FINANCIAL REVIEW

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Where cautious fundies are hunting in 2020

James Thomson *Columnist*

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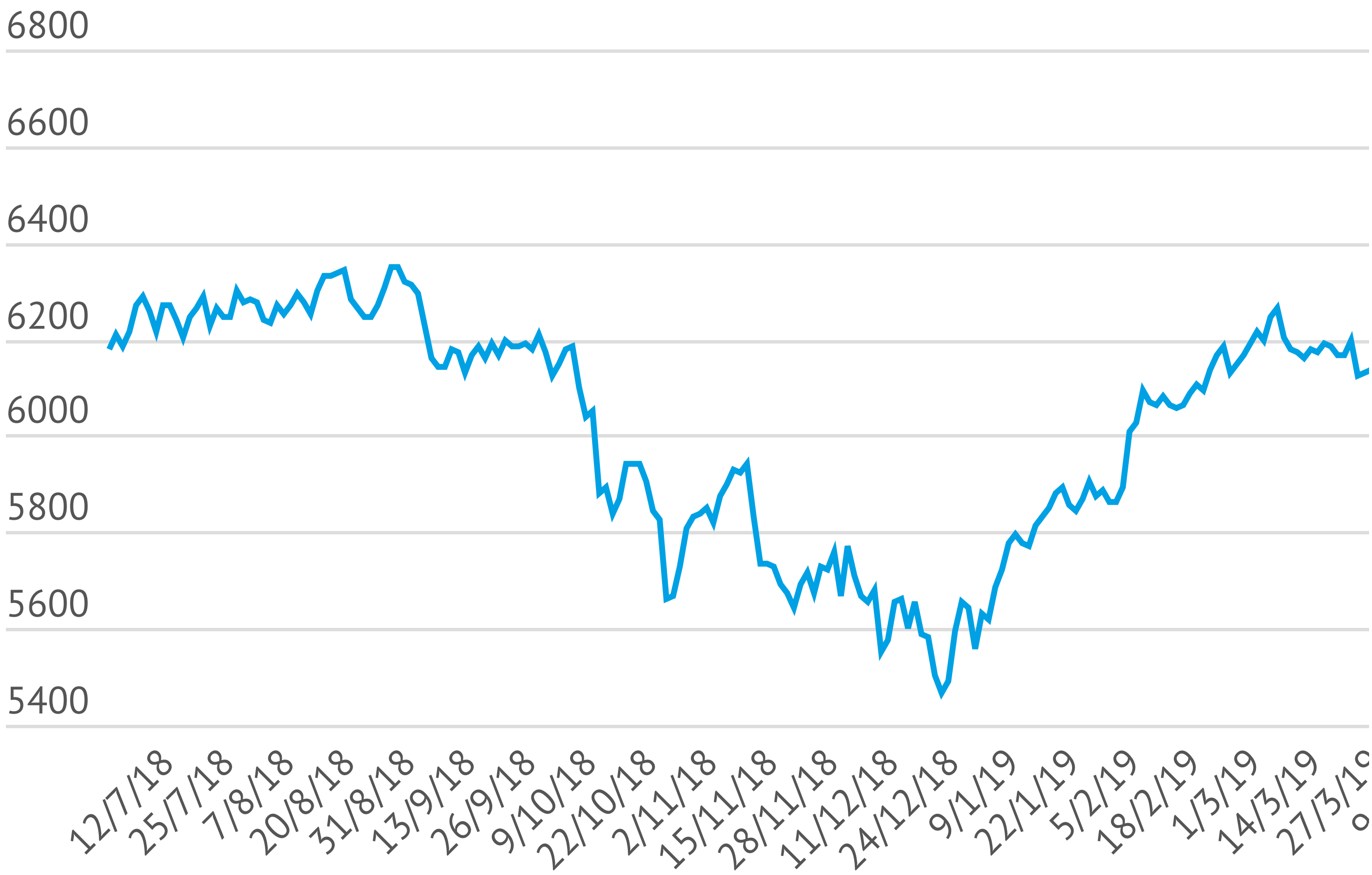
Sharemarket rallies are supposed to make investors happy. But you won't find too many celebrating the local bourse entering the 2020 financial year at an 11-1/2-year high.

That's partly because the rally has been so concentrated. If you didn't own the right growth stocks, the big miners or the big banks, then you've probably been chasing your tail for most of the year.

But as *AFR Weekend* talked to professional investors across range of sectors the big worry was clear: Falling interest rates.

While lower rates have sparked a scramble for yield, pushing investors towards growth stocks and the reliable dividend-payers so popular in Australia, any joy about rising equity prices is being tempered by the signal rates are sending about the economy.

S&P/ASX 200 Index



July 2018

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"I think the challenge is that interest rates are going down in response to very poor economic growth, in a context of very high personal indebtedness," says Gabriel Radzyminski, the managing director of activist investor Sandon Capital. "To us, it's conflicting news."
Still, Radzyminski isn't sitting on the sidelines, waiting for the correction that many think is inevitable.

The momentum in the market means investors want their money working. And the hunger for growth means bargains are popping up in other areas of the market.

"When the music is playing, you've gotta dance. And I think that's where a lot of managers are today."

The blue chip investor

For Dion Hershan, the head of the $8 billion Aussie equity and fixed interest manager, Yarra Capital Management, the federal election was an important marker in the final months of 2018-19.

"A lot of things that have transpired after May 18 have been good for the economy and good for corporate profits," he says.

Dion Hershan says interest rates can't drive stocks higher forever. **Louise Kennerley**

While he's carefully non-partisan, Hershan says the election result itself cleared up uncertainty around changes to policies around franking credits and housing, and ensured tax cuts should flow sooner rather than later. The prudential regulator's decision to lower the interest rate buffer used by banks to assess lending capacity, and the cut to official cash rates, also helped.

As a one of the few investors to publicly make the bull case for Australia's banks over the last 18 months, Hershan's patience has been rewarded. **Commonwealth Bank,** for example, is up 15 per cent since the start of 2019.

And while he's quick to concede there is no shortage of challenges ahead for the banks, Hershan believes their recovery can continue heading into 2020.

"There's genuine resilience in the sector. The businesses are simpler, they've got sufficient capital, they're proactively addressing their costs bases ... and you can see a path to credit growth returning."

But Hershan sees an inherent fragility in the low-growth environment. Low interest rates – particularly low five and 10-year bond yields, which have the biggest influence on equities – can only help equities grind higher for so long.

"At some point you need to see follow-through in corporate earnings," he says.

Hershan's positioning is in defensive stocks, with his biggest overweight positions in banks and infrastructure. His pick in the latter sector is **Atlas Arteria,** the former Macquarie Atlas Roads. Like all infrastructure stocks it is has benefited from falling rates, but the more important is the potential gains it could enjoy as it brings management in house.

Other key positions include online classifieds players **Seek** and **Carsales** and energy companies **Origin** and **Santos**.

"I think when you're in difficult periods, history suggests it's the better companies that invest through the cycle that tend to get rewarded," he says.

Looking ahead to 2020, Hershan has a word of warning about cheap money: Be wary of companies borrowing to do a deal to fill an earnings hole.

"The combination of cheap and highly accessible credit, and companies papering over cracks, creates activity," he says.

"We always treat M&A with a degree of caution and scepticism."

The international investor

Catriona Burns is blunt on the conundrum of falling interest rates and surging equity markets.

Catriona Burns is looking outside the United States **Christopher Pearce**

“I don’t think that disconnect can continue for much longer. The question is: Are bond markets or equity markets reading the future correctly?”

As the lead portfolio manager for Wilson Asset Management’s listed investment company WAM Global, Burns is watching data points from the US economy closely, and trying to get a sense of the state of the economy from on the ground. She says the test for markets could come as early as next month.

“If the Fed does not cut rates in July, and the data coming out of the US continues to deteriorate, it’s very hard to see equity markets moving higher,” she says.

The challenge for WAM Global is finding decent returns in markets where cyclical stocks are unloved, but money is pouring into high-tech growth stocks.

"We are trying to sit in the middle of those extremes. While we are not trying to call whether a recession is imminent, it does feel prudent to be wary of deep cyclicals ... nor are we playing companies trading on crazy multiples of revenue without any earnings. We are focused on the opportunities that exist in between."

"You've got to do some digging, get on the ground and go out and meet management."

Part of this is being willing to look outside the US.

For example, one of Burns' picks for 2020 is Japanese supermarket operator **Kobe Bussan**. Unlike in Australia, where the grocery sector is relatively concentrated, the top 10 players in Japan have a total market share of about 15 per cent.

Burns says Kobe Bussan, which has seen its shares rise 61 per cent since the start of the year, looms as the equivalent of Aldi in the Japanese market.

"They've got a really compelling private label offering, at prices that are 50 per cent to 70 per cent below other players in the market, because they've got a vertically integrated model.

"Japan has some exciting opportunities, but you've got to do some digging, get on the ground and go out and meet management."

Burns is also looking to Europe for value.

Burns is also looking to Europe for value.

“Sometimes it does get overlooked in favour of the US, but there are some high quality companies that we still find are well placed to grow despite the difficult macro environment.”

Her pick there is German company **CTS Eventim**, which is similar to Australia’s Ticketek.

The business has delivered consistent earnings growth, has a net cash position on its balance sheet and is 43 per cent controlled by the founding family, meaning there is plenty of skin in the game.

But Burns is particularly attracted by the margin boost the company should continue to enjoy as it migrates more of its customers online. The stock is up 24 per cent year-to-date.

The small cap specialist

Cyan Investment Management portfolio manger Dean Fergie is one of **Afterpay Touch**’s true believers, having ridden the stock’s incredible rise from $2 to more than $27.

“There’s no question that it’s been remarkably successful in Australia,” Fergie says. “When something becomes a verb, you’ve got a valuable business.”

But even with Afterpay's stellar performance – it's still up 211 per cent in 12 months, despite its recent issues with regulators and founder share sales – Fergie admits that 2018-19 hasn't been an easy period to navigate.

Cyan hunts for winners with market values between $50 million and $200 million, where the market can sometimes struggle to properly price companies.

Cyan's Dean Fergie has a warning on neobanks. **Stefan Postles**

Fergie says the environment has changed dramatically in the last decade, as online trading has made them much more accessible to a broader class of investors. “It’s like a Bunnings opening up. People start thinking: You know what? I could remodel my kitchen.”

He argues this has accentuated the herd mentality around stocks, which can run harder – or fall faster – than they would ordinarily. “The wave around mean valuation has expanded two or three times.”

Low interest rates have only added to the momentum in the market.

He points to Cyan holding **Audinate Group** as an example. The company, which makes software for use in the audio-visual sector, has seen its shares leap from $3.56 to $7.90 in the space of just six months.

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Fergie will be playing – or at least watching – a few big trends in 2020.

Cyan has extensive holdings throughout the tech sector, and Fergie names video technology firm **Atomos** (up 28 per cent year-to-date) and music data group **Jaxsta** (up 26 per cent) as two stocks to watch.

He's also keen on watching the eSports market given its rapid expansion in Australia and overseas. Minnow Esports Moguls is the only real way to play the sector on the ASX.

Fergie remains keen on a group of companies he calls the consolidators – basically companies buying up rivals in their sector. Panel beater **AMA Group**, accounting group **Kelly Partners** and travel firm **Experience Co** are among Cyan's holdings.

One area in which Fergie urges caution is neobanks – the online banks trying to eat a slice of the big banks' lunch.

"My concern is that although the top line numbers might look really good, you just can't make any money from it," Fergie argues. "It's a really competitive market and you're going to need a lot of scale."

He believes the neobanks might find it harder to get customers than they think. "No-one gets really excited about customers than they think." "No-one gets really excited about signing up to a financial institution."

The activist

Sandon Capital's Gabriel Radzyminski has watched the money pouring into growth stocks – particularly the tech stars – from afar.

"There are a lot of people that have punched out phenomenally good results ... on the back of companies that as value investor we find very difficult to rationalise. In Australia, most of the companies that offer growth don't seem to offer profits."

Sandon Capital managing director Gabriel Radzyminski says private equity will play a big role in 2020. **Jessica Hromas**

But that doesn't mean he's sitting on his hands.

"We're close to fully invested now. We are bargain hunters and we just can't resist."

The Sandon model is to find stocks where they believe value can be unlocked, and agitate publicly for change.

Radzyminski and analyst Campbell Morgan were successful in pushing perennial underperformer **Speciality Fashion** to orchestrate a deal to maximise the value of its City Chic chain in early 2018, and in March this year pushed mineral sands giant **Iluka** to pay special dividends to release its big bank of franking credits.

Some of these plays take years to come up trumps, of course, and Radzyminski's pick for 2020 is one of those.

Sandon has been a holder of industrial fasteners group **Coventry Group** for more than five years, and was part of a push to remove executive chairman Roger Flynn in late 2014. The business has struggled in the years since, but Sandon is enthusiastic about chairman Neil Cathie, the former chief financial officer of market darling Reece, and chief executive Robert Bulluss.

With the infrastructure sector heating up, Coventry's fasteners business is well placed on the eastern seaboard. On fasteners business is well placed on the eastern seaboard. On the other side of the country, its Cooper Fluid Systems business is also benefiting from jump in mining activity. The stock is up 3 per cent since the start of the year, but Radzyminski is excited about the prospects of a business that finally appears to have its ducks in a row.

One challenge for activist investors is the shadow of private equity firms, who are cashed up and likely to keep prowling the market in 2020, according to Radzyminski.

While a PE bid will often crystallise a payday for investors, Radzyminski argues there has been an increase in opportunistic bids that come too early in a turnaround.

“A company could be the subject of private equity bids at a substantial premium to the market price and yet still a substantial discount to their true worth. And that to us is the most frustrating situation of all.”

Fortunately, he doesn’t see Coventry appearing on the radar of PE at this stage.

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