From the desk of Paul Taylor

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Low growth, high volatility

Back in December last year, when I sat down to write my outlook piece for the Australian market in 2019, I was surprised how positive I was relative to other investors and commentators. It was not that the outlook was getting more exciting or even improving, it was really that expectations were so low. Increasingly, market commentators were thinking we were likely to move into recession in 2019, market participants had high cash levels and consumers were focused on bank deposits. We were worried about the election, the economy, a US–China trade war, Chinese growth, interest rates and the residential housing market. Now here we are five months on, still worried about all the same issues, but the market has moved considerably higher. In market parlance, this is known as 'climbing the wall of worry'. Even though the environment still feels very negative, the equity market goes up. This really means that these concerns are already factored into the equity market. As we move through a few of the issues, the market will realise it is not the end of the world and transition from Fear of Loss to Fear of Missing Out (FOMO).

While we are on the subject of market parlance, another market saying in focus this month is 'sell in May and go away'. The market heuristic is that you make your money at the start of the year. This heuristic is really based on the belief that we start each year with high hopes, but then we slowly see earnings downgrades as more realism enters company expectations and the world is not as positive as our New Year optimism might suggest. While I like this market saying, and it can be a useful heuristic, I do not think it is particularly relevant in 2019. We did not start 2019 with the usual New Year cheer and optimism – but rather with fear and pessimism.

While noting my general positive demeanour for 2019 based on low expectations I certainly remain a believer in a continued low-growth world. No recession in 2019, but still low growth. My mantra has been low growth, high volatility. In a low growth, high volatility world there are two types of investments that typically work: (1) yield, and (2) growth. Strong cash flow businesses that deliver a good and stable dividend yield are strongly sought-after for their stability and focus on income as growth is hard to achieve. Growth companies are also attractive in this environment. In a low-growth world, any company that can achieve growth is a rare asset and will be well bid up by the market.

Within this context, I have structured the portfolio in a barbell-type structure. At one end are strong cash flow businesses with good management teams, large moats around their business, attractive industry structures and excellent dividend yields. These cash flow type businesses are the foundations of the portfolio and represent the largest part of the portfolio. At the other end of the barbell are growth businesses. In a low growth world, these growth businesses are rare assets and will continue to be bid up by the market. While these growth businesses will likely continue to out-perform over the longer term, they are vulnerable to greater volatility in the shorter term and as such are a much smaller portion of the overall portfolio. The growth end of the barbell adds the 'oomph' to the stable cash flow end of the barbell with the intention of delivering strong returns to clients in a risk-controlled manner.

In constructing the portfolio, I also believe that duration considerations are vitally important. I am sure speculation around trade wars as well as pontifications on central bank movements in official interest rates in Australia and around the world will create volatility in the short term. We meet with companies every quarter and maintain our own earnings, cash flow, valuation and balance sheet models with ratings every quarter, but ask ourselves the question, 'Is this going to be a better, more valuable business in five years' time?'. By taking a longer duration we can make volatility work for us by adding to great long-term structural growth stocks in periods of high volatility.

Market valuation currently looks reasonable on an absolute basis and, importantly, attractive on a relative basis. The Australian market is currently on long-run average valuation multiples and while earnings growth is lower than average (low single digit), interest rates are much lower than average and earnings quality is much higher than average, meaning there is a strong foundation providing valuation support. The higher the quality of earnings, the higher the price-to-earnings (P/E) ratio should be, and the lower the interest rates, the higher the P/E ratio should be. On a relative basis, Australian equities are the stand-out asset class, providing a dividend yield of around 4 to 5 per cent. Cash is on a P/E ratio of 50x, with no growth but plenty of support.

In summary, expectations are low, absolute market valuations are reasonable, and relative valuations are attractive. We remain in low growth, high volatility. In a low growth world, strong cash flow and high dividend yield investments work, as do strong growth investments. A barbell structure to the portfolio of yield + growth should deliver good returns in a risk-controlled manner. Focusing on longer duration investments allows the portfolio to take advantage of higher volatility. In the words of Warren Buffet: 'The stock market is designed to transfer money from the active to the patient.' 2019 will provide more opportunities for the patient to get wealthy!

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