IML INVESTORS MUTUAL LTD

Investor Series: The Case for Value Investing Going Forward

by Anton Tagliaferro and Phillip Gray
14 July 2020

An Extraordinary Environment

A decade of ultra-low monetary policy stimulus through low interest rates and sustained economic growth have been compounded recently by the onset of the COVID-19 virus and consequent massive fiscal stimulus and other supports. Share prices have been driven even higher both locally and globally by hopes of a quick return to normality and by the huge amounts of liquidity in the system. This has been a significant driver of activity, particularly at the speculative end of the market. We remain however confident that at some stage the sharemarket will begin to value companies more according to their fundamentals, and that investors will again benefit from a consistent, value and quality-focused approach to investing which has rewarded investors over longer timeframes.

The huge speculative bubbles we are seeing in stocks such as **Tesla** and **Afterpay** are clear indications that we may be about to enter a period in which a fundamental approach will again literally prove its value. The extraordinary spike in Tesla's share price this year, for instance, appears hard to justify on the basis of fundamentals such as revenue and earnings when compared to Toyota.

The pandemic has also prompted unprecedented market participation by people who suddenly found themselves with a lot of time and money in their hands. This has contributed further to driving many prominent stocks' prices to arguably even more unsustainable levels. Popular US stock trading app Robinhood, which charges zero brokerage, has experienced a big jump in users, many of them first-time investors attracted by widespread media coverage. This has produced a wall of 'hot money' which has further pushed up valuations of trendy sectors such as 'buy now pay later' companies, as well as supporting many other companies' already very rich valuations. Much of this trading activity has flown in the face of conventional market wisdom. In the US, the most popular Robinhood-traded stocks in June were Carnival Cruises (a cruise line unable to provide cruises for a while yet), American Airlines (an airline unable to provide many flights), and Hertz (a bankrupt car rental company!). Trading activity has been similar in Australia. There has been a sharp increase in new trading accounts, a resumption in trading from previously dormant accounts, and investors have been attempting to profit from buying and selling around short-term share price movements.

This has all helped drive companies like **Afterpay**, **WiseTech Global**, and **Zip** to ever-dizzier prices and eye-watering valuations for many companies which have yet to make a profit, especially when compared with solid global, well-established industrials companies like **Brambles**, which has a long-established history of earnings and reliable payment of dividends.

This environment has been extremely challenging for value-style fund managers like Investors Mutual, which invest in companies with real and recurring earnings, a strong competitive advantage, and which are run by experienced and capable management teams, rather than chasing market momentum or the latest trendy sector or fad.

Outlook for IML's Value-Style Approach

Much of the local and global economy has been in an unreal state of 'suspended animation'. Government income supports and deferred or reduced home mortgage and business rental payments have helped greatly reduce economic pain for many businesses and individuals. However, it's still hard to understand what 'normal' will be like for the economy as we look ahead.

Households now account for a very substantial proportion of economic activity. In a period of prolonged economic slowdown likely to follow reduced government support, high consumer debt, higher unemployment, and resulting reduced consumer spending power are likely to weigh heavily on economic activity and corporate earnings. The banking sector is unlikely to be as profitable as it has been in recent years. This will lead to a lower return on equity and reduction in dividends compared to what many investors have become accustomed to receiving. In this environment, it will be more important than ever to invest in companies which have proven sustainable earnings.

A recessionary environment is the time when good management really stands out. Many companies we have been speaking to are taking a very cautious outlook and are actively reducing costs or deferring or cancelling capital expenditure, which will have implications for their future growth and ability to increase their future earnings.

In this environment, we believe the recovery will be a lot more prolonged than many expect. Household income growth is likely to remain tepid and corporate earnings growth more modest. In an environment where interest rates are going to stay low for a long time, companies that offer good and sustainable dividend yields are going to be well-supported by investors for an extended period.

This environment is likely to be much more favourable to the kinds of stocks value managers favour, and in particular to businesses with real earnings, rather than companies which may (or may not) become profitable at some point down the track. Afterpay and WiseTech may have been able to achieve growing revenues to date, but are unlikely to have an identifiable pathway to sustainable profitability during a period of subdued economic activity.

How IML is Positioning Your Investment

All of this is why it's more important than ever for your money to be invested in quality companies that produce real and recurring earnings, have a strong competitive advantage, and are run by experienced and capable management teams. Because of this, we are investing in companies which are not dependent on a 'V-shaped' recovery and which are reasonably valued, and we are ensuring that your investment is diversified across sectors and companies which will generate sustainable earnings going forward.

We are also carefully assessing the likely demand outlook for each industry in a lower growth environment, as well as the outlook for prices of goods and services in each industry. Lower prices can have a significant impact on profitability. We are also looking for factors that can help companies improve bottom-line outcomes. This could be where a company can increase market share if it has weak competitors, or where it has the ability to cut costs to drive productivity. We are examining balance sheets closely – a strong balance sheet is particularly important given the economic uncertainties. We are also adding to our investments in companies we believe are well-positioned, trading at a reasonable price, and where we are confident earnings and dividends are likely to be resilient over the next two to three years.

Our approach of investing your money in high-quality companies with strongly defensive characteristics and tax-effective income streams, managed by a well-resourced and experienced team, has proven to work most effectively to deliver sustainable capital growth and income for our investors over longer time periods. The past few years have not been kind to value-style investors. The next few years could well show us how premature it would have been to write off value investing.