From the desk of James Abela

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'Time is the friend of the wonderful company, the enemy of the mediocre.'

– Warren Buffett

This is a frustrating market for many as high valuation quality or bond proxy names are being de-rated while low quality or beta is rallying hard. To cut through the noise, I use my process to consider the viability, sustainability and credibility of these price movements and I see four major clusters moving upward – value, cyclical beta, and financial engineering and momentum themes.

The first two, value and cyclical beta, I have been a buyer of over the last six months because of their appealing valuations and improving fundamentals. The later – financial engineering and momentum themes – have started to falter. Resources stocks in the steel, coal, nickel and copper markets continue to rally on rising commodity prices and improving earnings expectations.

What has been evident in reporting season meetings and AGM season is the consistent message that general industrial demand is weak. There is excess capacity, margin compression, expectation adjustment, competition increasing and rising regulation. This has been evident in a number of sectors including telecoms, outdoor media, financial services, aged care, retail, hospitals, casinos and gaming software, commercial services and infant formula.

There has been a raft of profit warnings from as many as 30 companies over the last few months. Valuation for small cap industrials is near all-time highs and concentrated in consumer, healthcare and technology. Caution is warranted in these areas.

As industrial valuations reach high levels, sector correlations are falling, macro is difficult to predict and volatility is on the rise. The macro-driven flight to safety and search for yield market of 2012–2015 has moved on to a much tougher stock pickers market that is much sharper on valuations.

So, where to from here? Now more than ever, I believe a balanced approach is required. With more than 20 years investing in markets, I have learned that holding a blend of assets I classify as quality, momentum, transition and value have portfolio relevance at all times and allows an investor to navigate well through market cycles.

Why? Because a good balance of these stocks should cushion the downside and provide opportunity on the upside. Holding a concentrated portfolio of quality stocks provides the opportunity for high valuation and expectation, and momentum stocks stand to benefit from rising themes in the market. Value should be held to create balance in a portfolio given the inherent low expectations in this stocks life cycle which can create enormous value,

Considering all this, I am positioned for an improvement in economic recovery driven by the USA and China, but am cognisant of the risks. Major themes that run through the portfolio are:

(a) Productivity tools - technology to improve ecosystems and workflow – Aconex, WiseTech, Class, Hansen Technologies, Webjet

(b) Non-macro-driven structural growth – Corporate Travel Management

(c) Innovative or defensive consumer services – Aristocrat

(d) Long-duration yield assets with inflation and/or development protection – Auckland Airport

(e) Quality industrial, high FCF yields with global scale or some IP protection – Bradken

Now is a stock picker's market. While caution is warranted, the volatility will provide opportunities…

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