



Inside the investment team...

Welcome to the 'new' retail

Amid recent market turmoil, one sector in particular – retail – has copped a serial battering, both in the market itself and in the press. Here we explain why Hyperion continues not only to hold selected retail stocks, but also expects them to outperform over the longer term.

It's no secret that consumers are holding their hard earned cash closer to their chests than at any time over the past 25 years. Savings rates at pre-1987 highs – above 10 per cent of disposable income – are translating directly to a diminished retail bottom line as spending slows almost to a halt. Growth in the retail sector is at a meagre 2.6 percent as compared to a long-term average of 6 percent. The consumer discretionary sector has been particularly affected – falling by approximately 17 percent compared with an overall market drop off nearer to nine percent.

In the case of specific stocks, some have suffered more than the average. David Jones' and Myer's share prices have fallen by 33 and 36 per cent respectively; JB Hi-Fi has shown similar misfortune and even consumer staple Woolworths has remained flat.

Why then, in the face of this bleak picture, does Hyperion continue to hold JB Hi-Fi and Woolworths – while avoiding what, on the surface, look like similar retail stocks?

In line with Hyperion's broader investment philosophy, it comes down to the fundamentals.

When assessing retail stocks based on critical criteria such as the company's value proposition, organic growth prospects and competitive position, differences between seemingly 'like' stocks become apparent. Add to that an analysis of a company's ability to adapt to structural headwinds – in the case of the retail sector, the ability to successfully adapt in a rapidly evolving environment characterised by changing buying habits and the rise of online competition, for example – and striking differences between them becomes increasingly evident.

JB Hi-Fi and Woolworths vs. David Jones and Myer

A case in point: David Jones and Myer. Two mature retailers, heavily dependent on discretionary spending with significant capital overheads such as quality fit-outs and traditional marketing and buying models. With disposable incomes at a 25-year low and a relatively high cost of doing business, it is difficult to convincingly forecast a return to discretionary spending significant enough to enable these companies to spring back into strong profitability in the near term.

A direct comparison between these two retailers and JB Hi-Fi illustrates our point. With cost of sales at 14.5% (the market's lowest), JB Hi-Fi is a still-maturing retailer with an innovative model and a growing product range for which there is consistently high demand. Further, it has considerable scope for growth; the company has plans for 214 stores and currently has 150, of which around 60 are newly established with predicted increasing sales as they mature. This kind of growth bodes well for heightened market awareness and, in particular, buying power as the company becomes increasingly important to its suppliers. This bolsters competitive advantage thereby putting it in an even stronger market position.

With the retail sector out of favour and its headwinds well understood, JB Hi-Fi is one of the most short sold stocks on the market, with approximately 17% of its shares outstanding. The strength of its business, competitive position and the ability to tackle the current headwinds has been largely overlooked.

Another example of a strong retailer, this time in consumer staples, is Woolworths. Once again it demonstrates a low cost base in conjunction with a very strong value proposition. Its chief competitor, Coles, still struggles due to failure by its previous management to maintain and invest in the business.

On the other hand, Woolworths has historically made considerable investments and improvements through its supply chain. It has wisely shared the resulting gains with shareholders and customers, creating a strong positive feedback loop. This, we believe, will stand the company in good stead despite its relatively moderate growth outlook; it is currently growing its footprint at around 3% a year. In fact, we believe the predictability of earnings

and quality of its business will lead to high single digit earnings per share growth over the medium term. This does not take into account Woolworths' other growth options, such as expansion into hardware, since they are unproven. They may, nevertheless, provide a surprise upside over the long term.

In addition to the longer term positive growth story, we believe the 'survival of the fittest' applies to these businesses. If they are able to build their market positions through difficult times, and maintain their exceptionally low cost bases, we can expect them to perform better, stronger and faster than their peers when the economy enters an up-cycle.

Given current extreme market volatility and the drop in share-price performance of these key (and numerous other) stocks, it is time to remind our investors about the difference between investing and short-term focused trading. The latter involves the uncertainty, difficulty and expense of buying and selling on a minute-by-minute basis; versus investing, which involves taking a longer term view of a company's real prospects of producing sustained growth and lasting strong returns.

Further, our research indicates that EPS and PER movements are not consistent predictors of short term returns. However, over longer periods, EPS drives returns and there is a very real arbitrage advantage from making investment decisions based on these longer timeframes – which Hyperion exploits to the portfolio's advantage.

Once again we come back to the need to steer a steady course, shut out the irrelevant noise and stick to what we know works. It's a philosophy that delivered us market leading outperformance during the GFC and, as we face continued instability in the markets, we are confident it will do so again.

Opportunities abound in the midst of extreme market volatility

The current uncertainty in the financial markets, while taking its toll on the portfolio, has meant there is a significant opportunity to deploy capital appropriately. The forecast five year IRR of the portfolio is currently 24% pa. In periods of significant uncertainty, quality companies should outperform and we have selected companies with the franchise strength necessary to prosper in these conditions. The investment team is confident that the portfolio will continue to drive earnings and dividends per share growth which will lead to significant alpha generation over our five year investment horizon.

Quality companies tarred with the same brush as they toil through current headwinds

The Hyperion Australian Equities Composite outperformed the market while the Hyperion Australian Equities ASX 300 Composite underperformed the market during July. The Hyperion Australian Equities composite returned -3.63% and the Hyperion Australian Equities ASX 300 composite returned -4.15% versus the S&P/ASX 300 Accumulation index return of -3.83%.

For the Hyperion Australian Equities Composite the largest positive contribution to active performance came from the portfolio's investments in Seek (+2.8%), Cochlear (-1.57%) and REA Group (+0.42%). The largest detractors from active performance during the month included Macquarie Group (-11.78%), JB Hi-Fi (-12.13%) and not owning Telstra Corporation (+3.46%).

For the Hyperion Australian Equities ASX 300 Composite, the largest positive contribution to active performance came from the portfolio's investments in Seek (+2.8%), Cochlear (-1.57%) and REA Group (+0.42%). The largest detractors from active performance included Macquarie Group (-11.78%), JB Hi-Fi (-12.13%) and not owning Telstra Corporation (+3.46%).

Macquarie Group underperformed both the ASX 300 and the banking sector. The group updated its guidance, expecting 1H12 cash earnings to fall below 1H11's \$403m. The group maintains FY12 guidance will surpass FY11 cash earnings (\$956m), however this remains subject to FY12 market conditions not materially deteriorating from FY11. The investment team has spent a lot of time meeting with divisional heads at Macquarie to reassess the calibre of its key executives and discuss the strategic direction of their business units. While markets are depressed at the moment, the team does believe Macquarie is still a quality business and is working through the issues that have arisen as it has grown into a substantial, multinational company. While it is not likely to generate the extremely high ROEs that the group has historically produced (20% plus), it is likely that Macquarie will once again deliver attractive ROEs.

Despite reiterating its guidance for the year, JB Hi-Fi came under substantial pressure during the month. The market, in general, paints companies with similar brushes despite differences in operating abilities and or business models. During the month David Jones downgraded its guidance for 2H11 NPAT growth to a fall of 9 - 12% year on year compared to previous guidance for growth of approximately +5% due to a "dramatic" and "unprecedented" deterioration in fourth quarter trading. David Jones shares fell 18.2% on the day of the announcement, along with other retailers. JB Hi-Fi has significantly more organic sales opportunities than Myer and David Jones and the investment team believe that JB Hi-Fi's result, due out in August, will be a solid one.

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (Oct 96)
Hyperion Australian Equities Composite	-3.63	-5.57	-0.66	8.62	5.24	13.55
Excess Performance over S&P/ASX 300 Accumulation Index	0.20	-0.42	-3.66	2.16	3.33	4.72

Hyperion Australian Equities Composite Top 10 Stock Holdings		
Stock	Absolute Weight (%)	Active Weight (%)
Seek	7.83	7.63
Cochlear	7.37	7.00
BHP Billiton	6.72	-5.57
Rio Tinto	6.69	3.47
Commonwealth Bank of Australia	6.21	-0.89
Sky Network Television	5.29	5.29
WorleyParsons	5.04	4.52
Woolworths	4.51	1.48
ANZ	4.41	-0.64
Platinum Asset Management	4.21	4.12

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (May 03)
Hyperion Australian Equities ASX 300 Composite	-4.15	-6.00	-1.59	7.14	6.54	13.59
Excess Performance over S&P/ASX 300 Accumulation Index	-0.32	-0.85	-4.60	0.67	4.63	4.24

Hyperion Australian Equities ASX 300 Composite Top 10 Stock Holdings		
Stock	Absolute Weight (%)	Active Weight (%)
Seek	8.43	8.23
Cochlear	8.35	7.98
BHP Billiton	7.72	-4.57
Rio Tinto	7.18	3.96
Commonwealth Bank of Australia	7.09	-0.01
WorleyParsons	6.20	5.67
Woolworths	5.75	2.72
Platinum Asset Management	4.92	4.84
Carsales.com	4.15	4.06
ANZ	4.15	-0.90

Steering clear of geo-political risk and single commodity exposure

The Hyperion Small Growth Companies Fund underperformed the benchmark during the month. The fund returned 0.15% versus the S&P/ASX Small Ordinaries Accumulation Index return of 1.40%. The biggest positive contribution to active performance came from Reckon (+12.72%), Sky Network Television (+6.74%) and not owning Adelaide Brighton (-15.21%). The largest detractors from active performance were Platinum Asset Management (-5.34%), IRESS Market Technology (-4.11%), and not owning Sundance Resources (+54.4%).

Sundance Resources had a stellar run during the month. The company received a take-over offer from Hanlong Mining, a substantial shareholder of Sundance Resources. Hanlong made a conditional cash offer for 100% of outstanding Sundance Resources script at a price of 50 cents per Sundance Resources share under a scheme of

arrangement. The Sundance Resources Board believed that the offer was not adequate and have advised shareholders to take no action at this stage. Hyperion has a disciplined stock selection process where unless a company has a proven track record of achieving above-average returns on equity for shareholders we cannot invest. Sundance is an exploration company and therefore doesn't meet the criteria.

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (Oct 02)
High Conviction Small Growth Companies Portfolio	0.15	-1.02	4.78	15.20	9.47	24.27
Excess Performance over S&P/ASX Small Ords Accumulation Index	-1.25	6.09	-7.41	5.49	7.25	14.08

High Conviction Small Growth Companies Portfolio Top 10 Stock Holdings		
Stock	Absolute Weight (%)	Active Weight (%)
Carsales.com	10.60	9.66
Sky Network Television	9.38	9.38
REA Group	8.83	8.21
Platinum Asset Management	8.25	7.35
Reckon	8.24	8.24
IRESS Market Technology	8.05	7.23
Wotif.com Holdings	7.08	6.56
Count Financial	6.67	6.67
Navitas	4.57	3.82
Domino's Pizza Enterprises	3.42	3.42

The information in this document was prepared by Hyperion Asset Management, ABN 80 080 135 897 AFSL 238 380, for wholesale investors. The information is not intended as a securities recommendation or statement of opinion intended to influence a person or persons in making a decision in relation to investment. This document does not take account of any person's objectives, financial situation or needs and before acting, an investor should consider the appropriateness of the investment having regard to their objectives, financial situation and needs. This document is provided to the recipient only and must not be copied or passed on to any other person without the consent of Hyperion Asset Management. Past performance is not an indicator or guarantee of future performance. Investment performance is presented gross of investment management fees and other expenses, including custody. Hyperion Asset Management believes the information contained in this communication is reliable, however, no warranty is given as to its accuracy and persons relying on this information do so at their own risk. Figures provided as at 31st July 2011.