From the desk of James Abela

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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