

Spotting danger on the radar

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Some sectors have a reputation for being riskier than others, but it's not always justified, reports Chris Wright.

Any investor who has been in the equity market for a decent length of time will have seen a stock hammered by a one-off event. Utility companies get punished when regulators set unfavourable price regimes; tourism businesses can be wrecked by storms or political change; the share prices of oil companies can be hit hard by an accident at a field; and the management of National Australia Bank is unlikely to forget the pounding the share price took when a subsidiary was the victim of a heist in Belfast.

But are there particular sectors or stocks that are especially vulnerable to disasters or shocks? And if so, should investors expect to be paid a premium for exposing themselves to those risks?

"Clearly insurers, airlines, single-operation miners and agricultural businesses may be subject to significant financial impacts as a consequence of major one-off accidents or disasters," says Guy Hutchings, chief investment officer of Tower Australia.

"A forestry business, for example, may be heavily impacted by adverse weather, and it is very difficult to hedge or insure against that risk." A bushfire in the wrong place probably wouldn't do it a lot of good either.

The sector that always comes up first in discussions of dangerous investments is airlines. On the face of it, it seems the most vulnerable. Planes crash occasionally, with terrible loss of life, and inevitably, global headlines.

Investors tend to assume that stocks in either airlines or aircraft manufacturers will drop accordingly when accidents happen. But while airlines certainly have their critics in the investment community, it is generally not for that reason.

"The inherent problem with airlines is that it is a raw commodity business coupled with a bad accounting standard," says Wayne Peters, head of Peters MacGregor Capital Management, a boutique funds manager.

"Depreciation is the problem area, or rather under-reserving. Instead of depreciating past aircraft purchases, management should be reserving for future aircraft purchases." The result, he says, is that the industry systematically underprices its fares, generally resulting in delusional behaviour until it is too late.

"How many big baths has Qantas taken over the decades? Can you name one [United States] carrier which hasn't been in Chapter 11 [bankruptcy]?" asks Peters.

"So with aviation, we have only two rules: first, never invest in commercial airlines; and second, never forget rule No. 1."

Hutchings agrees that airlines are a difficult industry in which to generate consistent and growing profits, being capital-intensive and highly regulated businesses with many different factors affecting operating conditions. But he, too, feels that it's these business issues, not the risk of plane crash, that are more of a threat to an investment.

"These factors increase the risk to an investor more than the prospect of an airline accident which, while catastrophic, can be insured and may have a much lower impact on returns," he

says.

Deutsche Bank Private Wealth Management's head of investment research, Tom Murphy, is a former aviation analyst and views things a little differently.

"Most of us think of it as one of the first places you avoid, but the reality is even though it's historically been an extremely poor performer globally as an investment, it is able to cover its risks very nicely," he says.

"That's personal liability risks, aircraft risks all of them. There are a lot of sophisticated strategies that have been in place for a long time."

The next obvious sector is insurance. Many investors will remember the battering QBE's share price took after the September 11, 2001 terrorist attacks in the US.

Says Peters: "Insurance has similar issues [to airlines] in that under-reserving can lead to inappropriate pricing, which will generally lead to financial disaster. However, brand name counts for more in the insurance world than the aviation world."

He says that with the right culture, an insurer can provide adequate, though not necessarily smooth, returns over time. "We invest in this area, but only in companies with a proven track record and culture."

Australia's big general insurers, IAG, QBE and Promina are strongly provisioned and generally admired by fund managers. Murphy reckons that reinsurers, rather than general or life insurers, are the problem.

"The one sector I coach individual investors against investing in is reinsurance," he says. That's because it requires a very long-term approach to ride out the waves of good and bad performance from the sector. "For individual investors the shocks can be quite severe."

General Re is under regulatory scrutiny in the US for some reinsurance contracts it has entered into, despite being owned by one of the world's most successful and cautious investors, Warren Buffett.

Murphy says QBE is the Australian insurer with the most reinsurance risk, but has world-class management.

Besides, QBE's own vulnerability to disaster has faded over the years, as recent developments show. The World Trade Centre attacks caused QBE a \$252 million after-tax loss. On September 10, 2001 its share price was \$10.26. Ten days later it was \$3.32. Yet in 2004, QBE had more net claims from catastrophes than it had in losses from September 11, including \$230 million of net claims from hurricanes in the Caribbean and US and \$80 million from the Indian Ocean tsunami. And that didn't even dent the full-year profit guidance.

Peter Vann, head of investment research at Constellation Capital Management, calls it "a vast turnaround from the problems generated by the WTC", saying QBE has changed its approach to concentration risk. QBE itself has told investors it has reduced its risk profile.

Nevertheless, there are fund managers that avoid QBE due to queasiness about the complexity of its insurance and reinsurance arrangements (it is active in dozens of countries, and constantly makes acquisitions in new ones). "I don't own it because I can't understand it," says one manager.

The fact that provisioning arrangements are very difficult to compare between insurers, since they don't have to disclose the assumptions that underpin their provisioning, also drives some investors away.

In other sectors, Hutchings tends to avoid miners with businesses based on a single operation, or if their accident or natural disaster risks can't be adequately mitigated.

Murphy thinks investors need to be cognisant of systemic shocks such as a financial system meltdown, and advises investors not to concentrate too much on financial services.

And Peters, for different reasons, dislikes telecommunications stocks.

"Telcos are even worse than airlines," he says. "Management can't even begin to estimate what their depreciation rate should be, nor the likely replacement costs. We use Skype [a form of voice over internet protocol] for free calls to anywhere in the world. How will Telstra make a decent return on that?"

Although not a disaster in a conventional sense, the arrival of new technology can inflict a bigger shock on an industry's stock performance than any earthquake or hailstorm.

Risky sectors don't necessarily warrant being ignored completely. Instead a clear understanding is required of what an appropriate premium for that risk is.

"Clearly investors should always demand a premium for [disaster risk], yet all too often we see them relax that demand and act as if recent performance will be the norm from now until eternity," says Peters.

Hutchings adds: "The return of any investment should compensate an investor appropriately for its degree of overall risk, but that is not to say that a premium should be paid simply due to the perceived operational risk profile of an actual industry."

It's all about individual judgements of what a fair trade-off is between risk and reward. "The price of risk is subjective," he says.