

# FUNDAMENTALS MATTER



**PERPETUAL INVESTMENTS**

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Mark Twain has been attributed with the words **“history doesn’t repeat, but it sure rhymes a lot”**.

**Every market correction is both unique and different at the same time**

The amazing turmoil in markets since February 20th is just another in a long line of market crashes that dot the history of financial markets. They come every decade or so - as regular as clockwork. Yet there are many aspects of this current crisis that we haven’t seen before, starting with the COVID-19 pandemic itself. The markets have struggled for precedent. The closest thing to it was the Spanish flu in 1918. Opinions vary on how bad this one will be, but the consequence for demand and supply chains has been obvious. Provinces in China and Italy completely locked down. Whole countries isolated. Flights banned. Cruise lines in turmoil. Shopping centres empty. Who predicted this before December?

**The oil shock has added a new complexity**

OPEC was created to constrain supply and harvest higher oil prices for big producers. Russia’s decision to defiantly add supply seems irrational, as does Saudi Arabia’s response. Maybe there’s a bigger game at play (putting the US shale producers out of business?) but the oil price drop was the biggest since 1991, smashing energy stocks, triggering a sharp spike in high yield spreads and stirring corporate credit default swaps.

**Coming into this crisis the warning signs were there**

US market capitalisation reached around \$34 trillion in late February, or 158% of US GDP. At the height of the US tech boom it was a mere 149%. On average it has been 80-100% of GDP. This is Warren Buffett’s favourite valuation measure. US stocks were a screaming bubble looking for a pin to pop them. The market had rhymed a lot with 2000 as the tech sector overtook financials in the MSCI for the first time since January 2000 - and some tech stocks traded at eye watering valuations, nurtured by the lowest interest rates in history and trillions in unconventional policy easing. Here in Australia the rhyme was similar with health, infrastructure and tech names defying gravity (and sense) as well. These extreme valuations haven’t fully washed out yet.

On Friday Westpac was down over -12% before lunchtime but then closed up more than +2% few hours later. Cochlear was down -5% in morning trade but closed up +21% in the afternoon. These are astonishing intraday moves. These wild swings may have been driven by everything from hopes of a US stimulus deal to an emergency injection of RBA cash into markets. But there were no fundamentals to assess. There were no major announcements from these companies. On Monday, despite hope from the Friday rally, markets again plumbed new depths.

The COVID-19 crash has started disrupting markets, but it may be far from over.

**We are focused on three things for our investors from here:**

1. **Value investing a powerful long term wealth creator**, as Warren Buffett would attest, but it doesn't always work perfectly, especially in the early stages of a market correction. As Joel Greenblatt likes to say: value investing doesn't always work, which is precisely why it does work. Because it requires capitulation for the value opportunity to emerge. We're not there yet. Unloved stocks are the best opportunities, and we continue to be on the hunt for these.
2. **Balance sheets are the really important piece of the puzzle from here**. So far balance sheet strength has been of little interest to the markets. Maybe it's because policymakers have continued to paper over the cracks for so long. This sell-off is not the same as the credit crisis at the heart of the GFC, especially with many more layers of capital and liquidity in the banking system. But recently listed "concept stocks" with a plan for disruption, but no earnings, could face an existential crisis, especially if they are reliant on capital markets for funding. Capital markets may become more discerning about who they finance and the importance of a path to profitability. As the crisis evolves having a good balance sheet becomes the only thing that matters. That's why we consider this before all other investment criteria.

**Opportunities that are both value and quality are at multi year lows.** On Monday the S&P/ASX300 closed at 4,958.7. Despite the scale of the market rout the market has only just fallen below levels of a year ago. Yet some of the highest quality and best value stocks trade at the lowest levels in many years. This does not make sense. But this is where the opportunity lies. Crown Resorts closed Monday at \$7.28. It last traded at these levels in in 2011, despite a solid balance sheet and world class assets. Distressed selling of well managed businesses like Event Hospitality and Entertainment are good opportunities for our investors. Whilst the general insurers like IAG and QBE were holding up relatively well, investors sent Suncorp to 2012 lows even though it is also predominantly in the same business. The last time Woodside Petroleum traded below \$18 was in 2004! We think that the safety and value features of these kinds of stocks have not been fully appreciated. But the time will come when they will be.

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