

# economic & investment horizons

Grant Thornton 

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## The fear of the unknown

As investment managers, it is our responsibility to identify worrisome trends and be appropriately positioned for the infinite “what ifs”. We are engaged to identify and manage the risks that are inherent within investment markets in order to create and protect wealth for our clients. Because of the seriousness with which we take on this responsibility, we become concerned when we see unregulated and complex markets such as hedge funds and credit derivatives representing trillions of dollars of unchecked financial positions. These unregulated markets, while seemingly far removed from our blue-chip portfolio investments, can create systemic failures across global markets. In fact, the potential collapse of just one key hedge fund has been ranked by the European Central Bank (ECB) as serious as a bird flu pandemic in its ability to create financial disruption. So why are we concerned?

### Hedge funds

True to their overall nature, the activities of hedge funds are undefined and varied. They use derivatives and high-risk strategies with the aim of generating high absolute returns. Hedge funds can be dangerous not only because they are highly geared and lack transparency, but also because many of them now follow similar strategies to each other. They therefore respond in the same way to changing market conditions and exert an even greater “herd-like” influence.

### Credit derivatives

Often used by banks, credit derivatives resemble insurance in that they provide banks with protection against default amongst those they lend to. These products, the global value of which is greater than \$17 trillion, create two immediate problems that then lead to longer-term risks. They encourage banks to lend more than they otherwise would to riskier borrowers, thereby fuelling credit expansions that can lead to market crashes. In addition, their lack of transparency, even to insiders, causes Warren Buffet to describe them as “financial weapons of mass destruction”.

### Risk upon risk

And who are some of the larger holders of these “financial weapons of mass destruction”? Hedge funds. And with these two highly leveraged markets interlinked, the risks are further multiplied.

As we often say, everything is fine until it is not. While the world is still awash with liquidity, the financial systems will continue to support these high-risk products. But if the hedge funds and other providers of these credit derivatives decide to “fly to safety” and withdraw from these markets, thereby causing a credit crunch, only then will investors truly understand the nature of the risk. While difficult to observe, it is inherent and of great concern. We increasingly view an implosion of credit risk and associated derivative risk as less of a “what if” and more of a “when”.

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## Telstra, a big...?

Telstra (TLS) is a vast business with an undeniable position of advantage in the Australian telecommunications business. It brings together an integrated collection of businesses encompassing:

- Broadband (Bigpond)
- Mobile
- Advertising (Sensis/Yellow)
- Fixed line (Telstra)
- Pay TV (Foxtel to 50%).

Telstra holds a leadership position in each of these categories. To a large degree as a result of the fundamental advantage of market leadership, TLS is highly regulated. Unfortunately the present regulatory regime and political policy is not suited to long-term investments (>3 years) and a telecommunications landscape which is experiencing ongoing "tectonic" shifts.

Telstra's ultimate value is its vast market share (that is, customers). We see an inevitable situation whereby the infrastructure assets are split from the distribution and marketing business, leaving two distinct business units. Combined with this, the government, both in its policy setting and mandating of the ACCC, needs to address the issues of:

- Access by competitors to TLS infrastructure
- Where access is granted, pricing that provides TLS with acceptable risk returns and
- Rural and regional telecommunications strategy whereby the government acknowledges that geographic differentials require subsidy.

Telstra executive management is itself not immune from review, particularly in regard to an improvement in its strategy

for the future and implementation of its transformation program. Rhetoric is unimportant in the context of the scale of the TLS business and the challenges it (and all other telecommunication providers and policymakers) faces.

## T3 position

Apart from normal portfolio activity in accordance with our stated programs and framework, we will not be participating in the T3 offer at the institutional or retail firm offer level.

We will only use current holdings and entitlements to fine tune existing positions. T3 represents a structured finance vehicle over the top of existing Telstra share capital. We have no reason to believe that the market will do anything but efficiently price T3. Accordingly we see little value in participating in T3 on the basis proposed by the Commonwealth.

## Transfield Services Limited "Serving up results"

Added to the Grant Thornton Investment Management (GTIM) domestic equity portfolio more than three years ago, Transfield Services Limited (ASX:TSE) continues to be a key contributor to the performance of the equity portfolio.

### The business

TSE's business model is split into two key segments: services and infrastructure.

**Services** Predominantly, TSE is a leading international provider of operations, maintenance and asset and project management services. For example, the company provides fundamental plant and machinery maintenance support to mining, infrastructure and defence industries. Long-standing customer relationships are held with the likes of BHP Billiton, ExxonMobil, Caltex and the Australian Department of Defence. Services operations span Australia, New Zealand, South East Asia, United Arab Emirates and Qatar, with recent acquisitions further expanding business into North America.

**Infrastructure** Through its infrastructure segment, TSE holds significant equity interests in key Australian power stations and water treatment plants. The company aims to pool infrastructure assets into a fund to be listed separately on the Australian Stock Exchange.

### The financials

Sustained positive results and a well-defined growth strategy have helped the company noticeably outperform the All Ordinaries

index since 2003, as highlighted by the accompanying graph. Continuing the positive trend, results for the year to 30 June 2006 saw after-tax profit rise 35.7 per cent to \$55.6 million, with strong growth across both the services and infrastructure segments.

### The future

TSE continues to position itself for future growth opportunities both domestically and abroad and is valued as such by the market. Creation of an infrastructure fund and the recent \$270 million rights issue will enable an overall reduction in debt – an important ingredient in facilitating their strategy of controlled growth.

Transfield Services Limited vs All Ordinaries Index

