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Sohn Hearts & Minds 2017: The best ideas of the top investors

Blake Henricks from Macquarie Asset Management tips a plumbing industry disruptor. Daniel Munoz

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Geoff Wilson, Wilson Asset Management

Long Virgin Australia (VAH:ASX)

Wilson Asset Management chairman Geoff Wilson had the crowd stumped when he introduced his diamond in the rough as an ASX-listed company with $5 billion of revenue, a $1.9 billion market cap, but left behind by the market. The intrepid fund manager revealed his discovery was Virgin Australia Holdings: "Arm the doors, cross check, and be ready to take off."

Wilson says Virgin is on track to extract close to $1 billion of costs via annualised savings of $350 million over three years. "They're doing what Qantas was doing two-and-a-half years to three years ago." More importantly, much of those savings - 70 per cent - will flow through to the bottom line. Virgin will be in an earnings upgrade cycle for the next 12 months at least, and those profits have already been starting to flow through.

Hamish Douglass, Mike Cannon-Brookes, Ramez Naam, Bobby Yazdani, Joe Lonsdale and Mark Nelson during the Hearts and Minds conference at the Sydney Opera House. Daniel Munoz

As for the growing and profitable loyalty program Velocity, Wilson values it at 30 per cent of the airline's current market cap - a "hidden gem". The bigger picture is a privatisation, nominating a time frame of two years, "the icing on the cake". The China factor is a big deal, with 120 million Chinese travelling internationally last year, but only 1.1 million to Australia. Here, Virgin has strategic relationships.

A hand raised in the audience wanted to know Wilson's view on Virgin management (Yes, it was John Borghetti asking). "There's good and bad about management," Wilson responded. "You've achieved what everyone believed was impossible," referring to withstanding the price war, recapitalising the company and winning business market share. Just as he was getting to "the bad side", Wilson was escorted off stage by Virgin cabin crew.

Matthew Ryland, Greencape Asset Management

Long Speedcast (SDA:ASX)

The Melbourne-based equity fund is backing the company that provides internet connectivity to remote locations such as ships, oil rigs and to the military.

Ryland says the $1 billion ASX-listed company is a market leader in a $100 billion market of which it has less than a 10 per cent share, giving it a "big runway to grow."

A recovery in the oil price should increase demand from oil rigs, improved global trade for ships, global tensions for military contracts, higher expectations from cruiseline passengers.

Ryland says the stock which has a short interest of about 5 per cent and trades at $4.60 is undervalued at 13 times forward earnings even though its growing twice as fast as the average ASX-listed stock. He sees more growth and analyst upgrades pushing the stock towards $7.00.

Raphael Arndt, chief investment officer, Future Fund

Idea – Stay flexible

Dr Arndt says there are five mega trends driving economies and markets at the moment.

1. The end of the leveraging tailwind as global debt levels peak. With less debt in the world asset prices will have less support
2. Declining populations. As debt levels have risen so to has the world's population supporting growth. But as that peaks once again economic growth and asset prices will lose support .
3. Income Inequality – The impact of globalisation, technology and low interest rates have made the rich richer and lifted incomes in the emerging markets. But the working class in the developed world has lost out, and that will result in more populist policies that are bad for growth.
4. The workforce is changing. Millennials account for a third of the workforce and by 2025 they and those younger than them will account for two thirds. They consume, interact and work differently.
5. Technological adoption is changing. Consumers are embracing new technology which is accelerating disruptive effects.

So what can we do about it?

Dr Arndt says the past is not predictive of the future, so investors need to think ahead.

It also helps to remain flexible to best respond to threats and opportunities. The Future Fund holds 20 per cent of its portfolio in cash so it can adjust to a new and uncertain world.

Dr Arndt says investors need to focus on the "value add" – by investing in useful property and infrastructure that is needed – such as residential property near universities, wind and solar farms and small businesses that need capital to grow.

He also advises to look for returns that are uncorrelated to equity markets that will bear the brunt of these mega trends.

The fund has $20 billion invested in hedge funds that deliver returns not correlated to equity and $2.5 billion in venture capital because "good ideas always have value even if market fall.

Robert Luciano, VGI Partners

Short Pandora (PNDORA: CPH)

Pandora's charm bracelets are as much a fad as fidget spinners, Crocs and lava lamps, says Luciano, who defines a fad as a product that sees a rapid rise in popularity followed quickly by a steep decline. "Fads make great shorts but you need to get the timing right," the fund manager said. A fully loaded bracelet costs $US800 even though the jewellery is made in Thailand.

"Pandora's seen very strong historical revenue growth," and the market believes the company can keep delivering. Pandora has higher margins than the best luxury brands in the world: higher than Hermes, Tiffany, Ferrari and LVMH. "This is remarkable and we don't believe it can be maintained," the VGI fund manager said.

He sees revenue growth slowing dramatically - a serious concern given the market's lofty expectations.

Luciano reckons that fewer people are doing Google searches for Pandora charms and visiting the web site. Amazon sells thousands of charms that can fit Pandora's bracelets. "What's Pandora doing? They're discounting. The best luxury brands, Hermes, Louis Vuitton, never discount. They would rather incinerate surplus stock than sell at a discount."

That discounting should see margins come under pressure if he is right. VGI also discovered "some shenanigans and a bunch of red flags". Management, Luciano says, is picking and choosing disclosures. "The smoke and mirrors gathered pace in 16;

they removed average selling prices."

Pandora appears to have also removed like-for-like sales growth and postponed their annual investor day. Underlying sales growth has turned negative, and "we view Pandora as a short and we see the stock price materially lower in 12 months time," Luciano concluded.

Blake Henricks, Macquarie Asset Management

Long Reliance (RWC:ASX)

One of Australia's top performing stock funds says there's 50 per cent upside to the manufacturer of sharkbite, which helps plumbers connect pipes.

Henricks says the market is pricing in the possibility that Reliance's top customer Home Depot will drop them after they sought to distribute their product through rival Lowes.

But he believes the probability is low given the popularity of the product which helps plumbers cut the time it takes to connect the pipes on a three bed room house from 6.5 hours (by soldering and crimping) to 1.5 hours.

Henricks says Reliance, which is over 100 years old, but developed the sharkbite product in 2004, can double its earnings over five years largely by increasing market share penetration.

That gives him confidence this plumbing company is the best growth stock in the Australian market.

"The plumbing industry has a problem and Reliance can solve it," Henricks says.

In the US, there are 500,000 plumbers but the average age is 58 years. In a decade there will only be 380,000 so we need innovative plumbing solutions such as sharkbite to make the few plumbers out there more efficient.

David Prescott, Lanyon Asset Management

Long NZMe (NZX)

In a world of overpriced assets, media company NZMe is a "cheap and rare opportunity", Prescott says, based on its unrivalled audience reach of 82 per cent of the New Zealand population. Lanyon says the decline in advertising revenue might shortly begin to slow, and notes that "advertising dollars follow eyeballs".

He argues the market may also have missed two potential "free options": One, editorial and distribution co-operation with Fairfax Media, publisher of The Australian Financial Review, which is appealing a regulatory ruling in relation to a proposed merger.

Two, the potential for success in employment, real estate and automotive online classifieds on which it is spending around $NZ10 million a year. Prescott say on their numbers, the company is valued at more than $NZ1.43 a share, compared to its 85 cents a share price.

Peter Cooper, Cooper Investments

Long TE Connectivity (TEL:NYSE)

The manufacturer of connectors and sensors is "a low risk turnaround" that could double from $US93 to $US180 if improves margins, takes advantage of growth opportunities and makes use of its strong balance sheet.

The $US33 billion ($43.6 billion) company was spun out of Tyco ten years ago and generates $US13 billion of revenue, split two thirds between developed and emerging markets.

Its target addressable market is $180 billion which means "they have plenty of room to grow"

Cooper says there are four golden rules in investing in low risk turnaround stocks – 1) a focus on management behaviour, 2) identifiable operating levers of improvement (TE's margins of 16 per cent lag its competitor Amphenol's of 20 per cent), 3) industry tailwinds (standard cars require $60 of senor products while electric cars require twice as much) and 4) it needs a great balance sheet.

Dawn Kanelleas, Colonial First State Global Asset Management

Long NextDC (NXT: ASX)

As on premise hosting fails to keep up with digital transformation, NextDC's services are in demand, Kanelleas says. The data centre provider offers scalability and flexibility to clients with respect to their information technology spending.

"They are able to flex that expenditure from sunk capital expenditure to operating expenditure," the fund manager explained, correcting an inefficient allocation of capital. Cloud providers like Amazon Web Services and Azure "prefer carrier neutral data centres" because their customers, like Netflix, "want connectivity choice".

"As investors we are attracted to NextDC's predictable and recurring operating cashflow which is underpinned by long-term customer contracts and their growing data demands. This recurring operating cashflow allows NextDC to confidently reinvest capital in more capacity given the growth in demand that I've been talking about," Kanelleas says, calling it a "very attractive investment". Finally, the fund manager sees "significant share price upside" from current levels.

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