Shoot first, ask questions later

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Outlook

Macro driven oscillations and violent price moves remain the order of the day in equity markets and just about every other market. The phenomena of decelerating liquidity and price setting based on relatively lower levels of true volume than in the past remains pervasive. The complex systems which underlie the real economy and reflect true human behaviour continue to confound economists determined to fit the data to more simplistic economic models as the admission that economics is closer to psychology than physics remains anathema to them. When no-one wants to sell their house despite skyrocketing prices for fear they won’t be able to buy another one, we’d suggest there is a bit of psychology at play. One certainty is that there will always be a commentator (like me) ready to provide a plausible explanation (in retrospect) for price movements, regardless of quantum. As resource stocks gave back ground this month despite solid results, significant debt reduction and vastly improved dividends from the likes of Rio Tinto (-7.0%) and BHP Billiton (-6.2%), often touted excuses such as concern over the sustainability of Chinese stimulus resurfaced as predictable excuses. As banks domestically rose solidly on results fuelled by ongoing high levels of credit growth in housing and an absence of bad debts supported by skyrocketing house prices, the same excuses were not required. The obvious irony in economically similar strategies supposedly resulting in markedly different outcomes depending on whether it emanates from your own economy or someone else’s is difficult to ignore. The basic questions on financial system stability remain the same: 1) Is there ever a point at which injecting further credit into the system is unwise? 2) Does the purpose to which the credit is channelled matter?

Fears over the ramifications of asset price declines on behaviour and economic stability have policymakers the world over locked in an unenviable Catch 22. If credit growth slows sharply and economic activity collapses, the tools to revive animal spirits (profligate consumption) are gone, heightening their reticence to take any action. Juxtaposed with these concerns are the risks of continued rampant speculation and ongoing leakage of additional credit into asset prices rather than economic activity rapidly eroding any prospect of long-term stability. Unfortunately, much as we strive, indicators of when this instability reaches breaking point are less than obvious. Incentives to postpone painful adjustments are powerful and confidence in the ability to fool most of the people most of the time remains high. The role of population growth in hoodwinking the public is often ignored, and domestically, is a massively underappreciated driver. Population growth is manna from heaven for economists and politicians. They can quote GDP figures which show rising activity even if per capita activity doesn’t move. It creates the means to make people feel richer (rising house prices) when in reality these can only be wealth transfers. Business will always campaign for it as it beats the hard yards of productivity gain. What it doesn’t do is improve living standards (about the only economic measure which
matters). As Ken Henry pointed out, continuing to cram more people into Sydney and Melbourne without commensurate infrastructure investment is not a viable long term strategy. The only reason we are currently building more than 200,000 dwellings a year is because we choose to foster a high rate of international immigration, often fuelled by incentives such as significant investor visas. With between 150,000 and 200,000 people entering the country nearly every year in the past decade (a significantly greater number than natural population growth), much of the additional housing stock requirement, not to mention the supposed ‘land shortage’, emanate directly from the assumption that these levels will continue. To generate the cherished ‘growth’, which remains the most misused and poorly measured term in economics, these levels of immigration will need to continue to rise. The lessons from the US and the election of Donald Trump should perhaps be a harbinger that the general population may not always remain inured to the illusory benefits of growing population. It is a factor we continue to watch closely given changes are likely to invalidate most of the core assumptions incorporated in corporate Australia’s business plans.

Earnings season continued the now well-worn trend of shoot first, ask questions later. For the most part, we struggled to determine even the direction in which share prices would move in response to earnings releases, let alone the quantum. Perhaps we’re unduly jaded, but the slide presentations which reconcile pro-forma earnings adjustments, list the non-recurring items which seem to recur 4 out of 5 halves and explain why the incoming CEO needs to ‘reset’ the earnings of the business on a sustainable trajectory, seem to have become the norm. Brambles (-10.6%) and Iluka Resources (-10.1%) both succumbed to this behaviour. When accompanied by rosier commentary only a few months ago followed by CEO share sales in the case of Brambles, the quality of Board oversight remains a topic of much contention. When the outgoing Wesfarmers CEO, Richard Goyder is appointed Chairman of Woodside Petroleum by the outgoing Chairman and former Wesfarmers CEO, Michael Chaney, the tendency towards ‘jobs for the boys’ and remuneration regardless of performance seems at least as prevalent as honestly determined remuneration for honestly presented results. Perhaps the Woodside appointment was the result of a thorough search for the best qualified individual, but whilst Bunnings might sell gas in bottles, the linkages to running an oil and gas business look a little tenuous. If possession of a gas BBQ is a sufficient pre-requisite for an interview, I’m happy to put my name on the list!

The pre-occupation with the trajectory of earnings over the price one is paying for a business remains perplexing for us. Acceptance that almost every business in the world is cyclical to a degree and will inevitably experience downs as well as ups, remains ignored by most analysts and commentators. It is certain that iron ore prices will retrace from current levels north of $US90. We struggle to link this with the necessity for the share prices of producers to head upwards as the price is rising and downwards as soon as the trajectory reverses. Revelations that visitation to bowling alleys and laser tag could fall as well as rise in the case of Ardent Leisure (-22.1%), that vitamin sales need not perpetually rise in the case of Blackmores (-11.3%) obviously delivered unwelcome surprises to investors with a preference for perpetual upward extrapolation. Instances where seemingly cavernous gaps in valuation for businesses with similar economic drivers but divergence in short term direction remain common. Corporate Travel Group (+8.1%) versus Flight Centre (-3.7%) is an example. The former has a market capitalisation of around $2bn, and reported total transaction value of $1.87bn, revenue of $150m and EBITDA of $40m for the half. Removing $350m in cash from Flight Centre’s $2.9bn market capitalisation sees its market valuation at less than $500m greater than Corporate
Travel. Considering total transaction value is more than 5 times the size, revenue nearly 10 times and EBITDA nearly 4 times Corporate Travel levels, valuations which differ by less than 25% seem perplexing. Explaining how the future economics of businesses engaged in the same industry with the same economics are likely to diverge at a sufficient quantum to justify this valuation disparity is tough. Rampant acquisition growth strategies and difficulty in discerning organic growth rates are often part of the story.

**Outlook**

It would be disingenuous for us not to express some disquiet over valuations which remain at the high end of historic levels, albeit tied to the manipulated valuations of almost all other assets which sit at similarly elevated levels. Buoyant gold prices and similarly ebullient valuations of gold stocks suggest many share some discomfort on the sustainability of the current manipulated asset price utopia and yearn for some insurance against potential unsustainability. The inability to rationally explain why a chunk of yellow metal, or better yet, an exchange traded financial exposure to it, should provide such protection, should remind us of the behavioural aspects which will continue to thwart those looking to fit human behaviour into a discounted cash flow or GDP growth outcome.

Our efforts will remain directed towards investing in businesses where we believe sensibly grounded expectations of the future are reflected in sensible business valuations. The distortive impacts of abovementioned issues such as excessive credit growth and population growth lie at the heart of determining whether earnings levels are sustainable and sensibly grounded, and adjusting for them is only becoming more complex. The size of the ever inflating financial sector which acts as a ticket clipper on wealth inequality and increasingly dwarfs the businesses with some prospect of improving living standards remains high on our list of portfolio construction conundrums (i.e. how much equity exposure is optimal to a highly correlated and financially leveraged sector which is endowed with a regulatory entitlement to highly lucrative returns yet is also key to the revenue outcomes of the entire economy). We would be lying if we said we’d found a wholly satisfactory answer as yet. Nevertheless, we remain comfortable that expectations for many businesses are wholly realistic. In our view, preoccupation with whether a business efficiently provides goods and services likely to improve living standards for the general population will remain a sensible starting point.