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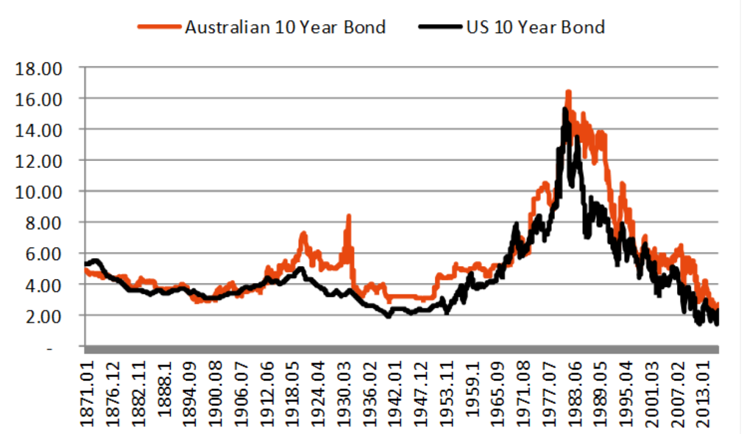
29th Nov 2016

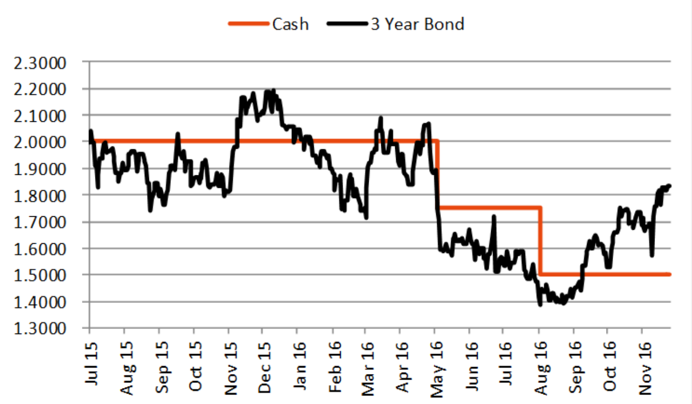
What to do at the end of the 35 year interest rate boom.

Dear Investor,
It is unusual for me to make grand macro predictions, let's just say I've been around long enough to know they aren't much use and are usually wrong. However, **I think that there is substantial complacency in today's markets (and by borrowers) around the risk of higher interest rates.** It's true equity markets have started to adjust, with sell offs in infrastructure and property stocks but I suspect this is far from over. For me the question is what should we be buying to profit from a change in this 35 year trend?
Lets look at the history of this boom.

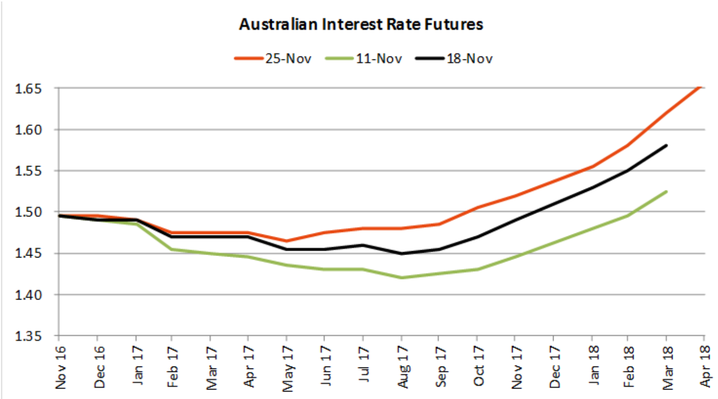
As the chart below shows, 10 year rates peaked around 1990 ("the recession we had to have" Paul Keating) and have been moving lower ever since.
(Chart Shaw Securities)



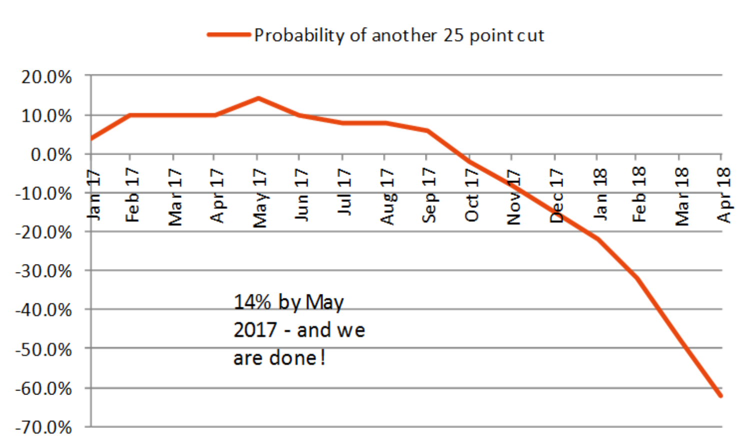
More recently, despite the cash rate remaining stable the 3 year rate has broken out and moved higher.
(Chart Shaw Securities)



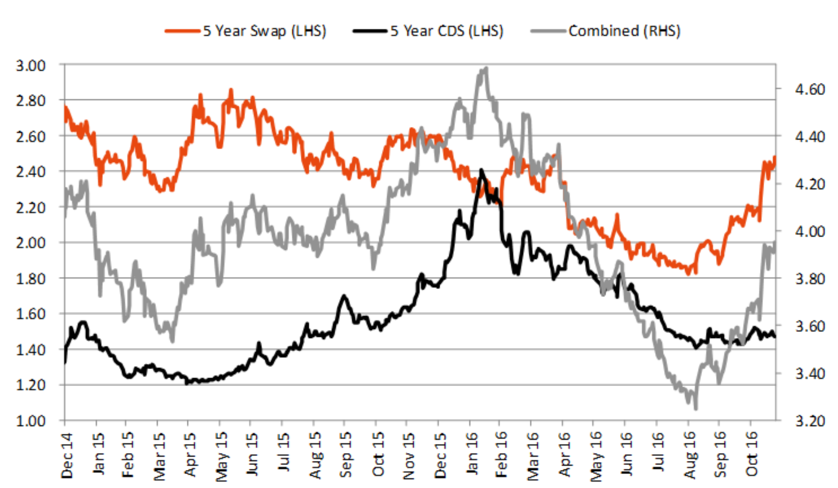
Futures markets have continued to steepen reflecting more investor certainty that rates have bottomed.
(Chart Shaw Securities)



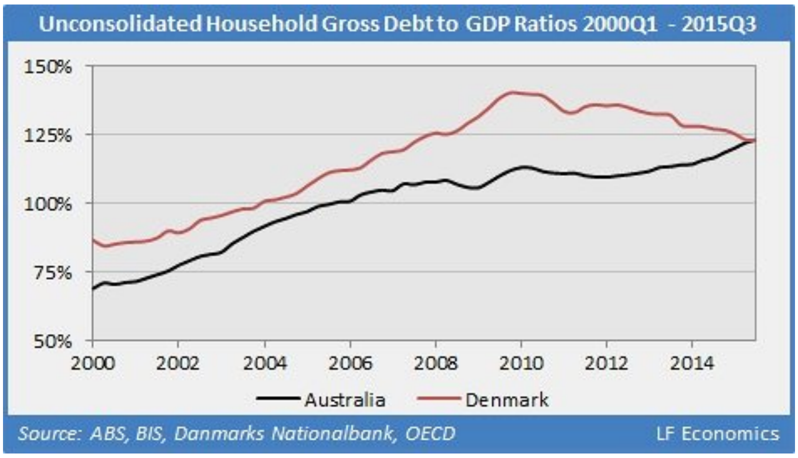
And subsequently reducing the chances of a further rate cut.
(Chart Shaw Securities)



As you can see below, even without a change to official rates in Australia, borrowing costs (for banks and others) are on the rise and it's only a matter of time before lending rates to you and me follow.
(Chart Shaw Securities)



Finally the context in which this falls is that both the Australian Federal Government and Aussie consumers are heavily indebted. As the chart below shows, Australians have the highest level of debt relative to GDP in the world. Consumers should be considering how they manage their financial situation in an environment of higher rates.



What's next?
While calling the end of a 35 year trend is fraught, it's fair to say that investing based on interest rates continuing their trend lower after the sort of fall they have already experienced seems like a poor risk/reward decision.
So what about an investment that will benefit from higher rates but is cheap at current levels and will most likely be a good investment no matter what rates do?

FSA is trading at around 10x this year's earnings and a dividend yield of around 6.2%ff. This is a grossed up yield of nearly 9%.
FSA provides bankruptcy and debt restructuring services to people in financial distress. **This services division will grow faster if interest rates start to surprise on the upside.** FSA also provides finance to non-performing (sub prime) borrowers to buy a car or home. **This lending business is growing.** There is also an additional growth product called Easy Bill Pay but it's too early to predict how it will go.
The stock has the following attractive attributes:

1) **Excellent management with a significant equity stake in the company.**
2) **Strong balance sheet.**
3) **Strong market leading position in debt services.**
4) **Sound existing organic growth rate.**
5) **Attractive valuation and a free option on the upside provided by higher rates (which we don't have to pay a thing for).**
6) **An attractive dividend yield that pays us while we wait.**

Compelling opportunities are tough to come upon in this competitive industry but I think FSA is exciting and hence, is our fund's largest position.

If you have any questions about Harness, our portfolio or strategy, please call.

Good investing,

Nigel Littlewood
Ph 0414585070

Note: Harness Asset Management Small Companies Value Fund (the Fund) own shares in the stocks mentioned above as at 30 Sept 2015. The above is in no way intended as financial advice, nor any recommendation by the manager of the fund.

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