Preface

Bear markets do not last forever. Unfortunately, as has so often been observed, no-one rings a bell when a bear market is over. Instead, stocks start to creep back upwards, and at some point, when they have already regained much of their perceived value, the average investor starts to decide it might be time to get back into the market.

It has never been the role of *Top Stocks* to try to forecast the market, but it is worth noting the comments of boutique fund management firm Hunter Hall, one of the companies in this book, when announcing its June 2012 financial results in its Preliminary Final Report and Dividend Announcement. Company management stated: 'As we see more evidence of a resolution of the structural problems facing the world we will run down our cash and gold and invest in equities. Our belief is that 2012–13 will lay the foundations for this investment strategy to be rewarded with better returns.'

Writer and portfolio manager Matthew Kidman, in an excellent book *Bulls, Bears and a Croupier*, stated his belief that a new bull market will start in 2013. He felt that Australian industrial stocks would be the initial beneficiaries.

In any case, even in the midst of a bear market and a weak economy can be discovered numerous gems — companies that continue to boost profits and dividends year by year — and certainly one of the roles of *Top Stocks* is to help investors find such jewels.

Fund managers Hunter Hall, cited above, also affirmed: 'We believe the difficult economic conditions are producing exciting opportunities for the Hunter Hall investment team to purchase undervalued equities.'

Despite the title, *Top Stocks*, now in its 19th year of publication, is actually a book about companies. Right from the first edition it has been an attempt to help investors find the best public companies in Australia, using strict criteria.

These criteria are explained fully later. But, in essence, all companies in the book must have been publicly listed for at least five years and must have been making a profit and paying a dividend for each of those five years. They must also meet tough benchmarks of profitability and debt levels. Share prices have never been relevant.

Of the 99 companies in this latest edition of the book, 66 saw after-tax profits rise in their latest full-year reporting period, despite the weak economy, while 63 saw EPS rise and 65 raised their dividend.

Of the 66 companies reporting higher profits, 47 achieved double-digit profit growth, with one company reporting a triple-digit increase. In addition, 42 of them saw profits growing at a faster rate than revenues, implying that their profit margins were expanding.

And though, as I have stated, share prices are not relevant for selection to *Top Stocks*, 34 of the 99 companies in the book have provided investor returns — share price appreciation plus dividends, share splits and bonus shares — of an average of at least 10 per cent per year over five years. And of these 34 companies, half have provided a return of more than 20 per cent.

To find such stocks it is probably necessary, more than ever, that investors are selective in their approach. For example, renowned fund manager Kerr Neilson, whose Platinum Asset Management enters *Top Stocks* for the first time, observes that shares now are not as highly correlated as they were previously, giving stock pickers an edge. In other words, it can be dangerous to buy a stock in a sector that looks promising without some intensive research into the particular company. Conversely, you may well find standout stocks within the most depressed of sectors.

It can also be dangerous to buy a managed fund, the favoured safety route of many investors in times of uncertainty. The reason is that most funds use a market index as a benchmark, and in Australia a small number of stocks tend to dominate many of the indices.

The S&P/ASX 200 index is widely used as a benchmark. In late August 2012 this index had a market capitalisation (the total stock market value of all its companies) of around $1038 billion. Yet BHP Billiton alone represented about

10 per cent of the index, and the 10 largest companies (shown in the following table) accounted for more than half the value of the index.

Trends in just these 10 stocks exercise an enormous influence on Australia's indices. Just the performance of BHP Billiton or of the banks can move them significantly. Fund managers who are using the S&P/ASX 200 index as their benchmark are virtually obliged to carry large holdings of BHP Billiton and the banks — regardless of their actual views on these stocks' prospects — for fear of underperforming. This may not worry you. But if it does you are well advised to select your own stocks.

S&P/ASX 200 index: 10 largest companies

Company	Market capitalisation ($bn)
BHP Billiton	106.3
Commonwealth Bank	86.3
Westpac Banking	76.6
ANZ Banking	66.8
National Australia Bank	57.4
News Corporation	53.5
Telstra	47.9
Wesfarmers	40.1
Woolworths	35.7
Woodside Petroleum	28.5

Trends among the top stocks

Each year I try to discern some of the trends that are moving stocks. For a couple of years I have been pointing to the rise and rise of Australian high-tech stocks. Just 12 years ago only one high-tech company — Computershare — made it into *Top Stocks*. But for several years now a dozen or so companies from the Information Technology (IT) and Telecommunication Services sectors have found their way into the book. This year there are 12 IT companies and two from Telecommunication Services.

Of the 11 broad sectors that comprise the Australian stock market, IT is by far the smallest, accounting for less than 1 per cent of total market capitalisation. (By contrast, IT is the largest sector in the United States, representing around 20 per cent of the market there.) So for 12 IT stocks — plus two from Telecommunications Services — to be among the 99 companies in the book suggests that something is happening.

Some years ago I noted the steady entry into the book of pharmaceuticals companies. This was at a time when stocks such as CSL and Cochlear were much smaller, and were not the superstars they are today. Perhaps something similar is starting to occur in high-tech.

As this book was going to press there was considerable debate about the direction of the resources boom. Mining activities may or may not be heading for a slowdown. But the number of massive multi-billion-dollar LNG projects continues to rise, and some companies in this book are realising stellar business as a result. For example, Mermaid

Marine is working to boost its fleet of support vessels in anticipation of a big increase in orders.

Fleetwood's traditional caravan manufacturing business is in the doldrums, but the company is seeing exceptional growth for its Manufactured Accommodation division — mainly the supply of portable accommodation for Western Australian resources projects — and this division is now 90 per cent of company profits.

Global Construction Services, a new entry to *Top Stocks*, said it had been experiencing extraordinary demand for temporary site accommodation from the Western Australian resources sector, with profits for this business up fivefold in one year.

Small stocks

A particular attraction of *Top Stocks* is the manner in which the book regularly places the spotlight on smaller, emerging companies that have just ascended into the rankings of the top 500 stocks. Some of these companies continue to rise, offering extraordinary gains to astute investors. The classic example is the Perth engineering company Monadelphous, which first appeared in *Top Stocks '99*, at a share price (adjusted for a subsequent share split) of 66¢. Two years ago it was in the book at $15.06, and last year it was $20.10. In this edition it is priced at $22.04, and it has been as high as $24.37.

Here are more examples of other high-flying stocks that have appeared in *Top Stocks,* sometimes well before they hit the radar screens of many small investors. Remember that, along with superb share-price appreciation, they have all also paid regular dividends:

- ALS, the new name for Campbell Brothers, is now enjoying booming profits from its laboratory business. It appeared in the very first edition of the book (though it has not appeared in every edition) — when its main business was making soap — with a share price (adjusted) of 74¢. Last year it was in the book at $9.18. This year it is $9.35, having been as high as $13.98.
- Four-wheel-drive specialist ARB entered *Top Stocks '99* with a share price (adjusted) of $1.00. It has been in every edition since, and in last year's edition of the book had a price of $8.56. This year it is $9.87, having been as high as $10.23.
- Portable home manufacturer Fleetwood made its debut in *Top Stocks*

2003 with a share price of $2.90. Now it is $11.71, and it has been to $14.25.

- Two of the new companies in *Top Stocks 2011* were Domino's Pizza Enterprises and M2 Telecommunications, with respective share prices of $5.37 and $2.00. Just two years later they are at $9.69 and $3.59.

Who is *Top Stocks* written for?

Top Stocks is written for all those investors wishing to exercise a degree of control over their portfolios. It is for those just starting out as well as for those with plenty of experience but who still feel the need for some guidance through the thickets of more than 2200 listed stocks.

It is not a how-to book. It does not give step-by-step instructions to 'winning' in the stock market. Rather, it is an independent and objective evaluation of leading companies, based on rigid criteria, with the intention of yielding a large selection of stocks that can become the starting point for investors wishing to do their own research. A large amount of information is presented on each company, and another key feature of the book is that the data is presented in a common format, to allow readers to make easy comparisons between companies.

It is necessarily a conservative book. All stocks must have been listed for five years even to be considered for inclusion. It is especially suited for those seeking out value stocks for longer term investment. Yet, perhaps ironically, the book is also being used by short-term traders seeking a goodly selection of financially sound and reliable companies whose shares they can trade.

In addition, there are many regular readers, who buy the book each year, and to them in particular I express my thanks.

What are the entry criteria?

The criteria for inclusion in *Top Stocks* are strict:

- All companies must be included in the All Ordinaries index, which comprises Australia's 500 largest stocks (out of more than 2200). The reason for excluding smaller companies is that there is often little investor information available on many of them and some are so thinly traded as to be almost illiquid. In fact, the 500 All Ordinaries companies comprise, by market capitalisation, more than 95 per cent of the entire market. (For the sake of continuity, an exception is made for two companies, Infomedia and Treasury Group, that were in *Top Stocks 2012*, and which were formerly in the All Ordinaries index but have since been excluded.)

- It is necessary that all companies be publicly listed since at least the end of 2007, and have a five-year record of profits and dividend payouts, each year.
- All companies are required to post a return-on-equity ratio of at least 10 per cent in their latest financial year. No company should have a debt-to-equity ratio of more than 70 per cent.

- It must be stressed that share-price performance is *not* one of the criteria for inclusion in this book. The purpose is to select companies with good profits and a strong balance sheet. These may not offer the spectacular share price returns of a biotech start-up or a promising gold miner, but they should also present far less risk.
- There are several notable exclusions. Listed managed investments — as defined by the Australian Securities Exchange (ASX) — are out, as these mainly buy other shares or investments. Examples are Australian Foundation Investment Company and all the property trusts.
- A further exclusion are the foreign stocks listed on the ASX. There is sometimes a lack of information available about such companies. In addition, their stock prices tend to move on events and trends in their home countries, making it difficult at times for local investors to follow them.
- It is surely a tribute to the strength and resilience of Australian corporations that, despite the volatility of the past few years, so many companies have qualified for the book.

Changes to this edition

A total of 20 companies from *Top Stocks 2012* have been omitted from this new edition. Three companies — Coal & Allied Industries, Count Financial and Macarthur Coal — were acquired during the year and delisted. Three companies from *Top Stocks 2012* were excluded because their debt-to-equity ratios rose higher than 70 per cent:

- Computershare
- iiNet
- Tabcorp Holdings.

The remaining 14 excluded companies had return-on-equity figures that fell below the required 10 per cent:

- APN News & Media
- Euroz
- Harvey Norman Holdings
- Industrea
- IOOF Holdings
- Newcrest Mining
- Oakton

- QBE Insurance Group
- Ridley Corporation
- Select Harvests
- Tassal Group
- Ten Network Holdings
- Toll Holdings
- Wide Bay Australia.

There are 17 new companies in this book (although six of them have appeared in earlier editions, but were not in *Top Stocks 2012*). The companies are:

- Breville Group*
- Clough*
- Crown*
- Emeco Holdings*
- Gazal Corporation
- Global Construction Services*
- Hansen Technologies*
- JB Hi-Fi
- McMillan Shakespeare
- NIB Holdings*
- NRW Holdings*
- Platinum Asset Management*
- Ramsay Health Care
- RCR Tomlinson
- Redflex Holdings*
- The Reject Shop
- Slater & Gordon.*

* Companies that have not appeared in any previous edition of *Top Stocks.* (Note that Crown was formerly part of Publishing and Broadcasting Limited, which has appeared in earlier editions of this book.)

Companies in every edition of *Top Stocks*

This is the 19th edition of *Top Stocks*. Just three companies have appeared in each one of those editions:

- ANZ
- Commonwealth Bank of Australia
- Westpac Banking.

Once again it is my hope that *Top Stocks* will serve you well.

Martin Roth
Melbourne
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2012