Proceed with caution on Australian equities

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by Jassmyn Goh (http://www.moneymanagement.com.au/authors/jassmyn-goh) | 0 Comments (/features/proceed-caution-australian-equities/#comments)

Australian equities have settled since last financial year's volatility but advisers have been warned to make selective and diversified decisions, Jassmyn Goh finds.

While the 2016 financial year was dramatic for Australian equities, this year has not been quite as volatile and advisers have been warned to proceed with caution.

So far, the growth trajectory and inflation has been far more positive for FY2017, along with stronger performance in commodities.

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Despite last year's performance leading to low expectations, the sector has actually performed better than expected.

Prime Value Asset Management joint chief investment officer and senior portfolio manager, ST Wong, said January kicked off with a number of profit downgrades in the small and midcap space.

"From that perspective, it has quite interestingly indicated that small midcap equities have continued to have a mixed performance overall since back in October and that seemed to have carried on into the early part of January," Wong said.

"The results season has been overall a little bit better than expected. Dividends in fact held up and were better than expected."

Aberdeen head of Australian equities, Robert Penaloza, said the themes for FY17 would still be similar to those seen the year before.

"These are still quite secular themes. I don't think there is anything on the horizon that we see as a particular game changer. This transition away from mining and more domestic bases is still a slow ongoing transition," he said.

"The biggest thing is if we are now going into an environment where interest rates are rising and we've already started to see that in the property investor side and that's going to put more squeeze on the pocket domestically and this search for value is certainly going to intensify."

State Street Global Advisors' (SSGA's) head of active quantitative equities in Asia-Pacific, Toby Warburton agreed there were positive signs of beating expectations in the resources complex, and that the equity market as a whole really followed the rest of the world.

"It [FY17] was pricing in an expectation of a benign gross environment, post Trump. A lot of his policies could be positive for equities. For example, reforms of the financial sector could be beneficial to banks, tax cuts could be beneficial to companies in many different sectors, but these policies also come with risks," Warburton said.

"If you have too strong a stimulus and tax cuts on top of that there is a danger of overheating.

"So I think the Australian market has really followed the US and the rest of the world in this very benign scenario which may well come to pass but we think there could be risk and volatility around the execution of some of

these plans."

BE SELECTIVE

Despite the market looking up, Wong warned that advisers should be cautious when considering Australian equities and to use a diversified approach.

He said advisers should have a broad exposure to different segments of the market so that they would not be caught out if a certain sector took off or slowed down.

"Don't be narrowly focused, be diversified but be selective in the companies that you hold. Being too narrowly focused will increase the risk profile of the portfolio," Wong said.

"For example if you think resources is a key sector you want to invest in, I'd say be a bit more broad minded, focused, and make sure you've got a diversified pool of stocks in your portfolio across value, growth, banks, and the resources sector."

Wong noted that growth was still essential in a portfolio but that advisers needed to be more selective from a valuation perspective.

"Be more selective but at the same time the market will gravitate towards growth for the medium-term," he said.

Penaloza said Aberdeen's approach was very much bottom-up stock picking, along with understanding the strategy of the business, the drivers to execute the strategy and the financial strength in the company that management could use to apply that strategy.

"We call those qualitative metrics that we really need to understand and to get our head around and be on board with. Those are without a doubt very important factors for advisers to be thinking about," Penaloza said.

He noted that while the going was good in the US with Trump, the president was an unpredictable variable over the mid-to-long-term "if his tenure lasts that long".

"Whilst we've all been buoyed by, maybe the Trump trade, it can be very easy to turn the other direction if he's not mindful with his actions and policies," Penaloza said.

Morningstar portfolio manager, Bryce Anderson, said advisers and investors needed to understand the risks associated with investing in a particular stock or asset class, and that trade-off between reward for risk.

"You might be getting paid a reasonable return but you might be taking absolutely enormous amounts of risk in the way you're accessing an opportunity or whether you're going passive into Australian equities. That return for risk is an important consideration," he said.

Anderson said having equities was not just about looking at the home front, adding it would be beneficial to look elsewhere as well.

"You don't even need to go far from home. [You can] go up into Asia and look up the world class companies that are under-represented in a sector point of view in Australia. You can tap into that quite easily," Anderson said.

"There are world class companies that are close to home that provide a great return potential for investors but also from a diversification point of view and not having all your eggs in one basket. Australians always have had a home bias but it pays to look elsewhere."

Noting the argument for franking credits with Australian equities, Anderson said while it did add to a portfolio it was only one part of the story.

"Let's say emerging markets did 10 per cent over the next five years, and Australia did 3.5 per cent figuratively speaking, I don't think anyone is really going to care about the 1.3 per cent franking credit on top of your 3.5 per cent when you could have gotten 10 per cent elsewhere," he said.

"It does provide a hurdle but given the opportunity set it's not an insurmountable hurdle having to overcome that franking credit you don't get offshore."

Warburton said advisers should think about fundamentals and not get too caught up on one or two themes.

"Focus on fundamentals, companies, share prices, and valuations. If advisers want to allocate their clients' money to active equities portfolios – they really need to make sure they're buying truly active management so make sure you're really getting real value for money and properly active portfolios," he said.

Warburton noted that there were a lot of active managers in Australia that were building portfolios on a relative base to a benchmark index.

"The dangers you end up with are returns based on the index. If you're truly active and you build your portfolio based on your best expectations you may end up with different returns and differentiated returns for your clients," he said.

PILLARS OF THE MARKET

Wong said he was generally positive on the market trajectory as the three key pillars of the Australian market – resources, banking, and industrials – were growing together for the first time in years. However, he was not feeling particularly bullish.

"Resources will be well supported and we won't see a repeat of last year where BHP went from $20 to about $25 to $26, Rio Tinto had a really good run but I think having said that they will be well supported, the banks in general will also find that support will be there," he said.

"I'm not super bullish but I think valuations have moved up. Earnings are reasonably robust and the fact that we have three major sectors growing at the same time I think that is quite positive for the Aussie market."

Wong noted that for FY17 he was not keen on the growth of small caps as he predicted they would have patchy performance despite some pockets of value.

He said he would avoid companies that were depending on significant store roll outs, especially in the retail sector.

"One of the key themes this reporting season is how patchy or divergent the performance is in the retail sector. Apparel has been negative, but on the other hand JB Hi-Fi is linked to housing markets and has been performing quite well... there are certainly distinctions between the sectors and even within the retail sector itself," he said.

On value, Wong said last year saw a huge rotation of growth and quality into value companies.

That process had gone a long way and Wong said the value and the best bang for investors' bucks would come through companies such as bio therapeutics firm CSL, and packing firm, Orora.

Penaloza also said CSL had really strong results along with Cochlear, and wine estates such as Penfolds.

"Those that have controlled costs may not necessarily have so much control on product pricing, so miners for example came out with quite good results and cashflow because they're quite careful on the costs earlier on," Penaloza said.

According to Anderson, it was hard to make a general call on a particular sector as it was reasonably stock specific at the moment.

He noted there was selected value in healthcare and that resources were not necessarily cheap.

"Going forward I don't think we see the iron ore price in particular sustainable above $90 and from here an entry point where the market is priced at $90 is not a good entry point to get into resources. So generally we think it's a reasonably expensive part of the market largely given where iron ore prices have gone to in the short-term," he said.

OUTLOOK

Anderson said advisers and investors needed to think about investing in equities over the long-term (five to 10 years) so that the valuation would play through.

"If you buy cheap assets, attractively priced and hold them for a long time you should do well. As opposed to if you buy expensive assets over the long-term… If you try to predict what markets are going to do over the next 10 months I think it's a very hard exercise," he said.

"But the opportunities to buy in the next 10 months will set you up for the long-term by sentiment driven markets which fall because of macroshocks that might have very little to do with the underlying fundamentals of a company."

For Wong, 2017 will still have high volatility thanks to event risk from political events.

"My view is that the market will react to headlines and will be investing in headlines this year as we've seen to some extent last year," he said.

"We won't be able to escape the headlines but within that there are opportunities to seek out value in the Australian market."

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