> Banks are about to hit a stone wall of rising stress among highly indebted apartment investors.
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Finding value in unlikely places

ROGER MONTGOMERY

When is quality ever cheap?

All investing is value investing. If price is what you pay, value is what you receive. Your job as an investor this year — and every year — is to pay a lower price than the value you get.

Perhaps one of the more challenging forms of value investing is deep value. Deep value is about buying troubled companies that are in need of restructuring or turnarounds, but the difficulty of course is that some turnarounds don't turn.

We all want to buy high-quality businesses, those with attractive economics, with a demonstrated track record and with bright prospects. The only challenge with this form of value investing is that quality is rarely available cheap.

Fortunately, however, even very high-quality businesses occasionally stumble and when they do, the markets can overreact by treating that which is temporary as permanent, sending the share price plunging. It is not unusual, however, for investors to take their cue from prices. For many investors, a plunging share price is not a signal to buy but a signal to panic, fear and worry.

Across the mid-cap and small-cap universe of Australian stocks, the last three months of 2016 produced a veritable smorgasbord of opportunity to value invest in quality businesses. A litany of companies saw share prices crash by 25-50 per cent in the quarter ending December 2016. And even high-quality businesses with bright prospects have been caught in this selected sell-off.

Healthscope and Vita Group were among the companies whose share prices crashed by 25-50pc in the December quarter

Healthscope

Take Healthscope, the operator of 45 private hospitals, whose shares were sold off by as much as 31 per cent from their recent highs amid concerns expectations of 10 per cent earnings before interest and tax growth were unachievable. Admittedly the company provided an update suggesting the hospital admissions for the September 2016 quarter were unusually volatile and weaker than expected, particularly in the month of September.

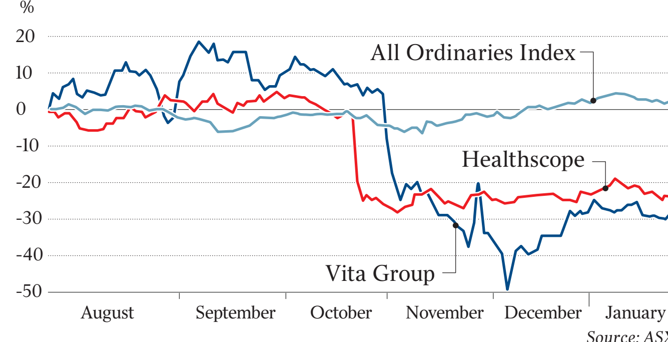
Looking back at the last 20 years of Australian surgical procedures, quarterly volatility is nothing unusual, but the trend is strongly positive. And this trend is unlikely to change given the largest contributing group to private hospital admissions is the 65-74 year-old cohort and the 85-plus cohort, which are also the fastest growing demographic cohort in the country.

Vita Group

Another company whose temporary setbacks are being treated as permanent is Vita Group. The largest licensee of Telstra stores announced a renegotiation with Telstra of their licensee revenue arrangements.

Although long-term benefits of the changes may accrue — and we believe they will — the market saw fit to sell first and ask questions later. The share price has declined 57 per cent from its highs. A value investor is rarely presented with the opportunity to back one of the country's best retail merchants at such a price discount.

Healthscope and Vita: two value picks lag the market



Source: ASX

The recent experience of Vita Group and Healthscope is not unique and as sure as night follows day, the pendulum will swing back. How did the sell-off come about when the broader market in the three months to December 31 was generally improving for most stocks?

For some years the large funds management institutions have been underweight the banks and the mining resource companies — having expected little growth from those two sectors.

In order to boost returns, they drifted down the market capitalisation spectrum looking for high-quality mid-cap companies to invest in. More recently, however, their sentiment towards the banks and resource companies became more optimistic. In any event, being underweight meant additional buying and to fund those purchases, cash was extracted through the sale of mid-cap high quality growth companies.

Stock market investors like smooth lines. They believe earnings should grow every year, and by a steady amount. Any disturbance of this fairytale could trigger consternation. In the real world, business is not smooth. There are rival businesses and economic cycles, competitors to defend against, there's changing consumer tastes, controllable and uncontrollable internal ructions, and a variety of inputs whose costs can change. But by definition, extraordinary businesses come good.

Quality and growth don't stay cheap forever. Perhaps 2017 will be the year investors realise the growth prospects in mid-caps is better than for the banks and resource companies. Banks are about to hit a stone wall of rising financial stress among highly indebted apartment investors who cannot afford higher rates, much less rising vacancies, all while prices might begin to decline.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund.

www.montinvest.com

How to come up a winner in the brave new world of investing

DON STAMMER
INVESTING

Like the curate's egg, President Trump's policies will probably have bad and good parts. There's a bit of irony here: the metaphor of the "curate's egg" was created in a cartoon (in *Punch* in 1895) with the title "True Humility", not a phrase frequently applied to the new president.

Donald Trump is generally seen as confronting, populist and authoritarian. In fact, the early impact of his policies will likely speed up the cyclical upswing already under way in the US economy. Longer-term, his policies and approach seem set to lessen sustainable growth in the US and globally — and to diminish investor returns.

Here are some thoughts on structuring an investment strategy for the early stages of Trump's term as US president:

- Investors should be sensibly diversified, to cope with increased uncertainties.
- The cyclical good times for shares seem likely to continue. Investors already holding their preferred allocation to shares might look for opportunities to top up a little further in coming months as and when share markets dip.
- The favoured Australian shares will be those with best ability to grow (or at least maintain) dividends — including banks, leading miners and selected medium-sized companies.
- Investors needn't take fright, at this stage, at the high price-to-earnings valuations on shares. Trump's early moves on tax, deregulation and infrastructure will likely quicken the cyclical recovery in the US economy — and boost shares globally.
- But investors should be concerned about the adverse effects Trump's policies could have, over the medium-term and longer, for trade, foreign capital flows, migration and technology — and thus for US growth, productivity and future returns to investors.
- For now, investors might find comfort in being overweight in cash and floating rate notes, along with relatively short-dated term deposits. As term deposits come up for roll over, play hard ball with banks to get the best deals.
- Allow that the market values of long-dated bonds could decline further, as the re-emergence of inflation in the US causes bond yields around the word to rise (bond yields and bond prices move in opposite directions). Favour positive-return bond funds. Some investors might also like to hold medium-term inflation-linked bonds for reliable protection against inflation.
- Australian property trusts are unlikely to repeat in 2017 last year's 13 per cent average return. But with current yields, and with global interest in commercial property, property trusts should produce a positive average return.
- The pace of increase in Australia's median house price in Australia will likely slow; prices in overbuilt parts of the apartment market could decline.
- The US dollar, which recently has traded at 14-year highs, might move a little higher as US growth quickens. The Australian dollar seems set to fall against the US currency (though perhaps by less than is generally expected).

Last year saw several big swings in how investment markets saw economic prospects of the big economies. Investors had to work out "is this move in market sentiment well-based or excessive?"

Early in 2016, sentiment on China turned extremely gloomy: the economy was seen as already contracting, and a "hard landing" was said to be imminent. Globally, bond yields fell, shares dropped, and commodity prices plunged. As things turned out, China's economy slowed only modestly. The policy stimulus introduced in March helped a little in achieving this smooth outcome, but the dominant expectation in investment markets was simply wrong.

In mid-year, Brexit fired predictions of global recession. Bond yields fell to record lows, and share prices slumped. The short-term effects, other than on the pound sterling, turned out to be minor.

In September and October, investors began taking a more positive view on the US economy. Bond prices fell; share prices rose. This was supported by the report that US GDP had grown at an annualised rate of 3.5 per cent in the September quarter.

Since the US election on November 8, many investors have adopted an optimistic view on the US economic outlook.

Experienced investors know to separate the cycle and the trend in investment returns. Keep that distinction in mind as markets react to the policies and style of Trump as US president.

Don Stammer is an adviser to Altius Asset Management, Stanford Brown Financial Advisers and the Third Link Growth Fund. The views expressed are his alone.

Trump, China drive bulls back in to bullion

ROBERT GUY

Gold bugs of the world have a simple message for Donald Trump: thank you for making gold great again.

Thank you for the spectacle that was your press conference, with the display of braggadocio ("I was offered $2 billion to do a deal in Dubai") and belligerence ("Mexico will pay for the wall"), rather than a considered outline of your economic agenda, doing little to allay concerns you're all slogan and no policy.

And thank you for selecting Rex Tillerson as your Secretary of State. He's not even in the hot seat yet, but he's already placed the US on a collision course with China — they of nuclear-armed status — with talk of denying them access to the islands they've built in the South China Sea. War, what is it good for? Gold prices, that's what.

This is a gold bull's dream, as Trump's failure to provide details on his much hyped plans to make America great again got a thumbs down from traders. Gold has soared to over $US1211 an ounce, bringing its advance from its December lows around $US1128 an ounce to about 7 per cent. RBC Capital Markets' head of commodity strategy Helima Croft summed it up nicely, saying: "Trump's election has introduced a proliferation of unknowns, which the market will have to work through as they surface."

Proliferation is an interesting choice of words, underlining the growing number of unknown unknowns as traders and investors are none the wiser about the new administration's grand strategy one week out from taking charge of the White House. Gold is a no-brainer hedge against the risks of the unknown.

The question on traders' minds is whether gold can maintain its upward momentum. History suggests there is a good reason to be bullish as Trump takes control of the Oval Office. An interesting analysis from Merk Investments shows presidential transition years have on average been great for gold.

But there's more to gold's renewed vigour than the changing of the guard in Washington. The yellow metal is also benefiting from resurgent inflation. Reports of the death of inflation look to have been exaggerated, with China's December producer price index showing factory prices rising at the fastest pace in five years thanks to rising prices for oil, iron ore and coal. Trump should be pleased: there's one thing that China isn't exporting to the rest of the world any more — deflation. But it's not just China where prices are on the rise — inflationary pressures are also growing in the US and Europe. Janus Capital's chief investment strategist Myron Scholes, who also has a Nobel prize to his name, argued this week that the rise in inflation isn't just a temporary jolt from higher commodity prices as many asset classes are signalling inflation "is here and on the rise".

China's attempts to reflate its economy and snap a five-year run of factory price deflation has been helped by the generous use of credit to juice growth. The lending spigot was opened wide in December, with Chinese banks inking new loans worth 1.04 trillion yuan ($192bn) against expectations of 667 billion yuan. The surge in lending was seen as a pre-emptive move ahead of a possible tightening of credit later this year. ANZ's calculation that 67 per cent of all new yuan loans went to non-financial corporates — the first time long-term corporate loans have surpassed mortgages — will no doubt embolden the bears concerned about an eventual popping of China's credit bubble.

> Gold is a no-brainer hedge against the risks of the unknown. The question on traders' minds is whether the precious metal can maintain its upward momentum

While the risks of a banking crisis rise with every poorly thought out loan to a zombie company, most brokers are focusing on short-term ways to squeeze the most profit from the rise in inflation. Long-term risks be damned!

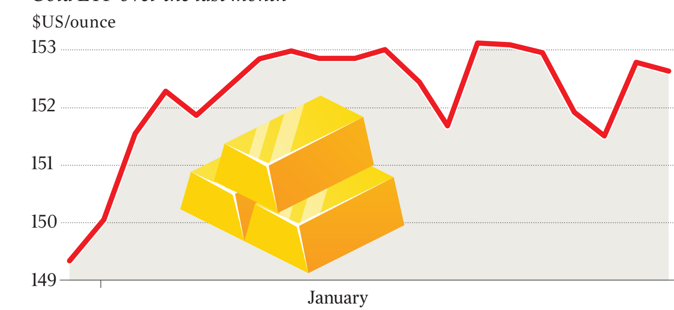
Deutsche Bank strategists Yuliang Chang and Joseph Huo say reflation is their favoured investment theme, and reiterated financials and energy stocks as overweight recommendations. The duo are expecting strength in the PPI to extend into the first half of the year, and see a pick-up in consumer prices in the second half. Given the tick up in inflationary pressures it's not surprising that Chinese gold prices are on the rise.

The benchmark price on the Shanghai Gold Exchange has also climbed from its December lows, and there could be further gains ahead of Chinese New Year celebrations. With Beijing cracking down harder on bitcoin exchanges, gold may be the last asset class of choice for Chinese investors unnerved by the prospects of a weaker yuan, stricter capital controls, the impact on growth from a tightening of credit, and a lack of alternative options given policies to rein in apartment prices.

This is an edited version of an article which first appeared in Barrons.com

Gold moves higher

Gold ETF over the last month



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