

OUR INVESTMENT FOCUS IN VOLATILE MARKETS

After the media spotlight was on the US debt ceiling discussions for the past few weeks, it has now moved onto the state of the US economy. With the market reaction in this last week, there is a clear expectation that all is not well with the economy there. This is not new news. The recovery in the US so far has been a jobless one – their unemployment rate remains at high levels and they are yet to see a rebound in house prices which is restraining consumer confidence.

The two phrases most used in the media at the moment are “a repeat of the Global Financial Crisis” and the “likelihood of a double dip recession”. Both of these actually mean that there is a heightened risk that the world economy may slip into recession again.

The Global Financial Crisis was a very specific collapse of North Atlantic credit markets in the wake of very poor lending practises and a substantial fall in the Real Estate prices supporting sub prime mortgages. The world has moved on and the specific circumstances are unlikely to be repeated. Hesitant economic growth, especially in the North Atlantic, is a quite likely outcome and share markets are going to find it difficult to find an appropriate level.

The media have been doing a terrific job of focusing on the most negative headlines possible and succeeded at playing on consumers and investors fears. As such, market volatility is beginning to increase as short-term investors take advantage of these fears. As long-term investors, we are aware that there will be periods when markets fall on investor anxiety.

Surprisingly, the sell-off overnight was broadly based; even gold and silver fell in what has been described as trading to cover margin-calls. To date, the market has pushed rare metal prices higher on the expectation that these would provide a safe-haven against a weakening US dollar and concerns over inflation. We now see that if a market is liquid, investors will sell any asset if they need cash in a hurry.

The Australian dollar also fell overnight. Recently, this has been considered a ‘safe’ way for international investors to obtain access to the China boom and resources markets without the direct exposure. Some selling may have been due to ‘risk-off’ trading that was moving capital back to US dollars and away from positions that have proved profitable (the Australian dollar has appreciated more than 20% versus the US dollar over the last three years).

This outcome isn’t too bad for Australian investors’ holding companies competing in international markets where the dollar has held back returns. Should the ‘risk-off’ trade prevail for a period of time, there may be further weakness in the Australian dollar which has positive and negative implications for the domestic economy (for exporters; a positive as our good become more competitive. For importers; goods being brought into the country for consumption will be more expensive).

Increased market uncertainty sees investors begin to question their share investments. Without a process for making investment decisions it is very easy to get caught up in the emotions of the market and execute investment decisions on the back of those emotions. This is when real capital is lost and we strongly caution investors that wherever possible, sentiment should not be the basis for investment decisions.

For those investors already in the market, it is a time when confidence in investments and company exposures needs to be very high. And for investors holding cash, it provides opportunities to invest into businesses at more attractive valuations.

Looking at recent financial results being reported by US companies, the recent US reporting season was quite good. Data compiled by Bloomberg reported per share profit growth of 17% versus the previous corresponding period and sales increasing 13% for S&P500 companies reporting second-quarter results since July. This gives a good indication of the level of overall corporate health. Following the GFC, companies globally have also been far more conservative and retained excess cash on their balance sheets. S&P500 companies now hold the equivalent to 18% of their market capitalisation in cash. This profit and

sales performance, lower debt positioning and larger cash holdings sees businesses in far better shape now than in the latter part of the last decade.

Looking at the Australian market, we are at the beginning of reporting season where we are expecting results to show growth in profits and dividends. Yesterday Transurban (final) and Rio Tinto (interim) released their results showing profit rises and increased dividends.

Based on ASX disclosure if results of companies are expected to be significantly more or less than previous guidance, this information needs to be disclosed to the market. We have seen very few 'profit warnings' in the market here, as a result there should not be any surprise results from the companies we focus on. Even though the market remains volatile while digesting the various macro concerns our confidence in the long-term earnings and dividends being generated by quality Australian listed businesses remains strong. Investors **should not** be panicking to hit the sell button.

Further reporting preview/ review information will be summarised in a separate document for companies we have exposure to.

We understand that it is difficult to remove emotions from investing in times like these. However, when investing savings / retirement capital / inheritances / etc. on behalf of clients, we seek to remove the short-term market price movements, which tend to move based on 'market noise', and consider what actually generates investment returns over the longer-term; earnings, earnings growth and dividends.

We are still strongly of the view that the investments clients have exposure to in portfolios we manage meet stringent quality filters. In addition, for direct share investments, the levels of earnings and dividends, and growth in these two measures, is something we believe can be attained through this period of poor market sentiment. Among other criteria, the types of companies we **exclude** as part of our investment philosophy are those that:

- Are poorly financed (ie. have too much debt),
- Are poorly managed or controlled by a select group where small shareholders interests may not be front of mind,
- Are too small leading to potential liquidity issues,
- Don't have market pricing powers,
- Have inconsistent revenue, profit and dividend outcomes,
- Have a single mine or / are single resource companies.

Our total focus when constructing portfolios is that they are established around clients' long-term lifestyle and financial objectives. The outcome of this is that we only consider businesses with very strong business models, well-known company names, consistent profits – some of which is paid to investors as dividends – and management aligned with shareholders. They are real companies that consumers and businesses deal with on a day to day basis and will be operating in years to come. We believe these are the traits sought in companies that will be around for long periods of time, providing a buffer in times of uncertainty and market volatility.

When we refer to 'quality companies', these are some of the characteristics that we consider.

Across the quality spectrum, different companies will exhibit different characteristics and some market prices will move more than others, this is why diversification across portfolios is an essential part of portfolio construction and allows a mix of companies to be held with a long-term view.

It is these characteristics that we also seek in fund managers across different sectors. We consider managers that are aware of market risks, but also restrict their investments to companies that are of a quality nature.

Considering some more specific company positions across the different sectors in the current market:

- **Financials**
 - Banks – domestic banks remain some of the most conservatively funded and well-capitalised institutions globally. While concerns regarding sovereign debt and borrowing issues may arise, the requirement for these institutions to raise capital is very low, and their funding from domestic deposits is higher than pre-GFC and rising.
 - Diversified financials – will continue to be impacted by market sentiment, however when conditions improve, could recover quickly. Expect some in this sector to remain volatile
 - Property – little impact based on recurring rental streams with most on long-term leases. Conservatively funded following GFC, so little concern over gearing levels for larger REITs.
- **Resources – Materials and Energy**
 - Small single commodity – very high risk, should ‘risk-off’ continue to be a focus, those small miners without commodity diversification, non-producers, located a long distance from infrastructure will have a difficult time. In addition, should commodity prices fall they will be hit harder again.
 - Large diversified – can contend with lower commodity prices as they typically have the lowest cost mines and their own infrastructure to export the resources.
- **Staples**
 - Little impact from market conditions – people will still need to eat and spend money in local supermarkets run by the big two or other local operators.
- **Discretionary**
 - Impacted by consumer confidence, interest rates and subsequent increased savings rate.
 - Currently experiencing difficult conditions which may persist.
- **Telecommunications, Utilities and Healthcare**
 - Little impact – majority domestically focused operators which are less impacted by market conditions.
- **Industrials**
 - Some sub-sectors here impacted by weaker consumer demand for transport and storage
 - Other sub-sectors, driven by resources sector – if contracts are with multinational miners, or low cost miners rather than small single commodity miners there is less concern.

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