# *CANOPUS INVESTMENTS Limited*

***Investment Advice    Sharebroking    Managed Funds    Fixed Interest    Property    Company Formations    Trade Mark Registration***

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**Investment Directions** **29 October 2014**

*"Analysis to action. Opportunities to outcomes"*

**In this Issue**

1. **Overview** – High volatility sees mid-October equity losses largely recovered by month end as margin traders happy to continue, US reporting round proves satisfactory and US interest rates plunge on strong demand for Greenback and US Treasury bonds. QE set to end but massive injection of QE money still boosting markets. "Lower for longer" interest rate outlook entrenched in New Zealand as inflation falls, deposit rates decline and oil price slides. US and Chinese Leading Economic Indicators still strong.

2. **Equities** – Contact Energy contemplates return of capital. Increased dividends usually much more attractive to shareholders than share buy-backs or share cancellations which, historically, provide little near term or even medium term benefit with purchase prices being set too low. Capital returns from Telstra and Auckland International Airport examined.

3. **Interest rates, bonds and debentures** – Best fixed term deposit rates from major finance companies. Term deposit rates falling.

4. **New and current issues –** Current managed futures funds from Man Investments Australia.

5. **Strategy** – Portfolios manage gains in September despite steep falls in Australian and US equity markets. Canopus portfolio owners make applications for shares in Australian Government IPO for Medibank Private but reported strong demand means heavy scaling of applications likely. Orion Health IPO to be given a miss – no financial forecasts.

## 1. Overview

October, the witching month, has lived up to its reputation again delivering high volatility and a sharp decline in US equity indices after a traditionally weak September, only for share prices to surge again after reaching a low on the 15th. Tech stocks led markets down, apparently triggered by the IMF lowering its global growth forecast, adding to concerns over Ukraine, ISIS and Ebola. As expected, US action impacted local markets with the ASX losing 8.4% from the beginning of September to mid-October but recovering 61% of losses in the past two weeks. Although following a similar pattern of high volatility the much smaller NZX has actually achieved a gain of 2.3% for the two months to date.

Reasons for the historically high occurrence of October market volatility remain a mystery with factors quoted ranging from end of the northern summer to oft-unfilled expectations from the latest corporate reporting round. Expectations for 2014 S&P 500 company Q3 earnings gain (yoy) fell heavily from 6.3% in June ‘14 through to just 1.6% at the start of October. In the event many US majors beat expectations including Ford, UPS, Microsoft and Caterpillar but Amazon failed to match the positive trend, losing 95 cents per share. Irrespective of past Octobers, 2014 volatility cannot help but have been accentuated by the US Fed’s enormous QE programmes putting cheap money into the hands of speculators and traders. Termination of QE3, scheduled to wind up after October, doesn’t alone give cause for severe share market weakness and has been well signalled. Rather, closure of massive margin trading positions in New York as prices declined would have fed volatility and may do so for some time yet. The sharp late October rebound indicates speculators still have access to ample cheap money and are happy to increase positions again, believing the “Yellen Put” has their back. Also, an unexpected decline in US bond rates would have helped boost the late October equities rally.

In New Zealand, lower than expected annual inflation, just 1%, keeps “lower for longer” the best bet as far as interest rate predictions go. Expectations for the next RBNZ OCR rise are moving out to late 2015 according to forward markets and some economists. The NZ dollar still has a strong yield advantage so expect continuing strength – especially if dairy and log prices establish a sustained trend off recent lows. The Global Dairy Trade Index rose 1.4% on 16 October and export logs were up 7% in September over August. Also expect more jawboning from the RBNZ against the “high” NZ dollar and threats of intervention, but the Reserve Bank will be wary of actually “walking the talk” as, historically, selling an assumed overvalued currency has little but temporary effect – and can lead to severe losses if badly mis-timed. RBNZ inflation predictions have been hopelessly wrong for some years. Eventually they may get it right, but not yet it seems. Lower inflation and falling oil prices give the RBNZ cause to defer its own predictions of the next OCR rise yet again.

Australian interest rate expectations are also moving out, with the CBA delaying its pick for a first OCR rise from March ’15 to August ’15. To restrict house price inflation CBA expects the RBA to use “macroprudential initiatives” (such as NZ’s LVR ratios or higher capital provision for bank lending on investment properties) to delay the need for higher interest rates. RBA hopes for a lower AUD/USD rate could be upset if the US dollar loses favour for global trade, as the world’s reserve currency. Challenges are arising but for now growing foreign holdings of US Treasury bonds indicate strong global demand for the US currency remains.

Subject to untold ifs and buts, high interest rate differentials of the AUD and NZD should see strength maintained against the lower yielding US currency, attractive to international investors seeking a positive return –well above the negative rates now on offer in Europe and Japan.

In Europe 25 of 130 banks failed capital stress tests at the end of 2013 but the ECB says most have since repaired their balance sheets with 10 Billion Euro in new capital still to be raised. The tests aim to determine European banks’ abilities to withstand another financial crisis. The ECB believes these results will encourage new bank lending to help Europe grow out of the GFC low-growth aftermath in which it remains stuck to this day. In its own version of QE the ECB will start buying private sector debt such as asset backed securities and covered bonds. Interest rates are to be kept on hold “for a very long time”. How these asset purchases are to be funded has not been made clear but no wholesale money creation – as per the US Fed – has been flagged.

Keeping our finger on the pulse of major Leading Economic Indicators (LEI) and other leading data:

| | Latest | Sep 14 | Aug 14 | Jul 14 | Jun 14 | May 14 | Apr 14 |
|---|---|---|---|---|---|---|---|
| 3 month LIBOR (end of month) | .23310 | .23510 | .23360 | .23960 | .23460 | .2274 | .22335 |
| TED Spread (points) | .21 | .23 | .20 | .20 | .19 | .19 | .19 |
| VIX equity volatility | 16.04 | 16.31 | 12.09 | 16.95 | 11.57 | 11.40 | 13.41 |
| US LEI | | +0.8% | +0.0% | +1.1% | +0.7% | +0.6% | +0.3% |
| Japan LEI | | | +0.3% | -0.8% | -0.8% | -1.2% | -0.1% |
| Eurozone LEI | | +0.0% | -0.6% | +0.3% | -0.1% | +0.4% | -0.2% |
| Australia LEI | | | -0.2% | +0.6% | +0.2% | +0.2% | -0.1% |
| United Kingdom LEI | | | +0.4% | +0.1% | +0.7% | +0.5% | +0.5% |
| China LEI | | +0.9% | +0.7% | +1.3% | +1.3% | +0.7% | +1.1% |
| New Zealand CLI (Amp adj. OECD) | | | | -0.4% | -0.3% | -0.3% | -0.2% |
| US Money Market Funds $T | 2.622 | 2.614 | 2.595 | 2.554 | 2.570 | 2.587 | 2.574 |
| US Gov. 10 year T-Bond (%) | 2.257 | 2.51 | 2.343 | 2.556 | 2.516 | 2.457 | 2.606 |
| Foreign holdings of US T-Bonds $B | | | 6066.6 | 5998.0 | 6013.2 | 5976.0 | 5960.9 |
| Margin debt, NYSE (US$ millions) | | | 463,018 | 460,231 | 464,311 | 438,457 | 437,155 |
| US M2 Money Stock (US$B) | | 11,474 | 11,439 | 11,414 | 11,343 | 11,298 | 11,228 |
| Velocity of Money US M2 | | | | | 1.535 | | |
| Forward P/E S&P 500 (12 month) | 16.25 | 16.85 | 16.75 | 16.55 | 16.60 | 15.84 | 15.73 |
| Trailing P/E S&P 500 (12 month) | 18.43 | 19.36 | 19.16 | 19.51 | 19.34 | 18.04 | 17.91 |
| Total Put/Call options ratio CBOE | 0.97 | 1.29 | 0.82 | 0.99 | 0.85 | 0.89 | 0.77 |
| S&P 500 Share Index | 1961.63 | 1972.29 | 2003.37 | 1930.67 | 1960.23 | 1923.57 | 1883.95 |

VIX equities volatility, loudly quoted when rising as the harbinger of doom by permabears, reached an intra-day high of 31.06 on October 15, closed at 25.2 and then promptly retreated largely back to where it came from by the end of the month. Although high volatility can be expected from time to time, as stated in Investment Directions last month, fundamental data does not justify a serious equities sell-off.

The sharp decline in US interest rates, as typified by the 10 year T-Bond yield from mid-September to mid-October, poses a new risk for sharemarket investors. Traditionally, lower interest rates favour equities but share markets could be vulnerable to losses should a quick rise in US interest rates occur off the new low base. Given the renewed global appetite for US Government securities, such a quick rise seems unlikely – but not impossible. US interest rates remain an important factor for equity investors to consider.

Total Put/Call options on the CBOE showed an interesting ascending average through the last week of September, prior to the mid-October equities sell-off. The ratio peaked at 1.53 on 13 October with the daily average then declining sharply before the strong equities market rebound. Options traders appear to have correctly predicted both the mid-October downturn in equities and then the consequent sharp rebound. Generally a steeply rising ratio tends to precede equities weakness as astute investors move to insure their portfolios. Values above 1.00 tend to coincide with sharp equity troughs but the correlation is weak.

For the record, the lowest October 2014 S&P 500 close occurred on 15 October with a value of 1862.49. To date the index has rebounded 5.32% to 1961.63, just 2.5% below its record of 2011.36 set on September 18. On the historical charts this decline will hardly rate a blip but other indicators need to be watched to indicate possible formation of a downward trend. Unexpectedly low US interest rates pose a problem as any quick move upwards from the new low base would be negative for equities. News for equities is still positive with US jobless claims down to a 14 year low and industrial output up. Earnings largely beat estimates in the recent reporting round and consumer confidence rose. US Fed's St Louis President James Bullard, regarded as a hawk, claimed QE should be continued after October to support the US economic recovery. Not likely.

The extent to which margin trading positions have been unwound during September and October may give some clue as to whether a new longer term retreat in US equities has commenced. A significant decline in margin positions for a relatively minor equities retreat would indicate the worst may be over. In contrast, relatively minor close-out of margin positions during October could indicate more volatility and signify more share declines as likely. We await September and October figures with interest but should already be able to see the trend by the time these figures arrive.

Leading economic indicators remain favourable for the US, UK and China, weak for Japan and variable for Europe and Australia.

## 2. Equities

**Contact Energy (NZX:CEN)** is to consider return of capital to shareholders via higher dividends, a share buy-back or cancellation - from increased free cash flow as years of heavy capital expenditure on new power stations come to an end. Over recent years Contact shareholders have received poor returns and faced the probability of having rewards confiscated by a Labour/Greens Government under Labour's electricity industry nationalisation plan. Labour's solid defeat means the policy will have to be reviewed but so far there is little acknowledgement from potential new leaders of the extent of rethink required for Labour to win back centrist voters. CEN could prove a good buy depending on the entry price in light of potentially higher dividends. However, while share buy-backs and cancellations may appeal to directors as an easy route to reporting increased earnings per share, they usually fail to provide any short or medium term benefit to shareholders. Frequently the buy-back or cancellation price is just set too low.

The recent share buy-back by **Telstra (ASX:TLS)** attracted criticism from private shareholders even in Australia where franking credits were applicable. Directors and management were told by small shareholders that the buy-back was not wanted because only large institutional holders and funds that could claim both franking credits and tax deductions for capital losses would benefit. New Zealand shareholders, unable to claim Australian franking credits, would now be suffering a loss if they had taken up the share buy-back offer which was completed at A$4.60 per share. Those who did not take up the offer stand to gain eventually from a rising share price on their full original holding backed by increased earnings per share on the new, reduced total number of shares on issue. Even without franking credits, Telstra still offers a reliable and strong dividend yield with growth potential.

**Auckland International Airport (NZX:AIA)** has been voted best airport in the Australia-Pacific region for the sixth year in a row at the 2014 annual Skytrax World Airport Awards. Winning a real award, as opposed to one concocted just for the purpose, can boost both user and investor confidence in a business. AIA possesses diversified revenue sources covering the airfield, passenger services, retail income, rents, car parks and share of an associated hotel and airports.

In April 2014 Auckland International Airport completed a return of capital to shareholders via a 1 in 10 share cancellation with a value of $3.43 being paid for each cancelled share. Ex entitlement date was 3 April. At the time AIA shares were trading around $3.90 and rose over six weeks to a high of around $4.15. Subsequent results have revealed no surprises and the shares drifted down to around $3.70 at the end of August. Some volatility, including the mid-October dip, has seen AIA recover to about $3.83. So a holder with 10,000 shares at the beginning of April would have owned an asset with market value of $39,000. After the 1:10 share cancellation the holder would have 9000 shares plus the payment of $3430. Today the total investment would be worth 9000 x $3.83 = $34,470 + $3430 (from the share cancellation), a total of $37,900, (ignoring a $630 dividend paid on 17 October). From 3 April to 28 October the NZX has advanced 3.8% but AIA shareholders are down by 2.8%. Hardly a good short term outcome – but the anomaly did provide opportunity in an expensive market for new shareholders to buy in at a reasonable price. All AIA shareholders, old and new, will have to wait for the increased earnings per share to reflect in a higher share price and higher dividends. Auckland Airport's unique potential, size, financial strength and stable income base place it as a core holding for New Zealand portfolios. Dividend is modest with a forecast 2015 payout of 14 cps (3.66% at a $3.83 share price) but 100% imputation credits should be available for the next two years at least and target payout ratio has been increased to 100% of profit after tax and expenses (with some conditions of course).

In summary, history indicates that shareholders are more likely to benefit from increased dividends rather than a share buy-back or share cancellation. Contact Energy shareholders beware.

## 3. Interest rates, bonds and debentures

UDC has reduced most deposit rates by up to 15 points. Only the very short and call rates remain unaffected. Market-wide, deposit rates are falling again. Finance companies report adequate inflow of funds and difficulty in finding suitable lending opportunities.

Current deposit rates, % p.a.:

| Issuer | $ min | Call | 3mth | 6mth | 9mth | 12mth | 18mth | 24mth | 36mth | 48mth | 60mth |
|---|---|---|---|---|---|---|---|---|---|---|---|
| F&P Finance | 1000 | 3.75 | 4.10 | 4.60 | 4.85 | 4.95 | 5.10 | 5.35 | 5.60 | 5.85 | 6.10 |
| F&P Finance | 25,000 | 3.75 | 4.25 | 4.75 | 5.00 | 5.10 | 5.25 | 5.50 | 5.75 | 6.00 | 6.25 |
| Heartland Bnk | 1000 | 3.75 | 3.80 | 4.40 | 4.35 | 4.50 | 4.55 | 4.65 | 5.05 | 5.15 | 5.60 |
| Heartland Bnk | 20,000 | 3.75 | 3.90 | 4.40 | 4.45 | 4.50 | 4.65 | 4.75 | 5.15 | 5.25 | 5.70 |
| Liberty Fin. | 5,000 | | 4.05 | 4.65 | 4.85 | 5.35 | 5.80 | 6.05 | 6.55 | 6.70 | 6.75 |
| Liberty Fin. | 20,000 | | 4.20 | 4.80 | 5.00 | 5.50 | 5.95 | 6.20 | 6.70 | 6.85 | 6.90 |
| UDC Finance | 5000 | 3.45 | 3.50 | 4.25 | 4.40 | 4.50 | 4.85 | 4.90 | 5.15 | 5.40 | 5.65 |
| UDC Finance | 100,000 | 3.95 | 3.60 | 4.35 | 4.50 | 4.60 | 4.85 | 5.00 | 5.25 | 5.50 | 5.75 |

Heartland Bank frequently offers existing depositors a small margin above normal rates for certain terms. Check with Canopus for their latest specials.

For the full range of debenture stock interest rates and credit ratings visit Debex at
http://www.debentures.co.nz/debenture_stock.html

Canopus advisory clients receive a full rebate of any brokerage paid on term deposits. This can add up to 0.5% per year to the deposit rates tabulated above.

Contact me for copies of investment statements and application forms alan@canopus.co.nz
or telephone 09 444 8055. No brokerage is payable by investors on applications made through Canopus.

## 4. New and current issues

4.1 Man AHL Alpha (AUD)
4.2 Man AHL Gold (AUD)

### 4.1 Man AHL Alpha (AUD)

Fund from Man Australia structured as a unit trust, based on the AHL Alpha Program and allowing investors to choose between distribution of annual profit or reinvestment. Fund is available only to New Zealand and Australian residents.


For full details of the Fund and access to the PDS and application form, follow this link http://www.maninvestments.com.au/manahlalpha/adv/canopus or Contact Canopus info@canopus.co.nz or telephone (09) 444 8055 for a copy.

### 4.2 Man AHL Gold (AUD)

An investment targeting the AHL Diversified program and gold.

Contact Canopus info@canopus.co.nz or telephone (09) 444 8055 for a copy of the prospectus.

## 5. Strategy

With little to reason to revise our "lower for longer" view on interest rates, our strategy of picking up medium term good quality bonds giving reasonable yield, when available, should continue. Over the past two years the strategy has provided us with yields above market as well as marginal capital gains.

Strength of the October rebound in US equity markets on the back of renewed margin positions may force us to re-evaluate our extremely cautious approach towards share purchases maintained over the past half year. Logically the early October sell-off could have further to run but the vast amounts of QE money available to traders and speculators in the US puts prospects of another imminent steep decline in doubt. To date these buyers have correctly assumed the US Fed will come to their rescue if times get tough. Staying aside from markets altogether may well mean missing out on growing dividends and share values for portfolio investors.

Our diversified income and growth portfolios both achieved minor growth in September despite steep falls in the ASX and US equity markets. Figures for October to date indicate a similar rise in portfolio value is likely this month. Making income an important consideration in any asset purchase helps reduce volatility in portfolio valuations through removing dependency only on capital values for growth.

Click this link to see charts http://www.canopus.co.nz/investment_advice.html#returns

Some of our portfolio owners have requested an allocation of shares in the Australian Government sale of state-owned Medibank Private, Australia's largest health insurer. The IPO was open to Canopus clients through our NZX broker ASB Securities and its parent, Commonwealth Bank of Australia, appointed Co-Lead Manager for the Offer. New Zealand investors can participate only through broker firm offers but demand has been high and applications are likely to be scaled. Positives for the float include access to the huge Australian health care sector, a sector with substantial growth opportunities, low capital requirements for this type of business, a reasonable dividend yield (around 4.3% cash yield), no debt on the balance sheet, a high return on equity, potential for operational cost savings and ongoing Government support for participation in private health insurance. The Australian Government will sell all 100% of its shares, freeing the Company from direct political interference.

Negatives include a wide indicative price range for shares, from A$1.55 to a maximum of A$2.00, with the final price being based on an institutional book build and unknown to private applicants before the offer closes. Reported heavy demand means the final price should be near the top of the range. The health insurance sector is heavily regulated and will remain vulnerable to future political policy changes. New Zealand investors will be unable to claim the expected taxation franking credits and will be exposed to exchange rate risk. Medibank Private will deplete its coffers by paying the Australian Government a special dividend of A$196.8 million prior to the float. The Australian Government reserves the right to reclaim up to 20% of broker allocations following completion of the bookbuild. A lot of "heads we win, tails you lose" conditions in this float.

Nevertheless this IPO seems to follow the rule that the best share floats are the ones you can't get hold of. Any allocations received should be positive for portfolios.

We will be giving the Orion Health IPO a miss. The Company may well have prospects and the great bulk of funds raised will go into Company development – not into the pockets of existing shareholders. However, an IPO that can't manage any sort of financial forecast as to profitability and dividends is of no use to our portfolios. A pig in a poke.

To discuss building a diversified, low volatility personal investment portfolio designed to produce income, growth or a combination of both, contact me by email at alan@canopus.co.nz or telephone 09 444 8055.

Please note – Canopus does not pool investor funds. Each Canopus investor is treated as an individual with a personal customised investment portfolio being built to suit each individual's requirements. Investments are registered in your own name greatly enhancing returns, security and transparency while providing access to valuable special issues and minimising management fees. Individual voting rights attached to securities are retained by the investor. Uncommitted portfolio cash is held in the investor's own personal bank account with full online banking facilities. High liquidity of investments means the investor has ready access to funds if needed. Ultimately, the investor remains in control of the portfolio.

Regards,

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Financial Adviser Disclosure Statement available on request, free of charge.