A MASTERCLASS IN PORTFOLIO MANAGEMENT

Paul Biddle,
Director and Portfolio Manager

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CELESTE FUNDS MANAGEMENT

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Celeste is one of the enduring performers on the small cap funds management scene, Celeste's policy of looking for quality Small Caps has paid off over the long-term. Here its portfolio manager Paul Biddle gives a masterclass in how to manage a portfolio for consistent long-term performance.

DON'T CHURN AND BURN AND YOU'LL REAP THE TAX EFFECTIVE PROFITS

Celeste Funds Management is one of the stayers in the ever-changing world of Australian Small Caps and one key to its success over the past decade has been its focus on after tax returns, rather than simply churning and burning like some of its competitors.

It's not uncommon for Small Cap managers to turn their portfolios over more than once a year, while Celeste tends to have an average investment holding duration of three years. That figure has drifted up in the past 12 months, but in the past 10 years it has been "pretty consistent" according to Celeste portfolio manager, Paul Biddle. This is a practice that Under the Radar's portfolios follow. Not only does lower turnover reduce trading costs, which are critical in the illiquid Small Cap space, but it also reduces the tax payable on gains.

Says Biddle: "Our clients want more money in their pocket to spend or reinvest, they don't want to give more money to the ATO.

"What we are focused on is after tax returns; the last time we [the Celeste Australian Small Companies Fund] paid a capital gain that wasn't held for more than 12 months was in 2006. This effectively halves the capital gains tax for our investors, making it much more tax effective."

For example, if you realise a $10 profit on a stock that cost $100 and that you had owned for less than 12 months, your pre-tax return is 10%, but your after tax return is much less because you have to pay capital gains tax (CGT) on the entire gain. If your marginal tax rate is 49%, then you will pay close to $5 in tax for an after tax return of 5%. On the other hand, if you had held the stock position for longer than a year, you are entitled to a 50% discount on the capital gain and so that you would only pay $2.50 tax. This increases your after tax return to 7.5%, but more importantly it means you would have an extra $2.50 in your pocket. This is a meaningful uplift in returns for the more patient investor.

KNOWING WHEN TO HOLD 'EM AND FOLD 'EM IS ABOUT VALUATION

Biddle is quick to point out that his fund's buying and selling must meet its "strict valuation criteria", which revolves around several metrics including the business model, the quality of the financial accounts and the quality of the board and management; as well as the value of a company's cash flow stream.

Partly because of Celeste's conservative buy and hold tendency, some of the stocks that continue to generate good returns have been held for a significant period of time. These include Breville (BRG), City Chic (CCX) and Steadfast Group (SDF). A consistent theme among these fast growth stocks is the progress they're making with export revenues, which have much bigger growth potential.

BREVILLE

On the kitchen appliances manufacturer, Breville, he says that "we're still holding the stock because its European opportunity remains significant. The market still underestimates how much cash the company should make out of its European and US operations over the next three to five years."

CITY CHIC

On City Chic, which specialises in fashion for the younger plus sized woman, he says: "It's a great story of the growth that an excellent management team can deliver when freed from being part of a bigger retail group. The company has bricks and mortar stores in Australia but delivers 40% of its sales online. The real opportunity remains increased penetration in the US using the online delivery model to mitigate the risks associated with a physical retail store rollout. We think the online volumes from the US in the next three years are going to explode."

STEADFAST GROUP

Insurance broker Steadfast, which Celeste has owned since its IPO in 2013, remains a beneficiary of rising insurance premiums. Global and local insurers have incurred significant insurance losses over the past few years and in order to build their capital and remain viable they are lifting prices. These price rises are happening across most products that insurance brokers sell.

Says Biddle: "We expect average price rises in the range of 5-7% and they are expected to deliver increased profitability to the insurance and insurance broking industry. It is a fantastic tailwind for the sector."

BEWARE OF HEALTH INSURERS

The same can't be said for health insurers like NIB Holdings (NHF) and Medibank Private (MPL), who face declining profit margins, if a Shorten led Federal Government delivers on its promise to cap premium growth at 2% when healthcare costs are rising by 7-9%.

On the other hand, some stocks that Celeste owns have been struggling in past six months. These include the plumbing group Reece (REH) and the litigation funding group IMF Bentham (IMF). Both have engaged in offshore expansions and this has caused the market to focus on their short-term earnings growth.

REECE

Last year Reece acquired the US based plumbing and HVAC distributor MORSCO for $1.9bn, which had annual revenues of $2.3bn versus Reece's revenues of $2.7bn. Reece shares have declined 16% in the past six months. The company remains controlled by the Wilson family, whose stake is just under 63%.

TOP HOLDINGS @ 31.03.19 CELESTE AUSTRALIAN SMALL COMPANIES FUND

1. **INVOCARE (IVC)**
   FUNERAL SERVICES
2. **MONADELPHOUS GROUP (MND)**
   MINING SERVICES
3. **REECE (REC)**
   PLUMBING SUPPLIES
4. **STEADFAST GROUP (SDF)**
   GENERAL INSURANCE BROKER
5. **IMF BENTHAM (IMF)**
   LITIGATION FUNDING

Says Biddle: "What we're seeing is the dichotomy between a company with a 10 to 20 year vision and market with a 10 to 20 minute attention span. It's going to take time for Reece to integrate MORSCO and it may take two to three years before it really starts to deliver. Meanwhile the Australian business continues to grow strongly and generate significant amounts of cash."

IMF BENTHAM

IMF Bentham's share price performance has also been challenging over the past six months, however Biddle is even more optimistic on the company's prospects: "The company has transformed itself from being an on-balance sheet litigation funder to a fund manager with $1.5bn of funds under management that just happens to be invested in legal cases."

The company has an average case duration of three years, so the success of this revised strategy should emerge over the next 3-5 years and generate significant amounts of cash. In Under the Radar's opinion as well as Celeste's, IMF's current share price does not reflect the significant value in the current case book. The market is fixated with the remaining two large cases that sit on IMF's balance sheet that are close to settlement. But the Westgem and Wivenhoe Dam (Brisbane floods) cases, if they are lost, might cost IMF $10-15m in cash payments for the legal fees of the winning parties. If IMF wins, however, the company has the scope to receive significantly over $100m in revenue share from the settlements.

Under the Radar hopes Biddle and Celeste are right. ■