen at an average annualised rate of 11% over the past 10 years (see Chart 2). In the year to 25 February 2012, Tesco generated worldwide sales of £65bn and underlying pre-tax earnings of £3.8bn (including profits from regular disposals of property). The group’s
operating profit margin of 5.8% is well above those of its UK and international peers.

All this is encouraging enough. But what really makes Tesco stand out is its massive property portfolio.

Although Tesco’s property is in the books at £22bn, management estimates it has a market value of £37bn. The company’s net debt of £6.8bn pales into insignificance in this context. Occasionally called ‘a property company with a retailer attached’, Tesco’s defensive business and property portfolio gives it a durability few retailers can match.

So if Tesco’s business is virtually indestructible, why can we buy shares at a price cheaper than paid by Buffett?

Save for a brief dip in November 2008, the last time Tesco’s share price fell below £3.00 was in 2004, a time when Facebook was but a glint in Mark Zuckerberg’s eye (see Chart 3).

Once a market stalwart, Tesco has hit a rough patch. As is so often the case, it’s come at a time of management change. A year ago, well-respected chief executive Terry Leahy stepped down in favour of fellow Tesco veteran Phillip Clarke.

In September 2011, Clarke announced the £500m ‘Big Price Drop’, a marketing initiative to publicise lower prices. It failed to gain traction with customers and was followed by poor sales over the key Christmas period. As a result, Tesco downgraded its profit expectations for 2012 and 2013 on 12 January. As it turned out, the biggest price drop that day was Tesco’s stock price, tumbling 14%.

The profit warning also admitted to some ‘long-standing business issues’, including under-investment in the store network and customer service problems. Each will result in Tesco incurring extra costs, leading to ‘minimal’ profit growth in the 2013 financial year.

Trading conditions aren’t helping. As austerity measures begin to bite, the British economy recently fell into recession once again. Excluding petrol, Tesco UK same-store sales fell 0.9% in the year to 25 February 2012. Fortunately, Tesco has a substantial international operation that helps to offset the difficulties back home.

Australian retailers have an abysmal record of overseas expansion. Tesco’s is first class. Over the past 10 years, the company’s operating profit from its international business has risen from £0.2bn to £1.1bn (see Chart 4). It now represents almost 30% of total profit and provides useful currency diversification.

Asia, which includes Tesco’s operations in South Korea, Thailand, Malaysia, and China, has been the star, with earnings almost doubling over the past four years. Europe, including its businesses in Ireland, Poland, Hungary, Czech Republic, Slovakia and Turkey, has generally been resilient, with earnings essentially flat over the same period.

Failures are rare but notable. Tesco chose to exit the Japanese market in 2012 while its Fresh & Easy convenience format stores in the United States have, since 2007, racked up more than £700m in losses. Management now expects the US to break even in 2014, although the concept itself appears potentially flawed.

This investment case is essentially based on the notion that Tesco’s problems are a temporary upset rather than a more permanent downturn. Buffett, who has increased his stake to at least 5% since the January profit downgrade, certainly supports the former proposition. With £30bn of property (net of debt) more than covering the £24.5bn market capitalisation, the company is trading for less than its asset value.

For a company of its size and strength, Tesco appears excellent value. Yes, it has its challenges but this is a textbook case of a high quality business going through tough times. It’s also a defensive business well-placed if the Bank of England resumes quantitative easing (printing money)—supermarkets tend to be good hedges against inflation.

Tesco is suitable for most portfolios, up to a 7-8% portfolio weighting (acquired over time). As the Australian dollar has been strong against the pound for quite a while, Tesco also offers useful currency diversification should the dollar eventually weaken.

Buffett doesn’t buy international stocks very often so when he does, it’s worth paying attention. With Tesco, it’s not hard to see why he’s interested.

Note: Tesco has ADRs listed in the US. Though this complicates the currency issues, you might be able to buy it more easily than on the London exchange in the UK.

**VALUATION**

The stock looks attractive on a swag of other measures, too. The historical PER is 8.9 or, if we remove the profits from property disposals, 9.8. The stock trades on a two-year average free cash flow yield of 8.4% while the dividend yield of 4.4% compares favourably to that of Woolworths, if we ignore franking credits.
Vivendi: An unwanted treasure

Conglomerates are on the nose, as are telecommunications stocks and Europe. Gareth Brown explains why he finds the pungent aroma to his taste.

Where does one start with this French media and telecommunications giant, a sprawling company formerly run by an acquisitive and shareholder-wealth-destroying management?

Warts are everywhere, including the company’s hodgepodge of assets, some of which face substantial structural threats. Then there’s the history of overpaying and a long-fought shareholder lawsuit that is only now drawing to a close.

In fact, the warts in this business are so pervasive it’s difficult to see what attractions lie beneath.

One investor that does see beauty where others see ugliness is Seth Klarman, manager of US hedge fund Baupost Group. Klarman has established an impressive reputation specialising in complex, difficult investments like Vivendi, in which his fund now holds a substantial stake. In fact, it’s his third largest known position.

So what does Klarman see that others overlook?

With the share price halving over the past five years, Vivendi has a market capitalisation of €20bn. The group has net debt of around €12bn, giving an enterprise value of around €32bn. What’s today’s buyer getting for that sum?

Let’s start with the simplest assets. According to the current share price of listed video game maker Activision Blizzard, Vivendi’s 60.3% stake has an implied value of US$7.5bn, or €6bn. Its 53% stake in French-listed Moroccan telecommunications group Maroc Telecom is worth almost €4.5bn.

Deducting the combined valuation for these two investments from the enterprise value leaves today’s buyer paying some €22bn for the rest of the company. That includes 100% of GVT, a Brazilian telco Vivendi bought for a little over €3bn a few years ago (probably overpaying) and 100% of Universal Music, the largest record company in the world. Despite the industry’s problems, it’s probably worth at least a few billion euros and generates lots of cash.

That, though, is not the best of it. Vivendi owns 100% of French mobile phone and internet provider SFR. In early 2011, it bought the 44% of SFR that it didn’t already own from Vodafone for €7.95bn, implying a valuation of €18bn for SFR alone. Again, Vivendi probably overpaid and SFR is struggling with new competition. But this is undoubtedly a valuable asset.

Then there’s the 100% ownership of Canal+ Group, itself owner of a complex group of assets, including StudioCanal, a major player in European film co-production, acquisition and distribution and owner of one of the largest film libraries in the world. It also owns various content and distribution assets in Africa and Vietnam.

But Canal+ Group’s most valuable asset is an 80% stake in Canal+ France, the leading French pay television content producer. The company is also the direct distributor for much of this content, with more than 10m French subscribers and another 1.7m in Poland.

It’s here where comparison with Baupost’s largest current investment, News Corp, is unavoidable. News Corp has been a wildly successful investment for Baupost. Canal+ France seems to fill a similar role in the French pay television landscape that News Corp’s cable programming business, dominated by Fox News, does in the US.

While Canal+ hasn’t enjoyed the growth in revenue and earnings before income, tax and amortisation (EBITA) that News Corp’s cable programming business has in recent years, one wonders if Klarman sees similar untapped pricing power that he saw in News Corp a few years ago. The French like their culture French, which is why this business enjoys a fairly wide moat and little in the way of foreign competition.

Vivendi has been buying out minority stakeholders in Canal+ France, last purchasing a 5.1% stake for €384m in early 2010. That would imply a valuation for Vivendi’s current 80% stake of some €6bn, assuming the other parts of the Canal+ Group are worth nothing.
which they clearly aren't. Combined, the Canal+ Group achieved EBITA of €701m in 2011, on revenues approaching €5bn.

This doesn’t pretend to be a detailed analysis, merely a pointer for you to do your own research. So we won’t add up the sum of the parts for you lest it implies we know more about Vivendi than we actually do. But it’s not hard to come up with a valuation for the non-listed parts well in excess of the implied market valuation of €20bn.

We can’t say how Klarman and Baupost have arrived at their valuation either, although they appear to have arrived at pretty much the same location as have we. That alone makes Vivendi worthy of your consideration, although keep in mind the company’s debt and reputation for overpaying for assets.

All the value in the world won’t save an investment in a business like this if this trait continues unabated.

Disclosure: Staff have interests in Vivendi, but they don’t include the author Gareth Brown.

Portugese Stock | Gareth Brown

Sonae: A (cheap and risky) Portuguese Wesfarmers?

Portugal is a troubled country with a troubled economy, which is why its leading food retailer may offer an opportunity to make a killing.

First, a confession: We haven’t conducted extensive analysis of Sonae. Instead, consider it an idea for those willing and able to do their own analytical work (and take full responsibility for the outcome).

Fernando Bernad Marrase of the highly regarded Spanish value investing outfit Bestinver Asset Management, presented this company to the audience at the 8th Italy Value Investing Seminar in July 2011. Since then, the stock has fallen a further 30%. Bestinver is not an uninterested party either, owning 6.4% of this €1.3bn company.

Sonae has several things going against it. First, it’s a conglomerate in a world that prefers focus and specialisation. Second, it has international expansion plans. And finally, it has sufficient debt to make a total loss of investment a real possibility.

Against those caveats are some attractive points of interest. The group owns 100% of Modelo Continente, the biggest food retailer in Portugal (with a one-third market share). According to Marrase, Continente has already developed the best locations in Portugal, with a particular focus on city centres, and owns almost 80% of the real estate on which its stores are located.

Half the outlets are hypermarkets, the remainder supermarkets, creating a network that would be all but impossible to replicate today. Some 85% of the company’s transactions are through its loyalty card program.

Marrase calls Continente the biggest and best retailer in Portugal, ‘unbeatable on costs’ and with the highest margins. French giant Carrefour departed the market some years ago because it found it so difficult to compete. Sonae bought its operations and substantially increased its moat.

The retail operation (excluding property) achieved a return on capital employed of 28% in 2011. Continente grew its market share by 1.1% in 2011, stealing share from smaller players. Despite Portugal’s economic woes, turnover and ‘recurring’ EBITDA have both risen in recent years.

The group also owns 50% of Sonae Sierra, an owner of shopping centres in Europe, South America and North Africa, and 53% of Sonaeom, the third-player in Portugal’s

### Key Points

- Not for the faint-hearted
- A trifecta of unwanted: conglomerate, heavily indebted and Portuguese
- Modelo Continente an impressive supermarket business

### Chart 1: Sonae Share Price (€)

Source: Capital IQ
telecommunications market. But these account for perhaps one-quarter to one-third of the group’s enterprise value. Modelo Continente is undoubtedly the group’s most important asset.

As for ownership, just over 50% of the company is controlled by the chairman Belmiro de Azevedo, the second richest person in Portugal. His son, Paulo, is CEO and apparently a big fan of Warren Buffett, although a lot of people claim that. Still, Marrase has suggested the company has an excellent track record of wisely allocating capital.

Let’s now get back to the debt. Despite paying down €480m of debt in recent years, the company, with €2,660m of net debt versus total book equity of €2.0bn, remains heavily leveraged.

The situation sounds worrying enough to stop now but there are a few points worth noting. Over €1bn sits within Sonaecom and Sonae Sierra and is probably non-recourse to the parent (we couldn’t find confirmation of this in the footnotes to the accounts and haven’t confirmed it with management). Another €1bn relates to the retail operations and is mostly financing for a valuable company-owned property portfolio.

So ‘only’ €600m relates directly to the holding company. But, next to a market capitalisation of €1.3bn, it’s hardly a trifling amount. As we said earlier, debt troubles can’t be ruled out.

Right now, optimism prevails. Shareholders recently approved a buyback of up to 10% of equity and agreed to allow management to buy back company bonds.

That should not obscure the manifold risks the company faces, not just from its debt but also the fragile nature of the economy upon which it predominately relies. Food retailers, though, tend to weather economic storms reasonably well. Certainly, that so far seems to be the case with Sonae.

If the risks don’t come home to roost, it’s easy to imagine a world where this €0.55 stock price doubles or triples. But it’s only for those who are able to further assess (and bear) the risks themselves.

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US Stock | Gareth Brown

From acorn to Oaktree

This asset management company, controlled by one of the best investors in the business, has doubled in size in five years. But is it cheap, wonders Gareth Brown?

The glowing praise on the dust jacket of Howard Marks’s book The Most Important Thing—from the likes Joel Greenblatt, Jeremy Grantham, Seth Klarman, John Bogle and Warren Buffett—speaks volumes.

The book, a must-read for anyone considering this stock suggestion, and for anyone interested in investing at all, is authored by one of the finest counter-cyclical investors of our time. Marks is chairman, founder and equal-largest shareholder in Oaktree Capital, with US$75bn in assets under management. Having doubled in size over the past five years, Oaktree focuses on alternative markets such as distressed debt, corporate debt and control situations.

Australian investors might recognise the name; the group was behind the Alinta restructure in 2011 and is about to take control of indebted health club chain Fitness First. It also owns much of the debt of Nine Entertainment Co. and is likely to wrestle control of the equity in that business from current private equity owner CVC.

This, though, is the tip of the iceberg. With 650 staff in 13 countries, Oaktree is a genuine global business.

About two-thirds of the group’s assets under management are ‘closed end’. That means the funds are locked in for a specific period (typically 10 or 11 years) and can’t be
withdrawn. When dealing in unlisted and distressed assets, Oaktree needs to know capital flight won’t undermine its long-term strategy.

Not that there’s a huge risk of that anyway, at least not right now. Since inception its funds have averaged an internal rate of return of 19.4%, which suggests investors have little reason to fear being locked in. As a consequence, the group has generated more than US$1bn of fee revenue in each of the past three years from management and performance fees on this massive and growing pool of assets.

Oaktree tends to focus on sectors that are only lightly correlated, or even negatively correlated, to most stockmarkets. As noted in its recent prospectus, ‘weak economic environments have tended to afford us our best investment opportunities and our best relative performance’. The doubling of funds under management in the five years since the GFC supports that statement.

There are no guarantees that a stronger ‘positive’ correlation won’t emerge but the countercyclical nature of the business holds the likelihood of important diversification attributes for Australian investors.

And, while not crucial in a financial sense, the fact that Marks collects not a zack from Oaktree for being chairman is reassuring. His only reward is in dividends paid and capital growth achieved, so Marks’ financial incentives are genuinely aligned with those of his investors.

That’s the easy part. Valuing Oaktree is where it gets more difficult. This is a complex company in nature and structure. What follows are a few signposts for those interested in undertaking their own research, not a destination in itself. Oaktree is therefore probably inappropriate for inexperienced investors.

The stock was previously listed on the horribly named GSTRUE OTC market, only accessible by investors with net worth in the hundreds of millions of dollars. Having changed its listing to the New York Stock Exchange in April, it’s now open to almost everyone.

Other than Marks’s excellent reputation, what brought the stock to our attention was a substantial shareholder announcement. Shortly after the NYSE listing, highly respected value investor David Einhorn of Greenlight Capital declared a 5.5% interest in Oaktree Capital Group, LLC (worth about $70m at current prices).

Einhorn doesn’t appear to have been an owner prior to the float and probably bought his stake either in the float or soon thereafter, at prices probably similar to what we can pay today. Einhorn clearly believes the stock to be cheap.

A comparison with the fund’s management business of Australia’s own superinvestor—Kerr Neilson’s Platinum Asset Management—might test that hypothesis.

Platinum Asset Management has an enterprise value (market capitalisation plus net debt) of A$1.8bn. It manages about A$15bn of assets, down from more than A$22bn at the time of its 2007 float, and has an enterprise value-to-funds under management ratio of about 12%.

Don’t let the numbers on Yahoo! Finance or elsewhere fool you. The listed entity Oaktree may have a market capitalisation of just a little over US$1.2bn, but this entity controls only a 22% economic interest in the parent company. The other 78% is owned by principals and staff. In total, there are the equivalent of 150.8m shares with a current price of US$40.41. That’s a market capitalisation of US$6.1bn.

Adding the debt delivers an enterprise value of more than US$6.5bn and an enterprise value-to-funds under management ratio of just 9%. On this measure, it’s 25% cheaper than Platinum, for a company that doubled funds under management over the past five years as opposed to losing 30%. Note, though that, as the saying goes, past performance is no guarantee of future results.

The comparison is instructive but far from conclusive. Platinum operates mainly retail funds, which pay impressive margins. Offsetting that is Oaktree’s rapid growth in funds under management, locked in funds, exposure to countercyclical assets and an impressive track record.

For those who know how to investigate this opportunity, it may well be worth a closer look.
Gold stocks are notoriously poor allocators of capital. But when everyone knows it and is looking for profits elsewhere, the risk is reduced. Gareth Brown explains this leveraged bet on the gold price.

If you’re not a believer in gold as a diversifier and hedge against catastrophe—and many wise investors, including Warren Buffett and some of our analysts, aren’t—then you’re free to move on.

Those not specifically after a leveraged exposure to the gold price—one that theoretically, though not certainly in practice, will deliver more upside and more downside than the bullion price alone—then you’re free to go, too.

That’s what I thought. Only the gold bugs are left so please gather round.

No doubt you’re familiar with our previous efforts in this area, especially An instant gold portfolio of 28 May 12, Panning for profits: Gold stocks to buy of 24 Jun 11 and, in 2010, the upgrades of Silver Lake, Integra and Catalpa.

The portfolio approach taken with these stocks was no accident. Gold stocks are risky; much can and does go wrong. Buying a portfolio of underpriced securities offers the leveraged (and cheap) exposure gold bugs want but minimises some of the risks inherent with individual stocks purchases.

The 2010 upgrades are case in point: Silver Lake is up 215% on our initial buy price, Integra up almost 50% and Catalpa had fallen by more than 30% at the time we sold out. All looked good in 2010. In the end, two delivered, one didn’t, and a portfolio of all three performed very well indeed.

The Philadelphia Gold and Silver Index (stock code XAU) is an extension of this idea. It’s an index of 16 large metal mining companies listed in North America but with operations around the world, including Newmont, Barrack Gold, Anglogold Ashanti and Freeport McMoran. No Australian-only portfolio has the sort of gold producer diversity this index offers.

While this index is a leveraged play on the gold price, Chart 1 shows how it has actually underperformed the gold price over the past 11 years. This is mainly due to high mining stock valuations at the start of that period and depressed valuations today.

Right now, gold stocks are on the nose and the ratio of XAU to the price of gold bullion has rarely been lower.

All the reasons one might rationally avoid gold stocks—chiefly their capital intensity, propensity to dig profitless holes in the desert and horrendous record in destroying shareholder wealth—remain valid. But they’re somewhat less valid today than normally. Value investors know that a sufficiently low price forgives a multitude of sins.

The companies in the index are trading on low price-to-earnings ratios and price to cash flow multiples. And, in the current environment, they’re able to reinvest profits in new projects at high rates of return. Even if the gold price rises further, there’ll probably still be a few disasters among the 16 component stocks but there should also be some big winners.

For those looking for a leveraged punt on a higher gold price, the Philadelphia Gold and Silver Index could be a lower risk way to play it. But make no mistake—it’s not low risk and isn’t suitable for most portfolios.
A world of opportunity: Your overseas investing survival guide

It’s never been easier to invest overseas. Combine that with the fact that most foreign sharemarkets are trading well below their highs and the Aussie dollar has rebounded to within sight of record levels; now is an opportune time to consider adding overseas exposure to your portfolio.

Eighteen months ago I was struck with the idea of investing part of my portfolio overseas. The Aussie dollar held almost as much sway on the streets surrounding Times Square as Federation Square, value was in short supply on the Aussie sharemarket and a timely review of pokie manufacturer Aristocrat’s US rivals unearthed similarly high quality foreign companies that fell within my circle of competence.

As I explored the practicalities, it dawned on me that the list of arguments for investing overseas had never been longer. Specifically, a wide variety of options make it easy; brokerage costs are falling; you can access industries nonexistent in Australia; Australian businesses are becoming increasingly global; tax, legal and accounting regimes are synchronising; and information is easier to access.

However, investors who dined on similar logic ten years ago may wish they’d sent back their order; the MSCI world stock market index has withered by 0.73% per year over the past decade. It’s a damning statistic but, as we explained in the Q & A Forum on 10 Sep 2009, stock prices in 1999 were intoxicated by the excitement of the new millennium (as you can see in Chart 1) and it’s taken a decade for earnings to catch up, which perhaps augurs favourably for future returns.

In this, the first of a two-part series, we’ll develop a practical guide to investing directly in overseas markets. In part two, we’ll discuss the indirect alternatives for investors who want diversification without the onerous task of picking stocks. These include unlisted managed funds and listed investment companies (including those we’re currently recommending).

Before you cash in your traveller’s cheques to consider buying overseas shares directly, you’ll need a broker.

Choosing a broker

Just like buying domestic shares, before you can lay your international bets you’ll need to choose a broker. I use Commonwealth Bank’s Pershing service, which I have discussed in this Bristlemouth blog; a decision born of convenience.

Choosing a broker requires more than a simple comparison of trading costs. Other considerations include the markets you wish to access, whether you need to make foreign currency deposits before you can place an order, whether cash deposits receive interest, and the broker’s financial fortitude. That Pershing is a member of the US Securities Investor Protection Corporation provides a level of comfort.

It’s also worth noting that some US brokers give you the opportunity to hold shares via ‘direct’ registration—which works much like the Australian system—while others automatically register those shares in a ‘street name’. The latter means you’re reliant on the broker’s creditworthiness—refer to this SEC fact sheet for more information.

We’d also be wary of the glossy material your broker is likely to send your way. For example, a foreign margin loan application was included with my brokerage account approval pack. A quick phone call revealed that US dollar loans were accompanied by 9% interest rates, despite the country’s official interest rate of zero.

I wondered how investors coped in March when they received margin calls as US share prices tanked and their loans nearly doubled in Aussie dollar terms as our currency
plummeted. For the record, we don’t recommend employing leverage; doubly so when dealing in foreign currencies.

**House rules**

Opening a foreign brokerage account is like being granted a foreign driver’s license, but given local road rules you may need to tweak your strategy. Take the US, for example, where dividends don’t carry franking credits and most companies eschew paying dividends in favour of share buybacks (companies flush with cash during the boom wasted billions repurchasing shares at sky-high prices, which could’ve added real value in the bust).

If you live off the income from your portfolio, the lower dividends need to be taken into account—perhaps foreign stocks aren’t for you. Even if you do find stocks that do pay decent dividends, your income will swing with fluctuations in exchange rates, a subject we’ll come back to shortly.

**Fishing for ideas**

We’re now ready to fish for stock ideas. In 1998, Warren Buffett told an audience of MBA students that ‘the way to go is to get one good idea a year and ride it to its full potential.’

The Australian Stock Exchange (ASX) houses around 2% of the world’s listed companies. To help unearth the very best ideas from the remaining 98%, consider joining forces with newsletter services and free websites, such as those we’ve listed in the accompanying table.

Don’t let the fact that they’re all US websites fool you. Unlike the ASX, US stock exchanges, such as the NASDAQ and New York Stock Exchange, list a smorgasbord of foreign companies. Many Chinese companies, for example, are improving their disclosure so they can list in the US where it’s easier to raise capital. This means you can own Chinese companies and bypass the Shanghai Stock Exchange, which is still off limits to most foreign investors.

Combing through stocks owned by successful fund managers and investors is another great starting point for further research. Many fund managers, such as Platinum Asset Management, publish quarterly newsletters that disclose their (largest) stock holdings. However, you’ll likely get more bang for your buck from smaller stocks that fly under the radar of institutions (in contrast to Australia, some companies valued at more than a billion dollars in the US are considered ‘small caps’).

Keep in mind, though, that the most extreme instances of both overvaluation and undervaluation are usually found in the small cap sector. A practical approach might entail investing 70% of your portfolio in blue chip stocks and the rest in smaller stocks, as your knowledge and confidence grow.

**Exchange rates**

A foreign investing survival guide wouldn’t be complete without considering exchange rates. Exchange rates fluctuate, and if periods of high volatility (such as the Aussie dollar swiftly plunging from US98 cents to US60 cents in late 2008) are likely to lead you to panic sell, then foreign investing probably isn’t for you. Having a long-term view provides your first layer of protection, because over the long term the blows and the windfalls are more likely to balance out.

However, we’re cognisant that inflationist central banks and their money printing machines may be destabilising long-term relationships. To add a second layer of protection against a weak US dollar, for example, consider buying stocks that earn revenues in a variety of currencies. US-listed Yum! Brands, which owns KFC and Pizza Hut, for example, earns 55% of its revenue outside the US. This suggests Yum! Brands’ profits might gain weight if the US dollar sheds some calories.

**Laying some ground rules**

Now that we’ve discussed the practicalities of building a foreign stock portfolio, let’s lay down some guidelines to help get your foreign investing career off to a good start.

**Rule 1:** Stay within your circle of competence. Analyse relatively simple companies before branching out. My review of Aristocrat’s rivals provided a gentle stepping stone to the US market, for example.

**Rule 2:** Partner up with online newsletters and websites to help narrow your focus on the best ideas currently available.

**Rule 3:** Stick to countries where you’re comfortable with the risks. Six months ago I was tempted to investigate Chinese pharmaceutical company American Oriental

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**TABLE 1: A HELPING HAND**

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**TABLE 2: LEARNING FROM THE BEST**

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Bioengineering after reading about it in two separate newsletters. Having decided I wasn’t comfortable with the lack of disclosure of most Chinese companies, I thought nothing more of it until the company recently hit the headlines following revelations of dodgy management deals; emerging markets potentially offer high returns, but they come with higher risks.

**Rule 4:** Don’t take your knowledge of Australian companies and management teams for granted. For most investors, negotiating a foreign market will be like starting all over again. Be prepared to spend more time analysing unfamiliar managers and boards, for example.

**Rule 5:** Don’t diversify for its own sake. If your best opportunities are Australian businesses that you know well, then diversifying overseas makes little sense.

**Rule 6:** Apply your investment criteria ruthlessly. The major advantage of investing overseas is a larger pool of stocks with desirable attributes, such as owner/managers, low debt and high returns. Don’t lose this advantage by being lazy or impatient.

**Rule 7:** Don’t invest money that you’ll need within the next five years (preferably longer) and eschew leverage. This will help protect your portfolio from unfavourable exchange rate fluctuations.

**Better for the run**

Legendary investor John Templeton’s philosophy was to ‘search among many markets for the companies selling for the smallest fraction of their true worth.’ The underlying simplicity of Templeton’s philosophy belies the practical complexities, which perhaps explains why most investors prefer the familiarity of home.

My US portfolio still bears the scars of earlier mistakes. But having survived 18 tumultuous months without feeling like I’ve been hustled down a New York back street, a horse trainer might say that I’m better for the run. The challenge now is to make sure that experience translates into higher and safer returns.

**Tax tips**

The tax implications of investing overseas are not that different to investing at home but there are a few key points to be aware of:

1. Dividends on overseas shares don’t carry franking credits and may be subject to withholding tax* in the foreign jurisdiction. Investors will generally get a credit for the foreign withholding tax against their Australian tax bill on the dividend.
2. Gains on small holdings of listed shares are generally not subject to foreign capital gains tax. But this needs to be checked on a country by country basis.
3. Australian residents are required to pay Australian capital gains tax on foreign shares, just as they would Australian shares. Broadly, you will be subject to tax on the profit in AUD terms.
4. **More significant investments** (real estate for instance) may be subject to ordinary income tax in the foreign jurisdiction. This may require lodgement of a foreign income tax return.

**Withholding Tax:** A tax deducted by the payer (from interest and dividends) where payments are being made to a non-resident. The tax is levied on the payer instead of requiring the recipient to lodge a tax return and pay ordinary income tax.

*Please note: Intelligent Investor is not authorised to provide taxation advice, so if you are unsure we highly recommend seeking personal tax advice.*

Overseas brokerage

Over the past year or so, we’ve been recommending members allocate a portion of their portfolio to overseas stocks. Here’s how you set up an account.

In A world of opportunity: Your overseas investing survival guide (see issue 282), we examined the many compelling reasons to purchase foreign stocks.

First, you can access opportunities, industries and markets that simply don’t exist in Australia. Second, with the Aussie dollar buying you more than almost ever before, it’s a fantastic time to invest overseas.

If you’ve never bought a foreign stock and don’t intend to, there’s no need to read on. If you have considered it but don’t know how, this practical guide will set you on your way.

First, you need to choose an online broker. Your choices are CommSec’s Pershing account, Westpac’s Global Markets account, E*Trade, St George direct shares and ANZ’s international trading account.

The first two run on the Pershing platform whilst the latter three are variations of E*Trade. That means you’ve really only got a choice of two.

To save the hassle of switching, it’s probably best to use the international offering of your existing broker. If you’re starting afresh, E*Trade is slightly cheaper with a better sign-up process. See A world of opportunity: Your overseas investing survival guide for a more comprehensive list of what to consider when choosing a broker.

No pain, no gain

The next and most arduous step is to create and access your international trading account (we’ll assume you have either a CommSec or E*Trade account). Steel yourself before getting started or it won’t be long before exasperation takes hold.

CommSec application forms need to be printed off—they can’t be submitted online. As well as basic personal details, you’ll need your CommSec login number and some certified identification documents.

Then there’s the W8-BEN form, used by the US’s Internal Revenue Service to prove you’re a ‘non-resident alien’ for tax withholding purposes. Uncle Sam, like most bureaucrats, is a pedantic nit-picker. After writing ‘myself’ as the capacity in which I was acting, the form was returned with a big red cross on it and ‘SELF’ helpfully printed on a replacement. Glad they cleared that up—I’m too young for an identity crisis.

A new account will appear in your ordinary CommSec account soon after you’ve submitted your application. You can ignore it. To access your new global trading account, log into a Pershing website, not CommSec, a reasonably important point one would have thought CommSec should communicate. Find the link by following the menus through ‘Trading’, ‘Orders’ and then ‘International shares’ in your ordinary CommSec account.

Login details for the Pershing website will be sent in two separate letters. The first will contain your Pershing trading account number, written in the form of 0AC-123456. The second contains your password.

When logging in for the first time, remember that the first three characters of your account number is your financial organisation number, and that you enter your account number as 0AC-123456, without the hyphen. To make it a little more fun, you’re left to figure this out for yourself. (Eventually, we shall all succumb to the administrators will, finally becoming subservient to a master race of highlighter pens.)

Don’t relax just yet, you’re not quite done. For increased ‘security’ you must answer four completely inane questions. For CommSec, knowing your dream job is central to determining who you are. More sensible websites ask the name of your first guinea pig, which, by comparison, seems the embodiment of sanity.

Lastly, you must type in a secret phrase and choose a picture that will display when
you log in to verify you're not on a fake website. If you’re short of ideas, Franz Kafka images can be found here.

With the nitpickers vanquished and your dream job of forger now established, you’re ready to trade with CommSec, err, Pershing, err CommSec via Pershing. Well, you know what we mean.

**E*Trade easier**

To access the application form for E*Trade’s Global Shares product, login to the website and click on the ‘Products’ tab, then ‘Shares’, ‘Global Shares’ and ‘Activate Now’. Again, these forms need to be printed off.

After filling in your name, your existing E*Trade account number and attaching your certified documents, mail off the form and you’re done. Well, you might be.

If you receive an email telling you your account is activated, you’ll be able to trade Australian and international stocks from your existing account. I didn’t. After a month of waiting for my E*Trade account details, it turned out they hadn’t bothered to tell me they needed some more information—not my dream job though.

In part 2 we’ll explain how you trade and how much you’ll pay to do so.

First published online 28 Nov 2011.

**From the Vault | Nathan Bell, CFA**

**Part 2**

**Overseas brokerage**

The second part in this series explains how to purchase foreign-listed stocks and the costs involved.

Before you can trade, obviously you need funds in your account. CommSec, not wanting to part with tradition, makes things difficult.

You have to call them and ask for funds to be transferred from your nominated bank account into your Pershing account, which takes two business days (if you call before 11am you save a day). One advantage of this is that you’re able to hold foreign currencies, although these don’t earn interest (not that you’d be missing out on much at the moment).

An E*Trade account, on the other hand, comes with a dedicated Australian dollar bank account, although interest rates are paltry for balances below $50,000. When you buy international stocks the account is debited and the cash is automatically converted to the correct currency. It’s far easier than the CommSec carrier pigeon approach.

A foreign exchange ‘buffer’ of 2% is also added to all E*Trade purchases. This is a margin of safety that ensures there is enough cash to execute purchases should exchange rates fluctuate before the trade is filled. The actual rate you pay doesn’t include this buffer.

Trading itself is a simple matter. Though the CommSec Pershing website is a little different to the normal CommSec one, it’s easy to use and place trades.

E*Trade is even better; trading is exactly the same for Australian and international shares, and you can access overseas markets by clicking the ‘Global Shares’ tab on the trading page.

**But wait, there’s fees**

Disappointingly, neither E*Trade nor CommSec disclose all the fees associated with overseas trading in the one place. Though the fees are difficult to find on the websites, you can be sure you’ll find them on your trading statements. It’s always worth making a call to your broker just to make sure what you’ll be charged.

Brokerage for overseas markets is significantly more expensive than for Australian stocks (see Table 1, over the page). While a trade of less than $10,000 will set you back about
$20 for an ASX listed stock, be prepared to pay the greater of US$71.50 or 0.825% of the value of your trade using Pershing, and the greater of $64.90 or 0.65% using E*Trade.

But the fees don’t stop there. You’ll also incur fees when exchanging cash from Australian dollars to foreign currencies. CommSec’s fee varies depending on the cost of exchanging wholesale sums of money, and 25-30 basis points is typical for major currencies (a basis point is 1/100th of 1% so 30 basis points equals 0.3%).

E*Trade’s maximum fee for changing currency is 60 basis points. Although it was difficult to get a straight answer, I was told this might go as low as 30 basis points if you’re lucky.

Some individual stock exchanges also levy their own fees, which are then passed on to customers. Ones to watch out for are the London Stock Exchange, which applies stamp duty of 50 basis points on purchases, and the Canadian Stock Exchange, which charges a flat fee of 1.65 cents per share, regardless of their value.

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<table>
<thead>
<tr>
<th>TABLE 1: FEE SUMMARY</th>
<th>COMMSEC</th>
<th>E*TRADE</th>
</tr>
</thead>
<tbody>
<tr>
<td>TRADING FEE</td>
<td>US$71.50 or 0.825%~</td>
<td>$64.90 or 0.65%~</td>
</tr>
<tr>
<td>CURRENCY EXCHANGE FEE</td>
<td>0.25-0.3%</td>
<td>0.3-0.6%</td>
</tr>
<tr>
<td>INACTIVITY FEE</td>
<td>$75</td>
<td>n/a</td>
</tr>
<tr>
<td>OTHER FEES</td>
<td>Some foreign exchanges charge extra fees</td>
<td>Hard copy trade confirmations cost $2</td>
</tr>
</tbody>
</table>

~The greater of

Both CommSec and E*Trade allow you to participate in major European, Asian and US markets, with CommSec having an even more extensive range of options if you’re prepared to make your trades over the phone.

CommSec also charges some extra fees. If you hold stocks or cash in your Pershing account and don’t trade during a calendar year you’ll be stung for $75.

Having trade confirmations mailed to you will cost $2, but you can ignore the foreign securities custody fee that they disclose; it hasn’t actually been charged for about two years, according to CommSec’s customer service.

In short, an absolute minimum of about 1% of your investment will go towards fees when trading international stocks, and more for smaller trades or markets. Though this is ten times the 11 or 12 basis points you’ll pay for a large trade on the ASX, it still isn’t significant if you’re buying shares for the long term.

There’s some truth to the marketing: with only 2% of the world’s listed businesses, buying only Australian stocks limits you to 2% of the opportunities. If you’ve got the time to hunt through foreign markets, there are many bargains to be had. Now you know how to go about buying them you really have no excuse.

First published online 29 Nov 2011.
Part 3
Overseas brokerage

Nathan Bell explains the many virtues of Interactive Brokers and compares it to OptionsExpress, with both coming out better than E*trade or Pershing.

Initial research into overseas brokerage options led us to rule out Interactive Brokers. It seemed complex; opening an account was difficult; and there were reports of poor user experiences.

But as Gareth Brown is fond of saying, 'A low price forgives many sins'. A Streets Paddle Pop costs more than a stock or foreign exchange transaction on Interactive Brokers (see page 31 for a cost comparisons). Other advantages mean it's far preferable to E*Trade or Pershing, which were discussed in Part 1 and 2.

The paperwork takes half an hour or so to complete and is quite straightforward. Unlike other brokers, you can also complete the W8-BEN form online simply by entering your name as a proxy for your signature.

You'll also need copies of two documents to verify your address (I used a bank statement and a recent tax return notification) and two more to verify your identity (my passport and license). One of the documents in each pair must be certified as a genuine copy of the original document.

Once that's done, you'll need to deposit the Aussie equivalent of a minimum of US$10,000 in your new account, the quickest way being the ‘Pay Anyone’ feature in your online bank account. Once Interactive Brokers receives your certified documents, you'll soon receive an email saying you're ready to trade.

How it works

There's no getting away from the overwhelming nature of the first screen after you login. Interactive Brokers is designed for professional traders and money managers and it shows.

Each area of the screen is dedicated to a particular function, including showing the Aussie dollar amount deposited in your account [Note that if you want to trade in markets other than the US, the website says it's easy to add them later on].

If you want to buy a US stock, you'll have to convert your Aussie dollars to US dollars first, a simple and cheap process—just US$2.50. And no, that's not a typo. It's also lightning quick. Pershing can make you wait two days to trade and makes a fat margin on the currency exchange. There's none of that with Interactive Brokers.

To open the FX Trader module, select ‘New window’ at the top of your screen, then select ‘More advanced tools’ at the bottom of the list. Finally, select ‘FXTrader’. Because it's not one of the currency pairs that appears automatically, you'll need to add AUD.USD to the blank box. Simply double-click on the area where the description belongs and type in AUD.USD.

You should now see the currency pair in the top left hand corner of your screen under the heading ‘Contract’. To convert your AUD to USD, right mouse click on the currency pair and you'll see an option for ‘Trade’. After that, just type in the dollar amounts before executing the trade. Within an instant you should see your account details change to reflect the trade on your original work screen (i.e. not within the FXTrader module).

Now you're ready to buy a stock. Use the ‘Order Entry’ box on the left hand side of your original screen and make sure you use price limits at all times. That's particularly the case if you're opening a trade to execute while you're sleeping.

To see details of your completed trades, select ‘Account’ at the top of the screen, select ‘Activity’ and then ‘Activity Statement’. Then it's just a matter of typing in the relevant dates.

This is only a fraction of what this service can do. You can trade just about any market in the financial world but, unless you have an expertise in Portuguese swaptions, we don't recommend it. Same goes for the margin trading facility.
The system takes a day or two to get used to but with trading costs this low, who cares? A little investment in time could save you thousands over the years. Plus you control everything, unlike foreign exchange trades at Pershing, for example. It really is quite impressive.

**OptionsExpress**

OptionsExpress is also a low-cost alternative but focuses on products exclusively tailored to the US financial markets. It’s most competitive on costs in the US options markets but you can get quotes on stocks and futures, too.

Unless you’re opening a margin loan account (again, not recommend), there are no minimum requirements. An Australian driver’s license or passport will do, verified by post. Accounts are activated the next trading day after their receipt. With an Australian operation, your account can be quickly operational.

As with Interactive Brokers (but unlike Pershing) OptionsExpress charges according to the number of shares you buy. If you buy 1–1,000 shares, a standard commission of $14.95 will be charged. More than a thousand shares costs an investor $0.015 per share.

In the terrifying event your online broker goes broke, Interactive Brokers and OptionsExpress are protected by the US-based Securities Investor Protection Corporation (SIPC). US law requires both brokers to insure client accounts.

Both are insured well above the minimum requirements of around $100,000 per account. Interactive Brokers is insured up to $500,000 per account—guaranteed by the SIPC—while OptionsExpress can insure above $500,000 depending on the composition of your portfolio. We highly recommend consulting the respective companies for further details.

Please note that this information is accurate to the best of our knowledge, but that we aren’t experts with these services and have no formal business association with either Interactive Brokers or OptionsExpress.

If you are in any doubt about the services offered and your financial protection, please consult the service providers directly.

If you’re only going to buy or sell stocks a few times a year and you’re prepared to stomach the high costs associated with E*Trade or Pershing, then you might feel more comfortable sticking with them. They’re familiar brands with straightforward websites.

But if you’re going to invest overseas regularly, Interactive Brokers and OptionsExpress are worth considering. I’m about $5,000 poorer for relying on the ‘convenience and familiarity’ of Pershing over the past five years alone. With that sort of cost saving on offer, I’m more than happy to switch.
ONLINE BROKERS OFFERING TRADING FACILITIES FOR DIFFERENT MARKETS

<table>
<thead>
<tr>
<th>INSTITUTION</th>
<th>PRODUCT</th>
<th>MARKETS</th>
<th>BROKERAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>COMMSEC</td>
<td>Standard pricing &amp; internet preferred pricing</td>
<td>New York Stock Exchange, Nasdaq, American Stock Exchange, Canada</td>
<td>$US65 or 0.75%, whichever is greater Additional fee of $0.015 per share for Canada</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Indonesia, New Zealand, Philippines, Singapore, Thailand, Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Luxembourg, The Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey</td>
<td>$US143 or 1.10%, whichever is greater</td>
</tr>
<tr>
<td>E*TRADE</td>
<td>Standard, Website, Pro &amp; Power</td>
<td>Nasdaq, New York Stock Exchange, NYSE Amex Equities, Toronto Stock Exchange, TSX Ventures Exchange, Singapore Stock Exchange, Hong Kong Stock Exchange, London Stock Exchange, Euronext Paris, Euronext Brussels, Euronext Amsterdam</td>
<td>$2,000–$10,000: $64.90 $10,000 and over: 0.65%</td>
</tr>
<tr>
<td>INTERACTIVE BROKERS</td>
<td>Interactive Brokers</td>
<td>USA, Canada, Mexico, Austria, Belgium, France, Germany, Italy, The Netherlands, Spain, Sweden, Switzerland, UK</td>
<td>Flat rate: $US0.005/share Flat rate: $50.01/share Flat rate: MXN0.1% of trade value</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Australia, Hong Kong, Japan, Singapore</td>
<td>Flat rate: 0.08% of trade value Flat rate: 0.088% of trade value Flat rate: 0.1% of trade value</td>
</tr>
<tr>
<td>SAXO BANK*</td>
<td>SaxoTrader</td>
<td>Austria, Belgium, Denmark, Finland, France, Italy, Germany, The Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, UK</td>
<td>0.1% of trade value</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Poland, USA, Canada, South Africa, Hong Kong, Singapore, Japan</td>
<td>0.3% of trade value $US0.02 per share $50.02–$0.03 per share 0.25% of trade value 0.15% of trade value</td>
</tr>
<tr>
<td>ST. GEORGE BANK</td>
<td>Directshares</td>
<td>Nasdaq, New York Stock Exchange, NYSE Amex Equities, Toronto Stock Exchange, TSX Ventures Exchange, Singapore Stock Exchange, Hong Kong Stock Exchange, London Stock Exchange, Euronext Paris, Euronext Brussels, Euronext Amsterdam</td>
<td>$2,000–$10,000: $64.90 $10,000 and over: 0.65%</td>
</tr>
<tr>
<td>WESTPAC SECURITIES</td>
<td>Cash investment, Account &amp; Standard account</td>
<td>New York Stock Exchange, Nasdaq, NYSE Amex Equities</td>
<td>$US57.95 or 0.65%, whichever is greater</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Canada, London Stock Exchange, Japan, Hong Kong</td>
<td>$US57.95 or 0.65%, whichever is greater Additional fee of $0.027 per share for Canada</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Indonesia, Philippines, Singapore, Thailand, Austria, Belgium, Denmark, Finland, France, Germany, Italy, Ireland, Luxembourg, The Netherlands, Portugal, Norway, Spain, Sweden, Switzerland, Turkey, Israel, New Zealand</td>
<td>$US115 or 0.9%, whichever is greater</td>
</tr>
</tbody>
</table>

* Broker may have minimum costs for certain trades. Check individual websites. Data correct as at 27 Apr 2012.
