Investment Insight

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A 2017 perspective on long-term valuation driven investing

Morningstar Investment Management Australia Limited

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"Every once in a while, an up-or-down-leg goes on for a long time and/or to a great extreme and people start to say 'this time it's different'. They cite the changes in geopolitics, institutions, technology or behavior that have rendered the 'old rules' obsolete. They make investment decisions that extrapolate the recent trend. And then it turns out that the old rules still apply and the cycle resumes. In the end, trees don't grow to the sky, and few things go to zero."
– *Howard Marks, The Most Important Thing: Uncommon Sense for the Thoughtful Investor*

Intuitively investors know the principles of buying low and selling high. Yet investors tend to do the opposite of what works in investing because investment decisions are often driven by emotion. Investors get excited when the market's rising and everyone else is buying. And of course, on the flip side, they panic and sell when the market is trending down. This behaviour leads to the poor outcomes identified by the 'investor behaviour gap' (the difference between a fund's reported return and the investor's return).

In Morningstar's opinion, the best way to ward off the negative outcomes mentioned above is to:

- Set clear and realistic long-term goals,
- Select quality investments at prices offering a margin of safety relative to their intrinsic value, or what something is 'really' worth,
- Be prepared to invest with an independent mindset relative to the short-term herding behaviour of the market, and
- Consider the role of each distinct holding through the lens of the total multi-asset portfolio

With this in mind we make the following further comments:

- **We are aware that some clients may feel disappointed with the recent returns in our multi-asset SMA portfolios.** It's easy to see why clients may feel that way, given the strong returns (+22% total return) delivered by the Australian stock market over the 12 months to 28th February 2017, with newspaper headlines ever bullish, whilst the Balanced portfolio delivered 7.4%, over this period. In the previous two years however, the situation was reversed with Balanced portfolio returns exceeding the Australian share market, while at the same time, experiencing a fraction of the fluctuations in account balances.

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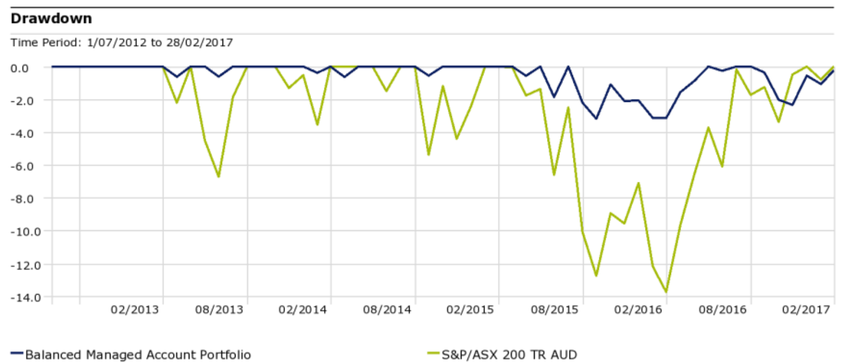

Source: Morningstar Direct

We know it's natural to be looking at competitors and peer groups over 12 month periods but caution that it is not the right way to create long-term wealth. Avoiding the human urge to follow short-term trends is incredibly difficult; but our investment philosophy and investment principles are clear…. "A disciplined focus on long-term investing and meeting portfolio objectives is the only sure-fire way to grow wealth and avoid investors changing strategy at the wrong time." In times when investors are challenged by near-term market pessimism or euphoria, it is imperative that they acknowledge these uncomfortable emotions but look beyond the noise, volatility and sentiment in remaining committed to their investment strategy.

"The four most expensive words in the English language are 'This time it's different'." – *Sir John Templeton*

Remember the concerns in the first two months of 2016 when equity markets were down over 10%, yet the Balanced SMA's capital value fell by less than 3%? Investing where we see the best reward for risk makes sense for us, although being different does make you stand out from peers from time to time, which brings us to the below point:

- **The SMA portfolio objectives are to beat CPI by a margin, over a time horizon in excess of 3 years, whilst minimising capital drawdown.** The portfolios remain ahead of their CPI+ objectives over the longer term, whilst demonstrating that they minimise losses in times of market stress.

In late 2016, we avoided the urge to buy Australian and US equities at times when we considered the broad market to be overvalued. Also, consider that the valuation of certain sectors may offer more portfolio attractions than the broad market. In the US, Healthcare and Telecoms offer more attractive opportunities going forward than Materials/Commodities and Technology. Financials, especially Banks, are cheaper everywhere outside of Australia. Energy companies are only attractive in Europe where the large companies have balance sheets and operating leverage to withstand oil price downturns. As multi-asset investors, we can position our portfolios toward these specific themes and currencies.

A desire to be independent means that we see opportunities to buy bonds, along with new areas of the Australian equity market where the current price is below fair value with a margin of safety – Brambles, Platinum, Telstra. These companies might seem a difficult place to invest right now, but often the best time to buy is when a stock is unloved and experiencing short-term pain.

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Portfolios have started off the 2017 calendar year with low single digit returns despite the stock market being driven by a small number of sectors; and the overall risk to value equation looking ever threatened.

- **Perspective on 2017 Australian reporting season:** Overall this was a good reporting season with evidence of a broadening profit improvement. Resources stocks, despite their strong results, underperformed, implying broad profit taking and a view that commodity prices may have peaked for now.

  Given banks are typically late cycle, the most recent results do not alter our negative view on the Banking sector. Whilst housing remains firm, we still consider the macro backdrop as fragile given the highly indebted Australian household sector will confront a much more challenging and hostile earnings environment in the next few years. The good times from easy monetary policy (which has boosted household cashflows) is likely to slow significantly and, if our analysis is correct, possibly turn into challenging times as the RBA has used up most of its ability to sustain relatively higher credit growth rates to the household sector by continuously lowering interest rates.

  Industrials delivered mixed results. Woolworths delivered a solid result, while Brambles fell short. The Healthcare sector was mixed, while consumer companies from Navitas (adult learning) to Crown (gaming) have revealed future outlooks different to what was previously communicated to the market. We maintain our research focus on these companies and will avoid the urge to act with a short-term mindset.

  The key themes in this season were stock-specific rather than thematic:
  - Lack of strong growth being converted into cashflow
  - Input cost pressures are rising
  - Management choosing to buy back shares and return capital to shareholders, as opposed to reinvesting in the business

- **Outlook:** Our key portfolio positions reflect a view of relative weakness ahead in many parts of the Australian economy, continuing improvement in the US economy but with share valuations remaining stretched, improving earnings growth in Asia and Japan coupled with a rising US bond yield environment.

  Experience has taught us to see the investing world through the lens of absolute and relative valuation; cautiously but positively awaiting opportunities to buy great quality assets at times when their price is below the intrinsic value. The last years have taught us that those opportunities always become available and we expect 2017 to be no exception. M

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