

Small Talk

When fear and greed meet risk

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It's that time of the year when fund managers and strategists forecast share market returns for the year ahead. Invariably a positive year is expected (no-one likes a Grinch) based on a number of indicators, be it economic or something a little less scientific say the sign of the zodiac. In fairness, the fact that the share market tends to rise in the long term probably steers commentators to the upside with their forecast. The only thing we know with certainty is the longer the time frame the greater likelihood of a positive outcome. Unfortunately, one year is hardly the long term. We suspect monthly performance surveys have conditioned participants into believing so. Sometimes it does feel that way.

Why is one year too short a time frame? The share market is essentially a savings vehicle. The time horizon of those invested funds clearly varies between the short and long term. Short term monies are usually speculative whilst the majority of long term monies are generally superannuation related. With superannuants retiring anywhere between 55 and 65 and then living for another 25 years on average with regulated caps on lump sum drawdowns, it's difficult to conceive how a one year time frame is of relevance to the majority of share market investors. Perhaps in the future it will be of greater importance as the cohort of those in retirement (drawdown phase) exceeds the inflows from the cohort in accumulation phase. A kind of scary scenario for an economy built around consumption and high asset prices the result of an enormous household debt binge over the last 20 years. Alas, that discussion is for another time. For now, we are investing our clients' monies for the long term, which in our mind is well beyond one year.

This brings us to the first principle of investing. That is, the share market is inefficient with share prices driven by fear and greed in the short run allowing long term investors (like us) to exploit such bouts of pessimism and optimism. For those emboldened by a sharply rising share price, that it represents some form of success is missing the point. Ideally, given our long term bent we would like our preferred companies be trading below deemed fair value so we can buy more. A price above fair value is typically an unattractive investment and ultimately if the premium is significant enough will result in us having to potentially sell a fundamentally attractive business to invest in a business that is less flattering but of better value and therefore lower absolute risk. Higher share prices are clearly no panacea, quite the opposite in fact for the long term investor.

Excessive liquidity leads to riskier lending. One such manifestation not previously discussed is the explosive growth in number of start-up non-conforming lenders. Can there really be that many people in Australia with poor credit records that cannot borrow from a reputable lender? Whilst there are similarities to the US experience pre GFC, we are in the fortunate position that none of these lenders can lend against a house. That is, amounts borrowed are small enough not to impact the broader economy in the event of widespread default. For shareholders in this space, the risk appears two-fold. One, credit quality deteriorates as unemployment continues its ascension from cyclical lows and the current benign loss experience reverts to higher level that erodes earnings and confidence in these lenders. The second and perhaps more pertinent risk is that overcapacity promotes aggressive competition for customers leading to mispricing of risk and higher than expected loss rates.

In both cases, debt facilities will invariably reprice upwards or in the worst case be revoked, exposing shareholders to broken business models. Interestingly, the current observed loss ratios of ~4% are well below overseas benchmarks of ~15%. A near quadrupling of loss rates would have a severe impact on earnings for this sector whether it be the result of higher unemployment or mispricing. Despite our concern the sector continues to attract interest and in large part share prices have performed extraordinarily well. Let's hope the US experience of 2007 is not replicated here in 2014.

Another phoenix rising from the ashes is the debt collection companies. A market darling sector pre-GFC that went to dust as collection rates dried up after aggressive ledger purchases at declining marginal rates. These companies necessarily reverted to harvesting during the GFC with great success, buoyed by government handouts to their constituents that flowed straight through to their coffers. With those harvesting days ending a couple of years ago, these guys have embarked on – surprise, surprise – debt ledger acquisitions. With competitors bidding strongly for ledgers, the recipe for a repeat of past sins seems a strong possibility. Free cash flow will likely be pressured and capital therefore a necessary ingredient to meet market expectations. Mispricing risk is real and any deterioration in the economy will have disastrous earnings consequences. Again history is repeating.

Greed: The infatuation with roll-up strategies continues with abandon despite ghosts from previous cycles rearing their ugly head. Most recently Crowe Horwath, a previous market darling accounting roll-up (formerly known as WHK group), announced its latest profit warning after a monotonous chain of them; it's down nearly 90% from its peak in 2007. Still the music plays and the market piles into the new breed of roll-up with Greencross (veterinary) and G8 Education (child care) share prices enjoying stellar gains in 2013. We suppose the one lesson learned is never overstay your welcome in these vehicles, there are very few that have avoided major blow-ups. Excessive financial leverage is usually a precursor to demise.

Loathed: The gold companies were found to be swimming naked in 2013, with a number of the smaller miners being the worst performers in the small ordinaries index. A mix of financial leverage and high cost fixed structures exposed the groups' fragility to a relatively moderate fall in \$A gold price (when compared to base metals). Several raised money in 2H13 and further raisings are likely. Removing financial leverage from the equation might make the sector more palatable, although there is a distinct lack of quality in the smaller cap end of the market with either reserve life or sovereign risk difficult issues to overcome. We suspect costs will come out to the detriment of contractors and the labour market. Who knows where the gold price is going given the lack of fundamental drivers but given the universal bearishness it would not surprise if an upward move shakes out the shorts. Ditto smaller mining companies, although there seems better quality amongst this space particularly the nickel plays.

Fear mingled with obsession: Like a moth to the flame, investors seem drawn to the mining services and engineering/construction sectors. Just when you think a lesson has been learnt and that fear is reigning, the market re-embraces this space. We remain of the view that capital expenditure as a percentage of GDP will peak at around 5% in 2013 and may decline to 2% - the historic average. Under that scenario with a precipitous decline in demand and ensuing overcapacity, there will be pressure on these providers for the foreseeable future. Perhaps, a freewheeling infrastructure spending campaign will remove some of the overhang, however, for now we think it's best to mind the gap.

Outlook

Opportunities to invest exist but are not abundant. Earnings generally remain under pressure as the economy is patchy and when viewed geographically there with some strength in the eastern states promoted by RBA's monetary easing. Sydney in particular is the main beneficiary from the strength in the financial economy. We suspect the RBA is concerned with weakness in the mining exposed states and will continue to underpin the economy with relatively low interest rates. The old adage "don't fight the Fed" probably applies to Australian market, however, many of the sectors exposed to this theme are trading at unforgiving multiples. Our portfolio is relatively diverse with a healthy exposure to the resource sector. We remain wary of high multiple stocks and have cycled out of these winners into more appropriately priced companies.

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