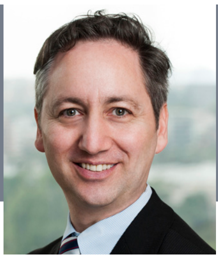

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Time for a valuation reality check-up!

This reporting season was one of the most positive we've seen in years, with Australian companies across many sectors delivering strong growth, despite the challenges of the Covid pandemic.

For equity markets, the 'valuation reality check-up' cycle looks to have kicked off, a theme which is likely to dominate for much of 2021. Bond market observers have been concerned about low risk spreads for an extended period. Whereas equity markets have witnessed record loss-making IPOs, record valuations for many sectors and momentum factors delivered outsized returns. We also saw an abundance of liquidity delivering euphoric conditions and correlations rise as everything moved to high valuations.

Let's look at the current market through the lens of the fund's investment process – in context of viability, sustainability and credibility. With respect to viability, the return outlook has improved and the direction of earnings and return on capital rising with economic recovery and increasing confidence.

One sticking point though is likely to be pricing power. Companies that dominate their field and have pricing power will have an easier journey than those with intense competition. Increased activity levels may make it difficult to make a margin or pass through inflationary pressures despite significant recovery on the horizon.

In terms of sustainability, cash flows are improving and corporate debt levels in Australia are generally reasonable. Pockets of high momentum such as the 'buy now, pay later' sector have relied on low costs of capital to gain market share and this will be tested as the cost of capital rises. To date, capital intensive businesses have enjoyed growth with a low cost of debt; however, debt spreads are rising. Credibility will likely become more relevant throughout the year as corporate survival, leverage to recovery and love premiums or momentum euphoria normalise.

From the contextual portfolio construction view of quality, momentum, transition and value (QMTV), one dominant feature to emerge was lower stock correlations. Stock specific and valuation factors were a far greater focus during first-half results season, and this is likely to continue in 2021.

Quality valuations are more in check now that growth premiums are being dispersed throughout the economy. We are seeing growth in the cyclical industrials, consumer, financials, resources and energy sectors reducing the need for investors to place significant PER (Price-to-Earnings Ratio) scarcity multiples on quality names. The phenomenal euphoric valuations momentum stocks have enjoyed will be challenged by rising rates, rising scepticism and a greater focus on sustainability and viability. Transition and value stocks will need to deliver earnings growth and demonstrate pricing power and margin growth beyond that of the top line growth associated with high economic activity levels.

There were a few disappointments during the results season which demonstrates that some industries remain highly competitive even during tough times. The value rally has run through a couple of stages now. Stage one – price to book normalisation. Stage two – rising expectations wave. Stage 3 – will be the reality phase and stocks will need to deliver to continue moving upwards and out of value into transition. Some will return to peak cycle, peak earnings, peak sentiment as they move into momentum.

2021 is shaping up to be a far more positive year. Stock picking and disciplined valuation check-ups will be key!