

FINANCIAL REVIEW

A STAR-SPANGLED PORTFOLIO

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It's the elephant in the room. For Australian investors putting together a portfolio of international stocks there's no going past the United States market. Here are our top 10 picks.

It's the world's biggest market - and then some. Other economies come and go in importance and attractiveness, but there's no doubt that when it comes to global equities, the US is the main game.

Most Australian international portfolios put half their money there. It's not laziness or lack of imagination: they are benchmarked against indices such as the MSCI World Index that derive half their performance from the US, reflecting the volumes of capital moving around in different parts of the world.

And while US markets are a little unfashionable as opportunities emerge in Europe and Asia, investors who want a global outlook need to be on top of US stocks.

It's an interesting time to look at them given the fractious nature of the markets in the last two weeks. On May 10, the Dow Jones Industrial Average was within 53 points of its record, hit back in January 2000. Since then it's lost 4.5 per cent but it's not alone, markets from Denmark to India have plunged too.

If a prolonged correction is due, some think the bigger markets are the safest places to be. "When things get nasty people fly to the most liquid markets, and the most liquid in the world is the US," says Peter Opie, of Merrill Lynch's private wealth services division.

In selecting our top 10 we were after recognisable, decent-sized names and we needed stocks that looked like good bets for the long term. Microsoft is one of the great American success stories, but it doesn't make it onto our list because it's harder to argue that it will continue to boom than it is to demonstrate how well it's done already.

Ideally, the stocks would already have done well over the long run - but we also wanted to identify some opportunities in companies that have fallen upon hard times. You'll find a few fallen angels on this list, amid the companies going from strength to strength.

We made a few tough decisions on what to exclude. One was that there shouldn't be a bank on the list because things are as good as they are going to get for American banks at the moment, and the accommodative monetary policy that has supported them is coming to an end.

While one fund manager made a compelling case for Bank of America, we decided it was probably a time to be taking profits on US banks.

We left out some stocks because they might not be well known enough to Australians. Lists like these are always subjective, so let us know what you think.

3MStock code: MMMOne-year return: 16.48 per centEstimated P/E: 18.8Industry: Electronics, communications, consumer goods "3M has such a broad and high-quality

product range that most of us, without even realising it, use 3M products every day of our lives, including weekends," says Thomas Murphy, head of investment research for the private client arm of Deutsche Bank, who also owns the stock personally and is quite familiar with its strength, having lived for years in its home town of St Paul, Minnesota.

A diversified group, it is highly active in consumer products, with brands such as Scotch and Post-it, and in communications, health care, and safety and security. And it is going global: at its annual meeting on May 9, chief executive officer George Buckley said he planned to double investments in Brazil, Russia, India, China and Poland.

It's also not a bad time to buy. "The share price trend, which was upwards and smooth for 20 years, faltered in the last two years, and the CEO's agenda is no longer to spend so much time attacking the expense line but to aggressively target top-line growth," Murphy says. Also, if you take the view the US dollar is going to depreciate, it's good to look for companies that draw their revenues from overseas.

American International Group
Stock code: AIG
One-year return: 26.21 per cent
Estimated P/E: 11.9
Industry: Insurance
This is the first of several fallen angels on the list: once-great companies, fallen on difficult times, that should improve and so look like decent buying opportunities.

AIG is a vast global insurer with operations in 130 countries, in life and non-life markets, at a commercial, institutional and individual level. It probably has the most complete global network of any insurer, and is also powerful in retirement services, financial services, asset management, aircraft leasing and trading.

It's also had serious regulatory problems. Earlier this year it agreed to a \$US1.64 billion (\$2.15 billion) settlement of bid-rigging and fraud charges, including setting up a \$US375 million fund to compensate policyholders who bought excess casualty coverage in AIG policies through insurance broker Marsh. Its chief executive resigned last year as investigations into this situation intensified.

More recently, it was fined \$US1.1 million for receiving directed brokerage business in return for preferential treatment of 12 fund companies through a business unit in Houston.

"It was a wonder stock of the 90s, and it really has come down, and derated significantly," says Habib Subjalli, head of global equities at First State Investments in London. "That said, when we look at the sector we think AIG has a global footprint; the need for global savings continues, and when you look at what's going on in the bond market a steepening yield also helps insurance companies.

"It's derated, so far the risk-reward ratio is quite favourable."

Bloomberg puts AIG's forward price-earnings ratio at just 12.

Research analyst and portfolio manager at Templeton Global Equities Group, Peter Wilmshurst, shares that view. "It's an outstanding global franchise," he says. "It's had its issues with turbulence in management but fundamentally its operations are very sound. In particular it's got a strong footprint throughout much of Asia." Perennial also has a major holding in the stock for its International Equities Trust.

Berkshire Hathaway B-shares
Stock code: BRK/B
One-year return: 7.73 per cent
Estimated P/E: n/a
Industry: Holding company
Is this cheating? Probably. But who cares. Warren Buffett's investment holding company has been one of the most consistent stocks in recent American history and the man and his methods continue to captivate

investors worldwide, even as the men at the top of Berkshire Hathaway drift well into their 80s.

What are you buying when you buy a Berkshire Hathaway share? You're buying a listed vehicle with more than 40 subsidiaries, from the Acme Brick Company to XTRA Corporation. Buffett himself, in the company's 2005 annual report, calls it an "eclectic collection which sells products ranging from Dilly Bars to fractional interests in Boeing 737s".

A key subsidiary is insurance, and Berkshire owns two of the biggest reinsurers in the world, including General Re. It also has stakes in big companies, including Procter & Gamble (following its merger with Gillette), Coca-Cola and American Express. All investments are managed in the much-imitated Buffett style: don't buy something you can't understand; buy things where you're happy to leave the management to go and run things; and if possible buy the whole company.

To state the obvious, he knows what he's doing. The average annual gain in per-share book value of Berkshire Hathaway since 1965 is 21.5 per cent. But after a modest return in the past year, some believe it's undervalued, including the army of Buffett disciples in Australia.

One, Wayne **Peters** of fund manager **Peters** Macgregor, was in Omaha, Nebraska, at Berkshire's AGM when Smart Money got hold of him. No surprises in his pick. "BRK is a 13 per cent position in our portfolio, and we clearly believe it's well under intrinsic value," he says.

For most investors, it's only the B share they'll be looking at - the A share is trading at \$US89,900 a share. The B share is always a 30th of the price of the A, so there's no difference in outlook in owning one or the other.

General Electric Stock code: GE One year return: -1.45 per cent Estimated P/E: 17.6 Industry: Electricity, financial services As this stock - the biggest of them all - has declined in the past year, one might consider it another fallen angel. But its scale makes it impossible to ignore.

"We can't have this discussion without mentioning GE," says Murphy. "It's had disappointing results since 2000, its earnings yield is approaching 3 per cent and some of its other fundamentals make it look like a defensive stock, but it is in fact a growth stock." GE is also the single largest holding of the Perennial International Equities Trust.

Everyone knows GE is a powerhouse (if you'll excuse the pun) in electricity generation and distribution. But it's less well known that it is among the leaders in the global wind-energy market. "There are few products in the world with the pricing power that windmills have at the moment," says Murphy.

And its power in consumer finance is also underestimated. "It's an example of their cleverness and financial muscle. It takes someone with a \$US360 billion market cap to come in and attack any market they want to," says Murphy. "But they have a consistent track record of double-digit returns going after these markets."

Recent weak performance means an opportunity to buy in, and the yield is attractive, too, for an American stock.

JC Penny Stock code: JCP One-year return: 38.62 per cent Estimated P/E: 15.7 Industry: Department stores The retailer JC Penny operates department stores in the US, Puerto Rico and (through its Renner brand) Brazil. It's been suggested for our list by James

Falkiner, who runs that rare thing, an Australian global-equities boutique.

"What struck me is, if you look at its history over the very long term, it has these beautiful up and down waves, depending on how good the management is," he says. "No one's ever blown this thing up." And the management today is doing well.

It's had to, because a few years ago JC Penny was in trouble. "It's only just got its credit rating back, which allows it to fund its receivables in a commercial paper program. That's almost a given in a successful retailer," Falkiner says. With that and other measures in place, the stock has powered ahead of the market since 2003 and has above-average earnings per share growth, too.

While department stores may sound staid - and it's true the retail sector is vulnerable to any contraction in US consumer spending - there is another appealing element to JC Penny. "The topping on the cake is that it has one of the most successful e-commerce platforms," says Falkiner. "They do over \$US1 billion through it, which ranks it five or six in the US - and I'm counting the eBays and Amazons of this world. It's a bit of a sleeper."

News Corp
Stock code: NWS
One year return: 20.97 per cent
Estimated P/E: 23
Industry: Media
How strange to be looking at News Corp as a US stock. But that's what it is: incorporated in Delaware, with a US citizen at its helm.

Although changes announced on Thursday may mean the stock will eventually be reincluded in the S&P/ASX 200, its removal from the index caused a fall in the share price as many Australian fund managers were forced to sell their shares. For many, though, that represented a buying opportunity. "There are a few opportunities in media, and News is one we've bought in the last year," says Peter Wilmshurst at Templeton. "It's still attractively valued." An Australian investor can buy News Corp on an Australian exchange, though the numbers at the top of this item refer to its US listing.

"If I had to pick one media company this would be it," says another fund manager. "You saw recently how Murdoch cleverly went into an emerging market [Mexico], developed satellite access, sold out and made a capital gain. He's never afraid to go into a market like that, build assets and sell them off. He creates value in markets . . . and does it extremely well."

PepsiCo
Stock code: PEP
One year return: 5.24 per cent
Estimated P/E: 19.8
Industry: Beverages and food
Everyone knows Pepsi, but the company is about more than just the cola. Its other brands include Gatorade, Tropicana, Lay's potato chips, Doritos, Quaker oats and (internationally) 7 Up.

It fits into the portfolio as a defensive stock, well protected against economic downturn. In falling markets, people still have to eat and drink.

"You get world-class brands when you buy Pepsi Co," says Murphy. "There's a solid performance track record and a relatively smooth share-price trajectory. Its acquisitions track record is quite good."

Pfizer
Stock code: PFE
One year return: -6.27 per cent
Estimated P/E: 12.7
Industry: Pharmaceuticals
Despite the woeful return over the last 12 months, drug company Pfizer is a popular holding. Peter Wilmshurst at Templeton argues pharmaceuticals are more defensive than you might think: "While some drugs compete with one another . . . a patent gives you exclusivity over a drug for a certain period," he says. "So that gives you less head-to-head competition than in other industries, and strong returns."

There's much debate about which is the best global drug stock - GlaxoSmithKline and

Novartis both have their fans - but among US stocks Pfizer is the most widely mentioned, followed by Merck.

Pfizer's recent weak performance has partly been due to patent expiries, leading to subdued revenues, but the bright side for a potential buyer is that it's trading at 12 times earnings. "You get a company delivering tremendous cashflow and balance sheet, and the ability to substantially reduce costs," says Wilmshurst.

Procter & Gamble
Stock code: PGO
One year return: 3.64 per cent
Estimated P/E: 21.5
Industry: Consumer goods
This is another stock built on the strength of its brands, among them Braun, Crest, Pampers, Duracell, Gillette, Head and Shoulders, Hugo Boss, Lacoste and Pringles. "When we talk about brands, P&G is world-class," Murphy says. "On our numbers, its valuation on 2007 earnings is 17.5 times [Bloomberg has it at 21.5 times for 06] so the stock is not expensive. It's enjoying new product growth and good organic growth.

"It's a large-cap company - \$US185 billion - so it's not a stock that an investor is going to make a killing on, but one where an investor can put their money away for 20 years and do very well."

Murphy also likes the company's research.

"In the US P&G is synonymous with R&D," he says. Harvard case studies of R&D often point to examples at P&G, where top graduates are recruited to think up new brands, he says. "Nobody does it better."

Wal-Mart
Stock code: WMT
One year return: -0.4 per cent
Estimated P/E: 16.4
Industry: Discount stores
This will probably be the most controversial name on the list. The stock has flagged recently, has union problems, is the subject of an unflattering film accusing it of all manner of social misdemeanour, and has an increasingly ugly reputation for trying to impose American approaches onto global expansion.

But it also has appeal as a fallen angel. Habib Subjalli, at First State Investments in the UK, holds it for that reason: "The consensus view seems to be: it has got too big; where does it go from here, it's [already] so good at what it does. But our view is the risk/reward on Wal-Mart is now quite favourable."

Subjalli says Wal-Mart is looking at its stores and moving them up from the low-end market they seem to have ended up at. "They're improving the quality of merchandise in the stores, and also trying to reduce inventory in the supply chain. Given their size and their technology this can be a significant competitive advantage."

Another potential opportunity may be the gradual thawing of restrictions on foreign retailers setting up in India. This year the country allowed single-brand retailers - Reebok, for example. The feeling is that it's inevitable this process will end with multi-brand retailers, such as Wal-Mart, coming in.