HORIZON
INVESTMENT SOLUTIONS

August 2018 — Over the Horizon Market Commentary by David Offer

August was a positive month for the Australian share market, with the All Ordinaries index up 62 points (1%) to close at 6,427 points. This was our fifth straight positive month and as at the end of August we are up just under 10% since our recent March low of 5,862 points. For the month of September, our market has been a little more sobering. At the time of writing, we are currently off 188 points or 2.9%.

Our share market is presently polarised, with a very apparent ‘in-crowd’ of growth shares lead by technology and healthcare companies with much of the balance of our market, by comparison, lethargic and appearing much less exciting.

A recent article released by Schroders illustrated this point by highlighting that high flying healthcare shares CSL, Cochlear, Fisher and Paykel Healthcare and Resmed have a combined market value approaching $150bn, for which they generate approximately $16bn in revenue and a little over $4bn in operating profit. This compares to Rio Tinto which, on its own, reported a profit just shy of $13bn, supported by cash flow generation of $18.5bn and yet, with a market capitalisation of $110bn, is worth $40bn less in value than the above mentioned glamour healthcare shares. To reiterate, RIO reported a profit more than three times in value, greater operating cash flow than the healthcare companies combined revenue and yet is worth 27% less in value.

While we commend management and admire the real ‘on the ground’ success these healthcare shares have achieved to date, we have to conclude that as good as these healthcare shares are, they are simply way too expensive at the current time. Using CSL as a case in point, on Morningstar’s forecasts, CSL is still forecast to trade on a price to earnings ratio (PE) of 28 times in June 2021. This is despite Morningstar assuming an earnings-per-share growth rate of 15% for the next three years - a rate much higher than has been achieved in the past. A prospective PE of 18 times in 3 years would, by normal convention, still not be cheap. To trade on this lower but more reasonable prospective PE ratio, CSL would need to currently trade at $134.64 versus its current price of $208.72. As such, CSL shares have scope to materially fall in value. Given CSL at its peak represented more than 5% of the All Ordinaries Index, any such material share price fall would provide a significant headwind for share market indices to overcome.

Switching to technology shares, consider Wisetech Global, Altium, Appen, Afterpay and Xero. All have had meteoric share price rises and now collectively have a market value of approximately $23bn and combined revenue of $1bn. None are reporting anywhere near $100 million in operating profit. This contrasts to (say) MYOB, a technology share that we now hold extensively that is valued at $1.7bn. This year, MYOB alone is forecast to generate $455 million in sales, a normalised after tax profit of $101 million and is on a prospective PE ratio of 17 times. With IT expenditure and marketing peaking over the next two years as the Company moves its small business client base from desk top accounting products to a superior cloud based solution, MYOB should thereafter experience a decade of revenue growth and falling costs that will result in widening margins and growing profits.

We feel that the current syndrome of ‘Growth At A Stupid Price’ (GASP) is potentially on its last legs and that investors who have chased glamour growth shares to dizzying heights due to a ‘Fear Of Missing Out’ (FOMO) stand to be badly burned. While price is what you pay, value is what you get. Wanting to get maximum bang for our investment dollar we will continue to remain value orientated with our investment selections.

In the global arena, it is interesting to note that the current trade brawl between America and China does not appear to be impacting the Chinese economy just yet, or that the recently imposed US trade sanctions are having their desired effect.

Official trade data showed the Chinese trade surplus with the US hit a new record in August at $31.05 billion. It is worth noting that given China’s surplus with the United States was larger than China’s net surplus for the month, overall China would have run a trade deficit if trade with the US was excluded.

Imports, a key measure of the strength of China's domestic demand, grew strongly. Importantly for Australia, **China's commodity imports such as coal, iron ore, oil and gas held up in August. With the exception of iron ore, which has seen volumes flat-line, all are up substantially from a year ago. For example, c**oal imports are close to four-year highs, crude oil imports at 8.99 million barrels a day were up 12.9% and total gas imports in August were at 7.77 million tonnes, up 39% from the 5.66 million tonnes imported in August 2017. Despite the recent sell off in the copper price, copper concentrate imports also saw a solid year on year rise, up 15.4% to 1.66 million tonnes in August from a year earlier.

Despite being business as usual in China, the Chinese share market (red line in the chart below) has copped a drumming over the last year, falling 22% versus the US share market up 17% (blue line).

The US dollar strength and trade war rhetoric have driven unprecedented outperformance of US equities over nearly all other developed and emerging markets.

As we have detailed previously, we are wary of current US share market valuations and high weighting towards technology shares. Conversely we consider China and more broadly Asia and Europe as offering much better value on all conventional valuation measures.

One way to gain Asian and European exposure is via the **Platium International Fund**, which can be bought as an ASX investment under the code PIXX. Platinum has an enviable long term track record and tends to outperform during periods of share market turmoil. With net weightings presently 50% towards Asia, 20% Europe, 2% America and the balance cash, we consider that this fund offers good diversification at the current time.

More assertive investors could consider the parent group **Platinum Capital (PTM),** the share price graph of which is below. Particularly if the shares fall below $5.00. Platinum Capital offers a potentially strong recovery in share price should the above disparity start to unwind resulting in investors further supporting the Platimum suit of funds and triggering performance fees to once again apply.

We reiterate our view that at some point investors will switch from momentum investing to value investing, both in our local share market as well as global share markets. We have been pleased that acceptable returns have been generated to date with a value orientated approach and feel that our portfolios are well positioned for what may come our way in the future.

If you would like to discuss any of the above or any other aspect of your investment portfolio, please do not hesitate to contact our office.

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