



Investment opportunities during market pullback

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We are at the end of perhaps the most difficult financial year on record, but Platypus Asset Management's outlook for the Australian market remains positive. It seems probable the market established a major cyclical low in March and, from the way it has traded since then, it is unlikely to enter a major consolidation phase until the All Ordinaries Index reaches the mid-4000s.

The mid-4000s level is an appropriate short-term target for the market from a number of perspectives. It represents around 15 to 16 times forward consensus earnings, a number which represents the historic median price-earnings (PE) multiple for the market, and is also the level where the market was trading around the time of the Lehman Brothers collapse. If one considers we are trading on trough cyclical earnings, then the current PE multiple may understate the value inherent in today's stock prices. In the mid-4000s we expect the market will track sideways for a while until the economic fundamentals become clearer.

Furthermore, there is no longer justification for investors to be pricing in another systemic financial collapse of the same magnitude as Lehman. We believe prices below levels seen last October (mid-4000s) are pricing in a worsening systemic risk situation, which may not eventuate. Central banks and governments appear to have done enough to stabilise the financial system and this is starting to be reflected in improving economic data.

In Australia, this data is suggesting we are closer to the end of recession than the beginning. The parts of the economy that would be expected to respond to massive monetary and fiscal stimulus (housing and retail) are responding, and should make up for continued weakness in business investment and the inevitable weakness in net exports. In addition, investor sentiment is turning more positive, as evidenced by the resumption of inflows into equity funds and the strong participation in the many equity capital raisings since March. Leading economic indicators, such as consumer

sentiment, business confidence and retail sales, are showing signs of improvement, while credit market indicators such as the London interbank offered rate and TED spread have also improved, which should give confidence that the financial system has reached a sustainable level of stability.

Investors are still displaying a 'buy the dips' mentality; hence we believe corrections will be shallow. The most recent pullback at the start of May, both in Australia and the United States, has been more of a sideways pattern than a fierce correction. The general feeling is that investors do not want to miss the rally, therefore Platypus believes any market pullbacks will be well supported with buying. From a technical perspective, the market looks to be breaking out of a basing pattern, so this could add further momentum to buying support.

As investors – both professional and retail – start to return to the share market, the lessons of the last financial year shouldn't be forgotten. These include:

- Companies with excessive amounts of leverage should be avoided, for example, Allco, Babcock & Brown, MFS and Centro.
- Stock prices can fall much further than you think, particularly when sentiment takes hold of a market and drives stock prices well below their fundamental value. This occurred in many of the mining services stocks, where solid companies with strong balance sheets were trading on one or two times earnings. There was a fear that the end of the mining boom would mean the end of these businesses.
- Understanding the consequences of counterparty risk, especially for over-the-counter (OTC) derivatives. Lehman Brothers was the counterparty to many OTC transactions and some investors didn't properly consider or understand the risk involved in selecting and accepting counterparties to derivative transactions.

If these lessons are kept in mind, there are now a number of tempting opportunities for investors. As stated above, we believe

that corrections will be shallow and, as such, buying during the pullbacks should be a good strategy. Stocks that are showing technical strength or leadership are worth keeping an eye on. However, to be considered as an investment opportunity, a company must have a strong balance sheet and the ability to grow earnings strongly once the economic cycle begins to properly recover.

A major theme in the market will be rotation in and out of specific sectors/stocks to make money. For example, banks and resources led the start of the market rally, while industrial stocks initially lagged. After their strong start, banks have tracked sideways for the past two months. Resources have continued to remain strong and industrial stocks have caught up from their initial underperformance. Heading into the end of June, it is probably time to start taking profits in the sectors that have outperformed and adding exposure to the lagging sectors, such as financials.

In line with this theme, at Platypus we think Commonwealth Bank of Australia and Westpac are looking reasonably positive and offer some of the better risk/reward opportunities in the market.

Toll Holdings is another interesting proposition for investors. It has a strong balance sheet, a good appetite for acquisitions and has performed well through this economic downturn. Its ambition is to consolidate the freight forwarding market in Asia and Australia, with the goal of moving more volume through its network. It is highly leveraged to any pick-up in global gross domestic product and will benefit from inventory restocking.

Another standout company to investigate on a stock price pullback is David Jones. Sales fell by about 10 per cent at the bottom of the cycle, however, its profit growth was still positive. This comes down to management's ability to control costs and prepare for a downturn, which David Jones did exceptionally well. It also has one of the strongest balance sheets in the retail space, which helped it weather the difficult trading conditions. «

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