As outbreak rages, a value investor practices calm

Monday fundie It pays to keep things in perspective.

Vesna Poljak

Nathan Hughes started investing at age 18 when his life's passion for football made way for a new obsession: balance sheets, moats and intrinsic value.

"I started reading everything I could, naturally you start off with [Warren] Buffett but then [Peter] Lynch, Phil Fisher's book *Common Stocks and Uncommon Profits*, that sort of stuff. It was just something I found myself enjoying more and more," he says.

Hughes worked in accounting and after about seven years applied for a role at Perpetual in distribution and sales support. His big break came later when he was picked for the investment analyst program, open to anyone in the business, which concludes with a presentation to the investment team.

From there, he got an opportunity to join the dealing desk, progressing to managing small caps and now overseeing the ethical fund.

Promoting from within is a key part of the Perpetual culture. "A lot of our portfolio managers today have been with us for a very long time," he says.

Head of equities Paul Skamvougeras also got his start on the dealing desk "many, many, many years ago with Pete Morgan," recalls Hughes – now approaching 10 years at the firm.

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A value stock isn't necessarily a stock with a single-digit price-to-earnings multiple, says Perpetual's Nathan Hughes. PHOTO: LOUIE DOUVIS

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As outbreak rages, Hughes stays calm

"We've got a good history of bringing people through the business."

Growing up in Engadine, in Sydney's southern suburbs, Hughes' career could have taken an alternative path: he represented Australia in soccer at under-17 level in 2003.

"It's so long ago now," he says quietly. "But I'm very proud of it."

Hughes came from a generation of players who had to straddle the transition between the end of the National Soccer League and the introduction of the A-League. "I changed tack, went to uni and it worked out for the best."

Speaking to *The Australian Financial Review* last Monday in the thick of the COVID-19 outbreak, Hughes is a picture of calm. "The reality is the market had such a great performance last year, it was all driven by valuation re-rating rather than earnings growth," he says.

"Last week was a really bad week, one of the worst performances in 10 years or so, but we're coming from a

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really high level. It's just important to have that perspective."

Perpetual's value-oriented philosophy means Hughes' stocks have been spared the full force of the market's angst, which is targeting more speculative and unproven businesses.

Anything with a lot of debt is vulnerable. "We're looking for things with good balance sheets and good market positions," he says. "A good balance sheet's really important to us. A balance sheet with optionality can provide you with the ability to do things when your competitors can't. And also protect against dilution. If your balance sheet's stretched and you need to raise capital at a heavily discounted price, then you dilute away future returns."

He's unsure, though, that value and growth are as different as they're made out to be. He wants to own companies which are growing, he just doesn't want to pay a crazy multiple to own them. "There's a bit of a quality-at-any-price mentality." A value stock isn't necessarily a stock with a single-digit price-to-earnings multiple, he emphasises.

"We would say that some valuations have gone too far, too far, and leave very little room for error. All investing is probabilistic, but when you're paying such a high price to begin with, sometimes the odds aren't skewed in your favour."

AUB Group is a stock he likes. "At the moment they're growing on an underlying basis high single-digit to low double-digit earnings," he says. "The market environment for them is favourable given commercial insurance premiums are up circa 6 to 7 per cent, which is good for their broking revenues."

The earnings season ruled off in February was soft, Hughes says, and probably one of the weakest in a long time.

Lease accounting confused a lot of people, he believes, and there was a greater emphasis on "underlying" earnings he's not really comfortable with.

He does own Event Hospitality, which he expects will have a tricky half as a result of its hotels business experiencing weak tourism activity. "Again, it's got a really strong balance sheet because they own a lot of property and the stock's actually trading below the asset backing of that property, despite having a few other divisions on the side.

"The near term's obviously going to be tough, but this is a business with a very long history, pays a healthy dividend … and has grown opportunistically through cycles when things have been tough before."

With his ethical screen, he has naturally gravitated to the mid- to small-cap end of the market (he can't own gaming, alcohol, fossil fuels, tobacco or weapons businesses).

Novated leasing provider Smartgroup is another one he owns, heavily sold-off from an earnings downgrade, but where the medium-term picture looks more flattering than the near term.

"The stock's on 10 times earnings, almost a 9 per cent free cash flow yield, [and] an ability to pay the vast majority of that out, because the ongoing capital requirements are quite low, and we think that's pretty compelling in today's environment," he says.

All of Smartgroup's risks were known to the market when it was trading as a market darling on 20 times earnings. "In a fundamental sense, the business hasn't changed and yet the multiple's halved." That, Hughes says, is value investing.

In soft commodities, a vital crop insurance contract has taken a lot of volatility out of GrainCorp's business, Hughes says, which at current prices "we're not sure that's fully appreciated by the market".

The real attraction is its malting business, which is on track to be split from the group. But the cyclicality of the residual GrainCorp business, which is the minority component of the valuation, has arguably blurred the visibility of the soon-to-be independent business.

At least the return of rain will help the sector, including Bega Cheese, where Hughes is optimistic it can deliver improved earnings. "There are a few levers available to them which can drive earnings without relying on an easing in milk price competition, namely the commissioning of the Koroit lactoferrin plant and a cost-out program, which will both contribute to 2020-21."

Companies are getting better at guiding the market, he says. "Are the earnings that companies say they're making being converted into cash flow? We're looking at things like provision utilisation, whether it's in receivables, inventory or on the liabilities side of the balance sheet."

Perpetual's process is all about the financial statements, he says.

Returning to his other life's passion, Hughes thinks this Liverpool side is the best he's seen in his lifetime. Liverpool are within three wins of their first league title in 30 years.

"They've got the best goalkeeper in the world, the best central defender in the world. Probably being biased, two of the best full-backs. And a front three – in the past we've had one, like we've had a Torres, we've had a Suarez – but collectively as a unit, I think it's probably the best front three we've had."

Best player? "Steven Gerrard, without a doubt."

Sport's a lot like investing, Hughes says, finding cheap players relative to what they're worth. "Selling Torres was horrific at the time, but it was probably a great piece of business. Selling Coutinho for £140 million – or whatever it was – great piece of business. On the other side, we've bought Alisson and van Dijk, paid up huge sums of money for both of them, but I think they're worth every pound or more."

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