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From valuation agnostic to valuation driven

The heady days of reckless momentum passed their peak around six months ago and with it went the exuberant sales-based valuations of concept stocks and billion-dollar-loss-making companies. Since then, we've seen a sharp reversal toward cyclicals, low momentum and value, while extreme valuations in momentum and quality have begun a multiple de-rating.

Over the last few years, a scarcity of growth, yield and certainty has led to a premium being applied to companies that exhibit these characteristics. As financial markets have become more fundamental, more stock-specific and less correlated, the performance of sectors and stocks has begun to diverge.

Globally, we've seen examples of this in the tech space with WeWork, Uber, Lyft, Slack and Pinterest, and domestically too, with a number of software and fintech names falling over in the last six months. This has led to commentary about the unwellness of the listed equity market to legitimise the irrational and exuberant valuations in private markets due to the very low cost of capital around the world. I think it's just the beginning of 'reality bites' as the market's support for ideas, concepts and stories fades into demand for cash flows, profits and near-term visibility.

Locally, the construction and consumer sectors remain challenging as cyclical weakness seems to be increasing in breadth. Higher regulatory costs, softer outlooks, poor pricing power and an increasingly competitive environment have also affected many small to mid-cap names over the last six months. Sectors particularly under pressure include aged care, telecommunications (SpeedCast International and Amaysim Australia), IT services (ARQ Group and Citadel Group), electric vehicle resources (Syrah Resources, Galaxy Resources and Pilbara Minerals) and banks (CYBG Plc). Economically, times are tough.

The style debate has turned to value vs growth as the value rally seems to be gaining pace and excessively valued growth stocks fade in premium. During the year we've seen numerous small to mid-cap Australian stocks with over 100x price/earnings ratios: Xero, Afterpay, Wisetech, isignthis, Polynovo, Nanosonics, Promedicus and Freelancer, to name just a few. In contrast, there has been a number of cheaper cyclicals, consumer and financial stocks which have experienced weak earnings, weak sentiment and low valuation ranges.

Whether or not 'value is dead' is a vexing question right now, but what I have learned over the last 20 years is that valuation discipline is a concept that should always be adhered to across an investment portfolio. For example, over the last six months, we've seen quality and momentum stocks signalling over-valuation and over-earning and this needs to be balanced in a portfolio.

For investors in the Fidelity Future Leaders Fund, the strategy is always to maintain a style balance and focus on companies that possess:

- Sustainable and long duration quality or yielding assets
- Lower leverage and which are not dependent on liquidity of debt or equity markets
- Supportive market structures to deliver above average returns on capital and growth
- Cashflow-generating assets that can be sustained during tougher economic times
- Reasonable valuations
- Credible management

Fund performance

Net returns as at 30 September 2019

Timeframe	1 year (%)	3 years (% p.a.)	5 years (% p.a.)	Since inception (22/07/2013) (% p.a.)
Fund	11.16	14.30	16.12	15.16
Benchmark	3.69	9.80	11.86	11.22
Active return	7.47	4.50	4.26	3.94

Total net returns represent past performance only. Past performance is not a reliable indicator of future performance. Returns of the Fund can be volatile and in some periods may be negative. The return of capital is not guaranteed. Benchmark: S&P/ASX Mid Small Index.

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