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When growth makes itself scarce

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Australian equities have been given a bad rap since the decline in the mining and resources sector, but is there still value there or is it really all doom and gloom?

Australian equities have certainly had a rough start to the year: market volatility and uncertainty have plagued 2016, and the mining and resources sector has declined following the fall in commodity prices.

However, while investors were predicting doom and gloom, some advisers are not convinced we are in bear market territory. They believe there are still many opportunities in the space.

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Prime Value Asset Management portfolio manager, ST Wong, said the three major concerns for the sector this financial year were declining oil prices, global growth concerns, and policy uncertainty in China.

"I think these will continue to linger on investors' desks for some time and I think it will make it difficult for risk assets in the short term," Wong said.

"It was a poor start to FY16 but I don't share the media and across-the-board view that we're entering a bear market.

"There are risks in the market but in my perspective there are sectors that are still quite interesting within the Australian market."

AMP Capital head of investment strategy and chief economist, Shane Oliver, said the market slipped into the bear market territory for one day this financial year.

"I suspect if the market doesn't dip back into bear market territory, was it even a bear market to begin with?" he said.

Goldman Sachs, senior investment manager for Australian equities, Katie Hudson, said "what's been unusual with the market is that despite it being a down market, it's actually been rallying risk".

"So you've seen resources and energy sectors, and a lot of cyclical businesses outperforming which is slightly unusual in a down market environment," she said.

"In terms of what's been good, the first half of FY16 didn't deliver the major downgrade to earnings that a lot of people were expecting, but it was certainly not an upgrade.

"About 60 per cent of companies reported numbers at that line and above market expectations. So that's a pretty solid outcome against the backdrop of the market that was quite nervous and had traded down for the first part of the year," Hudson said.

FLAT AS A PANCAKE

While the sector could remain flat for some time, advisers should be looking outside the top 10 to 25 per cent of the top listed companies, and could perhaps look at small to mid-cap sectors, Wong said.

"The fact is, there are a number of companies that are growing quite well and actually sit beyond the top 10 to 20 companies in the listed space. We think that will continue to feature in the Australian market and into the next 12 months," he said.

Wong cited packaging products company, Orora, as a typical mid-cap firm that did not fall into most fund managers' radars.

"As a mid-cap company it has a market cap of $2.7 billion, so it really sits outside top 50 companies. It's going to grow at an average of 10 per cent in the next two to three years from a combination of good organic growth, potential acquisitions, and trades on a decent PER [price to earnings ratio] of 17 times," he said.

"That is a typical company that is well managed, has a very strong balance sheet, and able to grow a decent clip of earnings of high single digits to about 10 per cent. Paying about 17 times next year's earnings is not excessive for the quality of the company of such nature."

Wong said it was important to look at structural growth themes affecting the market during a flat market to protect the downside and to have sustainable growth over the medium-term.

"Aged care and healthcare are structural growth themes affecting the market, but obviously be quite cautious in paying for stock. That's one area I think advisers should be looking for," Wong said.

"Demographic change is also important as it affects a number of subsectors, even to the extent of young people in childcare. But demographic change is not limited to Australia.

"We see a key demographic change in terms of Asian consumers. We've seen how Bellamy has made investors 10 times profit in the past 12 months, but the crystallisation of that concept is demographic change.

"Also, what the Chinese consumers are consuming is not just dairy products but also travel and tourism. These are areas that will benefit the Australian market, and where advisers and investors should be looking."

Hyperion Asset Management portfolio manager, Jason Orthman, said advisers needed to pay attention to the balance sheets and net cash in such a flat environment, and find companies that have robust organic sales growth.

"It's pretty flat out there, and so if you look at that top line, that would put your stock portfolio in good stead," Orthman said.

"On the qualitative side, look for those that have pretty defendable business models. So franchises you know and understand are pretty strong and defendable.

"Again in a flat market they can get pretty competitive and you can have discounting breakout or competition breakout, so you really want to find the best businesses and not go down the quality curve, you need to stay up the quality curve."

Pengana Australian equities senior fund manager, Rhett Kessler, said his division was looking for good business models run by competent management teams that generate strong, predictable cash flows at an appropriate yield, regardless of external equity market conditions, and the right price.

"The Australian equity market is fairly unique in terms of the weighting of mining companies and the four main banks in the main indices. As a result, advisers need to consider the exposure those specific companies present to investors who pursue an index," Kessler said.

Hudson said advisers should look to pick winners in the market leaders, but warned not to over pay for growth.

"So where growth in a market is difficult to find I think it's really important to maintain that discipline. And I think we saw evidence of that in this reporting season because we saw a number of growth stocks underperforming because there was no margin of safety around their valuation," Hudson said.

"People are focused on picking the winners and the market leaders, but you need to maintain valuation discipline to make sure you're not overpaying for that growth."

WHERE IS THE VALUE?

With profits in the resources sector plummeting by 41 per cent last financial year and declining another 65 per cent this financial year, Oliver said the Australian economy had to transition away from mining.

He said that the industrials, utilities, and health sectors were doing well.

"If you think of Amcor and Brambles, they might have an offshore business where they're getting paid in US dollars and as the Australian dollar has gone down in value the US has gone up, suddenly their offshore earnings rise and look much more attractive," Oliver said.

"The other thing is a few years ago we were in a two speed economy and now it's going in reverse. If you're exposed to housing related activity or consumer spending, or spending on things like health or education in New South Wales or Victoria, you're doing very well. Those states have received a boost of interest rates coming down, and the Aussie dollar has come down.

"So at the top of the performance leg over the last 12 months is the industrials, then utilities, health is in positive territory, retailing has come down but mainly consumer staples, and consumer discretionary like JB Hi-Fi and Harvey Norman are down four per cent, but it's not a big loss."

Platypus Asset Management chief investment officer, Donald Williams, also said there were some core industrial companies that were producing good growth.

"Healthcare, consumer discretionary, and some consumer stables were still producing reasonable earnings growth, by which I mean better than five per cent," Williams said.

"Growth is very scarce at the moment and that's where we have been playing. So companies like Fisher and Paykel Health for example, JB Hi-Fi produced a very credible result for the first half, and Mantra is a mid-range accommodation hotel chain that provides consistent business.

"We have quite a big exposure to infrastructure names as well with Sydney Airport taking up close to four per cent of the portfolio, and all the infrastructure plays seem to be working."

Williams added that his firm thought the natural resource sector were more opportune now.

Hudson said the banking sector looked extremely attractive, particularly post the recent sell-off.

"We think the concerns around the mortgages and the housing market and credit risk is overplayed and from our perspective the banks have modest but attractive top line," she said.

"They're using their investment technology to drive down costs and retain its productivity basis and in our view banks have adequate capital. In many cases a number of major banks have two times the capital they had pre-GFC, and we think that will prove to be adequate for the marketplace and operating environment they're in."

A BRIGHTER FUTURE

Despite this financial year's shortcomings, Wong believes the market earnings will grow about four to five per cent.

"That's not a great growth rate but when you strip out the two major sectors affecting the market — resources and banking — it is not so bleak," he said.

"Resources is estimated to grow -15 per cent, and when you strip out the banking sector, estimated to grow five to six per cent, you'll find that the market will grow at a decent eight to nine per cent earnings growth rate in the next 12 months. In my view that represents some value in the market," he said.

Rhett said it "feels as though there is a reasonable amount of liquidity continuing to flow into, or waiting to be deployed into equities which continue to enjoy a positive yield spread compared to cash or bond instruments".

"We do however continue to exercise caution, and think volatility could remain a feature in the near term."

However, if advisers and investors were looking for long-term growth, Oliver said it was probably better to jump ship and go overseas.

"But if you want income you'll probably get better income in Australia. People often forget that all the numbers are share price levels and ignore dividends which are quite attractive," he said.