COVER STORY


Marcus Hughes of LHC Capital

# No Worries

An Australian hedge fund is enjoying 20%-plus returns with an unusual local strategy—no mining stocks.

PHOTOGRAPHY BY CHRIS GLOAG

**by Eric Uhlfelder** One early investment of the LHC Capital Australia High Conviction fund wasn't all that unusual for a Sydney-based firm: It bought a stake in a mining company that seemed poised to offer big returns. With gold prices rising in 2011, the hedge fund bought shares in **Teranga Gold,** which had a cheap stock price and proven reserves in Senegal. A bank had insisted that Teranga have a sizable hedge against a fall in gold prices as part of a financing package to build a refining mill. With the project nearly done and the expensive hedge about to expire, Teranga was expected to enjoy a jump in free cash flow, enabling it to pay a big dividend. But Teranga's executives abruptly changed course, redirecting the cash flows toward more—and by LHC's reckoning, riskier—exploration. By March 2013, with gold prices headed south, LHC sold out at a 45% loss.

Teranga (ticker: TGZ.Australia) was the last mining stock that LHC partners Marcus Hughes and Stephen Aboud ever owned. Abstinence has worked out pretty well.

Today, they run a $195 million hedge fund that has had annualized gains of more than 23% since its May 2011 launch, in part because they avoided the meltdown in commodity prices. They've profited by buying mostly small-cap Australian stocks, many with growing worldwide businesses, whose intrinsic value, they believe, far exceeds their share price. Hughes and Aboud employ a concentrated strategy, holding only 10 stocks and actively shorting others. They use index and stock puts to hedge the portfolio and help manage risk.

Although foreign investors often view Australia as a collection of giant mining companies powering China's development, LHC's returns show the country to be more than that. Mining shares make up only 10% of the Australian market's free float. Financials constitute nearly half of the market valuation, with industrial, health-care, consumer-staples, and telecom stocks all substantial sectors.

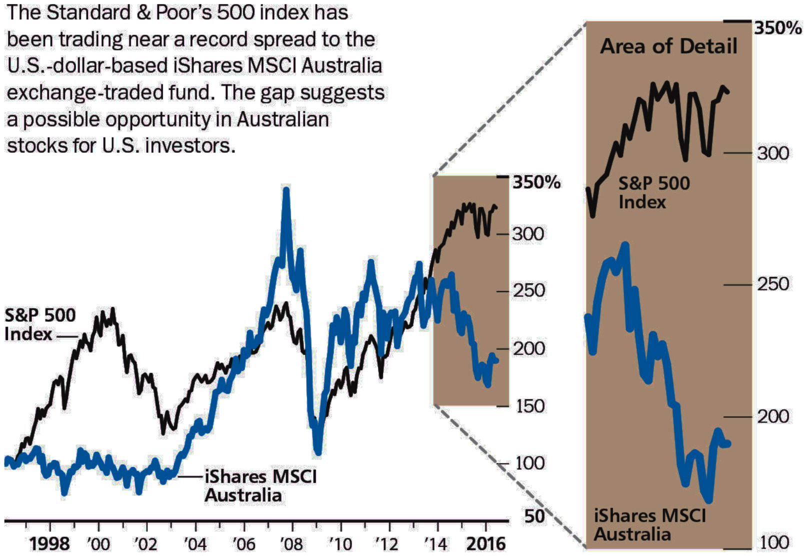
Even as China pivots away from construction, Australia should benefit by providing it with services and consumer goods. The island continent has enjoyed 25 years of uninterrupted growth, and the International Monetary Fund forecasts a 3% expansion of gross domestic product in 2016 amid low inflation. "Moreover, Australia is home to some very well-managed and increasingly globalized companies," Hughes told *Barron's* in an interview from London, taking a break from a recent vacation. The companies' ventures abroad are important in a country with a population of just 24 million.

The Australian market is of particular interest right now, because the gap (see graphic below) between the U.S. Standard & Poor's 500 index and the Australian market, as measured by the U.S. dollar-based **iShares MSCI Australia** (EWA) exchange-traded fund, has rarely been wider.

**Australian native Aboud** founded LHC and hired Hughes as partner in 2012 to do fundamental, bottom-up research.

## An Opportunity in Australia?

The Standard & Poor's 500 index has been trading near a record spread to the U.S.-dollar-based iShares MSCI Australia exchange-traded fund. The gap suggests a possible opportunity in Australian stocks for U.S. investors.




Source: Thomson Reuters

## Up Top, Down Under

The concentrated LHC Capital Australia High Conviction fund has had stellar returns in tough local market conditions and beaten hedge fund peers.

| | Total Returns* | | |
|---|---|---|---|
| Investment | 1-Yr | 3-Yr | 5-Yr |
| LHC Capital Australia High Conviction** | 20.96% | 26.82% | 23.23% |
| Barclay Equity Long/Short Index | –2.54 | 3.78 | 3.43 |
| S&P/ASX 200 Index** | –2.38 | 7.71 | 7.54 |

*Thru May 31, 3 and 5 year annualized. **In Australian dollars.

Sources: BarclayHedge, Standard & Poor's

"I'm geared to short-term, dynamic trading," says Aboud, "where Marcus is very good at quickly discerning the larger picture and trends."

Hughes credits his days as a competitive chess player for nurturing his stock-picking ability. "Being able to imagine a half-dozen moves ahead while anticipating your opponent's response is essential" in chess and helps in analyzing a company's course, too, he explains. As a child, he won the South Wales junior chess championship.

Hughes, now 37, ventured abroad early in his career, working in London at UBS and Citadel Investment Group, where he was a portfolio manager on the event-driven equity team and got experience running a concentrated portfolio. Later, he returned to Sydney, where he managed both global and domestic portfolios at Caledonia Investments.

Aboud, 53, has spent more than 25 years working in the Australian markets at firms such as Macquarie Group and Deutsche Bank. Prior to creating LHC, he spent a dozen years at Lowy Family Group, the family office and private-investment business of one of Australia's richest families. Lowy gave him the opportunity to help manage a high-conviction Australian portfolio. Aboud found that limiting the number of holdings improved portfolio management and performance.

LHC Capital's professional staff of six targets stocks with market values of under one billion Australian dollars (US$751 million), because their prices tend to suffer from structural inefficiencies, according to the managers. The reason: low liquidity due to lack of interest from institutional investors and scant coverage from analysts at brokerage firms.

Disciplined stock selection is vital to the fund, whose clients are family offices and high-net worth investors (the managers' own investments are 5% of the fund). Any addition to its general 10-stock limit requires a corresponding sale. Positions are gradually raised from 5% to 15% as conviction grows about the shares' outlook. The typical investment horizon is three to five years, but LHC doesn't hesitate to pull the trigger if its investment thesis breaks down.

**Despite owning** smaller stocks, LHC's returns haven't been very volatile. In local-currency terms, they've been only half of its overall 20%-plus annual gains. Its worst drawdown of just 8% was less than half that experienced by the S&P/ASX 200 in the years following the financial crisis. Because of its narrow focus and lack of commodities, LHC delivers performance that's relatively uncorrelated to the Australian stock market (just 0.24). The fund's management fee is 1.5%, and it gets 20% of the gains. Minimum investment in the local fund is A$500,000, though there are offshore options in U.S. and Australian dollars.

Health care has been a drag on most portfolios of late. But Adelaide-based **Mayne Pharma Group** (MYX.Australia), a global specialty manufacturer of patented and generic drugs, has been a huge winner for LHC. The co-managers first became interested in the company, which had a market valuation of just A$55 million, in mid-2012. Then, that October, Mayne announced plans to buy Metrics, a North Carolina–based contract developer and manufacturer that was twice its size. "This was a game changer," says Aboud.

Mayne wanted to use Metrics' scale, expertise, and relationships with big U.S. drug makers to help it win more generic-drug-making opportunities. Mayne's free-cash-flow margins have tripled since the acquisition. The stock has risen fivefold in that time, and LHC still has 10% of its assets in it, believing there's more upside.

Targeting government, universities, and small and midsize companies, Australia's largest enterprise-software development company, **Technology One** (TNE.Australia), is the nation's "version of **Salesforce.com** [CRM]," says Hughes. The Brisbane-based company is displacing part of **Oracle**'s (ORCL) and **SAP**'s (SAP) foothold in the Asia-Pacific region and the United Kingdom with cheaper, more flexible, and more intuitive cloud-based software for its smaller clientele. Technology One now has 1,000 customers in six countries. They allowed the company to grow its revenue at a 10% annual rate over the last six years and its pretax earnings at about 15% per annum.

In all, Technology One, which had a market value of A$420 million when LHC bought shares in late 2012, has nearly quadrupled in price since then. Although the hedge fund has taken some profits, it continues to devote about 5% of its assets to Technology One.

LHC Capital shifted its focus to large-cap securities to bet against the four biggest banks in the country, **National Australia Bank** (NAB.Australia), **Commonwealth Bank of Australia** (CBA.Australia), **Australia & New Zealand Banking Group** (ANZ.Australia), and **Westpac Banking** (WBC.Australia).

Early last year, the stocks were selling at record price-to-book ratios, yet property loan growth was expected to fall as new limits to foreign inflows of money came into play. Banks also were adopting new international regulations that would raise their capital requirements. Hughes and Aboud thought the banks would have to sell more shares to raise money to meet these new guidelines and sustain their high dividend payouts. Issuing more stock would dilute shareholders and send share prices lower.

They were right, and within six months, they walked away with gains that boosted the fund's value by 2%.

Hughes concedes that LHC's first five years have gone better than even its partners could have hoped and that its returns may eventually gravitate back toward their 10% to 15% annual target. But it's also possible that foreign countries like China will shift their purchases from commodities to software and services, and that other nations, including the U.S., will discover that Australia can produce more than iron ore and gold ingots. ■