

CASE STUDIES IN FINANCE (FIN3CSF), SEMESTER 2, 2016 – TUTORIAL 2

CASE STUDY 1 – PORTFOLIO CONSTRUCTION

Assessment allocation across the components for Case Study 1:

- Outlining of investment strategy for the portfolio – 6 marks
- Description of the portfolio components – 9 marks
- Explanation of the relation of the portfolio components back to underlying investment strategy – 5 marks
- An assessment rubric / marking guideline will be provided on the subject LMS site

Approach to formulating the investment strategy

Lecture 1 outlined a range of investment approaches and strategies. Wanted you to think about these sorts of approaches and develop a strategy which you think will meet the requirements of the client

Advice:

- There is no necessary right answer or preferred approach or strategy
- Recommend avoiding a bottom-up (fundamental analysis) strategy, mainly because this requires a substantial amount of firm-level analysis
- Better approaches might be based on a top-down analysis focusing on overall market expectations or sentiment, or linking economic indicators to identify preferred markets or industries to focus investment on
- A screening approach based on one or more indicators, although this may require you to locate additional firm-specific attributes
- An approach based on historical firm or wider market price trends or movements

Examples:

1) Observation that the US market is at an all-time high value whereas the Australian market has yet to recover pre-GFC market index levels

- May indicate that the US market is expected to underperform in the near future and the Australian market might relatively outperform
- Although a momentum strategy might be consistent with the reverse belief
- Investment actions based on the first expectation:
 - Buy large-weighted shares in the S&P/ASX 200 index
 - Buy shares in the Argo Investments LIC which provides diversified exposure to the ASX 200 index
 - Buy units in the Vanguard Australian share index ETF
 - Buy futures contracts on the SPI 200 or SPI 200 call options
 - Short-sell shares with exposure to the US market, such as construction companies such as Boral, CSR and James Hardie, QBE Insurance Group which invests in US Government bonds and Westfield which owns shopping centre properties in the US
 - Short-sell ETFs focused on the US market

2) Expect that the recent decision by the Reserve Bank of Australia to cut the official cash rate to 1.5% will further stimulate demand for lending and increase the lending activity of banks, resulting in an increase in interest income and increased bank profitability

- Investment actions based on this expectation:
 - Buy banking firms such as Commonwealth Bank, Westpac Banking Corp, ANZ Banking Group and National Australia Bank, Bendigo Bank, Bank of Queensland
 - Buys shares in the bank-focused Milton Corporation LIC

3) Interest cut rate in 2) might also be expected to result in a depreciation in the Australian dollar

- Investment actions based on this expectation:
 - Buy shares in export-based companies, such as Graincorp, iron ore mining companies such as BHP Billiton, Rio Tinto and Fortescue Metals Group
 - Short-sell import-based companies such as Harvey Norman and JB Hi-Fi
 - Buy ETFs based on overseas currencies, such as BetaShares US dollar or BetaShares Euro ETFs

4) China continued growth strategy

- Investment actions based on this expectation:
 - Buy shares with exposure to China activity such as iron-ore exporting companies (BHP Billiton, Rio Tinto, Fortescue Metals Group), vitamins (Blackmores), casinos (Crown Resorts), wine (Treasury Wine Estates)
 - Buy shares in the Platinum Capital LIC, which has an Asian focus
 - Buy shares in an international ETF, such as the Vanguard MSCI World index

5) Company turnaround strategy, based on identifying companies that have experience large share price falls resulting from profit downgrades, management departures, adverse announcements or bad investment decisions

- Investment actions based on this expectation or strategy
 - Buy shares in companies that have experienced large share prices over the last few years, such as Woolworths, Ansell, BHP Billiton, Flight Centre, Santos

6) Screening strategy based on creating a diversified portfolio of large companies

- Investment actions based on this expectation:

- Buy shares in the largest firm in each GICS Industry sector, such as Commonwealth Bank, CSL, Macquarie Group, Wesfarmers, Westfield, Woodside Petroleum, Telstra Corporation, Qantas Airways, QBE Insurance Group
- Short-sell shares in the WAM Capital LIC, which is focused on smaller companies

7) Price momentum strategy

- Investment actions based on this strategy:
 - Buy shares in firms at or near their all-time high prices at the current point in time
 - Short-sell shares at or near their all-time low prices currently

Investment Portfolio Construction

Need to outline:

- Individual company shares being long purchased, including the number of shares multiplied by the current price
- Individual company shares being short-sold (if any), including the number of shares multiplied by the current price – note this will effectively be an inflow to the portfolio and will increase the total investable amount, but also requires a cash holding for position coverage
- Individual LIC or ETF purchases (or short-sales), including the number of shares/units multiplied by the current price
- Hedging exposure, using future contracts or index options, for the Australian direct share component (sum of long share purchases net of short-sales positions), which is required to be a minimum of 50% of the value of the direct share component
- Any other investment positions in futures contracts or index options
- The desired or required cash holding position

Explanation of individual investment components

Based on the sample portfolio shown in Tutorial 1:

Summary strategy based on:

- Positive global market sentiment based on Australian Federal Election completion, decline in Brexit uncertainty effect and US sharemarket strength
- Individual share price momentum defined based on one-year price increases greater than +45% or price declines greater than -20%

Explanation for equity share purchases:

- Based on the calculation of percentage share price changes from 01/07/2015 to 01/07/2016
- Identification of share price changes greater than 45%

Share price increases > 45%	
Company	Percentage price change
Bluescope Steel	$(\$6.47 - \$2.93) / \$2.93 \times 100 = 120.82\%$
Fortescue Metals Group	98.36%
Newcrest Mining	88.53%
Treasury Wine Estates	87.75%
Domino's Pizza Enterprises	86.61%
Aristocrat Leisure	72.08%
Cimic Group	63.40%
REA Group	49.76%
Vocus Communications	49.73%
Cochlear	48.44%

Explanation for equity share sales (short sale positions):

- Based on the calculation of percentage share price changes from 01/07/2015 to 01/07/2016
- Identification of share price decreases greater than 20%

Share prices decreases > 20%	
Company	Percentage price change
Santos	$(\$4.63 - \$7.002) / \$7.002 \times 100 = -33.88\%$
BHP Billiton	-28.37%
Ansell	-23.92%
Woolworths	-23.41%
Woodside Petroleum	-23.14%

Explanation for LIC and ETF purchases

Platinum Capital LIC

- Diversified exposure to global sharemarkets including the UK and US to benefit from expected overall positive international sharemarket performance in the near future

WAM Capital

- Diversified exposure to Australian companies, and particularly smaller companies based on the equity share purchases and short sales being smaller and larger companies, respectively, in the ASX Top 100

SPDR S&P/ASX 200 ETF

- Exposure to movements in the Australian sharemarket based on the largest 200 companies by market capitalisation, to benefit from the expectation of overall positive Australian sharemarket performance following the finalization of the Federal Election process

iShares S&P 500 ETF

- Exposure to movements in the US sharemarket based on the 500 largest companies included in S&P 500 index, to benefit from the expected continued positive US sharemarket performance in the near term

BetaShares Gold Bullion ETF

- Exposure to the gold price, to benefit from an expected continued near term gold price increases, also supported by the substantial share price increase in Newcrest Mining in the last year

Explanation for Hedged Position

Direct share investment on the ASX = \$664,704 - \$145,790 = \$518,914

One SPI 200 Futures contract value = $\$25 \times 5,336 = \$133,400$

Requirement to hedge at least 50% of your direct share portfolio

- Decision was made to hedge 100% of the share portfolio value
- Number of futures contracts required = $\$518,914 / \$133,400 = 3.89$ (rounded to 4)
- Sell 4 December 2016 futures contracts, which will increase in value if the S&P/ASX 200 index falls in value
- Cost is the \$10,000 margin requirement per contract = $4 \times \$10,000 = \$40,000$

Explanation for Cash Holding Position

Main requirement is to provide sufficient cash to cover the short sales position = \$145,790

Remaining balance is to meet the full \$1,000,000 portfolio investment requirement.