Top 3 stocks for 3 years

INTELLIGENT INVESTOR
SHARE ADVISOR

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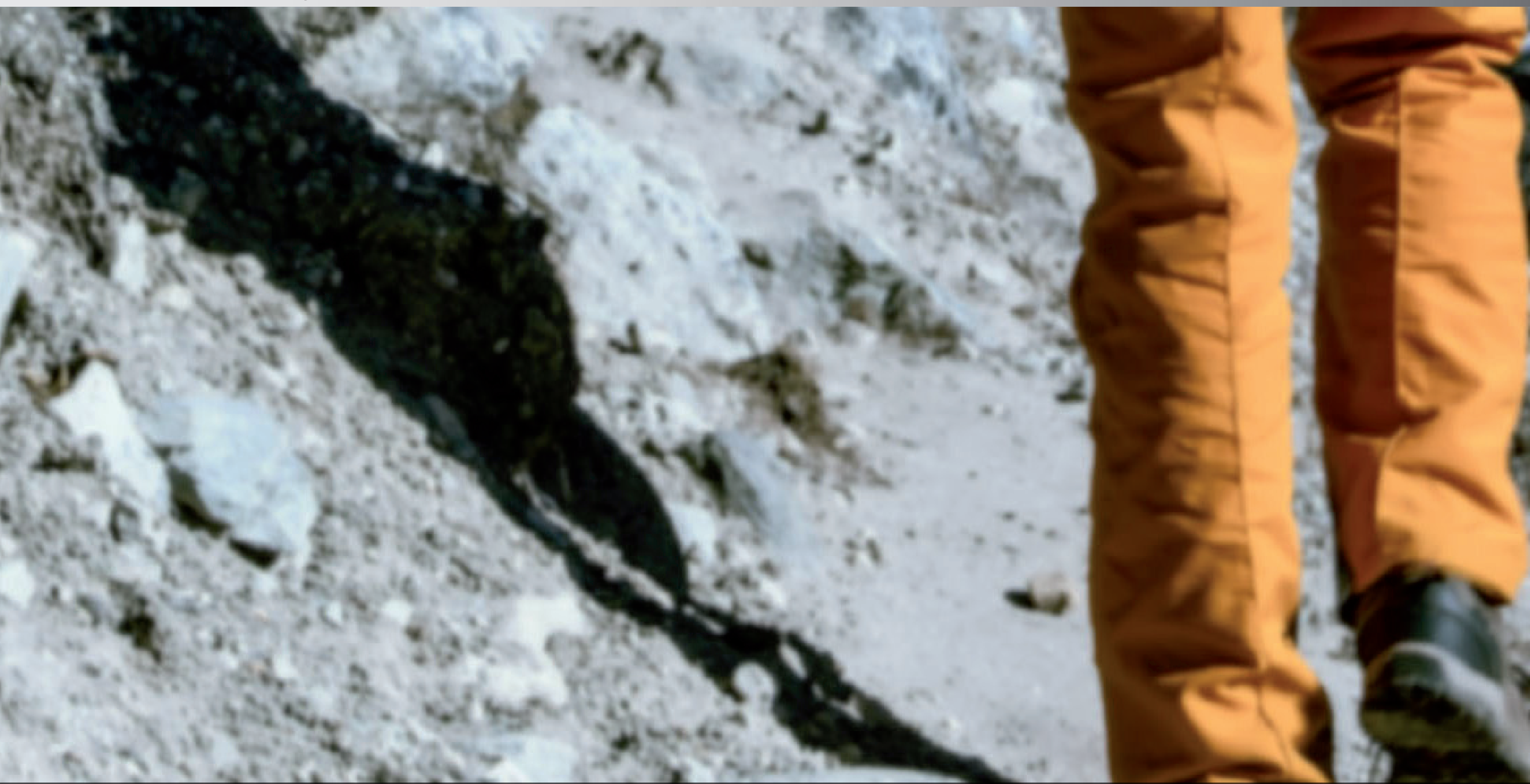

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PRICES CORRECT AS AT
7 November 2014

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And the winner is ...

Part competition, part educational and always lots of fun, here's the winner of the last Top 3 for 3 competition and your analyst stock picks for the next three years.

With returns 35% and 50% higher than the market in the past two competitions, building a portfolio from all the picks would have been a good idea.

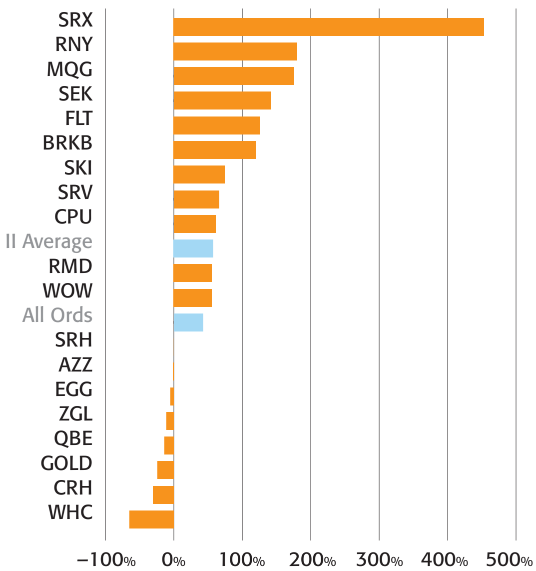
The *Top 3 for 3* competition is based on a simple premise. The ASX is about to close for three years and you have to pick three stocks, knowing full well you can't sell them until it reopens in three years' time.

That was the proposition we put to *Intelligent Investor Share Advisor* analysts and a few respected fund managers in December 2011. In this special report we'll reveal the winner of that competition, take a few lessons from the performance of the group of stocks picked and kick off the next competition with your analysts' top three stock picks for the next three years.

The idea is contrived, of course, but usefully and entertainingly so. Whilst we aspire to own quality companies for the very long term, a three year holding period – too short to measure a person's stock picking skills – does focus the mind. The simplicity of the idea offers up its own lessons.

The first competition ran from 2005 to 2008, the second from 2008 to 2011 and this, the third iteration, from 2011 to 2014. In the first competition the basket of stocks selected beat the benchmark index, the ASX All Ords Accumulation Index, comfortably.

CHART 1: STOCK PERFORMANCES



Source: Capital IQ

With 2008 being a great year to pick stocks, the second series smashed it. The returns from the basket of stocks selected was 69% against the benchmark performance of 39%, an annual return of 19% compared with the index return of 12% over the three years. Not bad.

So what of this competition? Have we maintained the record of out-performance and if so, by what magnitude? Chart 1 has the answer, which is very much in the affirmative.

With six stocks more than doubling there were some big winners in this competition, although none more so than **Sirtex Medical**, which delivered a huge 452% return. Of the 19 stocks selected only seven ended in negative territory and only one stock, **Whitehaven Coal**, more than halved in value. That laid the groundwork for a very good overall performance.

The average return from this basket of stocks over the three year period was 58% compared with the benchmark's 43%. Whilst not quite as impressive as the results from 2008–11, it's still 35% better than the index. Over a decade or more, this kind of outperformance can have a huge impact on overall returns. That's what you're paying us for and once again, we like to think we have delivered.

Note also that Graham Witcomb's picks – **Computershare**, **Saferoads** and **Zicom** – were only included in the competition last year, thus having only 12 months to play out, and James Carlisle's selections, which performed far better, have been active for only two years. Nevertheless, they have been included in the overall results and still the basket of stocks comprehensively beat the benchmark index.

Before covering our analysts' stock selections for the next competition and revealing the winner of the competition just concluded, let's pause to consider the lessons.

1. **Diversification wins** – A tiny portfolio of three stocks is something that we'd never advise. But the great value of diversification is evident in the basket of stocks selected by the entire analytical team rather than just any one mini-portfolio. In each of the past three competitions, the 15–20 stocks selected has beaten the index comfortably, despite some companies failing miserably.

   With returns 35% and 50% higher than the market in the past two competitions, building a portfolio from all the picks would have been a good idea. This shows the protection and performance that diversification delivers.

2. **Big winners offset the losers** – This is one of the major benefits of diversification. As many of the mini-portfolios demonstrate, the big winners usually more than offset the losers. It's tempting to think that one can deliver even better gains by 'only picking the winners' but that's not how it works. By adopting a diversified approach you dramatically

reduce the possibility of crushing losses, even if it means missing out on occasional but very risky high returns from a more targeted approach. We always advocate the former approach, one of getting rich slowly with minimal risk.

3. **Stocks don't go up (or down) in a straight line** – This lesson was ably demonstrated in the last competition, where seven out of nine analysts selected travel agency group **Flight Centre**, a stock which went on to produce a total return of 126% over the three years. But in the first four months of the competition it fell 64%. In this competition it rose 39% in year one, 84% in year two and then fell 12% in year three.

   QBE Insurance fell 13% over the three years but actually rose almost 50% in the second year of the competition. And **Enero Group** fell 66% in year one, rose 92% in year two and rose a further 48% in year three. Meanwhile, **Antares Energy** delivered figures of +26%, –7% and –16%. Stocks fluctuate in price all the time but only by concentrating on value rather than price can you make sensible decisions about whether to add or lighten your exposure.

> ***Stocks fluctuate in price all the time but only by concentrating on value rather than price can you make sensible decisions about whether to add or lighten your exposure.***

4. **These returns could have been even better** – It sounds absurd to say it but a return of 58% over three years could have been bettered had we been allowed to actively manage our positions. Obviously, the rules don't permit that but being able to add to positions in stocks with falling prices, for example, should lead to even greater returns. The value of active management and engagement with your portfolio should not be understated.

AND THE WINNER IS …

After coming second to Forager Funds' Steve Johnson in the last competition, this time Tony Scenna of Selector Funds Management stormed home thanks to his Sirtex Medical pick, which enjoyed a total return of 452% over three years. Interestingly, Tony also picked the worst performer from the basket of stocks – Whitehaven Coal, which happily demonstrates the value of #2 above – that big winners will often offset the losers.

Before getting into the analysts' picks for the next three years, let's now present the wall of pride and shame – the analyst rankings for the 2011–2014 *Top 3 for 3* competition.

TABLE 1: THE WINNER'S MINI-PORTFOLIO

STOCK (ASX CODE)	PRICE AT 15 NOV 2011	PRICE AT 3 NOV 2014	TOTAL DIVS	VALUE AT 3 NOV 2014	TOTAL RETURN
FLIGHT CENTRE (FLT)	$20.07	$41.25	$4.01	$45.26	125.5%
SIRTEX MEDICAL (SRX)	$4.75	$25.88	$0.36	$26.24	452.4%
WHITEHAVEN COAL (WHC)	$5.74	$1.51	$0.53	$2.04	–64.5%
AVERAGE					**171.2%**

TABLE 2: ANALYST RANKINGS

ANALYST	TOTAL RETURN
TONY SCENNA	171.2%
JAMES CARLISLE	87.8%*
NATHAN BELL	74.5%
GREG HOFFMAN	72.6%
GARETH BROWN	55.9%
STEVE JOHNSON	54.0%
ASX ALL ORDS	42.8%
GAURAV SODHI	16.7%
GRAHAM WITCOMB	1.8%**
JASON PROWD	–15.8%

** Only in the competition for two years*
*** Only in the competition for one year*

Nathan Bell

Our research director reflects on his 74.5% three year return and looks to healthcare and garbage for his next picks.

BELLSEYE NEW PICKS

Prices as at 7 Nov 2014

- ResMed (RMD) – $6.03
- Transpacific Indus. (TPI) – $0.91
- Virtus Heath (VRT) – $7.67

Macquarie Group was a classic contrarian play. Most people thought I was mad at the time.

Given the limitations of the competition, I'm quite pleased with the performance of my small group of stock selections. My three blue chips delivered a total return of 74.5% over three years, showing how distorted the market can become. Who would have thought that blue chips would trade so cheaply for so long, and that you could get these kinds of returns despite picking a poor performer?

Macquarie Group was particularly pleasing. In the dark days of 2011, I was aware of only one other analyst recommending it as a Buy. It was a classic contrarian play. Most people thought I was mad at the time and I took a fair bit of flack for it, just as I did when we recommended sticking with **Aristocrat Leisure** when the share price breached $2. Aristocrat is now a market darling and Macquarie redeemed.

There's no hiding from the fact that QBE Insurance was a disappointment, though, but there's a lesson here, too, and perhaps a more valuable one. Buying cheaply – that all important margin of safety – offers an insurance policy against being wrong. QBE was a mistake but because it was purchased cheaply it didn't result in a large loss.

We knew there was a reasonable chance of a poor result and adequately prepared for it with our recommendations, steadily reducing the portfolio limit over time as it became clear the company was not the high quality insurer overseas that it was in Australia.

The interesting thing about **Computershare** – still on our Buy list by the way – is that its earnings haven't increased much over the three years, but the multiple it trades on has. Under certain conditions, valuations on growth stocks can travel to great peaks but this was one business that walked face first into the GFC, which allowed us to purchase it cheaply. Investors can still win in several ways with this stock but the company remains stuck in first gear, despite the price increase over the past few years. Once its profit growth resumes, we may see it return to growth stock status.

PICK #1: RESMED

We've written plenty on respiratory care company ResMed, which is my first pick. As long as this company keeps doing what it's always done it should be bigger and more profitable in three years' time. Whilst not obviously cheap, if the sharemarket or the Australian economy hits a pothole then this will be a company you'll be happy to own. My biggest concern outside an unfavourable change to regulation or health funding is the new CEO doing something stupid. That's always a concern with any business. But the company's quality and track record mitigates the risk.

PICK #2: TRANSPACIFIC INDUSTRIES

To restore the company's value **Transpacific Industries**, my second pick, has gone back to basics and brought in a bunch of Americans with long histories in the US waste management business. As the company is profitable and the balance sheet in pristine condition, this is no longer a turnaround story as such. But management has plenty of work to do to take back market share in a slowing economy. If they can do that, the current enterprise-value-to-EBITDA multiple of five will seem very cheap indeed.

PICK #3: VIRTUS HEALTH

Virtus Health shares a lot in common with ResMed. It's a high growth business benefitting from strong tailwinds. The biggest risk is a cut in government funding for the IVF services it offers. This is a relatively new float too, which introduces further risks.

But the investment case is straightforward. Virtus is the dominant Australian IVF provider and is expanding overseas. As more and more women wait to have children the demand for Virtus' services should increase. If this wasn't a competition, I certainly wouldn't have a third of my portfolio invested in it but, for a small part of a well-diversified portfolio, it could join the ranks of **CSL** and **Cochlear** as one of the many Australian healthcare companies boasting dominant market shares around the world.

BELLSEYE RESULTS

STOCK (ASX CODE)	PRICE AT 15 NOV 2011	PRICE AT 3 NOV 2014	TOTAL DIVIDENDS	VALUE AT 3 NOV 2014	TOTAL RETURN
MACQUARIE GROUP (MQG)	$24.03	$60.85	$5.35	$66.20	175.5%
QBE INSURANCE (QBE)	$14.61	$11.47	$1.22	$12.69	–13.1%
COMPUTERSHARE (CPU)	$8.16	$12.29	$0.85	$13.14	61.0%
AVERAGE					**74.5%**

James Carlisle

Despite a late start Carlisle's Crackers delivered an 87.8% return over two years, and he's sticking with one of those stocks for the next few years.

CARLISLE'S CRACKERS NEW PICKS

Prices as at 7 Nov 2014

TradeMe (TME) – $3.60
ResMed (RMD) – $6.03
Ainsworth Game Tech. (AGI) – $3.10

If underlying earnings per share jumps 9% in a bad year, as it did for ResMed in 2014, you know you're onto a good thing.

It may have been a disadvantage to join the contest in the second year but if you've got to miss a year 2012 was a good one to pick. Mind you, by then **Sirtex** had already doubled and Tony Scenna could be glimpsed disappearing over the horizon, hands waving furiously in victory while I was still pulling on my pants. But really, who's going to complain about an almost 88% return in two years? Not me.

As I wrote when entering the competition, most of the talk was about yield. I departed from that view, seeing the best potential value in stocks with strong businesses and clearly defined growth prospects. That position has been vindicated and I'm sticking with it for my three picks for the next three years.

The market talk is still about yield but many of the market's best growth stocks have done far better. **Seek** for example has moved from a historic price-earnings ratio of 22 to 34, while its earnings have increased by 37%, although my personal experience with the stock has been bittersweet. I sold the last of the shares in my personal portfolio for $11.51 when this re-rating was only halfway through. Still, in this competition you're locked in – sometimes that's a help and sometimes it's a hindrance.

ResMed has emphasised its quality, delivering a 56% gain despite strong competition and operational difficulties in the US over the past 18 months. Meanwhile, Servcorp's rapid expansion is finally starting to deliver.

As for my picks for the next three years, things are looking trickier. With both yield and growth stocks looking highly priced I'm again opting for quality, especially stocks that have hit a bit of a growth hiccup and are therefore cheaply priced.

PICK #1: TRADE ME

Top of that list is **Trade Me**. When asked last April 'what website do you think of first when you go to buy something online (excluding travel, event tickets, accommodation and groceries)', 46% of New Zealanders said Trade Me, with Amazon in second place on 7%. The trouble is that with three-quarters of the Kiwi population signed up and only so much junk they can sell to each other, the general items business is running out of growth.

There's better news from the classifieds, which have been able to drive growth by adding improved functionality and 'listing depth' products, where you pay more for prominent positioning on the website. Classifieds has now overtaken general items as the company's biggest profit contributor, and the group's performance should increasingly reflect the better business.

The other major development is that from almost nothing in 2011, mobile devices now contribute 61% of Trade Me user sessions. Getting the products fixed up for these new channels is expensive but should increase the company's barriers to entry.

PICK #2: RESMED

I'm sticking with **ResMed** for the next few years, too. If underlying earnings per share jumps 9% in a bad year, as it did for ResMed in 2014, you know you're onto a good thing. With signs that the US market is beginning to stabilise after the second round of CMS competitive bidding, some exciting new products recently introduced (including the AirSense 10 range of flow generators) and some help from the lower Australian dollar, things look good enough to continue to back it.

A positive result from the SERVE HF trial looking at treating central sleep apnoea in heart failure patients would also be a major boost. We're somewhat more cynical about ResMed's new S+ sleep monitoring device, but it shows that consumers are becoming more aware of sleep problems and that should be good for the company in the long term.

PICK #3: AINSWORTH GAME TECHNOLOGY

Finally, and for a little spice, I like the look of **Ainsworth Game Technology**, which our newest analyst Jon Mills upgraded recently in *Ainsworth spins the reels in Vegas* (Buy – $3.03). This company has a remarkable history, with the stock hundred-bagging between 2008 and 2013. It has since fallen around 30% and this looks like a decent opportunity for those that missed it the first time.

After some industry consolidation, the US pokie machine market is dominated by IGT and Scientific Games, with Aristocrat a distant third and Ainsworth at less than 1%. But the casinos will want to keep a range of suppliers on their toes to hold down prices and Ainsworth's games have been performing well, at least in Australia. The company is thinking big with a $30m new facility in Las Vegas, which should give it another leg up into the US market.

Disclosure: James Carlisle owns shares in Trade Me and ResMed.

CARLISLE'S CRACKERS RESULTS

STOCK (ASX CODE)	PRICE AT 13 DEC 2012	PRICE AT 3 NOV 2014	TOTAL DIVIDENDS	VALUE AT 3 NOV 2014	TOTAL RETURN
SERVCORP (SRV)	$3.42	$5.33	$0.35	$5.68	66.1%
RESMED (RMD)	$3.94	$5.98	$0.15	$6.13	55.5%
SEEK (SEK)	$7.05	$16.53	$0.52	$17.05	141.8%
AVERAGE					**87.8%**

Greg Hoffman

After poor showings in previous competitions, our former research director was less focused on winning and more interested in not running last.

HOFFMAN'S HEROES NEW PICKS

Prices as at 7 Nov 2014

NRW Holdings (NWH) – $0.68
Fleetwood Corp. (FWD) – $1.66
Macmahon (MAH) – $0.092

That a combination of three household names could produce such hefty returns speaks to the power of buying in gloom.

It's interesting to follow through the stocks selected in the previous competition, which makes it a 'top three for six'. The results are simply staggering. For instance, **Infomedia** (selected previously by both myself and Steve Johnson) has subsequently six-bagged, **Select Harvests** (chosen by Gareth) has three-bagged and Tony Scenna's three picks are all total monsters.

If history repeats, it might pay to put the stocks from the competition just closed on your radar, as James Carlisle has done by continuing his support of ResMed. As for my selections' performance, at 72.6% it's very satisfactory and comparable with Bellseye's. Given the fact that we shared two stocks for the period – QBE and Macquarie – that's no surprise.

As Nathan notes, QBE Insurance has been a disappointment. But losses of this magnitude are part and parcel of investing, underlying the importance of diversification. The bigger point – that a combination of three household names could produce such hefty returns – speaks to the power of buying in gloom. Late 2011, when this competition fortunately commenced, was the most recent opportunity to purchase cheap, high quality stocks.

I've tortured myself over my picks for the next three years. I'm keen on several mining services stocks at the moment but selecting just one in this sector could be financial Kamikaze. So my choice was between totally steering clear of a sector I like or going 'all in' and selecting three players to give some kind of portfolio protection in a dangerous sector.

Caution has been cast to the wind and I've gone for the latter approach. Unlike last time, this gives me a real shot at winning but also opens the way for a potentially disastrous performance. In practice, I continue to build a mini-portfolio of mining services stocks within my broader portfolio (I'm currently at six holdings but may add one or two more). Here's my trifecta.

PICK #1: NRW HOLDINGS

I made the case for this one recently in *Analyst picks: best buys right now*. **NRW Holdings** is my favourite stock in the sector but that's no guarantee that it'll perform well. It's quantitatively cheap, offering a tasty discount to net tangible asset backing, featuring a low PER and a high fully franked yield.

That may not count for a lot if revenues halve and recent profits become a string of losses. But I doubt that's a likely outcome. The company should produce at least one more year of decent cash flow, enabling it to eliminate its remaining debt. Then, if industry conditions are still bleak, management should have had an opportunity to 'right size' its cost base.

PICK #2: FLEETWOOD CORPORATION

Fleetwood, which makes caravans and manufactures and operates mining accommodation villages, lacks the accounting profits and free cash flow of NRW Holdings but trades at a discount to its net tangible asset backing. And bear in mind that its key Searipple Village asset has been fully depreciated, so isn't even counted in that figure.

Fleetwood's directors also have a long history of being sensible. Throughout the mining boom, they resisted the temptation to undertake any 'company transforming' acquisitions and instead handed back gobs of cash to shareholders labelled 'special dividends', effectively flagging that the good times wouldn't last forever. You couldn't ask much more of directors in that situation.

PICK #3: MACMAHON HOLDINGS

If you weren't put off by the first two stocks, then try **Macmahon Holdings** on for size. Its stock price is down around 95% from its boom-time high and now trades at levels that suggest its survival is under threat. At the time of writing, the company was also in a dispute with a major customer in Mongolia.

It's a riskier pick than my other two, which is saying something. But the potential returns are mouth-watering if things go well. If the market simply took a very dim view of the stock (rather than its current catastrophic one) and priced it at a 25% discount to net tangible assets, then the price would almost triple.

This is a classic Benjamin Graham 'cigar butt'. The stock price is so low that if anything other than total catastrophe eventuates, owners are likely to do well. It adds some real spice to my entry in the competition, that's for sure. Let the chips fall where they may.

Disclosure: Private portfolios managed by Greg Hoffman currently own shares in NRW Holdings, Fleetwood and Macmahon Holdings.

HOFFMAN'S HEROES RESULTS

STOCK (ASX CODE)	PRICE AT 15 NOV 2011	PRICE AT 3 NOV 2014	TOTAL DIVIDENDS	VALUE AT 3 NOV 2014	TOTAL RETURN
QBE INSURANCE (QBE)	$14.61	$11.47	$1.22	$12.69	–13.1%
MACQUARIE GROUP (MQG)	$24.03	$60.85	$5.35	$66.20	175.5%
WOOLWORTHS (WOW)	$24.76	$34.24	$4.24	$38.48	55.4%
AVERAGE					**72.6%**

Steve Johnson

Chief investment officer at Forager Funds, Steve enjoyed a huge winner and two small losers and is going back to the well for his next three picks.

STEVE'S STARS NEW PICKS

Prices as at 7 Nov 2014

RNY Property (RNY) – $0.285
Hansen Tech. (HSN) – $1.56
Service Stream (SSM) – $0.18

While most serial acquirers buy small businesses and destroy the culture and morale of the business they acquire, Hansen does the opposite.

The end result – a 54.0% return over three years – is a fair reflection of the stocks I picked at the start of the competition. I had one big winner in **RNY Property Trust** and two disappointing performers in QBE Insurance and **Enero**, the former Photon Group. The share price movements of all three reflected business performance over the period, proving that whilst markets can get stuff wrong, they get a lot of things right.

Still, while mistakes are inevitable, I'd prefer to be getting two right for every one wrong. Let's just blame the sample size.

The biggest lesson came from the wild gyrations in Enero's share price. The stock price fell by two thirds in the first year, only to recover almost all of those losses over the ensuing two years. Despite it producing mediocre returns over the three-year period, we managed to make a lot of money for our fund investors by buying more near the bottom and selling it back as the share price recovered.

PICK #1: RNY PROPERTY (AGAIN)

Despite being my best performer in the previous Top 3 for 3, I'm throwing **RNY Property Trust** back into the mix. The stock price has almost tripled in the past three years but the opportunity is as good today as it was then. This trust owns US commercial property. The Australian dollar has fallen against the US dollar, the US economy has improved, interest rates remain low and employment in the US has been particularly strong. Yet this ASX-listed trust still trades at a 44% discount to its asset backing.

Patience is required, though. Management still has lots of work to do before the assets can be sold or dividends can commence. But such patience should be well rewarded by the end of the three year period of the competition.

PICK #2: HANSEN TECHNOLOGIES

This stock has recently been introduced to Intelligent Investor members so I'll add to what Graham has already written rather than rehash the same arguments. First, its defensive characteristics and the significant percentage of revenue generated overseas give my portfolio some important balance. I think it's going to be a very difficult three-year period for the Australian economy so I want to own a few businesses that are largely immune to any downturn. **Hansen** fits the bill.

Second, I think its growth prospects are under appreciated. Second-generation owner-manager Andrew Hansen has been very successful buying similar businesses and making a lot of money from them.

While most serial acquirers buy small businesses and destroy the culture and morale of the business they acquire, Hansen does the opposite. It typically buys very small businesses out of huge global corporates and gives them a new lease on life. Hansen looks reasonably priced on the basis of its organic growth prospects alone and I'm confident the acquisitions will add value.

PICK #3: SERVICE STREAM

Service Stream provides construction and maintenance services to Australia's largest telecommunications and utilities companies. It was badly bruised by its first encounter with NBN Co, the government company overseeing Australia's national broadband network, but is well poised to benefit from the experience.

Even under the government's new 'hybrid' approach of using as much existing infrastructure as possible, there is at least another $30bn (and perhaps as much as $60bn) that needs to be spent to build the NBN. With Service Stream one of only a few companies that can meet the demands of such a program revenue isn't a problem for at least a decade.

Turning that revenue into profit is another matter. While new CEO Leigh Mackender looks to be a good choice, management and the board remain the areas I am most concerned about.

One look at the share price chart will show you how unloved this company is. Investors have placed it in the sin bin – and with good reason – but the value on offer looks compelling.

Disclosure: Portfolios managed by Steve Johnson own shares in RNY Property, Hansen and Service Stream.

STEVE'S STARS RESULTS

STOCK (ASX CODE)	PRICE AT 15 NOV 2011	PRICE AT 3 NOV 2014	TOTAL DIVIDENDS	VALUE AT 3 NOV 2014	TOTAL RETURN
QBE INSURANCE (QBE)	$14.61	$11.47	$1.22	$12.69	–13.1%
ENERO GROUP (EGG)	$1.13	$1.08	$0.00	$1.08	–4.8%
RNY PROPERTY TRUST (RNY)	$0.10	$0.28	$0.00	$0.28	180.0%
AVERAGE					**54.0%**

Gaurav Sodhi

Our resources analyst neatly sums up the inherent dangers in the sector with his portfolio's performance but managed to resist the temptation with his new selections.

SODHI'S STOCKPILE NEW PICKS

Prices as at 7 Nov 2014

Transpacific Indus. (TPI) – $0.91
Trade Me (TME) – $3.60
Hansen Tech. (HSN) – $1.56

It's fair to say this wasn't a great performance on my part. The investment case for **Spark Infrastructure** worked out as I had hoped, although the next regulatory period will likely cut returns. Nevertheless, this has been a great boost to an otherwise mediocre portfolio performance – just 16.7% over three years versus the rise in the All Ordinaries of 43%.

Antares Energy was especially disappointing. Despite an announced asset sale the share price stagnated. Management was better off not rejecting two takeover offers and now must spend years drilling out another asset to prepare it for sale.

To be fair, early signs are good and the upside is large if the company can replicate the production rates of its peers. But that will take time and debt. Still, there is asset value here. Shareholders have to be patient and a little lucky to realise it. The great risk is persistently low oil prices.

The decision to include gold as an effective 33% position that I could not change was unwise. Three years ago interest rates were low and staying that way; QE3 had just been announced and there was genuine fear about monetary probity. Gold is fine for a small piece of a portfolio but the best thing investors can do is buy cheap stocks. I've learnt my lesson with my next three picks.

> ***Gold is fine for a small piece of a portfolio but the best thing investors can do is buy cheap stocks.***

PICK #1: TRANSPACIFIC INDUSTRIES

Transpacific Industries is a business of reasonable quality that's going cheap, largely because it had been poorly financed in the past. It boasts a genuine competitive advantage and can deploy cash flow at decent rates of return. Still, you can't buy cheaply without a few blemishes. Transpacific faces cyclical headwinds as its industrial division slows and returns are dependent on the actions of management. But we don't need geniuses to run it and the price is attractive enough.

PICK #2: TRADE ME

My second pick is **Trade Me**. Anyone beyond the shores of New Zealand – except perhaps James Carlisle, who has also picked it – will be shocked at the strength of this site. It is Ebay, Carsales, Seek and REA rolled into one, boasting dominant market shares in classifieds and general sales.

Classifieds, the former stars for publishers, have only just overtaken general goods. Lower growth in general sales masks just how well the classifieds business is doing and I suspect there is a lot of latent pricing power to tap. For such a dominant business it's attractively priced.

PICK #3: HANSEN TECHNOLOGIES

My last one is a little trickier. Like Greg, I thought about **Fleetwood** and a few mining services stocks like NRW Holdings. They are certainly cheap enough but they also carry a high degree of risk. I don't mind that but this time I'm going to let the rules of this game determine my attitude. If you can't sell for three years I'm opting for stability and **Hansen** is my choice.

The fact that this business is 43 years old and still relatively small tells us that market share is hard to steal. Customers are sticky and revenue stable but the business can grow by buying customers and exercising some pricing power. I don't think this is a steal in terms of valuation but it's enough to earn a spot.

Disclosure: Gaurav Sodhi owns shares in Transpacific Industries.

SODHI'S STOCKPILE RESULTS

STOCK (ASX CODE)	PRICE AT 15 NOV 2011	PRICE AT 3 NOV 2014	TOTAL DIVIDENDS	VALUE AT 3 NOV 2014	TOTAL RETURN
SPARK INFRASTRUCTURE (SKI)	$1.28	$1.91	$0.33	$2.24	75.3%
ANTARES ENERGY (AZZ)	$0.43	$0.43	$0.00	$0.43	–1.2%
EFTS PHYSICAL GOLD (GOLD)	$168.74	$128.24	$0.00	$128.24	–24.0%
AVERAGE					16.7%

Graham Witcomb

He only joined the team last year so don't judge him too harshly on his measly 1.8% return. Instead, let him introduce his picks for the next three years.

WITCOMB'S WINNERS NEW PICKS

Prices as at 7 Nov 2014

Hansen Tech. (HSN) – $1.56
Perpetual (PPT) – $48.15
FSA Group (FSA) – $1.025

"Billing sits at the core of a business so companies tend not to fiddle with it. This gives Hansen significant pricing power.

As market sentiment improved Computershare performed quite nicely, at least compared with Zicom Group, which turned out to be one of my worst personal investing mistakes to date.

I've owned Zicom for a couple of years and it still looks cheap by most statistical measures. But after a series of profit guidance misses it became apparent that management is quite promotional. It tends to misattribute failure rather than describe reality, to say nothing of the liberal use of stock options. Perhaps a low price compensates for poor management but not in this case, where trust was broken. For my next three picks I'm using able and honest management as my first investing filter.

PICK #1: HANSEN TECHNOLOGIES

The first stock on my list ticks that box, with the added bonus of captive customers. Hansen Technologies makes billing software but its customers are mainly utilities, which due to high switching costs almost never leave once the company's software is installed.

Billing sits at the core of a business so companies tend not to fiddle with it. This gives Hansen significant pricing power. The company is growing organically in the mid-single digits, with the prospect of savvy acquisitions adding a few percentage points. With low capital expenditure, this is a highly cash generative business. Combine this with a pristine balance sheet and shareholder-friendly management and the current price-earnings ratio of 17 and 4% dividend yield begin to look pretty cheap.

PICK #2: PERPETUAL LIMITED

Wealth manager Perpetual is another highly cash generative business. What's more, over the long term, a continuous flow of money into superannuation should steadily reach Perpetual given its reputation for outperformance. Any growth in the underlying asset values will also help to boost funds under management.

The company's value investing culture, operating leverage and formidable distribution network only add to its qualities. Given Perpetual's exposure to the share market, how the stock performs over the next few years will inevitably be tied to overall market returns.

PICK #3: FSA GROUP

With an eye on diversification, I'm going to stretch my wallet a little and add FSA Group to my top three. It's somewhat of an anti-Perpetual in that it does best in times of crisis but, even without an Australian recession, the company has grown revenue six-fold since 2003.

FSA is Australia's largest originator of debt agreements for people facing insolvency and charges a fee for negotiating with banks on behalf of debtors for more manageable repayment terms (see *FSA Group: Result 2014*).

Priced at just 10 times earnings for 2014, it's far from expensive. The only catch is that in addition to the regulatory risk associated with its counter-cyclical debt agreement business, half of net profit comes from subprime lending (albeit isolated from the parent company in a separate trust so there is limited risk to equity). FSA shows great potential, but the significant risks mean we need a larger margin of safety – say, at around 90 cents – before upgrading our official recommendation, currently a Hold, to Buy. Because I'm trying to develop a portfolio to beat the market this inclusion is a bit of a hedge against a big downturn which would hit Perpetual.

Disclosure: Graham Witcomb owns shares in Hansen.

WITCOMB'S WINNERS RESULTS

STOCK (ASX CODE)	PRICE AT 29 NOV 2013	PRICE AT 3 NOV 2014	TOTAL DIVIDENDS	VALUE AT 3 NOV 2014	TOTAL RETURN
COMPUTERSHARE (CPU)	$10.89	$12.29	$0.29	$12.58	15.5%
ZICOM GROUP (ZGL)	$0.25	$0.22	$0.00	$0.22	–10.2%
SAFEROADS (SRH)	$0.17	$0.17	$0.00	$0.17	0.0%
AVERAGE					1.8%

Jonathan Mills

With Jon new to the team, there's no need for reflection. Here he names his top 3 for 3, finding common ground with a few other analysts.

MILLSY'S MONSTERS PICKS

Prices as at 7 Nov 2014

Ainsworth Game Tech. (AGI) – $3.10

NRW Holdings (NWH) – $0.68

Transpacific Indus. (TPI) – $0.91

High barriers to entry and economies of scale mean Transpacific is a good bet to regain lost market share.

PICK #1: AINSWORTH GAME TECHNOLOGY

My first pick is **Ainsworth Game Technology**, a recent addition to our Buy list and completely coincidentally also my first Buy idea since joining *Intelligent Investor Share Advisor*. As James has mentioned, this manufacturer of pokie machines has grown dramatically in recent years but its share price has fallen more than a third from its high, despite increasing earnings by 18% in 2014.

The company is affected by the rate at which casinos and clubs buy new pokies, and that rate has slowed over the past year due to continued low economic growth in the US. But punters like its machines and so do the casinos.

While growth in Australia will probably be moderate, the company should continue to expand in the US and elsewhere. Reasonably priced at 16 times earnings, this is likely to be a volatile stock but is a good chance of having appreciably higher earnings in three years' time.

PICK #2: NRW HOLDINGS

Due to the mining downturn and the ongoing plunge in the iron ore price, no-one seems to want a bar of mining services stocks. Hence my second pick: **NRW Holdings**. I purchased this recently at 76 cents thinking I had picked it up cheaply and the stock is down more than 10% since then.

Like Greg, I wouldn't own just one mining service stock and so NRW Holdings is part of a mini-portfolio of three that I own in practice. Yet for the purposes of this competition I'm putting one-third of my portfolio in what appears to be the best of the bunch. It could either prove fool-hardy or, hopefully, help propel me towards the top of the standings in three years' time.

As Greg noted in *Analyst picks: best buys right now* from 27 Oct 14, it's selling at a large discount to net tangible assets and low multiple of expected 2015 earnings of around 10 cents per share. Strong cash flow should enable it to continue to reduce gearing and pay fully franked dividends of 6–7 cents per share over the next year, giving it a yield of around 10% at today's price. There may also be opportunities for additional 'capital management' including special dividends, particularly with its large franking account balance.

PICK #3: TRANSPACIFIC INDUSTRIES

Continuing the theme of trying to profit from investor disgust, my final pick is **Transpacific Industries**. As Nathan noted in *Five reasons to buy Transpacific* on 23 Jul 14 (Buy – $1.08), this company went on a debt-fuelled acquisition binge that, perhaps unsurprisingly, ended in disaster.

Furthermore, the increase in its provisions for landfill remediation announced in its 2014 result and the recent temporary grounding of its entire fleet due to one of its trucks being involved in a fatal accident haven't helped.

Yet this company is now a very different beast. Dozens of businesses have been disposed of and debt has been slashed, resulting in the company recently resuming dividend payments. Waste management may be as dull as, err, toxic industrial waste but the high barriers to entry and economies of scale mean Transpacific is a good bet to regain lost market share. Should that occur, earnings and dividends should rise nicely, taking the share price with them.

Disclosure: Jon Mills owns shares in Ainsworth Game Technology and NRW Holdings.

The popular favourites

From the 13 stock picks for the next three years, two clear favourites emerge, with a handful of stocks making it into more than one analyst's selections.

The nature of a properly functioning team of analysts means efforts are inherently collective.

This penultimate section of our *Top 3 for 3* analysis is a little paradoxical. Value investing is like an anti-popularity contest. When something becomes deeply unpopular its price often falls well below its real value, allowing the purchaser to lock-in potential outsized gains.

So the idea of assessing the popularity of unpopular stocks among a group of analysts that seek out unpopularity is a little ironic. It also might be somewhat misleading. In the second iteration of this competition **Flight Centre** was the most common pick. It performed well. In the competition just finished, **QBE Insurance** held top spot and as this special report makes clear, it didn't.

So please don't mistake the appearance of **Transpacific Industries** and **Hansen Technologies** in the picks of three analysts as being evidence of sure-fire winners. It isn't and they may not be. With 30 stocks on the Buy list and a universe of thousands of listed companies, there is no shortage of potential buy ideas. The fact that some analysts have picked the same companies is not in itself additional evidence of a great stock.

Other factors may be at play. Analysts that didn't perform too well in the previous competition may have subconsciously opted for more conservative selections as a result, or even more speculative picks as they take a bigger risk to win the competition.

And the nature of a properly functioning team of analysts means efforts are inherently collective. Whilst groups generally make better decisions, throwing different perspectives into the analytical mix, the cost of that is the risk of groupthink. All of which is to say please do not read too much into the table below. Consider it an intellectual curiosity rather than a popularity guide in an unpopularity contest.

POPULAR FAVOURITES

STOCK (ASX CODE)	PICK TOTALS	ANALYST
TRANSPACIFIC INDUSTRIES (TPI)	3	NB, GS, JM
HANSEN TECHNOLOGIES (HSN)	3	SJ, GS, GW
RESMED (RMD)	2	NB, JC
TRADE ME (TME)	2	JC, GS
AINSWORTH GAME TECHNOLOGY (AGI)	2	JC, JM
NRW HOLDINGS (NWH)	2	GH, JM
VIRTUS HEALTH (VRT)	1	NB
FLEETWOOD CORP. (FWD)	1	GH
MACMAHON (MAH)	1	GH
RNY PROPERTY (RNY)	1	SJ
SERVICE STREAM (SSM)	1	SJ
PERPETUAL (PPT)	1	GW
FSA GROUP (FSA)	1	GW

To absent friends

A number of participants from the last competition aren't in the new one, including winner Tony Scenna and a few former research team members. Here are their results.

Finally, we're at the cheesy 'where are they now' bit. Aside from winner Tony Scenna, who was appropriately lionised at the beginning of this report, it's only proper to shine a light on the team members that contributed to the last *Top 3 for 3* competition, even though they aren't in the new one.

For the record, Jason is now chief operations officer with Intelligent Investor and Gareth is still plugging away in Vienna with Forager Funds, formerly Intelligent Investor Funds Management.

JASON PROWD REFLECTS

Whilst I've successfully shrunk a dollar to 84 cents, I'm most disappointed with **Crowe Horwath** – a dull accounting firm I chose to give my micro-portfolio some stability. It turned out to be the poorest performer after its business model was revealed to be more flimsy than I thought. Profits relied more on fickle consulting work and less on stable compliance work than I'd assumed. It's a powerful lesson in never doubting the fragility of services businesses.

> ***Expect regular updates on the website and an annual special report that examines the progress of the stocks chosen and the analysts' portfolios in which they reside.***

I'll chalk both Crowe and **QBE** up as mistakes but plead unlucky with **Enero Group**. I started behind the curve. Enero's share price jumped around 50% between finalising my picks and publishing the first report. Over the past three years Enero has slowly turned around, generating around $5m of free cash flow in the past year. There's still work to be done to justify the current $92m valuation but the signs are positive. Better yet those not pegged to the slavish (fun?) Top 3 for 3 rules had a tremendous opportunity to both trim their positions at over $1.50 a share and add significantly to it at less than 40 cents.

DONE AND DUSTED

So that's the last *Top 3 for 3* competition done and dusted and a new one out of the blocks. Expect regular updates on the website and an annual special report that examines the progress of the stocks chosen and the analysts' portfolios in which they reside. It should be a lot of fun.

JASON'S JACKPOT RESULTS

STOCK (ASX CODE)	PRICE AT 15 NOV 2011	PRICE AT 3 NOV 2014	TOTAL DIVS	VALUE AT 3 NOV 14	TOTAL RETURN
CROWE HORWATH (CRH)	$0.87	$0.49	$0.12	$0.61	–29.5%
QBE INSURANCE (QBE)	$14.61	$11.47	$1.22	$12.69	–13.1%
ENERO GROUP (EGG)	$1.13	$1.08	$0.00	$1.08	–4.8%
AVERAGE					**–15.8%**

Disclosure: Jason Prowd owns shares in QBE Insurance and Enero Group.

GARETH'S GREATEST RESULTS

STOCK (ASX CODE)	PRICE AT 15 NOV 2011	PRICE AT 3 NOV 2014	TOTAL DIVS	VALUE AT 3 NOV 14	TOTAL RETURN
QBE INSURANCE (QBE)	$14.61	$11.47	$1.22	$12.69	–13.1%
COMPUTERSHARE (CPU)	$8.16	$12.29	$0.85	$13.14	61.0%
BERKSHIRE HATHAWAY (NYSE: BRKB)	$73.77	$162.12	$0.00	$162.12	119.8%
AVERAGE					**55.9%**

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