THE AUSTRALIAN
WEDNESDAY, JUNE 1, 2011

WEALTH

INVESTMENT PROPERTY
Five signs you should consider selling (P5)

Hunting for value

Despite the weakened sharemarket, cheap buys are thin on the ground

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EVERYONE in the stockmarket wants to buy value: that is, a stock they can be confident will rise in price.

But what if value is hard to find?

"I look at the market and I just don't see any obvious value," says Monik Kotecha, chief investment officer at Insync Funds Management.

"It's such a tough market, with an upside bias to interest rates and the high Australian dollar affecting corporate earnings. I wouldn't buy anything at the moment."

Imran Valibhoy, senior analyst at WiseOwl, says the question of where value is, is "the $1 million question" at the moment.

"The problem is that investor sentiment is very weak and that sentiment is playing a bigger role in the market than it has for a long time.

"Even if you can find a stock looking attractive on a price-earnings ratio or some other valuation, people are really going to take their time to decide whether to buy it because they're wary of the market taking a dive if the sentiment gets any worse."

Broker estimates have the S&P/ASX 200 stocks trading at a forward price-to-earnings ratio (based on 2010-11 expected earnings) of 14 times and a forward 2011-12 P/E of 12 times. Given that the long-run average P/E (based on forward earnings) since 1993 is 14.7 times, that should imply a cheap market. But the problem is the E (earnings).

"The P/Es that the market is trading on effectively tell us that we're going to get 20 per cent earnings growth this year, for the market to be on 14 times, and then we've got to get 26 per cent earnings growth for the market to be on 12 times P/E for 2012.

"Given all of the headwinds around, that looks to me to a very big task," says Jeremy Bendeich, chief investment officer at Avoca Investment Management. "If you want to take those P/Es on face value, you've got to trust

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Finding the value in a fluctuating market

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the E [earnings] forecasts, and that's difficult for a lot of investors."

Valibhoy doesn't see the Australian market (the S&P/ASX 200 stocks) as being expensive, but neither does he see it as cheap. "The market isn't fully valued: it's just that there are times in the market in which sentiment plays a much bigger part than normal valuations and that's what we have at present.

"You can tell people that a particular stock is good value, but they're not going to listen to you if they're fearful of the market taking a hit because investors are jittery about the European debt crisis or the US debt build-up or the prospect of China slowing. Sentiment rules the roost at the moment," he says.

Bendeich is in the unique position of starting a new small-capitalisation fund from scratch, after UBS's Australian small-caps team left the firm in April. Bendeich and the team have partnered with Bennelong Funds Management to start Avoca, which goes live on July 1. He says it is an interesting time to be starting a new fund because "there's no screaming value that leaps out at us".

"There is not a lot of absolute value that we can see at the moment, but given that we invest on a relative basis — we've got to be invested, we can't just put the whole fund in cash — we'll choose the stocks that are least over-valued to invest in," Bendeich says.

"We're building our valuation models at the moment and we're getting a lot of valuations that are lower than current share prices. But those relative valuations are favouring industrials: a lot of the valuations we're coming up with in some of the resources stocks are even further from the share price than those we're coming up with for industrials."

There is "always value in the market" if you look hard enough, says Elio D'Amato, chief executive at Lincoln Indicators. "But the question that needs to be asked is, 'What type of value are you trying to identify?' because there is no one determinant of value."

There are many kinds of calculations that can be applied to try to identify value, D'Amato says. One of the most common is P/E ratio, which relates the share price to the earnings stream and costs it; the price-to-net-tangible assets figure (sometimes known as price-to-book), which compares the price to the dollar amount of the company's real assets that stand behind each share; and the dividend yield, the return in percentage terms represented by the dividend yield from a share investment. The lower the P/E, the lower the price-to-NTA ratio, and the higher the dividend yield, the better the value, or so the theory goes.

The NTA also can be compared with the intrinsic value of the company. Discounted cashflow calculations use projections of future free cashflow (what the company generates in cashflow after spending everything it has to spend to maintain the present business) and discounts them back using an appropriate discount rate to arrive at a present value, which can be compared to the share price. Other approaches involve high ROE (return on equity) and low debt stocks, or using an enterprise value calculation, which compares the operating earnings to the sum of the company's market capitalisation and debt.

"All of these can be used in different scenarios. Often when all are applied to the same company you can get conflicting results. Therefore every company needs to be analysed on its merits taking into account its forecasts, its current positioning both financially and within the industry it operates in," D'Amato says.

"Our method is to first ensure that a company meets key fundamental benchmarks such as solid financial health, efficient earnings generation and positive profit growth. Once we do this we take the company apart to analyse its current structure, positioning and growth prospects. We then apply a valuation technique appropriate to the business in its current life cycle and work out what we believe to be the stock's intrinsic value."

Roger Montgomery, managing director of Montgomery Investment Management, says retail investors often don't get past the P/E, the price-to-NTA ratio and the dividend yield, but the problem is that these three ratios are based on the share price.

"The P/E doesn't tell you anything," Montgomery says. "It can't tell you what's cheap or not because price can't tell you anything about value. When you're calculating value, it's got to be completely independent of price."

Montgomery focuses on the returns generated by the book value of the company. "We're looking at how powerful an earner is that book value. We use net asset value: we include intangible assets because they're actually more powerful in many cases, they're more valuable. We're valuing all of the money that's been put in and left in the company."

For example, he says, suppose you have $1 of book value, earning 10 per cent a year, and you're happy with that return. "That book value is worth $1. If it's available in the market for $2, you wouldn't touch it. But if it's available for 50c, you might be very interested in it.

"Or let's say we find a business that has $1 of book value, and we believe in the future it can continue to earn 20 per cent a year. We're happy with a 10 per cent return, so we can pay $2 for that $1 of book value, but no more. It's as simple as that," Montgomery says.

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