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Anton Tagliaferro wary of relying on rate cuts for value

Anton Tagliaferro, right, with Investors Mutual senior portfolio manager Simon Conn. Picture: Ryan Osland

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Anton Tagliaferro from Investors Mutual is wary of overpaying for shares pushed up by expected rate cuts.

After a worrisome sell-off in the December quarter as the US pressed ahead with rate increases, despite a worsening trade war, shares have surged as central banks lurch from interest rate hikes to cuts.

The S&P/ASX 200 accumulation index, which includes dividends, is now up almost 12 per cent for the financial year, with the benchmark hitting a 12-year high after rising 23 per cent from its December low. That puts the accumulation index on track for its third double-digit percentage rise in as many years.

But it’s been a tough year for value investors as dovish central banks have pushed bond yields down to record lows. That’s reignited a search for yield that has stretched sharemarket valuations since the global financial crisis.

"I must say it's a very tough time for a value manager," Mr Tagliaferro told The Australian in an exclusive interview.

"It's challenging because it's interest rate-driven. Most companies we talk to say the earnings outlook is pretty muddled.

"It's not disastrous but it's certainly not great."

The founder and investment director of Investors Mutual oversees just over $9 billion in small and large-capitalisation Australian equities.

"If you look at sectors with the momentum — resources, banks, REITS, infrastructure and technology — it's hard to justify increasing your weighting," he said.

"In REITS, for example, some are trading on a significant premium to NTA (net tangible assets) and some are reporting difficulties in terms of renewing leases, yet their share prices are hitting record highs because of the yield they offer."

Banks have rerated due to a lessening of regulatory risk, but Mr Tagliaferro sees an ongoing squeeze on their margins and limited potential for earnings growth in the event mortgagees use lower rates to pay off their loans, rather than increase their borrowing.

The IT sector is "bubble mark two" in his view and, with iron ore prices and equities having surged on supply disruptions, he doesn't think this is a good time to be buying the likes of BHP, Fortescue or Rio Tinto, even with the lure of greater dividends.

To be sure, aggressive central interest rate cuts may cause further crowding into the most expensive stocks in the market, causing another tough year ahead of investors like Mr Tagliaferro who are focused on value and quality rather than momentum.

“It’s hard to see the momentum changing in the short term but I think we will have a correction at some stage — some sort of reality check — because some of these sectors are priced as if the good news will last forever. You have to be a bit cautious,” he said.

“It’s certainly not a cheap market but, having said that, we’ve got record-low bond yields, so that’s the paradox.

“The economy is soft, so you get stronger bond prices, which supports the sharemarket. But ultimately, if the earnings picture doesn’t improve, I think that will reflect in share prices, too.

“In our opinion, some sectors do look a bit frothy and very optimistically priced but, funnily enough, there is value in certain sectors where there’s not earnings momentum.”

But he likes the gaming sector right now for defensiveness, value and yield, with Tabcorp benefiting from tougher waging regulations and Crown Resorts growing its suite of high-quality assets with a debt-free balance sheet and strong cash flow.

He still likes the packaging sector, particularly Amcor, and believes in Pact Group with its new CEO and a plan to remove $50 million in costs.

“It has hurt us over the last 18 months but that company should do reasonably well,” he said.

Telstra is another stock offering reasonable value and yield, according to Mr Tagliaferro.

“Telstra has rallied quite strongly but it’s a big ship that’s turning around and they are well positioned for the new 5G network versus Optus and Vodafone because of the issues with Huawei. They are taking a lot of costs out and the balance sheet is in good shape,” he said.

In healthcare, while he still holds CSL and Sonic Healthcare even after strong share price recoveries in the second half of the financial year, his funds have been reducing their exposure because they are looking expensive.

Mayne Pharma shares have performed badly, but he still sees good value: “It continues to struggle with its generics division in the US and we expect it to write down the goodwill of its generics business. But they have a contract manufacturing business which is doing very well and a branded drugs portfolio that's growing."

Overall, while the sharemarket has a valuation tailwind from falling interest rates, he doesn't see interest rate cuts generating much of an economic boost, if any. In that environment investors should be considering some defensive and value plays that can continue to pay dividends, give some share price upside and avoid the kind of sharp corrections that could beset some of the crowded stocks.

"Sectors like the REITS, resources, technology, the banks — given their outlook over the next three to five years — sure their valuations are being supported by low bond yields or higher commodity prices but you'd be wary of chasing them as they keep going up," Mr Tagliaferro says.

"It's very difficult because they are performing well, but when you look at them on a fundamental basis, it's hard to get excited at these levels. So we are trying to look at different areas that are reasonably defensive, quite good value and a little bit ignored."

While the RBA is signalling a series of interest rate cuts, he isn't so sure it will boost the economy.

"Rate cuts support help with the valuations but I think the RBA is pushing a bit of a string," he said.

"They will force people to look at stocks for yield, but I don't think they are going to have much impact on the economy. It's a bit of a fool's cause, cutting rates at these levels, because the benefit to most people is getting lower and lower."