



## Inside the investment team...

### ***Why the risk is in the benchmark for long-term investors***

*For most Australian equities managers, investment risk is defined and dictated by the share market index. Failure to keep up with the pack is the ultimate risk, while stealing a march on peers with short-term fillips from the latest trends, unsustainable by their very nature, is praised and richly rewarded.*

This approach appears to work reasonably well for many managers when their time horizon for investment is less than five years. After all, if you are looking for short-term results, beating the index matters.

On the other hand, Hyperion believes that most Australian investors are looking for solid returns over the long term (five years plus). This means that the indices are largely irrelevant; short-term by their very nature and based on factors such as market capitalisation and liquidity, and driven by trends, cycles and the "next big thing," they do not reflect the reality of an investor looking to grow his or her investments (most often super) over the long term.

### **Challenging the status quo**

If the share market indices are irrelevant to investors, and therefore to Hyperion, what counts is our ability to meet our five year internal rate of return (IRR) forecast. This is how we measure our performance, and indeed, the biggest possible risk for Hyperion is failing to make or exceed those five year figures.

We believe that the best way to meet our five year IRR, and our investors' expectations, is to buy a portfolio of high-quality, predictable businesses that have a strong likelihood of producing long-term growth in earnings and profitability. Companies must pass a stringent quality control process before we consider investing in them and their weighting on the index, or lack thereof, is immaterial to us. The fundamentals of a particular company – and the potential business risks it is facing – are far more important.

In Hyperion's view, a risky company is one that may not achieve earnings growth over the long-term, not a company that has a low weight in the index.

### **Safety in numbers?**

Just because the index holds a large number of different companies, and looks to be diversified, does not mean it is inherently low risk. In fact, when certain sectors of the economy are experiencing a cyclical upturn it can lead to the index becoming overly concentrated in one sector. A case in point is the resources sector, which currently makes up 33% of the S&P/ASX 300. Arguably these companies are reliant on the same drivers for profitability (commodity prices) and are vulnerable to the same potential risks. This leaves investors who hold the index overly exposed to the risk of a slowdown in China's economic growth rate – given its importance in determining commodity prices.

### **Benchmark insensitivity in practice**

To achieve attractive long-term returns, we believe it is necessary to construct portfolios that are not based upon the share market indices.

Let's look at Telstra (ASX: TLS). The stock can be found in many managers' portfolios and has a heavy weighting in the index. Despite its size and popularity, we sold out of the company in 2004 believing that Telstra is not a good enough long-term investment due to its lack of organic growth opportunities and therefore potential to grow earnings and profit over the long-term.

Conversely, Hyperion has invested in many companies over the years that have had no weight in the major share market indices and therefore, for a while, passed under the radar of most managers. JB Hi-Fi (ASX: JBH) and REA Group (ASX: REA) are examples of long-term holdings of Hyperion that were identified early on through our investment process.

Once the investment team has concluded that a business has passed our quantitative criteria, is easy to understand, has a sustainable competitive advantage and organic growth options, the weighting we give to the stock in our portfolio is dependent on its risk-adjusted IRR. There is no reference to the weighting the stock has in the share market indices, although it must pass certain liquidity requirements to enable us to move the stock into or out of our portfolio as we see fit.

The only investment decisions we make relative to the benchmark are where we have mandates that restrict us to a certain subset of the market. For example, when JB Hi-Fi recently entered the ASX100, we were obliged to sell it out of our Small Growth Companies Fund.

### Bringing it all together

Hyperion believes the risk is in the benchmark for long-term investors for two reasons. Firstly, the benchmark itself is flawed, deriving as it does from an index that rewards short-term gain at the expense of sustainable long-term results, and facilitating over-concentration of holdings in a particular sector.

Secondly, a preoccupation with benchmarks may lead managers to lose focus on what really matters to most Australian investors: long-term asset growth through investment performance from a manager who does what they say they will. Surely, for the post-GFC investment community, sticking to our promises to investors is the real test that we face.

### Market expected to refocus on quality fundamentals

If economic conditions remain subdued for an extended period of time, our portfolio has the capability to produce above average earnings and dividend growth. We expect investors will once again focus on those companies that can produce high, sustainable earnings growth in the August reporting season. The five year forecast portfolio IRR remains elevated and above 21% p.a., reflecting the broad de-rating of market multiples.

### Investors find refuge in Woolworths in a stressed market

The Hyperion Australian Equities Composite and the Hyperion Australian Equities ASX 300 Composite underperformed the market during June. The Hyperion Australian Equities composite returned -3.70% and the Hyperion Australian Equities ASX 300 composite returned -3.74% versus the market return of -1.98%.

For the Hyperion Australian Equities Composite the largest positive contribution to active performance came from the portfolio's investments in Rio Tinto (+1.83%) and Woolworths (+1.24%) and not owning Telstra Corporation (-4.30%). The largest reduction in active performance came from investments in Cochlear (-9.74%), Macquarie Group (-8.09%) and Seek (-5.29%).

For the Hyperion Australian Equities ASX 300 Composite, the largest positive contribution to active performance came from the portfolio's investments in Rio Tinto (+1.83%) and Woolworths (+1.24%) and not owning Telstra Corporation (-4.30%). The largest reduction in active performance came from investments in Cochlear (-9.74%), Macquarie Group (-8.09%) and Seek (-5.29%).

The rotation of investors out of market sensitive sectors and consumer discretionary in May continued in June. Nervous investors sought shelter in defensive sectors and higher PE stocks continued to de-rate. We expect investors will once again focus on those companies that can produce high, sustainable earnings growth in the August reporting season. Investors were attracted to the resilience of the Woolworths' business model in subdued economic conditions and volatile equity markets. The Woolworths share price performed strongly in both May (+3.4%) and June (+1.2%). Competitive rivalry has increased with a reinvigorated Coles, but with Woolworth's scale, efficiency advantages and strong brand, Woolworths should continue to outperform the broader grocery market. Despite expectations of moderating sales growth, we believe the quality of its franchise and balance sheet strength is being undervalued by the market.

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (Oct 96)
Hyperion Australian Equities Composite	-3.70	-2.09	5.35	13.78	5.17	13.92
<b>Excess Performance</b> over S&P/ASX 300 Accumulation Index	-1.72	-0.82	-6.55	1.31	2.80	4.74

Hyperion Australian Equities Composite Top 10 Stock Holdings		
Stock	Absolute Weight (%)	Active Weight (%)
Cochlear	7.62	7.26
BHP Billiton	7.23	-5.29
Commonwealth Bank of Australia	6.71	-0.55
Seek	6.58	6.39
Rio Tinto	6.10	2.87
WorleyParsons	5.27	4.75
Sky Network Television	5.05	5.05
Woolworths	4.93	1.92
Platinum Asset Management	4.52	4.43
IRESS Market Technology	4.46	4.38

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (May 03)
Hyperion Australian Equities ASX 300 Composite	-3.74	-2.12	5.15	12.96	6.16	14.33
<b>Excess Performance</b> over S&P/ASX 300 Accumulation Index	-1.77	-0.86	-6.75	0.48	3.79	4.36

Hyperion Australian Equities ASX 300 Composite Top 10 Stock Holdings		
Stock	Absolute Weight (%)	Active Weight (%)
Cochlear	8.19	7.83
Rio Tinto	7.62	4.40
Seek	7.46	7.27
BHP Billiton	7.29	-5.24
Commonwealth Bank of Australia	7.20	-0.06
WorleyParsons	5.97	5.45
Platinum Asset Management	5.33	5.24
Woolworths	5.26	2.25
IRESS Market Technology	4.36	4.28
Macquarie Group	4.30	3.34

### Risks of investing in most small cap resource stocks unjustified

The Hyperion Small Growth Companies Fund outperformed its benchmark during the month. The fund returned -4.38% versus the S&P/ASX Small Ordinaries Accumulation Index return of -5.09%. The biggest positive contribution to active performance came from Sky Network Television (+9.55%) and Nick Scali (+12.58%) and not owning a number of resource stocks: Medusa Mining (-24.34%); Aquila Resources (-19.44%) and Intrepid Mines (-25.26%). The biggest detractors from active performance during the month included investments in Wotif.com Holdings (-7.86%) and Fantastic Holdings (-10.36%).

The materials sector was the largest contributor to active performance in June as our underweight position (-32%) protected the fund against its fall of 9% in the month. Our focus on quality companies with sustainable competitive advantages and strong financial track records preclude us from investing (as opposed to speculating) in most small cap mining stocks.

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (Oct 02)
High Conviction Small Growth Companies Portfolio	-4.38	-1.65	5.55	17.46	8.83	24.24
<b>Excess Performance</b> over S&P/ASX Small Ords Accumulation Index	0.71	8.74	-10.87	3.70	7.62	14.13

High Conviction Small Growth Companies Portfolio Top 10 Stock Holdings		
Stock	Absolute Weight (%)	Active Weight (%)
Carsales.com	10.60	9.62
Sky Network Television	9.77	9.77
IRESS Market Technology	9.42	8.55
Platinum Asset Management	8.53	7.57
Count Financial	7.79	7.79
REA Group	7.62	6.99
Wotif.com Holdings	7.54	7.00
Reckon	7.16	7.16
The Reject Shop	5.37	5.07
Navitas	4.78	3.97

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