



Inside the investment team...

Equities versus cash – can there be surety in stocks?

*With the Australian share market as a whole drifting sideways and interest rates at levels not seen for many years, investors are questioning their allocation between equities and cash. In this article, Hyperion outlines what we believe are some very good reasons for remaining in the **right** equities for the long term.*

In very basic terms, investment decisions boil down to finding the best balance between the return and associated risk. The shock of the Global Financial Crisis and subsequent market return of -2.8% p.a. (based on the All Ordinaries Accumulation Index from 30 June 2007 to 30 May 2011) makes a cash rate of 4.75% seem attractive. Once we factor in the capital preservation advantages of remaining in cash the argument for switching out of equities and into cash would seem simple.

Of course there are two real-world parameters which need to be considered: tax and inflation. We will leave tax for another time but focusing on inflation, which sits at 3.3% p.a. as at 31 March 2011, the case for cash starts to look shakier. Still, many will be attracted to the zero capital risk attribute of cash, particularly with the Global Financial Crisis still in recent memory. Therefore, we ask, can equities provide surety as well as a superior return?

Based on historical data, Hyperion argues that an investment in quality stocks over a five year horizon can deliver both certainty and investment return performance, with quality being the key.

We have been experiencing a bear market over the last three years with the listed resources companies the only real drivers of share price appreciation. Unfortunately for those heavily weighted in resources, Hyperion believes the sector is close to being a bubble and as history has proven many times, the only way forward for bubbles after they expand is to burst. Our stringent investment philosophy screens out companies that do not have a sustainable competitive advantage and it is that screen which eliminates the vast majority of Australian resources stocks.

So while current market sentiment is favourable towards resources, despite a lack of fundamentals to support this (consider the shortage of earnings for many resources companies), other fundamentally sound companies find their share prices languishing. The February 2011 reporting season saw a brief return to a focus on fundamentals and it was during that time that Hyperion's clients enjoyed a 2% outperformance compared to the relevant benchmarks. So, while sentiment can drive the market in the short and sometimes medium-term, fundamental-driven investing is like the proverbial basketball – it can only be held under water for so long before breaking through the surface. When the market does return to appreciating company fundamentals, historical data shows investors enjoyed significant returns when invested in quality companies.

Two examples of stocks we hold which exhibit the characteristics outlined - and quite a few more - are:

Earnings Per Share (EPS) in cents for five financial years ending (FYE) 30 June.

Company	EPS FYE06	EPS FYE07	EPS FYE08	EPS FYE09	EPS FYE010
Navitas	9.6	10.6	11.8	14.6	19.1
REA Group	8.0	11.7	17.6	29.4	38.1

Navitas is using its historical success with Australian universities as reference points for international universities who are looking to outsource the recruitment and integration of overseas students into their campuses. This overseas expansion is expected to fuel 20% p.a. earnings-per-share growth over the next five years, which together with favourable current valuation levels leads to an estimated five-year total return of 23% p.a.

REA Group (REA) provides a strong value proposition to real estate agents in Australia with a large percentage of a typical agent's buyers becoming aware of a property they have for sale via realestate.com.au. Strong pricing power in Australia and growth from the company's Italian operation are the drivers behind an expected 23% p.a.

earnings-per-share growth rate over the next five years. Despite some contraction in the company's price earnings ratio over our investment horizon a total return of 24% p.a. from our investment in REA is anticipated.

Due to our focus on high quality companies and our unwavering focus on earnings predictability we believe the risk of being significantly wrong with our five year earnings-per-share forecasts for companies in our portfolio is low. As a result we have confidence in our current five year total return forecast for the portfolio of 20% p.a. A 20% p.a. return over five years equates to a 149% return versus an anticipated return from cash of 34% (assuming 6% p.a.). The return from the portfolio is, of course, much more tax effective than the return on cash, as dividends have franking credits attached. In addition, there is no tax on unrealised gains through capital growth, whereas the return on cash is taxable.

We believe the risk associated with buying high quality predictable companies is not nearly as great as the expected return differential suggests and that a large margin of safety is built into high quality companies listed on the Australian share market.

Quality positions mean the portfolios are well placed in a challenging environment

The companies in the portfolio have strong underlying customer value propositions, strong free cash flow, substantial organic growth options, experienced and proven management teams, and are lowly geared. This should position them well in a challenging global economic environment.

Brambles strengthens its position as market leader

The Hyperion Australian Equities Composite and the Hyperion Australian Equities ASX 300 Composite marginally underperformed the market during May. The Hyperion Australian Equities composite returned -2.12% and the Hyperion Australian Equities ASX 300 composite returned -2.30% versus the market return of -2.02%.

For the Hyperion Australian Equities Composite the largest contribution to active performance came from the portfolio's investments in IRESS Market Technology (+5.80%), Brambles (+9.36%) and Navitas (+5.41%). The largest reduction in active performance came from investments in Wotif.com Holdings (-10.70%), Platinum Asset Management (-6.93%) and JB Hi-Fi (-9.57%).

Brambles (+9.4%) provided a positive update during the month. Brambles, having sold business operations, is starting to benefit from a recovery in developed markets economic growth rates. Its underlying revenue growth is tracking at approximately 5% for the nine months year to date. On the back of positive momentum and the acquisition of IFCO, Brambles increased its FY11 EBIT guidance to US\$775 million – US\$820 million (using 30 June exchange rates). Its market leading position has been strengthened further with a key US competitor iGPS losing another contract to Brambles. iGPS has traditionally been a source of negative sentiment for the company. The company won a number of smaller contracts from Brambles suggesting that Brambles' dominance may be under threat. However, detailed analysis by the Hyperion investment team suggested that iGPS's business was unsustainable in the long-term and its contract losses seem to provide support to this thesis.

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (Oct 96)
Hyperion Australian Equities Composite	-2.12	3.06	5.77	19.30	6.48	14.30
Excess Performance over S&P/ASX 300 Accumulation Index	-0.10	-1.46	-5.36	3.47	3.29	4.92

Hyperion Australian Equities Composite Top 10 Stock Holdings

Stock	Absolute Weight (%)	Active Weight (%)
Cochlear	8.12	7.73
BHP Billiton	7.05	-5.89
Commonwealth Bank of Australia	6.34	-0.51
Seek	6.33	6.14
Rio Tinto	5.76	2.67
WorleyParsons	5.38	4.84

Macquarie Group	4.87	3.85
Sky Network Television	4.85	4.85
Woolworths	4.69	1.80
IRESS	4.61	4.52

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (May 03)
Hyperion Australian Equities ASX 300 Composite	-2.30	3.49	4.97	18.46	7.83	15.03
Excess Performance over S&P/ASX 300 Accumulation Index	-0.28	-1.03	-6.16	2.63	4.64	4.68

Hyperion Australian Equities ASX 300 Composite Top 10 Stock Holdings		
Stock	Absolute Weight (%)	Active Weight (%)
Cochlear	8.69	8.30
Rio Tinto	7.46	4.37
BHP Billiton	7.16	-5.78
Commonwealth Bank of Australia	6.87	0.02
Seek	6.72	6.53
WorleyParsons	6.15	5.61
Platinum Asset Management	5.20	5.11
Macquarie Group	5.17	4.16
Woolworths	5.04	2.15
IRESS Market Technologies	4.54	4.45

Highlighted again: Inherent risks in early stage Biotech companies

The Hyperion Small Growth Companies portfolio marginally underperformed its benchmark during the month. The fund returned -2.38% versus the S&P/ASX Small Ordinaries Accumulation Index return of -1.89%. The biggest contribution to active performance came from The Reject Shop (+9.65%) with IRESS Market Technology (+5.8%) and not owning Pharmaxis (-61.87%) also contributing strongly to performance during the month. The biggest detractors from active performance during the month included investments in Reckon (-10.77%), Wotif.com (-10.70%) and REA Group (-6.91%).

Pharmaxis' share price declined substantially during the month. The Committee for Human and Medicinal Products (CHMP) indicated (during a non-binding trend vote) that they were concerned with the clinical meaningfulness and heterogeneity of recent trials by the company. Should this trend be carried forward at its next meeting in June, Pharmaxis will need to appeal this decision thereby delaying its Bronchitol product by at least four months. The price reaction to the negative news highlights the risks involved with investing in early stage Biotechnology companies, generally screened out through our investment process.

Performance	1 mth	6 mth	1 year	2 year	5 year	Since inception (Oct 02)
High Conviction Small Growth Companies Portfolio	-2.28	1.24	8.78	23.65	10.18	25.15
Excess Performance over S&P/ASX Small Ords Accumulation Index	-0.39	0.15	-9.29	5.11	7.68	14.28

High Conviction Small Growth Companies Portfolio Top 10 Stock Holdings		
Stock	Absolute Weight (%)	Active Weight (%)
Carsales.com	10.44	9.45
IRESS Market Technology	10.01	9.11
Sky Network Television	8.67	8.67
Count Financial	8.43	8.43
Wotif.com Holdings	7.68	7.11
Reckon	7.31	7.31
REA Group	7.19	6.54
The Reject Shop	6.75	6.45
Platinum Asset Management	6.43	5.47
Navitas	4.77	3.94

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