

Your wealth: Fund manager looks for gems

The National Business Review - 14 Nov 2003 : 28-01

Investment
Nick Stride

Amid all the cant about the benefits of diversification, here's another thought - it's not the number of baskets you put your eggs in but their quality.

That's the basic investment philosophy of Peters MacGregor Capital Management, a boutique manager catering for high net worth investors on either side of the Tasman.

Founded in 1996, PMC's portfolio has held only 17 positions, mostly in US stocks. Today it has seven, including Michael Hill International.

That degree of concentration, chief investment officer Wayne Peters admits, gives some potential clients the jitters.

"But in my opinion that's the only way to outperform the market. Once you've got half a dozen positions in different industries you're gleaning most of the benefits of diversification."

In support of the theory he quotes research by Richard A Brealey, author of *An Introduction to Risk and Return from Common Stocks*. According to Mr Brealey, a simple five-share portfolio provides 77.4% of the benefit of diversification if each is in a different industry.

Eight companies brings that to 85.7%, 12 to 90.4% and 100 to 98.8%.

In other words, Mr Peters said, having dozens of shares in a portfolio as most traditional fund managers do means you're simply tracking the market.

He has other uncomplimentary things to say about the mainstream industry.

"Fund managers I've talked to over the years will say they're 85% in the market in the portfolios they manage. But if you ask, they'll admit their own personal investments are 85% cash."

"People espouse long-term but act short-term, including fund managers."

To invest with PMC you need to have a minimum term of at least 10 years. You also need a minimum \$2 million.

Mr Peters won't say how much his clients have invested with him but the 15 Australians and 10 New Zealanders each have between \$2-20 million in the portfolio, putting funds under management somewhere between \$50 million and \$500 million.

The business arose, he said, from managing his own money "so a lot of my own net worth is in the portfolio and clients can see management is eating its own cooking, so to speak."

PMC also doesn't get paid if it doesn't perform. There is no entry fee and no annual management fee. Like many hedge funds, it charges an annual performance fee of 20% of the net gains.

The investment philosophy is simple enough. PMC looks for companies that have a reasonable certainty of producing above-average returns over time and are undervalued by the market, according to its valuation methods, by at least 25%.

They need to have competitive advantage, sound economics, competent management and a minimum of unknown factors.

An essential characteristic is that the operating business model is unlikely to change over the investment period. Michael Hill International, for instance, will still be selling jewellery through mall and shopping strips in five to 10 years' time.

Technology stocks aren't considered. The economics of such companies change too quickly to allow investors to assess their present value.

The turn-of-the-century tech boom did provide PMC with some superb investment opportunities, however.

It found "old economy" companies that had delivered double-digit earnings growth for years trading at six or seven times historic earnings, snapped them up and waited. "I don't care if the people next door to me are making money faster than I am," Mr Peters said.

The approach seems to work. Over its seven-year history the portfolio has delivered an annual average compound return of 28.8%, far above the 12% target return. The best years were 1999 (68.7%) and 2002 (55.3%), when the markets rerated those severely undervalued old economy shares.

That is unlikely to be repeated in the future, PMC warns. But given the market's short memories, it probably will be.