

SHORT TERMISM DRIVES MARKET OPPORTUNITY



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As a fundamental investor, we look for good quality businesses which are out of favour in the short term. This can be for a myriad of reasons, one of which can be a cyclical downturn in the demand for the company's product or service.

Over the last few years, the stock market has been characterised by 'momentum style'. A certain stock starts to rally because there is a bullish, new narrative. This is confirmed by a good earnings result and a big talking CEO fuelling the fire. Share market analysts get on board, inventing new valuation methodologies to justify their buy recommendations.

As its share price rises and valuations become ridiculous, passive funds are forced to buy as the stock becomes a bigger part of the index. Then the active managers start to buy, for fear of short-term under-performance.

Although this sounds ridiculous, it's exactly how the market has traded in the last few years and is counterintuitive to fundamental investment.

Instead of buying the latest big thing, we aim to take advantage of the systematic psychological frailties of investors, which create opportunities for us. The psychological frailty we are taking advantage of in the current environment is short-termism.

Short-termism

Short termism relates to the fact that stock market participants tend to pay a higher multiple for companies with earnings that have recently grown and are expected to continue to grow. In the current market, with low interest rates and an increasing amount of money in passive, quantitative and momentum strategies, the multiple the market is willing to pay for such companies has been excessive.

The opposite also holds true – the market tends to sell any company with negative earnings growth where there is no clear catalyst for this to turn around.

Given this short-termism, a share price decline resulting from cyclical headwinds can provide us a good entry point into a quality business. Every company is exposed to some sort of cycle – it may be the price of oil, the employment cycle or product cycle. While most of these cycles are perceived as being leveraged to different variables, in a global recession people learn that most businesses are highly correlated to the same cycle.

This is where we find the opportunity. In our opinion, just because something is a cyclical company, it doesn't mean it is a bad business. It may be a good business with decent management and a comparative advantage, but is leveraged to the demand/supply of the product that it sells. It needs to meet our stringent investment criteria – a sound business, with a robust balance sheet and strong management team. It's our experience that the market loves cyclical companies at the top of the cycle, and at the lower end of the cycle, love turns to hate.

Case study – Costa Group (ASX:CGC)

CGC is a great example of short termism. Its share price got as high as \$8.30 in June 2018 as the market got excited by its perception of an agricultural structural growth story. Twelve months later, the share price had fallen 60% to \$3.35 after the company downgraded earnings expectations due to a deterioration in operating conditions.

As depicted in figure one, in June 2018 when CGC's share price was at its highs, the sell side analyst consensus target price was \$7.10 per share. Twelve months later when the share price had fallen materially, the target price had fallen to \$3.85. On the back of an earnings downgrade, the experts almost halved the valuation of the company in less than twelve months. That is the same company, with the same assets.



Source: FactSet

Figure one: CGC share price

Costa encapsulates what happens to companies' share prices through a cycle. Clearly, the outlook for Costa's short-term earnings outlook had changed during this period due to pricing pressures in some categories and yield issues in others; however it's astonishing to see the market attribute such different valuations in such a short timeframe.

Cyclical v structural headwinds

We have historically generated good returns by identifying quality companies; by taking advantage of weak investor sentiment due to cyclical headwinds, we aim to get a good entry point to buy these assets. The company must have a good management team and solid long term prospects, and we need to be confident the company has a balance sheet to see it through an extended down cycle. We don't try and pick the bottom of the cycle, we just try and work out what the mid-cycle valuation would be and start accumulating when the share price is trading at a material discount.

This does not always work. The biggest risk comes where the headwinds driving share price and earnings down are structural rather than cyclical. This can be difficult to differentiate and takes analysis and judgement. Traditional media and department stores are examples of industries where it would have been a mistake to have bought the companies when they seemed to face cyclical headwinds.

While we won't pretend to know what the market is going to do next week (or next month!), we're taking advantage of the volatility to find some good long-term ideas at great prices relative to mid-cycle valuations.

Find out more about the performance, strategy and holdings of the [Perpetual Share-Plus Long-Short Fund](#).

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