From the desk of James Abela

February 2016

Benjamin Graham (1894 – 1976) was a US professional investor who had a great influence on Warren Buffett among others and is often referred to as the 'father of value investing'. Among his many contributions was the insight that, 'In the short run, the market is a voting machine but in the long run, it is a weighing machine.' What he meant was that stocks can be driven by momentum or sentiment in the short term and bad stocks can do just as well as good ones. But over time, fundamentals win out. That means that in the long run good stocks will fare much better than bad ones.

Last year once again proved how true was the statement that Graham made in his Security Analysis book of 1934. In the first nine months of 2015, an unsophisticated momentum approach may have been successful. However, the last three months of 2015 showed this investment style has the potential to create unconscious high-risk exposures that can end badly for investors. Energy and materials companies continued to post declines in earnings as commodity prices slumped and their valuations fell accordingly. More alarming was the over 50% decline for various reasons in companies such as diagnostic imaging company Capitol Health, floor-cleaning product seller Godfreys, vocational trainer Intueri Education, outsourced facility and cleaning-services provider Spotless and vocational trainer Vocation after recent initial public offerings.

The more-than-halving in these small stocks shows once again that there is always significant divergence in the sustainability of growth and yields across the mid- and small-cap universe. It will be important to watch these potentially wonderful or highly disappointing investment opportunities closely. Some red flags will be insiders or founders selling down their holdings significantly, poor explanations of one-off expenses or cash flow mis-matches, over-optimistic return outlooks, questionable accounting treatment, poor corporate governance and high leverage.

It will be even more important to look for these warning signs as 2016 progresses. Equity and other asset markets across the globe have enjoyed over seven years of low interest rates and liquidity boosts from and for the financial system. As US interest rates are rising, investors are now re-pricing risk. The list of concerns that are top of mind include sluggish global growth, China's troubles, falling energy and commodity prices, excessive leverage, the lack of business investment and that yield assets are expensive. This backdrop will force the market to look at company fundamentals in a far more discerning light.

Over the past 10 years, we have seen strong sector momentum in the mid- and small- cap universe: mining services, property and financial services in 2007, energy stocks in 2009, expensive defensives in 2012, housing stocks in 2013, internet and education names in 2014 and software stocks in 2015. During these times, the companies that will prove to be sustainable quality investments after the momentum has petered out are few and far between. Be selective out there in 2016 because, as Graham warned, the constant discipline for investors to distinguish between sustainable quality and unsustainable momentum is critical.

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