AUSSIE STOCKS
PUNCH ABOVE THEIR WEIGHT

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WHILE AUSTRALIAN SHARES HAVE REBOUNDED STRONGLY SINCE THE GLOBAL FINANCIAL CRISIS, INVESTORS HAVE YET TO RE-ENTER THE MARKET ENTHUSIASTICALLY, PUTTING SOLID GAINS AT RISK.

When it comes to quality of earnings, exposure to other countries and plain old resilience, Australian shares punch above their weight, fund managers and economists say.

However, the domestic market's tough qualities did not shield investors from losses during the global financial crisis (GFC), with those in retirement having suffered most.

The benchmark S&P/ASX 200 Index has rebounded nearly 40 per cent since plumbing a GFC-related low finish of 3145.50.

Nonetheless, the gains have not yet enticed advisers and their clients to return to equities in a meaningful way – and they risk missing out on solid gains as a result. "Aussies have become too conservative," CommSec chief economist Craig James writes in a recent report.

"Foreigners are trimming cash holdings and embracing shares."

His comments were based on federal government data showing foreign investors bought a net $11.4 billion in domestic equities in the December quarter, an increase of $3.7 billion compared with the September quarter 2011 estimate.

Frankly, equity market returns on a risk-adjusted basis have been pretty poor. I don't think anyone should be surprised that people are hoarding cash.

– Don Williams, Platypus Asset Management

The increase brought the value of Australian-listed shares held by foreign investors to $537.9 billion as of the end of December. The sum represents 46.6 per cent of the market's total capitalisation – the highest proportion in 19 years.

"Australia is perceived in many ways as a proxy for emerging Asia," Fiona Clark, investor relations manager at fund manager Prime Value, says.

"We've got everything you could hope for in terms of a developed economy – our health system, our education system, our legal and regulatory system. On top of that, we've got this exposure to emerging Asia. It's really the best of both worlds. It provides foreign investors an opportunity to get that kind of growth exposure without the risks of the unknown."

Figures over the same period show cash remained king, with households holding 26.5 per cent of assets in cash or deposits in the December quarter. Companies held 45.4 per cent of assets in cash and deposits – a 22-year high.

The drastic reduction in the risk tolerance of Australian investors is worrying if the trend towards stepped-up foreign investment continues. However, the high cash holding does have an upside. "Certainly there is significant upside for equities when the cash starts getting put to work," James says.

Alphinity Asset Management principal Johan Carlberg agrees.

"I think we can say that risk avoidance went too far last year. I think we will see better appetite for risk assets such as equities this year. In the long term, I have no doubt that markets will provide solid returns from current levels," Carlberg says.

Risk on?

Platypus Asset Management chief investment officer Don Williams says the jitters are not misplaced.

"It's very understandable," Williams says.

"Quite a few markets have burned people over the last few years, especially during the GFC, so things that were supposed to be safe, like mortgages and property investments,

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John Carlberg, Alphinity Asset Management
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Shane Oliver, AMP Capital

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didn't work out the way they were meant to.

"Frankly, equity market returns on a risk-adjusted basis have been pretty poor. I don't think anyone should be surprised that people are hoarding cash. The other thing with cash in Australia is you actually get a decent return, unlike most places."

The conservative sentiment may be shifting, according to Russell Investments' first quarter 2012 Investment Manager Outlook survey of 40 Australian investment managers.

"This quarter, managers' risk appetite visibly increased," Russell Investments managing director of consulting and advisory services Greg Liddell says.

Liddell says the latest survey shows a strong swing towards Australian shares and other growth assets, such as Australian real estate investment trusts.

"This has been spurred along by relatively low yields on Australian bonds and attractive valuations on Australian equities, which 64 per cent of managers still believe are undervalued," he says.

He says improved outlooks for the United States and European economies, as well as China's ability to engineer a soft landing have led the managers surveyed to take a more 'risk-on' approach to allocations to Australian shares within their portfolios.

AMP Capital head of investment strategy Shane Oliver says domestic equities have held up well, despite the re-emergence of jitters over Europe.

Oliver says investors have started to recognise value in the domestic market after two years of relative underperformance, aided by the Australian dollar slipping below its highs, a growing view the Reserve Bank of Australia will cut interest rates sooner rather than later, and signs that China looks less worrying.

"After a strong March quarter, it's now clear that we have entered a rougher patch in global share markets, triggered by renewed worries about Europe and a softer patch of data in the US, with investors naturally fearful of a re-run of the last few years where a strong start to the year saw shares peak around April, only to fall 15 to 20 per cent over the next few months," he wrote a week ago.

"Our assessment is that this rough patch could continue for a few more months. However, any correction should be mild – say 5 to 10 per cent rather than 15 to 20 per cent – and we still see share markets higher by year end."

However, the positive sentiment has yet to filter to advisers and their clients, according to a survey by financial services market research consultant Investment Trends.

"There's a general trend away from growth assets towards more defensive assets," Investment Trends senior analyst Recep Peker says.

"This has affected planners' use of direct equities.

"Over the past year, only half of

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FUND MANAGERS' PICKS

Anton Tagliaferro, Investors Mutual investment director:

"You have to look for companies that can restructure, where there's value within the company and they release that value. One at the moment that we're focusing on is Origin Energy, which owns utility assets. It also owns the [Australia Pacific liquefied natural gas] assets in Queensland, which they're developing.

"At the moment, the stock, on all our measures, looks very undervalued. That's because many investors aren't comfortable holding a gas business with a utility business. If they could spin those apart, there's no doubt that would add value for shareholders."

Don Williams, Platypus Asset Management chief investment officer:

"CSL is one we've owned in the past and we've bought back in the last six months. I think CSL will hit all-time highs over the next few years. It's a great business, they continue to innovate and manage to grow at 10 per cent or better, which, given they're a major player in their market, shows you the quality of the business.

"We also like some consumer stocks. We own businesses like Domino's Pizza, Flight Centre and Super Retail Group. All of those stocks have performed quite well in their sector relative to the market, even though they're in a sector that, as a whole, has been doing it tough."

Fiona Clark, Prime Value head of investor relations:

"Two stocks we like are Amcor and Brambles. Both are turnaround businesses with core, stable backgrounds.

"With Amcor, the number one thing we like about them is their strong balance sheet. It fits with our risk-minimisation strategy and gives them the opportunity to pursue a variety of growth strategies."

planners say they placed new client money into direct equities. This is down from 63 per cent the year before."

Volatility is the big deterrent, according to the answers of the 522 planners and advisers who took part in the Investment Trends survey.

"The barrier with notable increases is market volatility," Peker says.

He adds that another group of planners said they weren't using direct equities because their clients weren't asking for this type of investment.

"We use that as a proxy for planners' confidence. When planners are confident, they won't wait for clients to ask," he says.

Investment Trends also asked advisers what would prompt them to invest more clients' money into direct shares.

"For 25 per cent of financial planners the answer was improved market conditions. That is a significant increase from a year earlier," Peker says.

Investors Mutual investment director Anton Tagliaferro says market volatility makes it all the more important for advisers and their clients, bombarded by 'noise' since the GFC, to filter most of the information out of investment decisions. "The important thing, the thing we try and focus on, is what do we believe a company is worth," Tagliaferro says.

"It's not what the share price is doing, it's not what everyone is buying, it's not that China is going to keep growing for 20 years or 100 years, it's not that everyone is buying technology stocks.

"Everything in our portfolio, we spend our whole day looking at that portfolio thinking, 'does that share price still make sense based on what we know that company is going to earn over the next 12 to 18 months, two years, three years, four years, or is it getting a bit overvalued?'"

Beyond borders

Russell Investments asked managers to name the biggest factor driving their investment decisions for the year ahead.

"The majority of managers ranked Chinese economic growth as the biggest contributing factor," Liddell says.

The finding appears to add weight to the view that even though Australia's market capitalisation makes up only 2 per cent of the world Morgan Stanley Capital Index, Australian stocks punch above their weight in terms of exposure to other markets, including the US and China. "Geographical diversity in the traditional sense – this much of your portfolio in the US, this much in Europe – is irrelevant to me these days," Clark says.

"What is important is the geography of earnings – where companies derive their earnings. To a large extent, you can get that diversity of earnings from Australian companies."

She cites Australian-listed companies with exposure to the US – including rubber gloves and condom maker Ansell and blood products company CSL, as well as building products manufacturers Boral and James Hardie. "There are companies in the resource sector that have exposure to the emerging companies in Asia, and some of our

banks, such as ANZ, do as well," she says.

Fidelity International portfolio manager Kate Howitt says Australia has been a huge beneficiary of the industrialisation and urbanisation of China. "Australia has been the lucky country over the last 10 years, particularly because of our leverage to China at a time when China was going through a very metals-intensive phase of our growth," Howitt says.

The Chinese government has been keen to see an economic shift away from building infrastructure to consumption, and Howitt says it would be difficult to get exposure to Chinese consumption-related stocks, such as luxury goods and car manufacturing, from Australia's market. Nonetheless, she says exposure to China and its heavy demand for Australia's resources have created the domestic two-speed economy, which is one of Australia's great strengths.

"Those businesses that we all despair of right now – retail, manufacturing, tourism – will do better when interest rates are lower, and employment is not being sucked up by people going out to the Pilbara to drive trucks, and the exchange rate is lower," she says.

"History says we have a flexible economy. When mining is strong, other sectors are weak, but when mining is

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>
> *– Kate Howitt, Fidelity International*

weak, the other sectors bounce back.

"Yes, mining might roll off, but the other sectors will bounce back and start to do the heavy lifting in the economy." «