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Cost-cutting, commodity price collapse were hallmarks of reporting season

Deutsche Bank says the correction on the market was overdone, and the cyclical industrial stocks are value buys. **Daniel Munoz**

by **Jeremy Chunn**

Reporting season may have been punctuated by global market disruption around China but Australian investors' reliance on local listed companies means they want to know what the next few years has in store.

Smart Investor asked a panel of leading local stock analysts - Catherine Allfrey, principal, WaveStone Capital; Roger Montgomery, CIO, Montgomery Investment Management; Paul Xiradis, CEO and head of equities, Ausbil Investment Management and Simon Mawhinney, managing director and CIO, Allan Gray - for their views on growth prospects. Recent market gyrations, a collapse in demand in China, lingering uncertainty about a global recovery and the outlook for interest rates both at home and abroad featured largely in the conversation.

What have you learnt from the reporting season about the state of the local equity market?

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Catherine Allfrey: The local equity market is being determined by global equity market gyrations rather than reporting season over the past month. Reporting season was broadly in line with expectations with 2014-15 earnings per share growth of -2 per cent due to resource earnings collapsing. Excluding resources and financials (or half the market!) the industrials delivered 12 per cent. The Australian dollar translation tailwind boosted earnings growth for companies with offshore earnings, unfortunately many of these companies issued disappointing guidance for 2015-16, such as Computershare, Ansell, Cochlear and Seek, as they deal with specific business issues.

Roger Montgomery: Much of the earnings growth has come from businesses pulling out expenses. This has been a feature for the past three to five years, so all the low-hanging fruit has been cut. Amid anaemic revenue growth earnings growth has slowed dramatically this year. Moreover recent cost cutting and increased dividends – at the expense of investing in the future – speaks volumes about managements' low confidence in achieving a decent return on capital and is symptomatic of a market that is being largely driven by low interest rates.

Investors need growing income more than they need high yields and so we'd like to see management focus on re-investment rather than simply stripping capital to pay higher dividends or return capital via special dividends and buybacks.

We wonder whether their apparent weakness is in fact merely self-interest; a function not only of low rates but also a cohort of pre-retiree baby boomers serving themselves first, by paying shareholder dividends and earning management bonuses supported by immediate returns.

Paul Xiradis: Reporting season is the best time of the year to interrogate corporate management teams and ascertain where the market's key opportunities or pitfalls may lie. At Ausbil, we have concluded there are pockets of real opportunity starting to appear. We believe the extent of the recent share market correction has been overdone and that more and higher quality investment opportunities are starting to present themselves in different sectors.

Simon Mawhinney: Market valuations are probably a little more stretched than consensus would have one believe as the outlook for company earnings seems to have erred on the side of disappointing. Consequently, those parts of the market that were priced for perfection were savaged by mediocre growth outlooks. Cyclical stocks (consumer discretionary, energy and materials) continue to lag given weak commodity prices and weak consumer spending as the market obsesses with uncertain catalysts and widely accepted concerns regarding China's growth trajectory from here. This uncertainty appears to be driving investors to continue to pay up for companies with more certain and defensive earnings streams. But none of that is new – it's been going on for a few years now.

What changes have you made, or intend to make, to your portfolio in the wake of the reporting season?

Allfrey: We were generally pleased with how our stocks performed during reporting season. We have made a few changes on individual stocks and decreased our exposure to telecoms and financials.

Montgomery: There have been no material changes to our portfolio. Only when the

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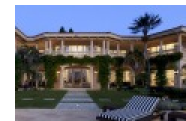

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prospects for a business or its quality change, or the price moves dramatically beyond or below our estimate of intrinsic value, do we make changes. We have simply followed our process and monthly rebalancings, which have caused us to add to positions in Challenger and Isentia.

Xiradis: Our investment strategy remains largely unchanged. Our key thematic approach has been to favour international earnings streams (particularly from the US and Europe), housing-related sectors and high-yielding sectors with earnings growth. In this period of sustained Australian currency weakness, we continue to target local companies that will benefit from global growth and the strong US dollar. We are also maintaining a cautious approach to resource stocks as commodity prices remain subdued and we are starting to see potential opportunities in the energy sector following the significant fall in the oil price.

Mawhinney: We tend not to make investment decisions based on short-term earnings results and instead focus on the long term fundamentals of the companies we invest in. Reporting season does seem to have exposed a few companies previously valued using unrealistic growth assumptions. We're doing a lot more work on these following their price corrections.

What did the reporting season tell us about which sectors equity portfolios should have an underweight exposure to, or no exposure at all?

Allfrey: On a three-year view, due to the oil price collapse some energy stocks will require equity raisings to repair stretched balance sheets before they are investable again. Mining services will remain under earnings pressure as mining companies such as BHP, RIO and Fortescue continue to cut capex and costs.

Montgomery: We believe commodity markets have very long cycles and that we are just a five years into a 10-to-15 year slowdown. Commodity prices (oil, coal, iron ore) will continue to fall, driven by huge increases in supply. At the same time, global demand has been weakening. In terms of the banks, moves by APRA to limit investor loan growth and to increase capital adequacy and risk weighting ratios as well as a re-pricing of investor loans will not go unnoticed by property investors or shareholders. Adding to these adverse impacts is the possibility of a material slowdown in the economy and its impact on the clear underprovisioning for bad and doubtful debts

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Xiradis: We expect the mining companies to remain focused on reducing costs further, which means the contractors and mining services sector in general will continue to be price takers. We expect margins for these sectors will continue to be under pressure.

Mawhinney: Companies with predictable and defensive earnings streams, like the banks, healthcare and infrastructure shares, have become very expensive relative to more cyclical sectors with short-term earnings headwinds. Whilst not a specific comment regarding reporting season, it does seem that these companies are being priced for perfection and any disappointment in their earnings outlook is likely to weigh heavily on their share prices. We are very underweight these companies.

Which companies/sectors should portfolios be overweight in?

Allfrey: We are stock-pickers and continue to be attracted to healthcare, non-bank financial and capital-light businesses with solid earnings growth prospects.

Montgomery: Particularly those with further exposure to a continued fall in the Australian dollar. This has provided above-average growth rates to those businesses with a material amount of offshore earnings. In telecommunications, the sector is characterised as a high-growth and high recurring revenue market – something we find attractive. A large number of businesses in storage, transmission and security are growing strongly with bright prospects amid high and growing rates of data usage, technology adoption and data storage.

Xiradis: The recent falls in the domestic market have been compounded by large share issuances from some of the major Australian banks because of increased capital requirements. The banking sector has corrected by more than 20 per cent, but the Australian banks are unquestionably among the strongest in the world and in terms of pricing and yield; the recent falls represent an excellent buying opportunity and we have increased our bank holdings.

We have also increased our overweight position in BlueScope, which rallied last week despite the China-induced sell-off. The company offers the potential of significant earnings upside and is still trading at a large discount to net tangible assets. We have also been buying more Fairfax Media, which is undervalued, particularly in light of the outstanding result from its digital property arm, Domain.

Mawhinney: The energy and materials sectors continue to massively underperform. The deep cyclical trough and uncertainty around China's future prospects has led to significant falls in commodity prices and an unwillingness to invest in these sectors. Poor earnings and large capital investment commitments have contributed to stretched balance sheets and added uncertainty about future earnings. Many if not most resource companies are trading at multi-year lows and the contrarian in me thinks this may well be the best place to invest for the medium to long-term.

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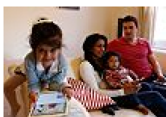
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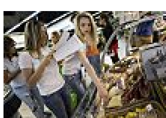
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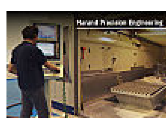
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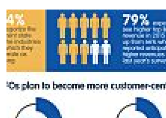
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