In The Know: Episode 60

Australian Equities: Where are we now, and what's next?

Announcement (00:00):

The information contained in this podcast is for general information purposes and does not constitute investment advice. You should seek investment advice tailored to your circumstances before making an investment decision.

Host (00:14):

This is In The Know, a monthly investment podcast brought to you by Magellan Investment Partners.

Matt Williams (00:20):

There's been a real divergence between the price, the market level, and earnings growth. And so I guess this is why people are unhappy and saying this is maybe a little unsustainable, but something's got to give. Either the market either comes back, either the prices come back or the earnings have got to rise to meet a flat kind of price if you like. So we'll have to see what happens.

Host (00:48):

That's Airlie funds management's head of Australian Equities, Matt Williams on the current state of the Australian market. Welcome to In the Know. We've just witnessed a volatile reporting season and the Australian economy remains sluggish, but it's not all bad news. Some of the key themes we're seeing include the recovery in small caps and the resilience of Australian consumers, according to Matt. In this discussion, Amy Manns, Magellan Investment Partners relationship manager, joins Matt as he unpacks the forces behind the heightened market volatility, talks us through some standout results from this latest earnings season, and shares valuable lessons he's learned throughout his career. But first, a warm welcome from your Host, Amy Manns.

Amy Manns (01:41):

Welcome to In the Know. I'm Amy Manns, and today I'm joined by Matt Williams, head of Australian equities and portfolio manager at AI Funds Management. Hi Matt.

Matt Williams (01:51):

Hi Amy. Thank you.

Amy Manns (01:52):

I'm excited to chat to you today. We're going to cover a lot of ground. We're going to look at the Australian market, reporting season, but perhaps we start with where we are right now. How would you describe the current state of the Australian market

Matt Williams (02:07):

Overall, pretty good. I mean we're a few percent below record highs. Globally, record highs as well in global markets. However, for active investors like myself that are lagging the market, we're pretty unhappy. And I think this is one of the most unhappiest bull markets that you read all the commentary and so many people are not happy. And the reason is that is because the market's quite narrow. It's been driven by a few narrow names and some seemingly non-fundamental kind of movements. And an example of that I think is probably the banks where valuations are stretched, but when we look at the market overall, the total return since 2022, so the end of 2022, let's say, the market total returns including dividends is up 40% over the last three years, but earnings are actually down over that period as a collective.

(03:08):

Now that's probably a factor that resources have dragged that down. Industrials have done better, but not as good, profits and earnings aren't up anywhere near 40%. So again, going to the banks and using CBA, the CBA share price is up over 60% since the end of 2022, but its earnings are up only 15%, so it's been a massive rerate. So there's been a real divergence between the price, the market level and earnings growth. And so I guess this is why people are unhappy and saying this is maybe a little unsustainable. Something's got to give. Either the market either comes back, either the prices come back or the earnings have got to rise to meet a flat kind of price if you like. So we'll have to see what happens. But in the meantime, I guess as investors in our funds, we're enjoying the ride.

Amy Manns (04:12):

Well, maybe we'll dive into the market a little bit further. We've just come through reporting season and it was fair to say it was quite volatile. What stood out to you the most?

Matt Williams (04:22):

I think the big dominant theme for the reporting season was once again the resilience of the Aussie consumer and that was shown up in the retail results. In our portfolio, Nick Scali, JB Hi-Fi Sigma/Chemist Warehouse just produce some really strong numbers showing that the Aussie consumer just continues to power along despite cost of living, housing sort of issues. I think it's important that the employment has been good. So look, that was sort of the key thing for us. The overall season was pretty sluggish overall. Other themes I think were the US housing exposure companies, including for us James Hardy. US Housing is in a real state at the moment. The market is sort of frozen there as mortgage rates remain stubbornly high. So James Hardy was weak and Reese, which is not in the portfolio that also showed itself up there. The other theme I think was the recovery in small caps. We saw some good moves in small companies and that's driven a bit by the anticipation of further interest rate cuts here in Australia.

Amy Manns (05:38):

And were there any other US exposed stocks? I know you touched on the housing sector, but was there anything outside of that particular sector that you were keeping an eye on?

Matt Williams (05:47):

Yeah, so we've got some other exposure in the portfolio including ResMed, the sleep apnea company, which I thought had the result of the season really. Its sales grew 10% over the year. Profit was up 20% sales up 10 profit up 20 net cash balance sheet, now really strong cash flow they've put in a buyback. So that was fantastic and after initially the stock I think went up over 5%. It actually finished the month down, which is a bit disappointing, but to us that was a fantastic result. And so ResMed is quite exposed to the US and it has very high market share in sleep apnea in the US about 80% at the moment.

(06:29):

CSL was sort of the other portfolio holding that's exposed to the US and it had a disappointing second half result surprise the market with the weakness in its blood products business. There was some explanations for that overall. At this point, our investigations sort of lead us to the view that the industry structure is not broken and bearing the CSL's division, blood plasma division is still a very good business. And so we've actually leant into the share price fall a little bit.

Amy Manns (07:03):

And with all that volatility that we did see, what do you think is driving that?

Matt Williams (07:08):

Oh yeah, you're absolutely right. I mean that was the other big theme in the results season was the volatility in the stock prices of companies on their results' day. It was the highest on record either up or down depending on how the results were interpreted by the market. So it was quite amazing. And I guess the question is why are we seeing such volatility? And I think it goes to the point I made earlier about the market overall. There's some non-fundamental factors sort of driving things.

(07:45):

The steadily increasing amount of money in passive funds and the very increasing amount of money run using sort of short-term momentum factors both from local managers and global managers where earnings, momentum price, momentum exacerbates these earnings results days as they really push stocks around. And so look for us as an active manager, we find this is providing great opportunities to either buy or sell when we think things have pushed too far because we're taking a more medium term view when a lot of these momentum short-term strategies are not. So we think that's a good thing for active management. We're not seeing it in our numbers at the moment unfortunately, but we think over the medium term though, we ultimately will.

Amy Manns (08:36):

You touched on banks earlier, how did they perform throughout this reporting season?

Matt Williams (08:41):

Yeah, so CBA reported its second half results and then the other three majors reported their third quarter sort of updates. And look again, it just goes to the sluggish kind of nature, the economy, the results were pretty flat, up a little bit. CBA, again, showing its quality wares by it was the best out of the three and they've tucked away probably a little bit of profit in reserve for the next six months. But overall, I think it just sort of shows that the banks are priced highly but delivering very little profit growth.

Amy Manns (09:20):

Okay. And if we think about growth, it seems more rewarded than ever. Why do you think that might be and do you expect that dynamic to hold?

Matt Williams (09:29):

Yeah, look, it's an interesting dynamic. I think as I sort of mentioned, the Australian economy is pretty sluggish overall if you wanted to argue the toss about it on a per capita basis. We've been in a recession for a little while now, GDP measured per person. So growth is hard to come by and when it's identified then it's really keenly sought after. I think when I look back at my career of under priced growth, I think a little bit of a failing in my career, but I think I've gotten better at it over the years. And I can give a couple of examples on stocks in the portfolio, but I'm just reminded when I think about growth companies and it's important to keep an open mind. And there was a fund manager quote that I've pulled out and I've kept with me for a long time now. This guy Steve Mandel, founder of Lone Pine Capital, he said, "I don't need an analyst to tell me when a 10 PE stock is cheap. I need an analyst to tell me when a 40 PE stock is cheap."

(10:30):

And I think that's really an important comment because it's not easy to identify the persistency of growth and I found it difficult, but I think I've gotten better at it. Another, a local fund manager pointed out to me the other day said, "REA, realestate.com, one of Australia's best businesses. 10 years ago when you looked at it, the stock was on a PE of 40 and you fast-forward to today the stock is on a PE of 40. In the meantime though the stock, it's gone up fivefold over that period." So you could have thought it was expensive at $60 where it was roughly then and you could still think it's expensive today at $240. So I think that's sort of an example of how we think about growth and it's difficult to explain which companies are going to be able to persist with that. Luckily for us in the portfolio, REA has been held de facto way through our holding in News Corp, which done very well for us over the years. And News Corp of course owns 62% of REA.

Amy Manns (11:46):

What about another example where you've recognised under priced growth?

Matt Williams (11:51):

Yeah, well one of our best performers in the portfolio over the last few years has been Sigma Chemist Warehouse and we think this is a really attractive company. The latest result showed absolutely fantastic growth metric double-digit sales growth and it's continued on into the new financial year. They've got store rollout to continue both in Australia and internationally. Absolutely just prints cash with very little CapEx requirements. So we think that we can get a value for this company above the current share price, but ostensibly this stock on a short-term basis is on a PE of 40 times.

Amy Manns (12:34):

You've spoken about growth, maybe we can touch on value. What do you think it would take for value investing to make a real comeback?

Matt Williams (12:42):

That's a good question and one that all the commentators like to talk about and makes good headlines and stuff, but at Airlie we do not try and look through that lens. We are looking for quality companies that are undervalued and they may be classified by others as value and some others as growth. And I talked about a few Sigma as an example of that, and so in the portfolio Blue Scope Steel, a company we like, it would be classified I guess as value and Sigma is growth.

(13:16):

So we don't really think about that so much, but I guess the bigger question is what will change the market, sort of this narrow push, narrow number of stocks pushing markets higher both locally and overseas? Short answer is, I don't really know, but the long answer is something I don't think none of us want is generally a recession usually brings an end to some kind of investment cycle. So we really don't want that. So it's hard to say what's going to change this current sort of characteristics of the market that I talked about, momentum growth, really just ever-increasing valuations in certain growth areas of the market, not just here but also globally. It's very hard to say what's going to change that.

Amy Manns (14:10):

We might change direction if that's okay. And I'll ask you to take a look into your crystal ball and look ahead to the next decade. What themes do you think will shape the Australian markets looking forward?

Matt Williams (14:21):

When I think about the Australian market, I'm thinking about the listed market and what I'd obviously like to see as a public listed market participant is a return to favour in public markets. We've seen the growth in private markets over the last 10, 15 years and we've always just thought, well the liquidity that the public markets provide will ultimately win through at some point, but that hasn't proven to be the case as yet. So we're really waiting for some kind of shift in this sector. Well look, we've seen some IPOs of recent times, the most significant one, I guess being Virgin Airlines, what we'd love to see is just more of those, more companies come to list. There's a big debate obviously around the different governance rules between private companies and public companies. Maybe that debate needs to be resolved in some way. We need to see maybe it being easier for companies to list on public markets.

Amy Manns (15:29):

Are there any other big shifts that you're considering at the moment?

Matt Williams (15:33):

Looking at influences on the Aussie market, there's a hell of a lot going on when you think about it. We are living through, it is sort of like the second industrial revolution, I think, the last 20 years and ongoing, we are living pretty amazing time. Throw in that we've got the energy transition affecting businesses and consumers. We've got the housing issue affecting consumers. That's a big thing that needs to be worked through. And then the big global influence and who knows how this plays out, but really it's about global indebtedness. The governments around the world, there's a lot of debt out there, money's being printed. You could have been scared about this for the last 15 years and missed one of the greatest bull runs in the market if you had all your money under the mattress.

(16:30):

So look, we don't spend any time sort of worrying about this, but I just think it's a factor when we look at the next decade. At some point this issue is going to come to the fore and I don't know how exactly it will, but it will come to the fore and that obviously will have an influence on markets. On the bright side, Australia, relatively our fiscal situation is one of the best in the world at the moment. Despite still a lot of government spending out there, we're coming from a better place than a lot of other economies. So look for all the problems Australia has, I mentioned housing and energy transition, productivity, et cetera. It's still one of the best places you want to be and want to continue to invest in.

Amy Manns (17:16):

Thanks, Matt. It sounds like there's a lot going on in markets at the moment. How do you think about this in the context of your career?

Matt Williams (17:23):

Yeah, that's a good question. When I think back to when I started in the early '90s, so what have I seen? We saw the big boom in tech that lasted for a long time, really in the late '90s. Then the bust in tech, that was a big bust. People maybe not remember just what the drawdown was there and it was, I think in the Nasdaq it was 80%, so quite a big bust. Then the GFC was a particularly stressful, interesting time. And then most recently, I guess COVID, so I guess the through line through all these types of sort of events is having our investment process, that sounds slightly dull, but it's having a process to keep you grounded whilst these big extremes are happening both on the way up and then on the way down, letting the process dictate what you're seeing out in the market and taking advantage of opportunities.

(18:30):

Because I remember in the GFC we were looking at stocks and we're going, "These things are getting so cheap, this is quite unbelievable." But all the commentary and the pundits were telling us, "Oh God, it's a depression, mark two here, this is terrible. You wouldn't buy any equity at all. The companies will be raising capital from here until forever." But we couldn't ignore what our process was showing us that there were some great companies on sale. I guess the other sort of thing I think about as particularly as have gotten older, is just making sure I don't get cynical about things. Always have an open mind.

([19:09](#)):

I'm always interested in learning new stuff, so I don't think I get too cynical, but that's not easy in today's, or let's just say political environment, but having an open mind, not dismissing different thinking or different points of view. I think that's why you surround yourself with really excellent team members. I'm always looking to hire people smarter than me and my deputy, Emma Fisher says that's a pretty low bar, so just always keeping that open mind because the world is just changing so much. But as I said right at the beginning of this, is that the process though, just making sure we don't deviate. Right now, you could get excited about some certain things, AI, et cetera, and lose your discipline around your process and we're very careful around that.

Amy Manns (20:00):

That's a really good lesson for our listeners, Matt. It's important with all the noise that's out there at the moment to not be distracted and stick to your knitting, stick to what you know.

Matt Williams (20:09):

Yeah, I think that's it. And in the early investment team, when we're looking at things and being affected by a lot of top-down noise that might be sort of relevant to a company that we're either looking at or invested in, it's just something that we remember that Peter Lynch, famous US investor in the '80s and '90s, there you go, showing my career age there. And he said, "If you can follow one bit of data, follow the earnings." And it makes perfect intuitive sense because there's so many bits of news and it's only gotten worse over my career. There's just so much noise and information now available on everything and the news cycle just keeps turning very quickly. Even the business news cycle turns very, very quickly. But if you just follow on what does this mean for the earnings of a particular company, and it's just a good way of simplifying down for us just what is important overall when you're looking at companies for the medium and long-term.

Amy Manns (21:18):

We've covered a lot today and it's great to be able to chat with you. Are there any thoughts you wanted to leave with our listeners before we wrap up?

Matt Williams (21:26):

Look, I guess I've got heaps of stuff I can talk about and rabbit it on about, but I think when I look back, the key sort of things, particularly for the younger listeners, obviously, and this is some motherhood statements here, but I wish I'd followed some of this advice myself, but the earlier you get in the market, the better. And obviously that's very hard to find the ready cash in a housing market such as we've got here at the moment, but it really is a truism. If you can get in the market and stay in the market. That's the other thing, the less you sell, the better you will do over time. Look, have your fun punt around hot tips and stock tips, but really either find good companies or find a good manager who's going to find those good companies for you and just stick with it through thick and thin.

(22:13):

I mentioned about the highs and lows we've seen in the market through the GFC et cetera, but you look at all the through lines, the market goes up and it just continues to grind onwards and despite all the news and the headlines that would scare you out, it really has been, my 30 years has been a remarkable period. I look back to the 1987 crash, which was big at the time. I was just a young worker and I thought, "Oh my goodness, this is pretty serious." You look at it on the chart now when the '87 crash happened, it's like a little blip. So it's about just sticking with it, I guess, and looked very easy to say, but hard to do.

Amy Manns (22:57):

Thanks for joining us today, Matt. It was great to chat and thank you everybody for listening.

Host (23:01):

That's Magellan Investment Partners Relationship Manager, Amy Manns in conversation with Airlie funds management's head of Australian Equities, Matt Williams. We trust you've enjoyed this episode. For more information on previous episodes, visit magellaninvestmentpartners.com/podcast where you can also sign up to receive our regular investment insights programme. Thanks for listening.