ASX INVESTOR HOUR

Price vs. Value
- best focus on the latter

SPEAKER: Mike Hawkins, Evans & Partners
LOCATION: Melbourne Investor Hour
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ASX

Price vs. Value
Best Focus on the Latter

Mike Hawkins; Chief Investment Officer

February 2012

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As equity investors we own a share of an operating business; not a share of an equity market.

As such, value is ultimately created and destroyed by a business; not by an equity market.

The drivers of value in a business influence, but do not always determine, the drivers of performance in its share price.

A valuable business has the following attributes

- **Improving shareholder returns (ROCE, ROE) – a product of wise capital allocation by management over the long term.**
- **A strong balance sheet (i.e. comfortable gearing).**
- **Steady free cash flow generation (i.e. low cyclicality) which ideally flows through to shareholders in a growing dividend stream.**
- **Diversification across products and customers.**
- **Structural flexibility – partly a product of wise management (i.e. don't get caught in yesterday's product).**
- **Is not heavily exposed to changes in government regulation.**
- **Honesty.**

A valuable business is not automatically a valuable investment. A valuable investment is a valuable business which is not priced as such by the equity market.

Equity market performance/valuation is driven by the interaction of three factors

1). Interest rates.

- Currently very supportive.
- Relative valuations/yield strongly favour equities.

2). Profit expectations.

- Under pressure.

3). Risk tolerance (i.e. greed & fear).

- Extreme risk aversion has been the primary driver of equity market performance over the past four years.

Thus, the sweet spot for equity markets (price) = low or falling interest rates, rising profit expectations & improving risk tolerance.

Sell into greed. Buy into fear.

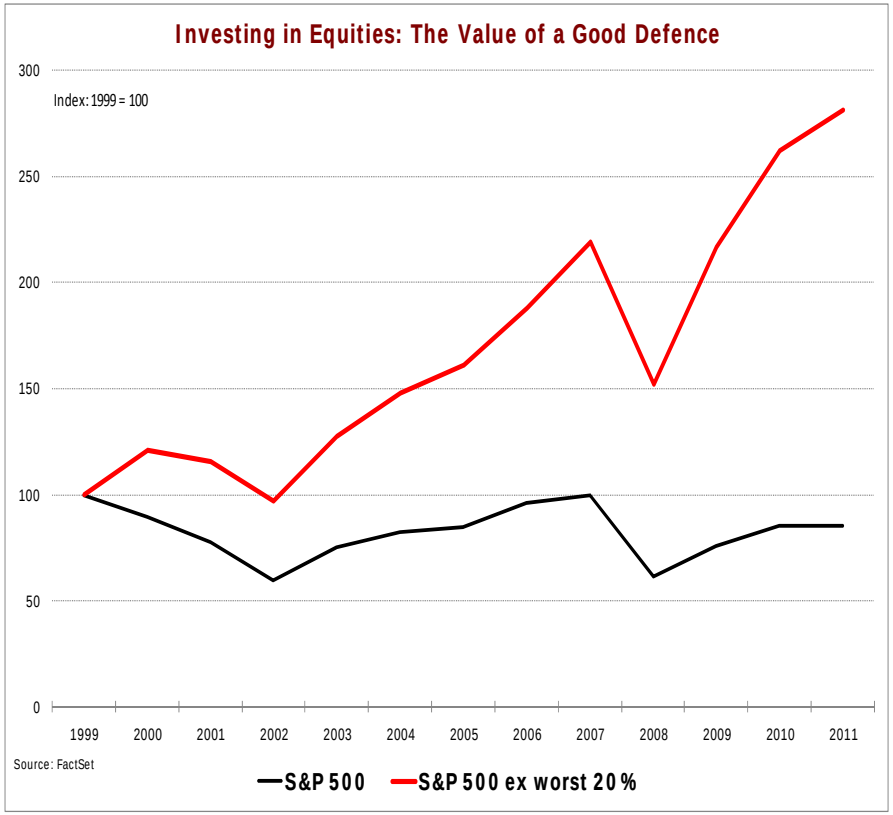
- **Thus, equity investors must differentiate between the risk to value (i.e. the risk to the business) and the risk to price (i.e. equity market volatility).**

  - **This is proving extremely difficult in the current environment but unlike 2008, market risk (Price) > security risk (Value).**

- **The marginal investor is currently fixated with market risk. As such, across global equity markets quality businesses are available for purchase at attractive valuations.**

- **Quality – which is a concept that can not be taken for granted – ultimately prevails.**

An equity investor ultimately derives performance from the quality of the businesses they own, ***not from a particular equity market or economy.***



FACT: If we had the foresight to only invest in the top 80% of performers in the S&P500 each year since 1999, we would have enjoyed an average annual gain of ~10%.

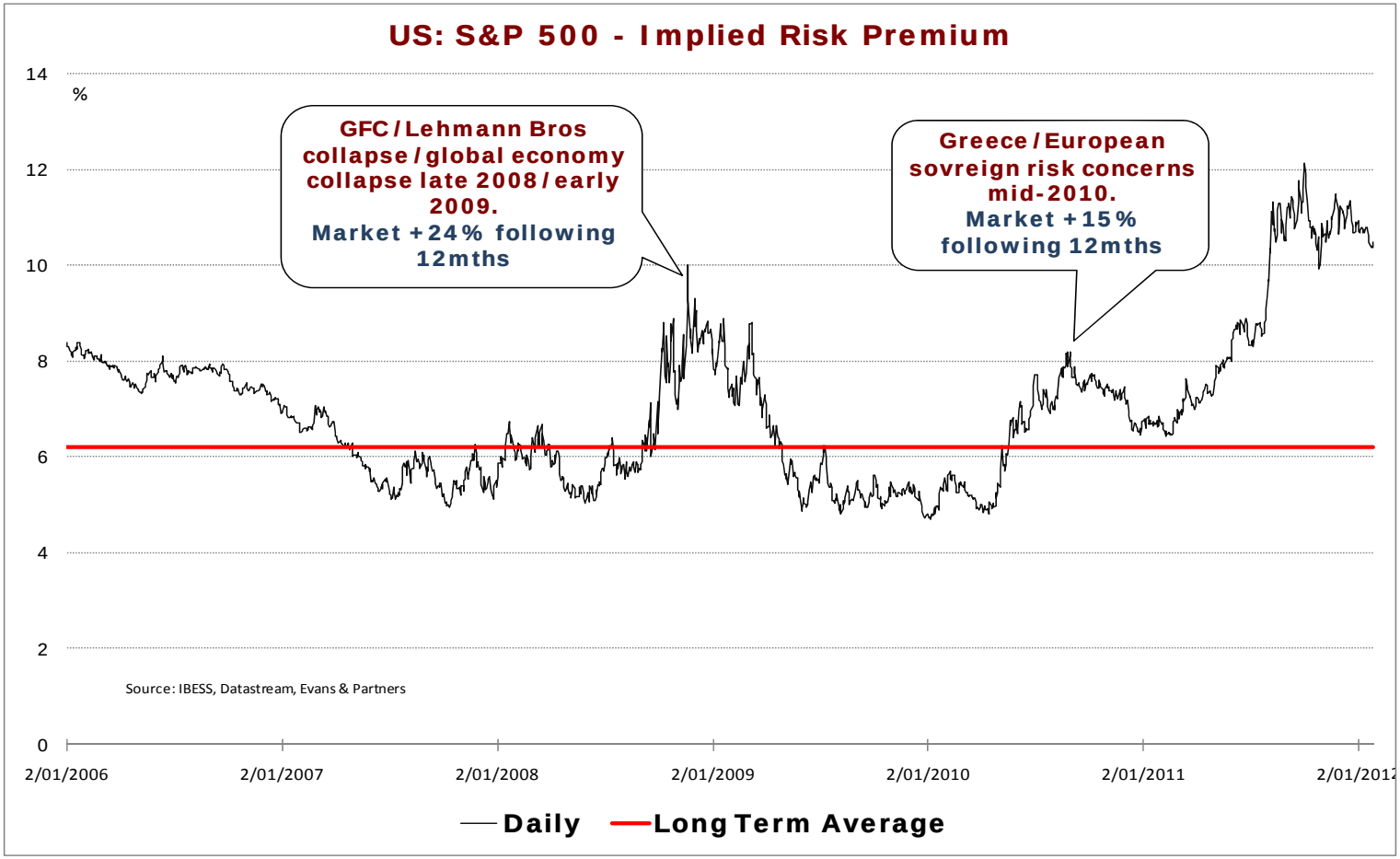
There are two critical messages that equity investors should take from this.

1). **Economies do not matter**! What matters is quality businesses at the right price.

2). We are far better-off looking for points of potential weakness/capital destruction within our existing portfolio than focusing on finding the next big thing!

Risk aversion remains at an extreme

"Buy into fear" will remain rewarding



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Market Risk (i.e. the risk to price)

Market risk extremely elevated. The marginal investor does not need a happy ending, just clarity.

Clarity is in the hands of -

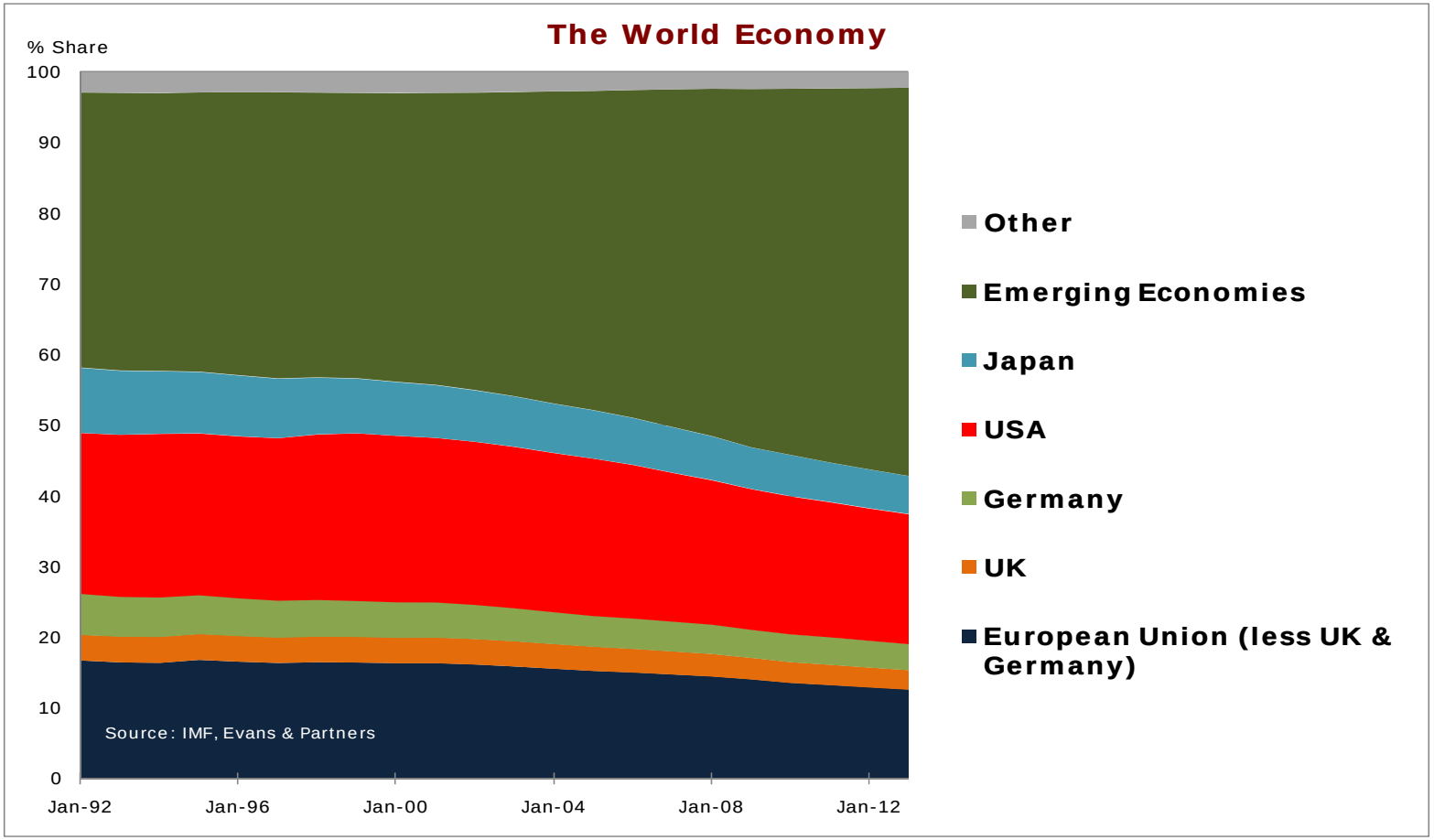
Europe, and to a lesser extent…

US

China

Australia

First, let's get the proportions right



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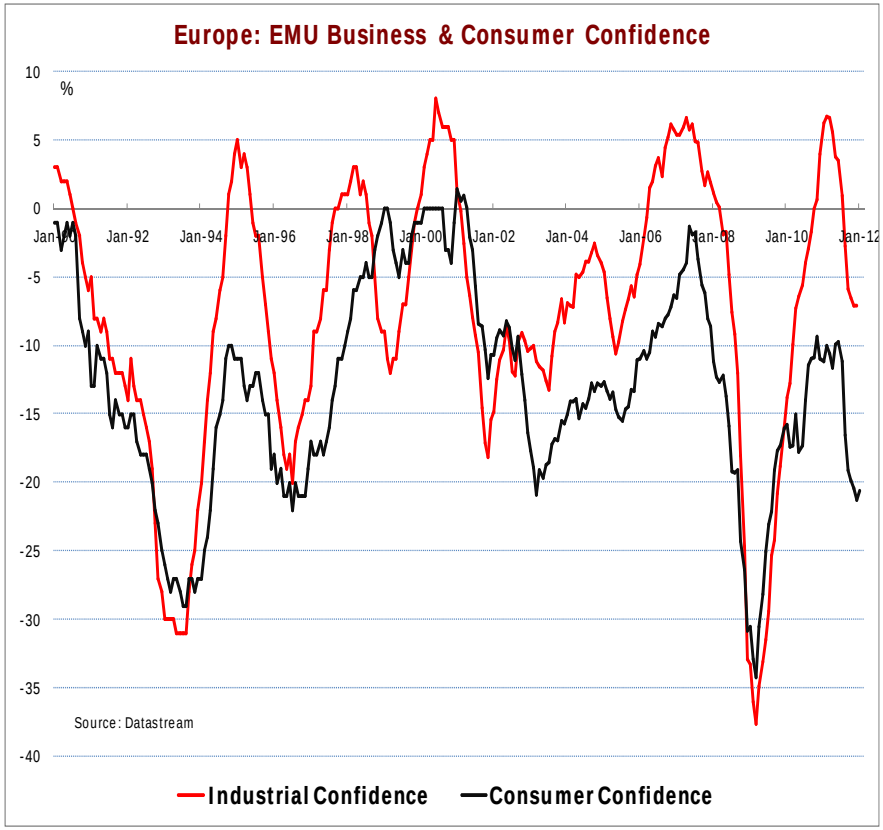
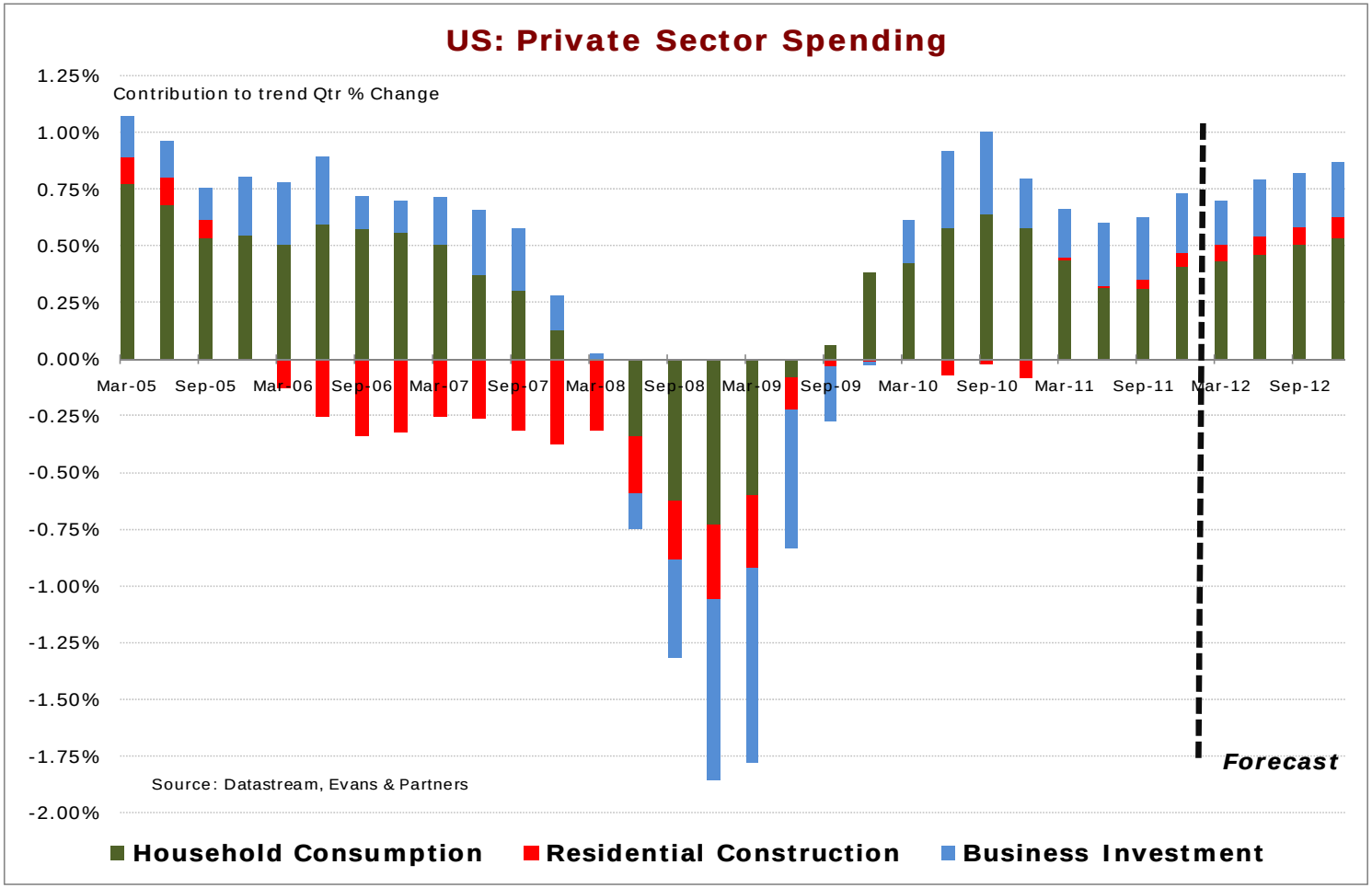
Europe: Finally a framework, but will it withstand broadening economic weakness & a buyers strike?

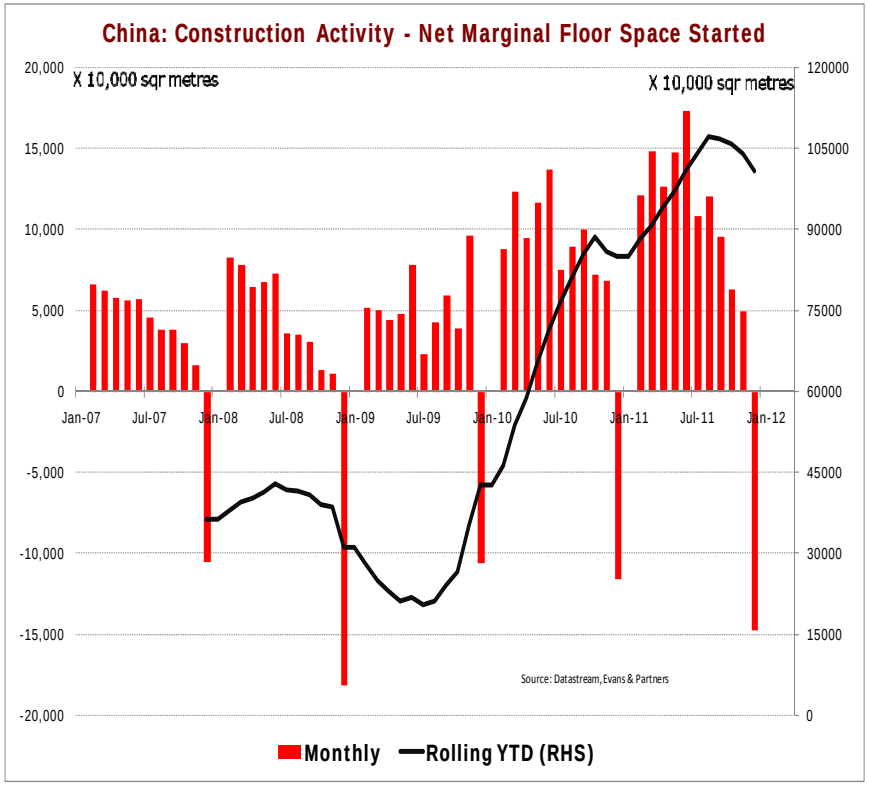


- The framework is viable but exposed to –
  - A failure of political will (Greece? Italy?).
  - A material economic downturn .
- This is a political process. Brinkmanship is clearly a negotiating tactic.
- The risk of a "Lehman event" is still low.
  - ECB underpinning bank liquidity & has ample capacity.
  - Clarity around bank recapitalisation requirements is improving. ~Euro115bn shortfall needs to be filled by June 2012 – retained profits, deleveraging, rights issues & debt buy-backs will assist.
- Global credit markets remain functional & prepared to differentiate across sectors & regions.

USA: Will clearly outperform Europe in 2012 = US$ strength



China: The gloss is coming off



Confidence around China (particularly within Asia) has steadily eroded over the past year. In the year ahead, economic outcomes will reflect -

- Slowing global trade (to be exacerbated by Europe).
- A still restrictive policy stance (liquidity constraints are clearly biting).
- The explicit policy shift away from fixed investment in favour of consumption.
- The inevitable payback from the activity brought forward by the massive 2009 stimulus program.

Commodities/resources/China remains a crowded global trade. It is difficult to see why the marginal investor will be a buyer inside the next 6 months. **UNDERWEIGHT RESOURCES.**

Australia: Structurally challenged but an impressive defence

1). Significant policy flexibility.

2). A healthy banking system.

3). The financially vulnerable were cleaned-out in 2009.

4). The ASX led the world in balance sheet recapitalisation in FY09.

5). China has a track record of doing what it takes to prop-up the economy.

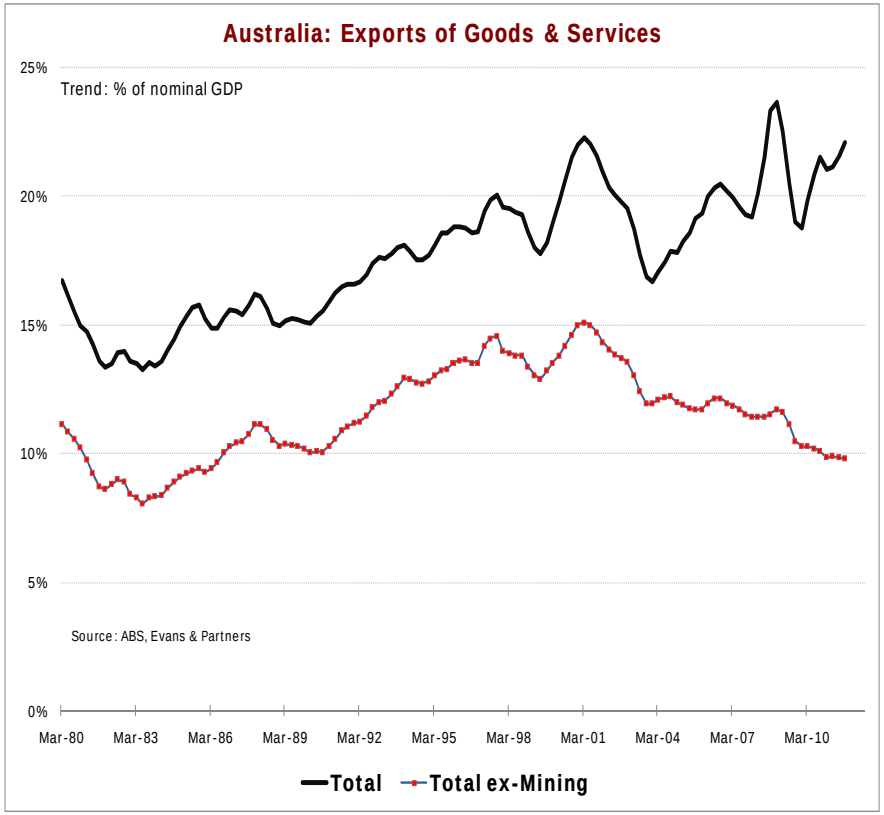
6). Australian households are already defensive.

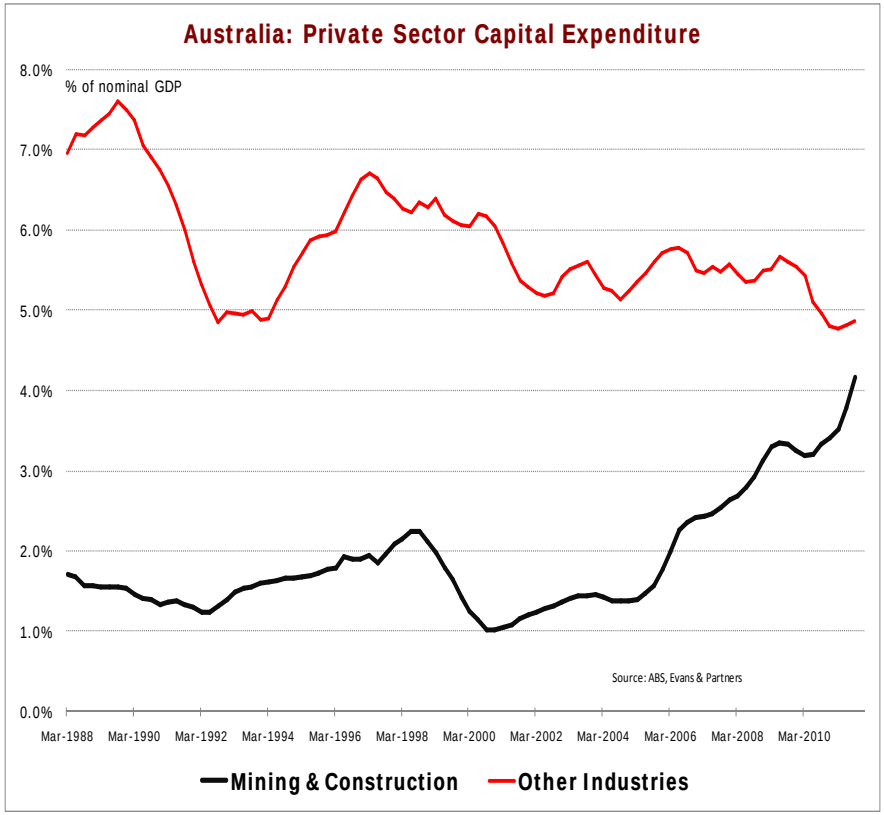
7). The resources capex boom is underway.

The risks which matter for corporate health in Australia.

- **China**
- **Australia's structural decline – brutally uncompetitive!**

Australia: Brutally uncompetitive!





Security Risk (i.e. the risk to value)

Will value be destroyed by a broad-based collapse in profits and balance sheets?

No!

Risk contained by –

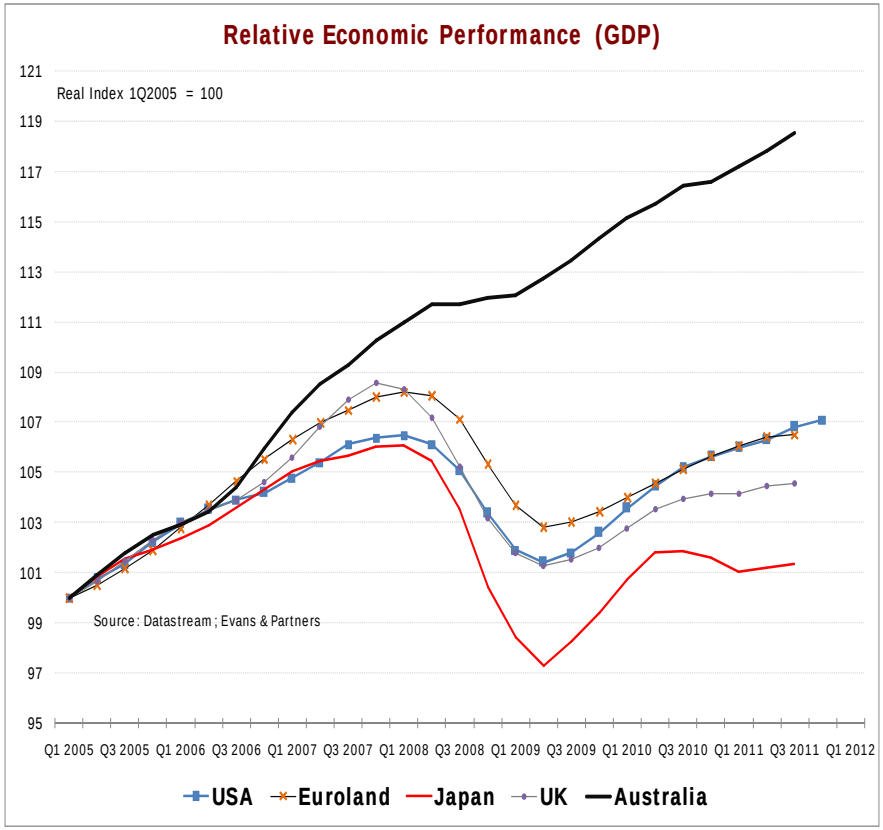
Absence of a global macro shock.

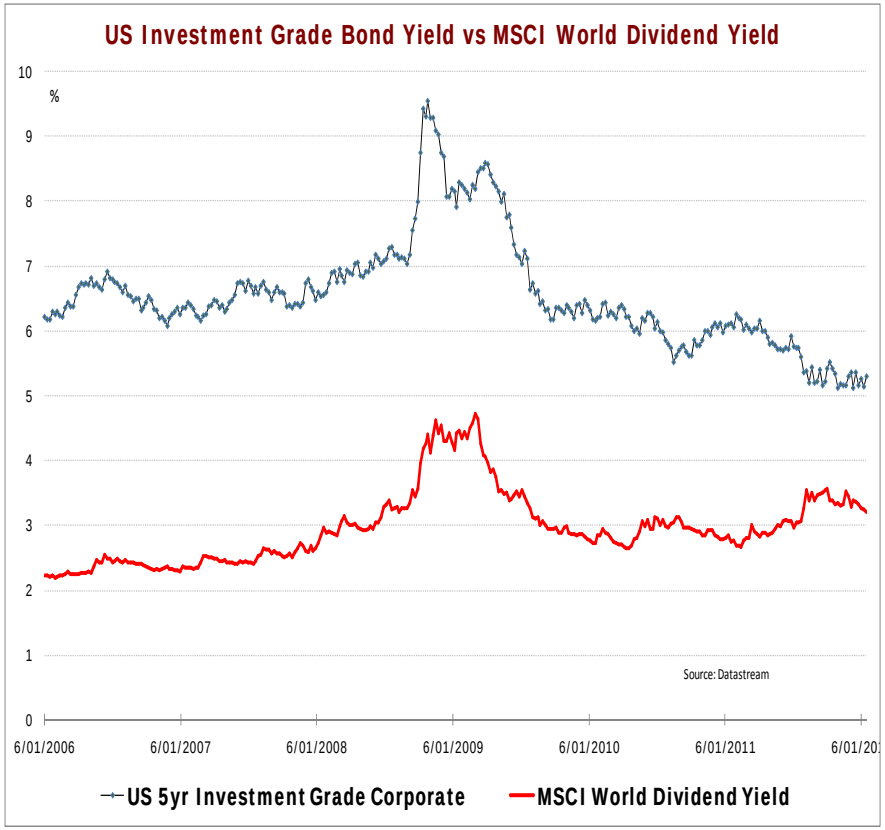
Rebuilt and cash heavy balance sheets.

Already wary corporates.

Resilient profit expectations.

The risk of a 2008-type global macro shock is low





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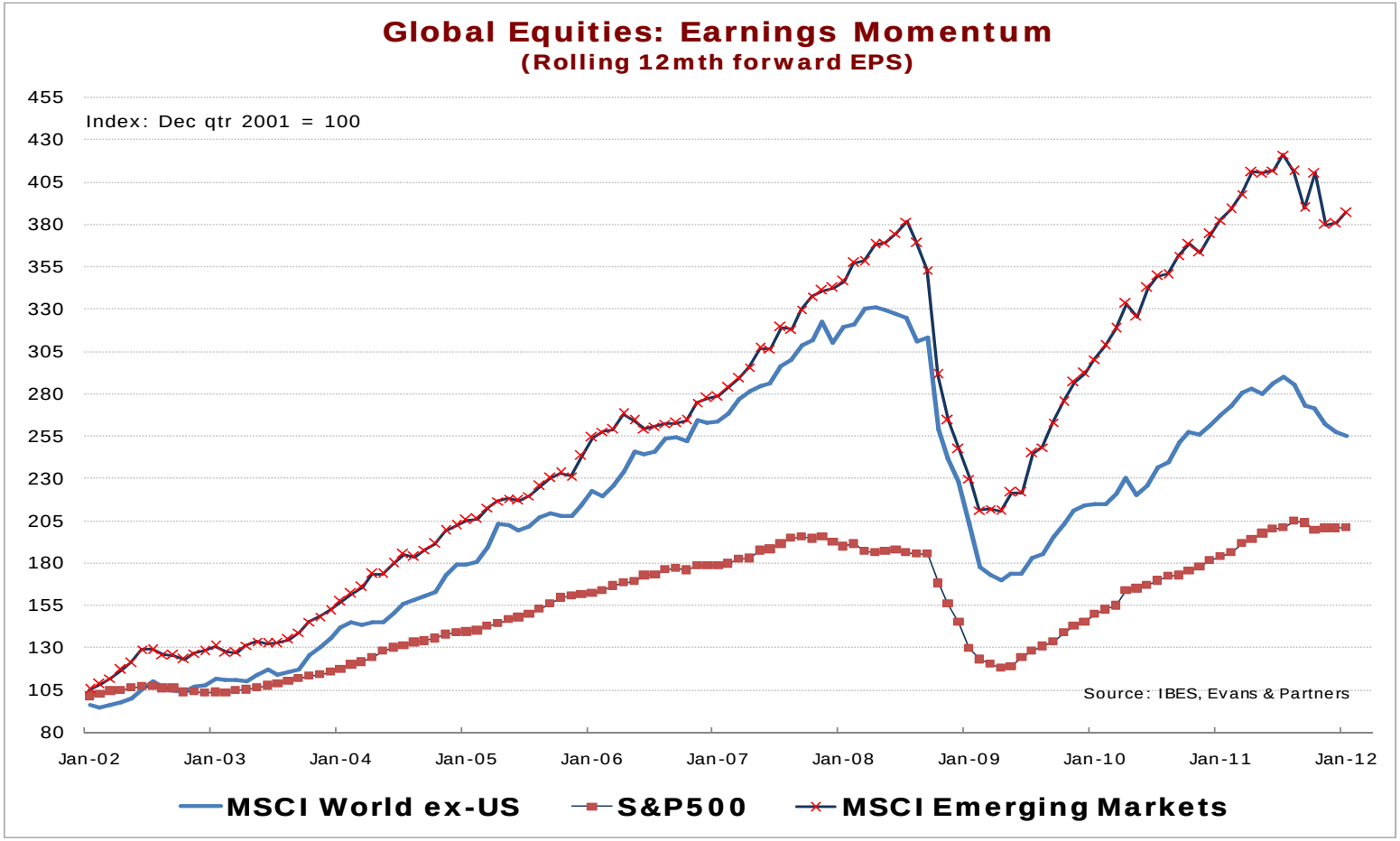
Is value at risk via a collapse in corporate profits?



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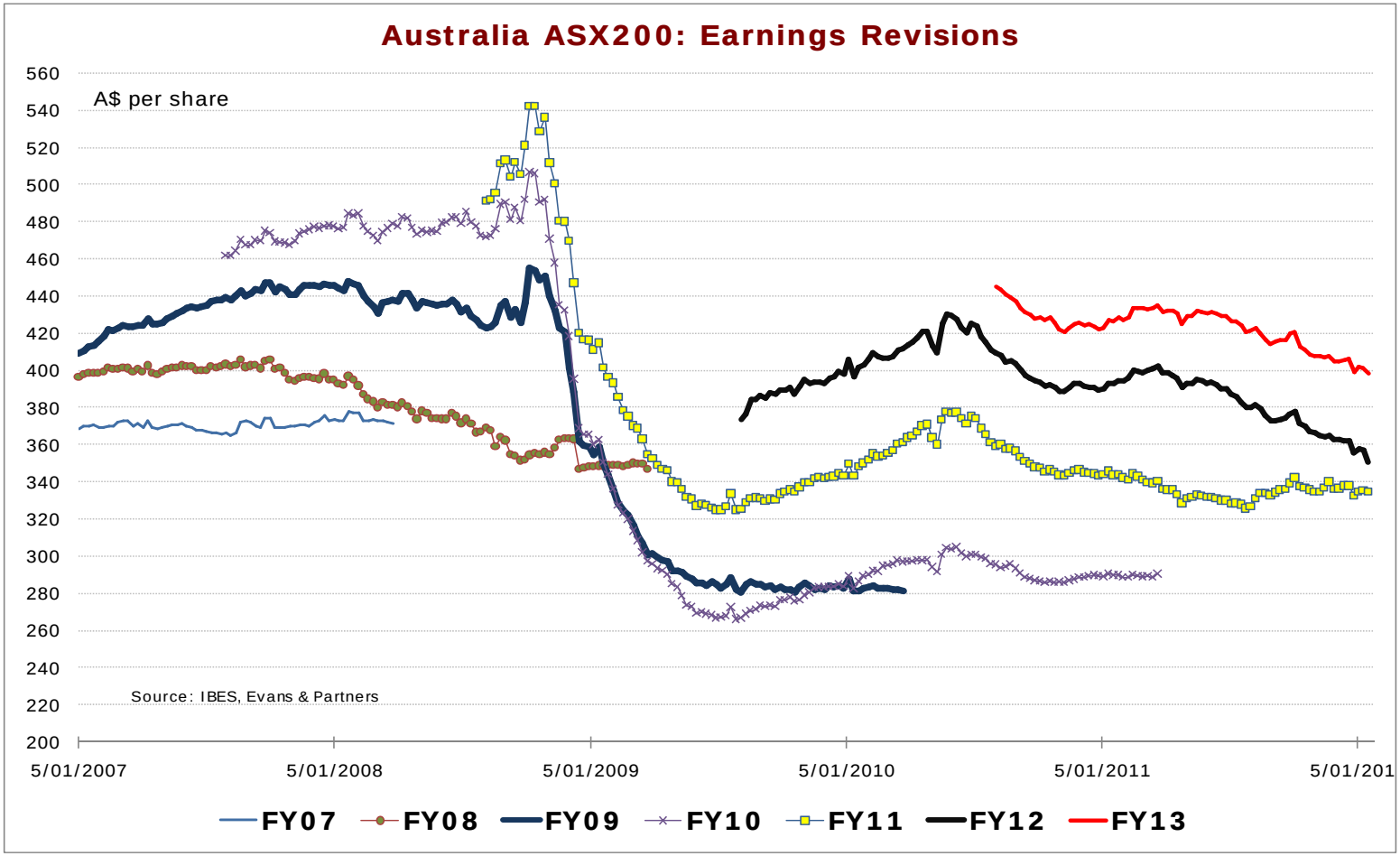
Australia: Is value at risk from a collapse in corporate profits?



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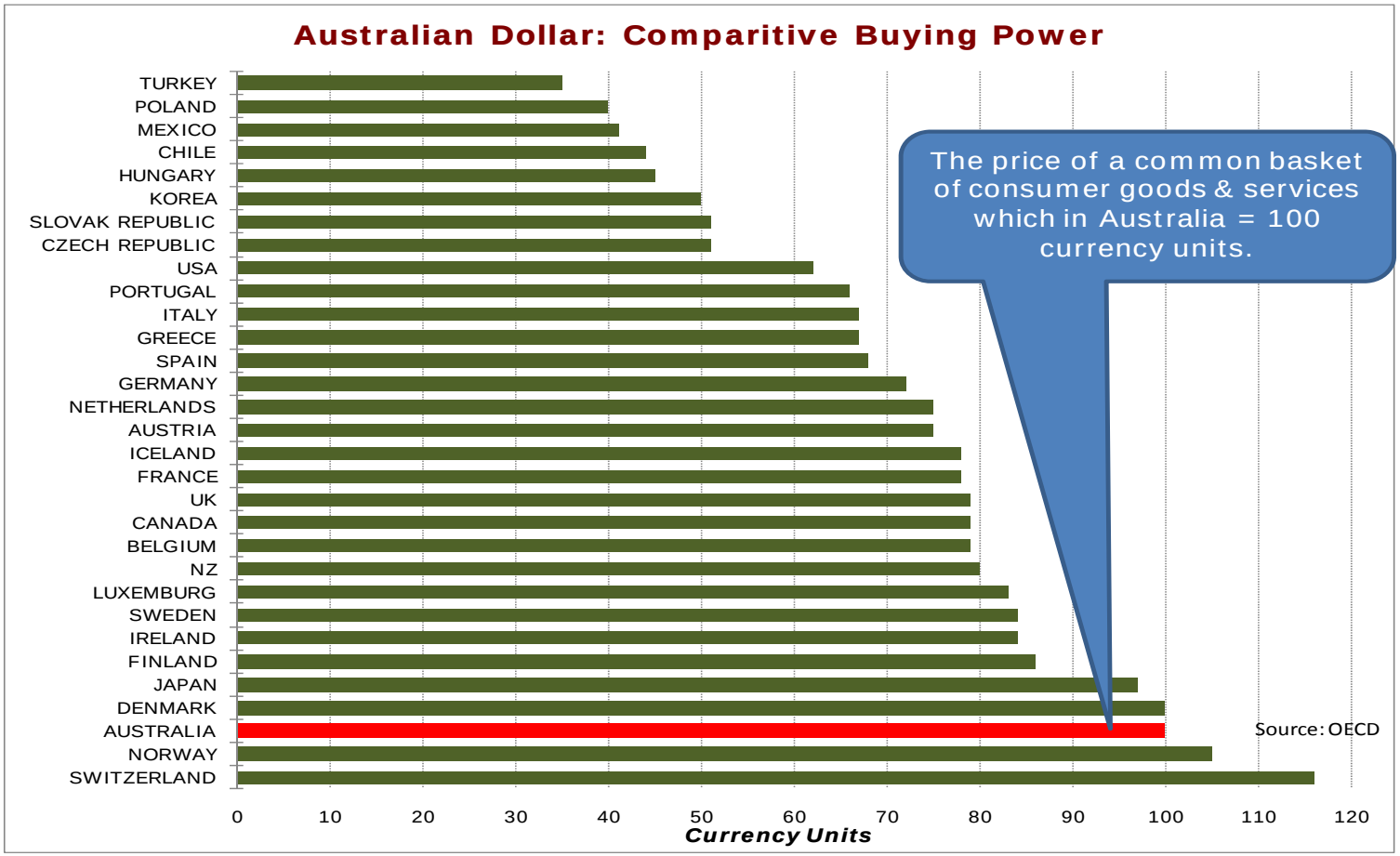
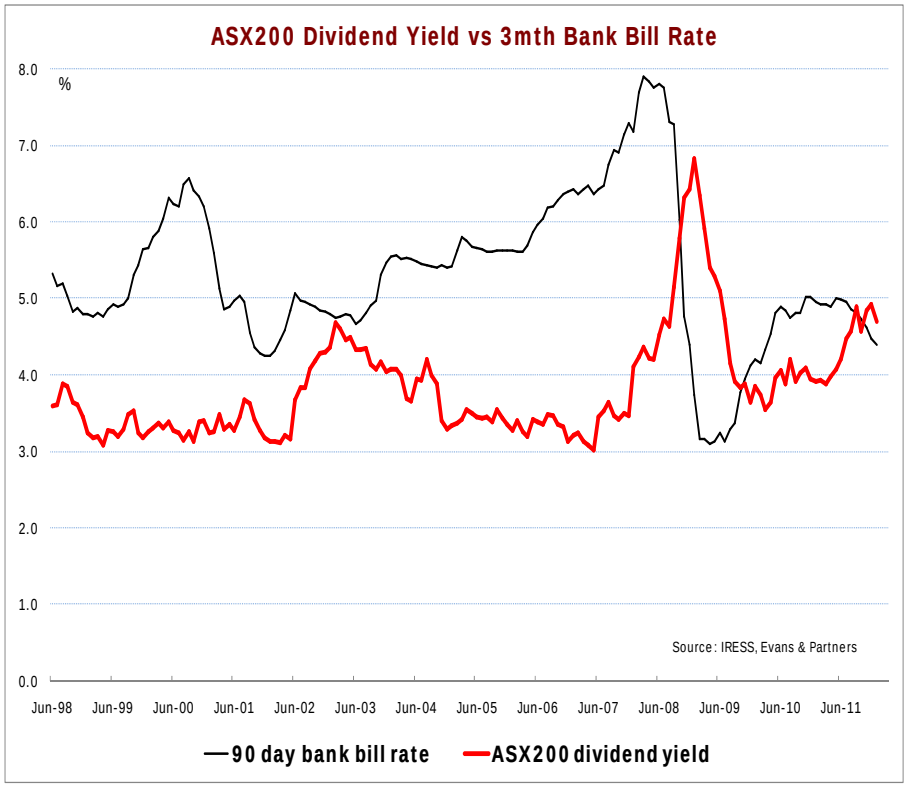
The Australian Dollar: Go forth & plunder!



Investment Income in 2012

A falling cash rate vs. a grossed-up ~8% with growth?



	2011	2012 estimate
CASH	4.7%	4.0%
TERM DEPOSIT	6.1%	5.1%
FIXED INTEREST	6.8%	5.7%
Government	*5.0%*	*3.6%*
Corporate	*7.6%*	*6.6%*
INDUSTRIAL SHARES	6.0%	6.4%
With franking	*8.2%*	*8.9%*
GLOBAL SHARES	3.5%	3.7%

Source: Evans & Partners

Key Messages - Portfolio Strategy

- Remember, portfolio volatility is controlled by your asset allocation strategy, not by trying to time markets.

- ***Worry less about Europe & more about -***
  - A chronically uncompetitive Australia.
  - The growing limitations of the ASX (ex franked income).
  - The vulnerabilities in the Chinese growth model.

These trends pose a far greater threat to portfolio performance over the next 5 -10 years.

- Use the growing ranges of portfolio tools at your disposal – ETF's, a deeper domestic fixed interest market, access to wholesale fixed interest, direct access to global markets, derivative strategies etc.

- ***Portfolio Action Points***.
  - View volatility as an opportunity. Market risk (price) > Security risk (value).
  - Respond to mispricing in corporate bond/hybrids – cash-up for new supply.
  - The entry point into international markets remains ideal.

Key Messages: Portfolio Strategy – Australian Equities

- ***The Fundamental Dilemma*** = What is good for the *Resources* is bad for the *Industrials* (via an overvalued A$, high interest rates, cost pressures etc.). We need to break out of this dilemma for the S&P/ASX200 to thrive.

- ***Be prepared for an aggressive "defensives into cyclicals" rotation in 2012***. Defensives (Infrastructure, healthcare, utilities, REIT's, Telstra) are relatively expensive. The question is – which cyclicals to favour – resources, financials, domestic industrials or global industrials?

- Depressed business cycles in Australia? Look first to ***financial services & builders***. ***Discretionary retail & domestic media*** swamped by structural risks.

- We are still wary about resources – less-so energy. Europe unlikely to stabilise before 2H12 & construction activity in China will continue to slow. US$ well-placed to strengthen.

- 20%-plus total return for S&P/ASX200 in 2012 as "risk premia" retreat. Thereafter, market will require profit growth!

- **Preferences**: Large-cap = **QR National, Computershare, NAB**. Small-cap = ***Tox Free Solutions, AWE, Australian Infrastructure.***