



A moment with Hyperion CIO Mark Arnold...

Practicing what we preach

Two big name stocks Hyperion doesn't hold – and why

As a long-only, high-conviction fund manager, Hyperion only buys quality stocks that we believe will outperform over the long-term - five years plus - in line with our clients' investment horizons.

When it comes to the vital question of what is 'quality', we assess against a number of set criteria. These have been developed through years of experience and provide us with an objective determination of the strength of a company's fundamentals. It's an approach that helps us stay well clear of some of the hype and noise that can otherwise distort the investment picture.

In general, quality stocks are those with:

- ✓ High return on capital
- ✓ Not capital intensive
- ✓ Low levels of debt
- ✓ Organic growth rates of around 2 times GDP
- ✓ Do not require significant capital raisings to grow the business
- ✓ Competitive advantages within its industry that gives it pricing power
- ✓ Consistent levels of free cash flow that grow steadily over time

While some businesses do meet these criteria, the simple reality is that, more often, they don't. And if they don't, we don't invest in them. This explains why we frequently choose not to invest in the big names, despite their seeming appeal.

Below are two prime examples. In each case, the application of Hyperion's investment criteria found the company concerned lacking the necessary level of business quality - despite being among the biggest names in the market. Notwithstanding this, it is likely you'll find these stocks in most Australian equities managers' portfolios purely because they are big names in the ASX 50 - and not because of the objective quality of their underlying businesses.

Qantas

It's all about capital

Qantas has very large historical cash outflows, which are capitalised on the balance sheet as assets. As at 30 June, it had non-current assets of \$14bn related to aircraft, compared to shareholders' equity of \$6bn. Meanwhile, average profit over the past 2 years has been \$115m.

By its very nature, the airline business is capital intensive. Buying or leasing aircraft requires large amounts of up-front capital, and raising that capital incurs significant amounts of long-term debt that will remain on the balance sheet for years. These very high fixed capital costs can't be reduced quickly in the event of a sudden downturn in demand (as we saw after 9/11).

The large funding requirement for investment in aircraft results in high levels of debt and high risk of bankruptcy. It also increases the probability that profit is overstated. Most airlines have large levels of off-balance sheet liabilities relating to operating leases for aircraft, and Qantas is no different. Prima facie, this understates the general level of financial leverage associated with the business.

Finally, and perhaps most critically, in common with other airlines, Qantas lacks pricing power, because customers are prepared to choose their airline based on ticket cost alone. In times of low demand, we see heavy periods of price discounting to fill the aircraft as management decides that some revenue is better than

none. However, prices are quite often slashed to levels that only cover operating costs, not capital costs. This is perhaps the most significant reason why ROC historically is so low – too low for Hyperion.

- × Not capital intensive
- × High and sustainable ROC
- × Low levels of debt
- × Doesn't require significant capital raising to grow the business
- × Consistent levels of free cash flow that grow steadily over time
- × Organic sales growth
- × Pricing power

Telstra

Nowhere left to go?

While Telstra currently enjoys a reasonable return on equity and return on capital, the outlook is not positive for long-term investors.

The company already has a very large market share in an industry that is increasingly competitive in Australia, with the core fixed line business in particular under threat from competitors and new technology. It is also a target for government regulation, but has limited ability to expand overseas without making risky acquisitions.

Additionally, Telstra's business is increasingly capital intensive. Management wants to prevent further declines in market share, so is spending to increase the strength of its value proposition to clients, particularly improving infrastructure, technology and customer services. As a consequence, both return on capital and free cash flows are likely to decline.

The only conceivable way to make money out of Telstra is to buy cheap and trade out after a short period of gain, which a lot of value investors are doing at the moment. However, this runs contrary to the Hyperion philosophy of investing over the long-term – so we have chosen not to hold the stock.

- × Organic sales
- × Growth rates of two times GDP
- × Not capital intensive
- × High and sustainable ROC
- × Growing free cash flows

In short, while our funds may not top the table every year, over five years we deliver strong returns, built on a solid foundation.

Mark Arnold, Chief Investment Officer

Portfolio maintains above average earnings growth outlook

The current IRR for the portfolio is around 20%, higher than the historical average IRR for the portfolio. Despite high long-term earnings expectations, the trailing PER of the portfolio has declined to 17.5x, below its long-term average of 19.0x. The quality of the portfolios, attractive valuation and above average earnings growth outlook should hold the portfolio in good stead over our investment horizon.

Broad caps were driven by two sectors rather than fundamentals

The Hyperion Australian Equities Composite marginally underperformed the benchmark S&P/ASX300 Accumulation Index during September. The portfolio returned 4.20% versus the benchmark return of 4.79%. Relative portfolio returns were driven by REA Group (+14.69%), Wotif.com Holdings (+13.85%) and not owning Telstra (-4.73%). The largest detractors from active performance during September included Carsales.com (-9.06%), Macquarie Group (-3.18%) and Platinum Asset Management (+1.02%).

Benchmark returns were primarily driven by the Industrial (7.85%), Materials (7.69%) and Utilities (7.07%) sectors. The worst performing sector was Telecommunication (-4.48%). With a bottom up stock selection process, it transpires that our sector bias is towards the Consumer Discretionary (5.06%), Non Banking Financial (3.67%) and Information Technology (3.14%) sectors. Being underweight Materials and Banks when compared with the benchmark contributed to our underperformance during the month.

Performance	1 mth	6 mth	1 year	2 year	5 year	10 year
Hyperion Australian Equities Composite	4.20	-6.56	2.18	13.36	8.61	11.28
Excess Performance over S&P/ASX 300 Accumulation Index	-0.59	-2.73	1.53	8.85	4.45	3.53

Top 10 Stock Holdings		
Stock	Absolute Weight	Active Weight
Seek	7.08%	6.86
Platinum Asset Management	6.84%	6.73
Woolworths	6.23%	3.01
Cochlear	6.18%	5.82
BHP Billiton	6.15%	-5.68
RIO Tinto	5.59%	2.42
Commonwealth Bank of Australia	5.49%	-1.68
Macquarie Group	4.21%	3.08
REA Group	4.16%	4.10
Sky Network Television	4.05%	4.05

It is starting to look like a fad amongst the large caps

The Hyperion Australian Equities ASX 300 Composite underperformed the S&P/ASX300 Accumulation Index during September. The portfolio returned 4.22% versus the benchmark return of 4.78%. The largest contributors to active performance during the month included IRESS Market Technology (+12.59%), Wotif.com Holdings (+13.85%) and REA Group (+14.69%) and not owning Telstra (-4.73%) also added positively to the performance during the month. The largest detractors from performance during the month included Carsales.com (-9.06%), Macquarie Group (-3.18%) and Platinum Asset Management (+1.02%).

Benchmark returns were primarily driven by the Industrial (7.85%), Materials (7.69%) and the Utilities (7.07%) sectors. The worst performing sector was Telecommunication (-4.48%). With a bottom up stock selection process, it transpires that our sector bias is towards the Consumer Discretionary (5.06%), Non Banking Financial (3.67%) and Information Technology (3.14%) sectors. Being underweight Materials and Banks when compared with the benchmark contributed to our underperformance during the month.

Performance	1 mth	6 mth	1 year	2 year	5 year
Hyperion Australian Equities ASX 300 Composite	4.22	-6.94	-0.42	13.56	10.11
Excess Performance over S&P/ASX 300 Accumulation Index	-0.56	-3.10	-1.07	9.06	5.95

Top 10 Stock Holdings		
Stock	Absolute Weight	Active Weight
Seek	7.82%	7.60
Cochlear	7.39%	7.03
Woolworths	7.18%	3.96
Platinum Asset Management	7.12%	7.01
BHP Billiton	6.70%	-5.13
Commonwealth Bank of Australia	6.21%	-0.97
RIO Tinto	5.61%	2.44
Macquarie Group	5.05%	3.92
REA Group	4.46%	4.40
WorleyParsons	4.23%	3.82

Small caps run on sector biases largely ignoring quality hurdles

The Hyperion Small Growth Companies Portfolio underperformed the S&P/ASX Small Ordinaries Accumulation Index during September. The portfolio returned 6.81% versus the benchmark return of 9.07%. Underperformance during the month was driven primarily by sector selection. Our underweight position compared to the benchmark in the Materials and Industrial sectors accounted for most of our underperformance (1.88%). It is worth noting that the portfolio's sector exposure is a direct result of our bottom up portfolio construction process. The process focuses on companies with high returns on equity, predictable earnings and

competitive advantage in their industries. The junior miners do not generally meet this investment criteria which explains our underweight position.

The largest contributors to active performance at a stock level includes REA Group (+14.69%), Count Financial (+15.09%) and Wotif.com Holdings (+13.85%). The largest detractors from active performance during the month included Carsales.com (-9.06%), Sky Network Television (-4.95%) and Platinum Asset Management (+1.02%).

Performance	1 mth	6 mth	1 year	2 year	5 year
High Conviction Small Growth Companies Portfolio	6.81	-3.28	11.07	22.13	12.81
Excess Performance over S&P/ASX Small Ords Accumulation Index	-2.26	-6.57	4.44	15.69	9.37

Top 10 Stock Holdings		
Stock	Absolute Weight	Active Weight
REA Group	9.19%	8.57
IRESS Market Technology	9.04%	8.20
Platinum Asset Management	8.90%	7.74
Reckon	8.31%	8.31
Wotif.com Holdings	8.02%	7.46
Count Financial	7.87%	7.87
Sky Network Television	7.40%	7.40
The Reject Shop	7.36%	6.92
Carsales.com	6.86%	6.41
Navitas	4.15%	3.36

Recent Mandate Wins and Remaining Capacity

September was a relatively quiet month for funds under management movement for Hyperion. An industry super fund mandate awarded in September is due to complete transition in October so it was just net retail flows that positively affected our FUM figures. The pipeline remains strong thanks to both consultant and research house support.

Product Capacity		
PORTFOLIO	UNIVERSE	REMAINING CAPACITY
High Conviction Small Growth Companies	Small Ords	\$0.05b
Australian Equities ASX 300 Composite	ASX 300	\$0.8b
Australian Equities Composite	All Ordinaries	Soft closed

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