



From the desk of James Abela

April 2017

As I travelled around a number of major cities during the month of April, I found a healthy level of discussion about asset valuations, rising volatility, style performance shifting away from quality or growth towards risk and value. Clients are well aware of the housing bubble speculation, and concerned about what happens to markets next or more simply, where to invest?

Debt levels remain elevated and at record \$217 trillion globally* with interest rates near or below inflation around the world. Domestically, we are carrying combined debt of \$6.2 trillion** which is 360% of GDP. Employment growth and wage growth remains low despite rising equity markets and housing prices. Broadly speaking for reporting season and company discussions over the last few months, competition for slow top line growth is leading to softer margins or higher investment. As one client so appropriately asked, 'Where does this all end?'

In my view, we are late cycle in monetary policy stimulus and a strong macro view needs to be balanced with a 20- or 30-year perspective. In the long run, quality businesses and well-managed cyclicals will continue to deliver solid above benchmark returns for investors.

My concerns stem from observations of a period of mispricing of risk and in some cases financial engineering. We have clearly moved down the quality and sustainability spectrum over the last 18 months. This is evident when you look at what's been happening in the mid- and small-cap IPO market. Returns from the weighted average IPO slid down to close to negative during late 2016, compared to more buoyant markets of 2013, 2014 to 2015 when the average weighted average performance was 31%, 21% and 9% respectively.***

How do I navigate this market? I haven't participated in the high-risk plays over the past two years, avoiding bankruptcies and profit warnings such as Vocation, McAleese, Australian Careers Network, McGrath, Temple & Webster, The Reject Shop, iSentia, 1- Page, Sirtex and Adairs that remind us about the inherit risks in markets and management behaviour. The Future Leaders Fund did not hold these companies as they are low on the viability, sustainability and credibility scores. A rigorous and disciplined approach to filtering out lower quality momentum has benefited performance for clients.

Instead I am cautiously optimistic, focusing on old-fashioned cash flows and principles of sustainability which can stand the test of time.

Valuation and stock picking are critical with stock correlations near lows of 20% which has historically occurred in recessions or market downturns in 1991, 2000 and 2012. Political volatility and valuation fear seems to be pushing investors to be positioned to be bearish (owning yield, REITs, utilities, cash, defensives) or bullish (technology, energy, materials). These kind of asymmetric macro bets are difficult to time and trade.

For the Future Leaders Fund I am focused on the bottom up, listening to 140 analysts around the world, incrementally buying quality companies with strong industry positions, sustainable cash flows and reasonable valuations. The fund is pointed more towards global leaders rather than the more challenging domestic housing and consumer environments with concerns of Amazon's arrival, banking system macro prudential controls and housing concerns.

Viability, Sustainability and Credibility (VSC) remain the 'pillars of success'. With this in mind, the fund owns:

- Quality at reasonable valuations – e.g. Corporate Travel Management
 - Productivity, structural growth, innovative or defensive consumer services
- Momentum with long duration assets and low financial engineering presence – e.g. Auckland Airport
 - Long duration yield assets with inflation and/or development protection
- Transition or Value with positive earnings tailwinds or cash generation – e.g. Bluescope Steel
 - Undervalued cyclical industrials with high FCF yields, commodity beneficiaries, global scale, or unique IP protection

Twenty years in financial markets have taught me principles core to my investment process for clients:

- QMTV is a balanced style approach that delivers alpha through the cycle as quality, momentum, transition and value have portfolio relevance.
- High leverage is not an everlasting provider of growth (remember 2007).
- Valuations are cyclical, and now being distorted as more important than business cycle, by discount rates (remember 2000).
- Returns on capital, earnings and cash flows ultimately drive valuations in the long run (remember VSC are the long-term 'pillars of success').

As fund managers we are paid by our clients to manage risk, not avoid it. In the short run, bad risks can deliver high returns such as high leverage, poor business models, speculative momentum, thematic investing. In the long run, high returns on capital, solid management, innovative industry leaders, sustainable businesses with balance sheet and cash flows will stand the greatest test of all, the test of time.

*Institute for Finance, January 2017

**Australiadebtclock.com.au

***Data sourced from JP Morgan

www.fidelity.com.au



This document is issued by FIL Responsible Entity (Australia) Limited ABN 33 148 059 009, AFSL No. 409340 ('Fidelity Australia'). Fidelity Australia is a member of the FIL Limited group of companies commonly known as Fidelity International.

Investments in overseas markets can be affected by currency exchange and this may affect the value of your investment. Investments in small and emerging markets can be more volatile than investments in developed markets.

This document is intended for use by advisers and wholesale investors. Retail investors should not rely on any information in this document without first seeking advice from their financial adviser. You should consider these matters before acting on the information. You should also consider the relevant Product Disclosure Statements ('PDS') for any Fidelity Australia product mentioned in this document before making any decision about whether to acquire the product. The PDS can be obtained by contacting Fidelity Australia on 1800 119 270 or by downloading it from our website at www.fidelity.com.au. While the information contained in this document has been prepared with reasonable care, no responsibility or liability is accepted for any errors or omissions or misstatements however caused. This document is intended as general information only. The document may not be reproduced or transmitted without prior written permission of Fidelity Australia. The issuer of Fidelity's managed investment schemes is FIL Responsible Entity (Australia) Limited ABN 33 148 059 009. Reference to (\$) are in Australian dollars unless stated otherwise.

© 2017 FIL Responsible Entity (Australia) Limited. Fidelity, Fidelity International and the Fidelity International logo and F symbol are trademarks of FIL Limited.

FD17317