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WHERE TO FIND VALUE IN SHARES

Value is harder to uncover as the Australian market recovers. But there are possibilities, based on the assumption that resources continue to boom and there is an eventual pick-up in the United States, writes **Tony Featherstone.**

The two-speed economy creates a dilemma for investors looking for value: should they pay more for resource-related companies exposed to Asia, or buy seemingly cheaper industrial stocks in anticipation of economic recovery in developed nations?

There is no easy answer. Continued strength in China and a faster than expected recovery in the United States would propel resource stocks and the local market to new highs and create the next bull market leg.

But risks are rising relative to stock valuations, with fears that global share investors are discounting serious threats: namely European sovereign debt issues, potential Chinese asset bubbles, rising US bond yields, global commercial property debt that needs to be refinanced, consumer indebtedness, and waning global growth as fiscal stimulus recedes.

A breakout in any of these risks would see resource stocks fall hardest and Australian shares correct. Conversely, stronger domestic growth could drive the official cash rate from 4.25 per cent today to above 6 per cent by late 2011 and widen the performance gap between Asian and domestic-focused stocks hurt by higher interest rates.

This part of the equities cycle – when easier gains have been made and higher valuations depend on earnings growth – is difficult to judge. Some fund managers say privately that they are finding it harder to outperform as rising valuations and lower volatility creates fewer buying opportunities.

Australian shares are nearing fair value on most measures. MSCI Barra data show local share trading in line or at a premium to most developed markets on metrics (such as average trailing price-earnings [PE] ratio, share price-to-book value, share price-to-cash-earnings, return on equity and dividend yield) as the accompanying table shows.

Rising valuations and lower volatility are creating fewer buying opportunies.

Forward-looking metrics also show the sharemarket nearing full value. Macquarie Research forecasts a full-year 2010 PE of 16.6 times for companies it researches, falling to 13.1 times in full year 2011. The average market P/E since 1997 is about 15 times. Macquarie tips a total shareholder return of over 15 per cent (from 4900 points for the S&P/ASX 200 index). UBS this month lifted its end of year market forecast by 100 points to 5550 points, or 12 per cent growth from current levels.

Bottom-up forecasts suggest the market has another 10 per cent left before it is fully valued.

Morningstar's equities research team examined intrinsic value against current share price for 240 stocks it covers. The ratio was 0.9, with 1 representing fair value. Fund Manager Roger Montgomery, author of the upcoming value-investing book, *Value.Able*, says 70 of 1874 ASX-listed companies are trading below their intrinsic value on his numbers, from about 300 stocks six months ago.

The view that the market is closing in on fair value prompts two questions. First, is it worth chasing shares higher in the short term for another 10 per cent, especially when the market is traditionally weaker after May? Second, is there more value than market metrics suggest, and hidden pockets of exceptional value?

"I don't believe the market is excessively valued at all," says George Clapham, managing partner of Fortis Investment Partners. "There seem to be some mismatches in value."

One of the biggest, says Clapham, is the changing composition of market indices amid the resources boom. Twelve commodity-related stocks, many without earnings, have joined the index in the past 15 months. Clapham says there are 52 resource or energy companies in the top 300 companies that will not make money in 2010. Their aggregate market capitalisation is more than $28 billion. The rise of mid-cap miners into the top indices constrains aggregate index earnings, and is possibly distorting the market's average P/E multiple.

There is also a case the market's long-term average P/E multiple should rise, given Australia's economic outperformance, stronger fiscal debt position, and improving terms of trade. The ability to support growth through higher immigration and Australia's position as a "Western" proxy on Asian growth also support a higher

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FINDING THE ROAD TO VALUE

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valuation. The main negatives are consumer indebtedness, a potential residential property bubble, and the need for companies to raise more funds though equity rather than debt, increasing their cost of capital and affecting performance.

On balance, fund managers are still bullish towards Australian shares, shows the latest *Russell Investment Manager Outlook*, which surveyed 36 local fund managers in March. Almost 60 per cent of respondents saw continued gains for Australian shares relative to international shares over 12 months, down from a record 73 per cent in the last survey. The number of fund managers who think local shares are undervalued doubled to 38 per cent.

"You have to invest where the momentum is and right now that is Asian economies and countries such as Australia exposed to them," says Joe Bracken, head of global macro strategy at BT Investment Management. "Within Australian equities, momentum is in resources and related sectors. At some point, investors will rotate away from the Asian theme towards the US. But that is at least 12 months away."

Investors who maintain a resources bias and see better value in commodity-related stocks are betting China maintains near double-digit growth. Jim Chanos (a prominent American hedge fund manager, short seller and noted China bear) warns China will have a hard economic landing due to a dangerous credit bubble. Australian equities have much to lose if Chanos is right.

Key local investors are more positive on China. Mark Delaney, AustralianSuper's chief investment officer, recently met authorities, economists and companies in China to gauge its economic sustainability. "I am confident policymakers are doing a good job of growing the Chinese economy but not stimulating it too much," says Delaney, whose fund manages more than $30 billion and the retirement savings of one in 10 Australians. "China should grow around 8 per cent or roughly in line with its productive capacity. I don't expect the type of double-digit growth we saw in 2006 and 2007 that fuels higher inflation and creates asset-price bubbles."

Delaney's positive China assessment contrasts sharply with that of the US economy by Neil Carter, a portfolio manager at Macquarie Funds Management. "I am bearish on the prospects for US economic recovery. Mortgage-stress is still front-page news, the US consumer is still grumpy, and unemployment could stay near double-digit rates for some time. Investors should stay exposed to companies benefiting from local and Asian economic growth."

Make no mistake: value is getting harder to find by the day as the market rises. Here are seven themes to spot opportunities over 12 to 24 months, predicated on continuing resources strength and, later, a US recovery.