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Rudi Interviewed: Megatrends A Go-Go

Feb 05 2024

In late January, I participated in Tech2024, a series of expert interviews on the outlook for technology companies in the year ahead, and beyond.

Below is a curated transcript of that 13 minutes interview.

Interviewer Danielle Ecuyer: My next guest says not all tech companies are good investments, and not all beneficiaries are labeled tech. For more Rudi Filapek-Vandyck from FNArena joins me now. Rudi, it's really great to have you here. I like to ask the guests to explain what is the process that you go through for stock selection?

Rudi Filapek-Vandyck: In my case it's probably a little bit different from most other people. I like to own stocks that can be kept in portfolio for longer than next week, or next month, hopefully for the next number of years. So for me, it's very important that I look at the prospective growth of companies. And I find that more important than a cheap looking valuation in the short term.

Interviewer: Okay. So within the context of that, you published a book in 2015, which is a great book, and it certainly opened my eyes about this whole concept of megatrends, growth and technology. So just share some insights that you established then.

Rudi: I've been writing about this since 2015. And I think too many people are too busy with valuation on a micro-scale: whether a stock is cheap or not; whether interest rates go up or down; and whether markets have a correction or not; or are they in a bubble?

I think the most important message for investors today, as it was in 2015, is that we are going through a period of technological innovation that is pretty much unprecedented in history. We have, however, one potential precedent: the 1920s. What we remember about the 1920s is what happened next in the 1930s. But the 1920s itself were absolutely fabulous for equity investors.

Society changed. Innovation changes society, and that means you actually create megatrends. Megatrends are new developments in society that will support companies that are riding the wave of that trend for many, many years on end. Most industrials and other companies have a few good years but then growth peters out. If you successfully identify megatrends, and you successfully pick the quality companies inside those trends, you can keep those companies in portfolio for multiple years on end.

If people go back to 2015, they can clearly see that has been the case for more than just a few companies. Yes, shares move up and down with interest rates, currencies and because of other influences, but at the end of the day, share prices move from the bottom left corner on price charts to the top right hand corner, and that's exactly what you want as an investor.

For me, that's the type of company you want to own as a long term investor who doesn't want to switch every five minutes into a new discovery.

Interviewer: Your point about labeling is really interesting. As a classic example, people look at secular themes from the top down, like clean energy. They say, wow, this is off to the races, and they dive into an ETF and then they discover all is not necessarily rosy. Does the same thing apply with technology?

Rudi: Absolutely. We are going to look back in 10 years time, to today or to 2015, and we'll conclude why didn't we see these developments coming? Why haven't we been more exposed to this? What is happening, essentially, is the technological innovation is coming through. As a first result, the stock exchange in Australia has changed, a lot. The ASX used to be all about financials and resources, and a little bit of industrials on top. Now we have a lot more technology on the stock exchange, and those who complain we don't have technology should open their eyes.

The other thing, of course, is we get these mega-trends, because of the process I just explained, and it's not just technology companies that are benefiting from those megatrends. Another observation to make is: don't get too bogged down in labeling. Technology is fast becoming a fact of life for most companies, even those who are far, far away from what we would regard as being a technology company.

It doesn't turn these companies into technology companies. I do remember, a few years ago, we had this public discussion whether Domino's Pizza ((DMP)) was a technology company or a pizza deliverer. As it turned out, Domino's was a pizza deliverer trading on a technology company's PE ratios – it's not quite the same.

I do think it's symptomatic of what is happening: technology becomes ever more increasingly important for all businesses. If you want to have a long term investment strategy, and you incorporate mega-trends, don't get bogged down simply on a company carrying the label of technology.

One company I have owned for many, many years is NextDC ((NXT)). Officially, it's a technology stock, in practice it's not. Nevertheless, I like it because it's carried by one of the strongest megatrends in the market. Another example is Goodman Group ((GMG)). Most people would regard Goodman Group a REIT, or a property developer, which, of course, it is, but Goodman is benefiting from one of the strongest megatrends globally.

That gives you an idea you don't have to stick with the stocks that officially have a technology label. Also, biotechnology has 'technology' in its name and it too is technology. One of the industries to look at, of course, is healthcare. Many companies are labeled as healthcare, but in practice, they often are technology.

Interviewer: I think that's such an important point that you draw out and it's particularly relevant with artificial intelligence, now it is being rolled out across so many different industries. So by definition, if investors just look at the big names in AI, they may be missing a whole lot of other opportunities.

Rudi: Absolutely. At the very beginning, it means a lot of companies will have to make lots of investments. What you see in the first phase is the so called pick and shovel providers for the industry are the initial beneficiaries. Later onwards, it's going to define the winners from the losers in every single sector. So quality and the ability to invest become increasingly important.

The other thing, of course, is that while we don't have an Nvidia on the Australian stock market, if you look into the finer details there's this relatively small cap stock, Dicker Data ((DDR)), that happens to be the exclusive distributor of those chips in Australia. So we do have Nvidia on the local stock exchange.

Interviewer: Let's throw some names out there, something like Car Group ((CAR)) by way of example. People would have thought, oh, it's just an online portal to sell cars, but maybe REA Group ((REA)) and Car Group are two great examples of there's a lot more going on beneath the hood?

Rudi: I've been doing the megatrend technology approach now for quite a while. The three of Seek ((SEK)), Car Group and REA Group were always on my radar. They are the so-called previous wave of technology stocks on the ASX. What is important here is that the winner takes all and there's a flywheel effect that benefits those companies. When you are the market leader, you can do a lot more than number two and three in the same sector.

We're now coming into a new wave of technology stocks, and we have new names coming up. Nevertheless, another example is TechnologyOne ((TNE)) and that's still one of the best performers on the stock exchange.

Companies that are maturing more recently in Australia include the likes of Altium ((ALU)) and WiseTech Global ((WTC)). We also have, in the healthcare sector, Pro Medicus ((PME)). The reason why I mention those stocks is because I believe these are amongst the highest quality, best performers we have on the stock exchange.

Two things you need to remember here: if you're constantly reading the Intelligent Investor by Benjamin Graham, you will never invest in those stocks. You cannot value them on the same principles as you do with banks, resources and your traditional industrials. That's number one.

The other element is these stocks usually outperform expectations, and they have been so far. So what's the best strategy to get on board? In my view, if you own them already, by all means, don't get too bogged down about the short term and stay on board. If you don't own them, do what I do: You wait for a significant correction to come through.

For example, for reasons I won't explain here, I did no longer own shares in WiseTech Global. To my delight, last August the market sold out of the stock. Guess who was buying? I think that's the strategy investors should have. Once you're on board, you just wake up with a smile every day and worry less. I mean, yes, the 1920s ultimately ended with the 1930s, but that's a worry, I believe, we might have to revisit later on. It's little bit too early for that at this stage.

Interviewer: I asked a previous guest the same question: Do investors underestimate the strength and longevity of secular trends?

Rudi: Yes, people don't understand a megatrend makes it so much easier for a decent quality management at a decent quality company to create shareholder value, and to continue creating shareholder value over multiple years. It's very difficult for your standard company to do that. Usually, what you see in practice, is companies do it for a few years, or sometimes even less, and then growth becomes more difficult to achieve. When you have a megatrend just carrying you along, it makes the task a lot easier. And I mean: a lot easier.

But, of course, you still have to distinguish quality from the lesser quality ones because, ultimately, quality will drive you through the good times and the bad times. It's particularly in the bad times when the difference becomes very, very visible in portfolios.

Interviewer: Unfortunately, one last question: Australians love their dividends. They love their yield. It's quite bizarre there's been so much investment moving into big tech in the US that doesn't pay dividends. Investors buy it for growth. Yet, for some reason, there seems to be this mental block here in Australia. How do investors get over that hump?

Rudi: They have to realise that even with dividends -and I write about this on a regular basis- even with dividends, it still remains important that the company grows. There are plenty of examples out there of companies that pay dividends and grow and thus will trade on higher multiples and therefore not offer you the same yield as another company.

But if you keep the shares for years, you actually end up with a higher total return and often also with a higher income from dividends as well, because those dividends grow faster. There are technology stocks that pay dividends. Apple pays dividends. Microsoft does. In Australia, the likes of TechnologyOne; they do pay dividends. You just have to combine that with a not overly overpriced share price, and still with growth underneath.

Interviewer: Fantastic Rudi, as always wonderful analysis. Very insightful. Thank you so much for joining Tech 2024.

Rudi Interviewed: Ongoing Potential In Technology & Growth

Feb 19 2024

It has become the 'unofficial' tradition in recent years: an interview with Livewire Markets ahead of yet another corporate reporting season in Australia. Below is a sub-edited transcript from the pre-February results season interview that took place on February 7. The video is available on Livewire and on YouTube.

Interviewer Ally Selby: Hello and welcome to Livewire's newest series Views from the Top – a series dedicated to bringing you the best of the best ideas and insights from those at the top of their game. Today we're very lucky to be joined by FNArena's Rudi Filapek-Vandyck for a deep dive into the reporting season and what you can expect. Thank you so much for joining us today, Rudi.

Rudi Filapek-Vandyck: It's a pleasure.

Interviewer: You told me I would be surprised by what you have to say today – so I am both excited and nervous, but let's get straight into it. The big picture – the market is looking through all the headwinds that we're seeing right now and betting big on rate cuts in 2024. Is there anything wrong with sticking to consensus?

Rudi: It's not necessarily wrong, but we have been here before, just a short memory back – February last year and August last year. In both cases, the setup was basically the same. We get a big rally leading into the reporting season and then, of course, the reporting season turns out to not be good enough to sustain the share prices and then we erase all the gains we had. And then the process starts again.

It's not inconceivable we will have a similar process. We have rallied on macro considerations. There's not an upgrade cycle happening in economies or profits, but there are two things I think that are different now. One is the carrot of interest rate cuts. Whether that is short-term or medium-term, the carrot is there and I think that will, to a certain extent, support share prices.

The other thing is that – while it's very early days – we've actually made a good entrance into the reporting season. The reporting season starts really slowly and gradually in Australia. So we have a very small sample, but the early signs are there that companies are tending to do better than forecast or at least meet expectations. So far so good. Again, it's a small sample, but at least we've had a good start.

Interviewer: Okay, we'll get into some of that granular detail later on. I want to talk about what you expect going forward. We saw value being tipped as the area of the market that would outperform in 2023. It didn't. Growth and momentum outperformed instead. What can investors expect this year and did that surprise you?

Rudi: In my view, and that's probably a little bit different from the majority of experts, we're going through quite an exceptional era of technological innovation. I've made the comparison a number of times in the past. The best comparison we have is the 1920s.

The 1920s were a great era of technological innovation. It also meant it was a great era to be a shareholder in the share market. And a lot of companies, of course, had tremendous growth on the back of new developments that were essentially reshaping society, and the share market and economies too.

We are going through a similar phase now. As a consequence, high growth driven by megatrends and technological innovation is not going to go away. So this whole discussion about whether we should go into value, which basically is either cyclicals or old economy companies, or high growth companies that promise the future, I think this whole discussion is a bit warped.

On occasion, we will see the pendulum swing between those two extremes in the share market. But I think on average, longer-term, sustainably, I think you can't ignore the fact that we are going through this tremendously exciting time. Technology should be on everyone's radar. Those companies will continue to perform and they will never be priced at nine times next year's profits.

Interviewer: Another area of the market that everyone says investors should be looking at right now are small caps. Do you agree with that?

Rudi: It's a universal forecast, small caps, and it's not such a difficult one. We've had two years of a tremendous bear market for small caps and you don't have to be a genius to work out at some stage that corrects itself. So small caps, yes. Other universal forecasts are the comeback of REITs, yes. The comeback of healthcare, yes – in particular quality healthcare. The comeback of small-cap resources and the comeback of emerging markets.

All those forecasts are probably correct, but they won't be universal.

I think the mistake investors will make is thinking that by default there are only gains to be made in small caps. Or that there are only gains to be made in REITs. Or that there are only gains to be made in healthcare stocks. That will not prove to be the case.

I think investors should be selective. The most important thing to add is that there's still a lot of growth and upside to be had out of large caps, out of growth stocks, out of technology, and that will not disappear. So I think the best strategy for this year is diversification across all those themes, not just picking one of them because, again, it won't be universal and it won't be all at the same time, every single time throughout the year.

Interviewer: If it's not universal, which companies do you think will outperform then within those sectors?

Rudi: Well, I just mentioned healthcare. Healthcare is always on my radar. I think we've already seen that with ResMed ((RMD))...

Interviewer: But that's also been a consensus call...

Rudi: Well, if it was that easy, we don't want to pay a dollar for everyone who was not in ResMed. CSL ((CSL)) is also making a comeback – it's visual on price charts – it's above $300 now. The market is also preparing for a very strong result in Cochlear ((COH)).

Outside of that sector, we have the REITs. The last three months or so have already seen some share prices move there. The market leader is Goodman Group ((GMG)); this company continues to perform. Again, expectations remain positive.

If you go to small caps, we have the laggards, the ones that haven't performed or maybe a little bit and that's where everyone's attention will go, of course. Looking through all the forecasts ahead of February, companies that are often mentioned are the travel industry – like Corporate Travel ((CTD)) and Webjet ((WEB)). A company that is definitely often mentioned is Hansen Technologies ((HSN)). Everyone sees that as a quality company with its share price not moving.

We just mentioned ResMed; my candidate for the next ResMed-like recovery might be IDP Education ((IEL)). At the moment the market is very unsure about how to deal with the uncertainty and once the situation becomes clearer, I think that could potentially lead to the next rebound, though not necessarily in February. It might require more time.

There's also the other side of the small caps and I just mentioned growth, technology, and megatrends. There's quite a group of relatively small-cap companies that already have performed. I think the mistake investors could make is thinking they're done with their growth because they still have a lot of growth in front of them. Obvious candidates, as far as I'm concerned, are NextDC ((NXT)) and Macquarie Technology ((MAQ)).

Depending on where you put exactly your demarcation between a small cap or a mid-cap, I also think Steadfast Group ((SDF)) and AUB Group ((AUB)) – the insurance brokers – look very good, still.

Then you have the financial platform operators, Hub24 ((HUB)) and Netwealth Group ((NWL)). The mistake investors could make is thinking, because these have all performed to date, there won't be anything coming beyond what already is in the share price. I think that would be a mistake.

Interviewer: You talked before about share prices not performing as expected post a company beating or missing expectations last year. What can investors expect this year?

Rudi: That is the big unknown. Because we are trying, as a community of investors, to look beyond the short term. We are looking forward to better times ahead, in the second half and in 2025. That's the big question.

Admittedly, we've seen, for example, with a disappointing market update by Bapcor ((BAP)) that the share price did not fall, it actually went up. So that could be good news.

I still think we will see some fireworks here and there. And for that reason, I think it's only smart to have a little bit of cash on the sidelines. If I can go back to last year, both ResMed and WiseTech Global's ((WTC)) share prices sold off quite heavily. I bought both. We will see more opportunities coming up this year. You don't know in advance which ones. So the best strategy is to have some cash and if it happens, buy and be comfortable.

Interviewer: We'll get to your cash holding a little bit later on. I know it's a spicy subject. Where are our expectations too high right now? Where could we see some of those fireworks?

Rudi: How long is a piece of string? We will have to find out, and as I said, we don't know how the market is going to respond to disappointments and surprises, but as an investor you have to know your strategy. Is your strategy to sit in undervalued assets and then wait for them to get to fair value? Or, in my case, are you comfortable holding companies that have many years of growth ahead of them and even if they dip or fall in price after the results, it doesn't bother you?

For example, two of my favourite stocks would be TechnologyOne ((TNE)), which is not reporting this month, and REA Group ((REA)), which does report in February. Often what happens is share prices fall after the companies report results. For me, that's never a problem. If I don't have enough shares, I buy more. If you look back 12 months later, the share price is higher.

So how you respond to that is basically defined by the type of investor you are and what exactly your strategy is. My strategy definitely is that I will keep my eyes open for those structural growth companies. If they do dip in share price, I might consider buying more shares or, if I don't own them, I might actually buy the shares.

Interviewer: You talked about having a little bit of powder on the side just in case any companies sell off on the day. Last August, and I think also last February, you told us you were holding 18% cash, which is quite a lot of cash. How much cash are you holding today and have you put any of that money to work?

Rudi: So, last year I was pretty confident, don't ask me why, but I was pretty confident those rallies we saw each time leading into a reporting season would prove futile – that those rallies were basically running on fumes and it would not be sustained. Twice I was correct. But the second time, after August, I started looking differently at the market and I decided to use some of that cash.

From memory, I've been buying shares in WiseTech Global, REA Group, Hub24, ResMed and Goodman Group; pretty much the companies I mentioned earlier. So I've been putting some money to work. I basically halved my cash level, it's around 9% now.

Is that a lot? Well, if you consider that I own about 20 stocks in my portfolio, 9% is two times five percent, four and a half, to be more precise. It can also be three times three.

So is it a lot? It's not, because I would still have to be selective in how to allocate that money assuming I'm going to allocate it in full after this reporting season. That may not necessarily be the case, I can be patient.

I do think the overall environment, at least for the time being, has changed. I think the bias is now less to the downside than it was last year. Even though last year the real downside didn't come through, except for some individual companies. As long as you can avoid the real disasters, and you can be confident in using share price weakness, like, for example, with ResMed and WiseTech Global, I think you're doing quite a good job in allocating your capital.

Interviewer: Okay. Last question for you today, Rudi. We like to ask all our guests what's something they've learned in their years in markets or from those connections they've made after decades working in similar roles. What's your view from the top?

Rudi: I learned a lot over the past two years or so from the share prices of CSL and ResMed. Both did not perform for a while. What I noticed is so many people are focused on price and on charts. When you are only focused on price action and on charts, you never get to the bottom of what a company consists of, what makes a company tick.

Unless you get to that point, you'll find it very difficult to understand why ResMed at $21 is an excellent opportunity. Or that CSL at $248 or however low it was, even at $260 or $280, is an excellent opportunity. The charts will not tell you that – the price action will not tell you that.

You have to try to get to the bottom of what makes a company. Sometimes the fundamentals of a company longer-term and the share price action diverge. At that point, it is very important to understand the fundamentals of a company. I've learned from the past few years there are so many people who are being led by price action and by charts. They literally don't understand the company. You have to question if you are an investor or a trader, whether that is the right way of approaching the share market.

Interviewer: Okay, well I've absolutely adored this chat today. Rudi, thank you so much for your time.

Investing Is About The Future

Mar 06 2024

By Rudi Filapek-Vandyck, Editor FNArena

The local December-half results season in February had its own script in mind, as also illustrated by the interim result release from California, USA headquartered Life360 ((360)) on March 1st.

It's not often Australian investors see a sizeable earnings 'beat' being rewarded with a 38.5% rise in the share price, not to mention the double digit follow-through that occurred on the following Monday.

By the market's close 7.87% of that follow-through was left for a 46%-plus gain over two days, which neatly summarised what February 2024 was mostly about:

-both analysts and investors had been too cautious in many instances, which provided a platform for big corrections upwards

-a two-year bear market for smaller cap companies also meant share prices proved too low

-consumer spending is still fine, both locally and overseas

-management teams have a much better grip on limiting cost growth

-the sky is literally the limit for technology companies, both large and small

That seldom witnessed melt-up experience for shares in Life360, provider of tracking services for family members and pets, is the result of an undervalued starting point in combination with operational momentum that has forced analysts to significantly upgrade forecasts, valuations, and price targets.

According to **FNArena's The Short Report** total short positions in the stock were less than 1.5% prior to the market update.

For investors, to understand the full message emanating from the Life360 share price explosion, both items supporting the share price move are equally significant.

I would actually argue the second part is the most important factor as numerous other technology-driven companies have equally enforced significant upward corrections in operational estimates and share prices, without starting from a beaten-down, too low share price level.

Spoiler alert: it is not just a smaller cap phenomenon either.

Goodman Group ((GMG)) has been one of my personal favourites in the local share market for numerous years and with a market capitalisation of circa $57.9bn it is one of the largest index constituents on the ASX.

Yet, its financial release too put a rocket under the share price and left analysts in awe, scrambling back to the drawing board to remodel upgraded forecasts and valuations.

It wasn't that long ago when investors on my X feed were seen discussing whether Goodman Group shares at $24 were 'fair value' or 'expensive'. Now the shares are trading above $30, backed by significant increases in analyst valuations. The current high-marker is Citi with a price target of $32.50.

It goes without saying, Goodman's story did not start last month, or even last year. Australia's largest property developer has gradually transformed itself into a large funds manager and developer of mission-critical assets for key customers, such as Amazon, around the globe.

That large hyperscale warehouse with all the latest modern technologies embedded inside that is facilitating Amazon's e-commerce expansion worldwide has probably been designed and build by Goodman Group.

That operational transformation has not gone unnoticed, of course, and what was once a share price judged by the dividend yield on offer is now priced as a growth stock.

At the current share price, the forward-looking yield is no more than 1% with price-earnings (PE) ratios of 29x and 27x on forecasts for FY24 and FY25, respectively.

Those numbers look way over-the-top for what is, officially, Australia's number one REIT. Those who look at Goodman Group from a pure property-REIT perspective have been calling the shares overvalued for many years now, to no avail.

It reminds me of the long-winded discussions whether US-listed Tesla is an ordinary car manufacturer or a multi-platform technology innovator.

As it turned out, the market cares not what misguided labels are being used by dyed-in-the-wool value investors who refuse to accept that **technological disruption and innovation have become the two major driving forces** inside the global economy during the present decade.

In Goodman Group's case, the positive carry from exposure to the steady awakening of e-commerce, a process with a very long tail, is now combining with the faster-than-anticipated acceleration in demand for data centres on the back of the world's investment race into generative AI.

Industrial property development (think those warehouses) remains Goodman Group's main bread-and-butter, alongside funds management, but data centres are re-shaping the company's future.

Data centres currently make up some 37% of work-in-progress, which is circa double the percentage from pre-covid, and compares with circa 25% share in September last year.

By next financial year already that percentage is expected to exceed 50%.

The secret sauce, so to speak, is that margins on data centres are a lot higher (roughly double those on warehouses, at circa 60%), hence Goodman Group as a whole is looking towards accelerated revenues on increased margins.

That can only mean one thing: a (much) higher valuation. *Quod erat demonstrandum* in February.

Adding some extra colour to the above: Goodman Group's work-in-progress amounts to circa $13bn, so the numbers involved are large, really large.

No double-guessing why Craig Scroggie, CEO of data centres operator NextDC ((NXT)), appears at media interviews with an extra spring in his step these days.

NextDC is equally enjoying operating at the right place, with the right business model, and the right track record and client base to find itself overwhelmed with demand for more and bigger data centres.

In case anyone still had any doubts: generative AI is awakening a seldom witnessed tsunami in fresh technology and hardware investments. Investors in US equities are already familiar with the theme as the likes of Nvidia, Microsoft, ASM Lithography and AMD have been propelled into a different stratosphere on the back of enormous growth in demand.

The February results season locally has effectively communicated to investors in Australia: the new era of tomorrow's future is real and tangible, and the ASX has major beneficiaries too.

Apart from the companies mentioned, these also include Macquarie Technology ((MAQ)), Megaport ((MP1)), and Dicker Data ((DDR)), as well as Car Group ((CAR)), Cochlear ((COH)), Hub24 ((HUB)), Netwealth Group ((NWL)), REA Group ((REA)), ResMed ((RMD)), WiseTech Global ((WTC)), and others.

Companies mentioned in the second half of that sentence are not necessarily carried by the same megatrends as are Goodman Group and NextDC, but they are equally disrupting the status quo and using technology to successfully reshape the world to their advantage, enjoying the prospect of many more years of strong growth ahead.

Discretionary retailers delivered many positive surprises during the season past, predominantly because analysts' forecasts were proven too cautious despite widespread mortgage stress and a cost of living crisis, but technology has been the real outperformer in February, as also identified by analysts at Macquarie.

Share price gains of 48%, 32% and 29% respectively for Megaport, WiseTech Global and NextDC underpin that statement, but underneath the surface all have enjoyed significant increases in forecasts, which has propped up market forecasts overall throughout the season, in multiple ways.

Let's not get side-tracked by labeling or what makes a technology company or not: Goodman Group's consensus target lifted in February to $29.11 from $23.90 (up 21.70%), NextDC's price target jumped to $18.77 from $15.23 (up 23%), Life360's target is now $13.62 versus $10.44 pre-result (up 30%).

As we are in the process of finalising reviews, updates and statistics for the February season, it becomes clear early euphoria on surprises delivered by discretionary retailers has not been sustained throughout the rest of the month.

The numbers have kept on worsening with the percentage of 'beats' sliding, and sliding, and sliding to circa 33% with 27.5% disappointing and the remaining 39.5% reporting and guiding in line.

What is important in this context is the **FNArena Corporate Results Monitor** assesses on a wholistic methodology, taking into account forecasts versus actual outcome, but also qualitative items, forward guidance, dividend payout, trading updates, et cetera.

Simply reporting a slightly better-than-expected net profit on a lower tax rate and reversal of a prior provision won't cut the mustard and if you happen to report a fantastic performance with a subdued outlook, well, you're in the naughty basket too.

What is worth highlighting is the overall percentages look less attractive if we limit our assessments to the ASX50 and the ASX200. The 50 largest cap companies generated decidely more misses (41%) than beats (29.5%) while the numbers for the ASX200 can almost be summarised as one third-one third-one third.

Thanks to the small caps thus, the season overall hasn't been too bad.

Reporting seasons usually take a slice out of earnings forecasts, reducing the market's average, but this time around, Macquarie reports, the net forecast has remained unchanged, with technology and discretionary retailers the two sector stand-outs.

Also pleasing is the fact price targets on average, and in aggregate, have gained throughout the month.

Prior seasons have seen targets fall or hardly gain on a net outcome. The last time we registered notable target gains was in August 2021.

The main detractors in February have been resources, media, and healthcare, while telecommunication proved a rather weak performer too. Both materials (miners) and energy are the worst performers in share prices as well as in reductions to forecasts.

Post February, the strongest growth forecasts reside with technology (by multiple arm's lengths, see the above for explanation), with utilities second and healthcare third. The lowest forecasts are reserved for energy (worst), materials, and financials.

Among notable disappointments were Newmont Corp ((NEM)), South32 ((S32)), Whitehaven Coal ((WHC)) and even Alumina Ltd ((AWC)), which ironically serves partner Alcoa in its acquisition intention.

Also remarkable is that Altium's ((ALU)) release would have seen severe share price punishment, if the stock wasn't under a heavy premium take-over bid.

In quant terms, Mid-Cap stocks have been the place to be, with Growth coming second. Dividend payers proved a recipe for disappointment, no doubt reflecting the many dividend cuts and disappointments throughout the month.

For the latest updates: https://fnarena.com/index.php/reporting_season/

What looks expensive today might well look a whole lot more attractive in the months ahead. Share markets seldom move in an uninterrupted straight line upwards.

There will be volatility and share price weakness. Investors not yet on board with some of the strongest growth stories on the ASX should draw up their wish list and wait for opportunity to come.

Your typical value investor, of course, would rather talk about insane, hyped-up valuations and the formation of the next bubble. Horses for courses!

Always make sure you know your own investment objectives and your own risk appetite and strategy.

Investing in well-oiled growth companies trading on higher valuations is not by default a higher-risk strategy. I'd argue buying cheap looking, low quality companies when the world around them is changing rapidly is.

As they say, different narratives is what maketh the market. The world is changing right in front of our eyes.

Being part of that change is a choice, as is not being part of it.

Rudi's View: Facts & Fiction About Gold

Mar 27 2024

By Rudi Filapek-Vandyck, Editor

If there had been an official Top Ten list of most disappointing trading & investment ideas these past number of years, no doubt gold would have been nominated by many.

Look no further than the share price performance of global industry stalwarts Newmont Corp and Barrick Gold over the past five years or so. Those are truly ugly looking price charts, mostly heading in the wrong direction.

The situation for ASX-listed gold miners and explorers is more diverse, and a number of them have participated in the general equities rally from October lows, also carried by the recent rally in the price of gold bullion, but volatility overall has been exceptionally large.

Many an investor who's had the courage and the tenacity to stay on board these past number of years would be feeling bruised and brutalised, and not necessarily vindicated as of today.

As per usual, the devil hides in the details.

Gold bullion, typically priced in USD, has actually performed quite well. Total return for Global X's ETF GOLD has been 11.93% per annum over the past five years, and 7.99% p.a. over the past decade. In comparison, total return for the ASX200, including dividends but not franking, has been 8.75% over five years and 8.21% over ten.

And now for the Big Surprise: VanEck's Gold Miners ETF, which comprises of 53 internationally listed gold miners, mostly in Canada, the USA, Australia and South Africa, has only generated 5.51% per annum these past five years. As indicated, the return from many individual companies has been far, far worse.

Conclusion number one: the outlook for gold does not by definition equal the outlook for producers of the metal. This is one lesson that needs to be learned and re-learned by investors time and time again.

For good measure: there are times when the return from gold miners exceeds the performance of gold bullion; this usually occurs when gold is in favour, experiencing a bull market. Hence, the indication from gold miners underperforming the metal is gold has not been in a bull market these past number of years.

That makes sense as the USD price first reached above US$2000/oz during the early covid panic in 2020 and only recently, upon the third attempt, has the price of gold managed to surge away from it.

Here the irony is, of course, once the panic subsided and the worst of the global pandemic had been relegated to the past, the world economy was confronted with an outbreak of consumer goods inflation, which did not result in gold outperforming.

This would have been another Big Surprise to many: the ruling narrative is gold acts as a safeguard against inflation. But when inflation did announce itself, gold ducked for cover!

Let's get this straight: does gold act as a trade-off against inflation?

The short answer is: yes. But the correct answer is: not in the way many think it does.

And herein lies the apparent enigma surrounding gold. To most investors who buy into the narrative of gold protects wealth versus inflation, this means when inflation goes up, so too should follow the price of gold.

A detailed analysis of gold's behaviour in the past reveals that's simply not how it works.

Admittedly, when looking at gold's performance in the 1970s, for example, it seems, at *prima facie*, that's how gold protects against inflation. But the true driver, even back then, is the so-called ***real yield*** on US Treasuries. To determine that real yield, we simply compare inflation with the US bond yield.

In today's context, consumer price inflation in the US is trending down from circa 8% in early 2022 to an estimated below-3% later this year. If the Fed's projections prove correct, the CPI should be back around 2% in 2025. In the same respect, the yield on the US ten-year Treasury rallied to 5% last year, and is currently around 4.20%.

We don't have to consult a mathematical genius to see the real yield is now in positive territory; the CPI is trending below the ten-year yield. History suggests this is not a beneficial environment for gold. Bullion benefits most when the real yield is negative, i.e. when CPI exceeds the yield available on the US bond market.

But simply drawing such conclusion is to deny financial markets' foresight. Equities have been rallying on the prospect of central banks lowering their cash rates. It requires no stretch at all to assume gold too is already looking forward to official cash rates falling later in the year.

With lower cash rates and lower inflation numbers come lower bond yields, and also lower real rates as bond yields eventually fall more than inflation. This is the core projection expressed by Fed economists and many of their peers elsewhere.

In a slower-growing world economy, and that pathway on longer-term trendlines hasn't changed, the long-term equilibrium is estimated at circa 2% annualised inflation and bond yields at circa 2.50%.

This only leaves a real rate of 50bps at the equilibrium; well below the averages from the past. It's also not difficult to see how quickly the real rate can possibly shrink to zero again, or return in the negative.

A valuable lesson for investors: it's not what the numbers look like in the here and now that determines the outlook for a financial asset such as gold. It's the destination on the horizon that outweighs the present. When real rates move from positive to negative, that's when gold thrives. When a reasonably firm positive real rate is shrinking in size, i.e. falling towards zero, that's equally a positive for gold.

It's when the real rate starts trending in the opposite direction that gold loses its support. And this is exactly what happens at the end of every bull market for gold; the real rate starts trending in the wrong direction.

This is also why gold remains an enigma to many. Inflation can still be high when the price starts trending lower, and vice versa. In the current context inflation is falling, but optimism regarding the outlook of gold is firming. Understand the underlying driver as being the real (inflation-adjusted) US bond yield, and a lot of what happens to the price of gold makes a lot more sense.

And yet again, this is not the full story, alas.

If gold has been in a bear market phase these past few years, how come the price hasn't genuinely tanked?

It's one observation to make that gold miners perform worse during a bear market, but the price of gold overall has remained relatively stable post covid, mostly fluctuation in between US$1800 and US$2000/oz.

This is even more impressive when one considers gold is also impacted by the US dollar, which has been strong, and often trades in the opposite direction of equities, which have been strong too (all-time record highs for all major US indices). Add the fact most related ETFs have seen funds outflows for the past 24 months, and something else seems to be happening; something unusual.

It doesn't happen often that a financial asset can rally to a new record high when investment funds are abandoning exposure in search of better returns elsewhere.

One group of buyers that has been noticeably active are central banks, in particular those from emerging countries, including Russia and China. In a world full of conspiracy theories, we could draw the conclusion those countries are preparing for trading relationships without having to involve the US dollar.

Adding more exposure to gold by implication means those central banks are diversifying away from US dollars. The Russians in particular have an extra motivation or two to do so. And so does Iran.

There could be a link to the notable increase in geographical risks with central banks purchasing noticeably higher quantities of gold since the outbreak of the Ukraine war.

Gold equally responds to central banks printing more fiat money and supplying markets with plenty of liquidity.

Officially, the Federal Reserve is now running down its expanded balance sheet -called Quantitative Tightening- but in practice the Fed and the US Treasury under former Fed-chair Janet Yellen have been working closely together in order to prevent liquidity falling too much, so that markets don't suffer from adverse affects.

One indicator for global liquidity is Bitcoin, and that price has been on a tear, probably indicating liquidity is not shrinking. The enormous expansion in US money supply means, when measuring against this particular benchmark, gold has only become relatively cheaper in the post-covid years.

Talking about relative valuation; compared to US equities, gold has seldom been as cheaply priced as it is today.

Quite a few experts believe it looks like central banks can never wean themselves off the liquidity tap ever again. In the foreseeable future, a re-election of Donald Trump as president of the USA would most likely bring about easier monetary and fiscal policies. This would likely lead to a weakening US dollar.

A recent research update from Oxford Economics was titled: QE makes a difference – and it's here to stay.

Standard modeling of bonds versus inflation versus gold and the US dollar suggests the price of gold bullion should be some -US$600/oz lower than where it is today. And gold managed to rally to a new all-time high without the added support of financial investors.

Might the answer be found in the additional drivers mentioned above?

Reasons to be positive on the outlook for the price of gold include the prospects of Fed rate cuts, weighing down the real rate, which is also expected to weaken the US dollar, while equities look expensive, and the risk for an economic recession remains. Also, the technical picture has improved, favouring an outbreak to the upside, which could start a renewed uptrend and with it the return of investor interest.

Where does this leave the Aussie gold miners?

On a simplistic comparison relative to the price of gold, gold miners might never have been as 'cheap' as they are priced today. But it's good to realise this is not simply the result of negative investor sentiment towards the sector.

Post covid, many businesses in general have found it hard to keep operational costs down, and many a mining company is still struggling with this challenge today. Gold miners have been among the worst performers inside the mining industry, also because the price of gold has not followed other commodities in rallying higher until recently.

Apart from rising costs, and thus downward pressure on margins, there have been plenty of other ways for gold miners to disappoint. Analysts at UBS in a recent frank report also added the need to replace depletion and grow production, as well as a dismal industry track record to generate accretive returns from buying growth (M&A), plus management teams' predilection to provide too optimistic a guidance which later on is not met.

One added observation is that a higher gold price in AUD seldom puts a rocket under the local sector. The real and decisive driver tends to be an up-trend in gold priced in USD, possibly indicating the sector needs foreign money inflows to genuinely move into bull market mode.

In recent weeks, significant rainfall in Western Australia is shaping up as the next operational challenge for miners in the state.

Recent sector updates by UBS might as well come with the warning of Buyers Beware!

However, after having underperformed by some -30% against bullion over the past three years, it is noticeable investors are starting to look at renewed exposure to gold miners again. In particular since momentum seems to be building for a renewed up-trend for gold.

Were we to witness another gold bull market, share prices in gold miners should make up for the relative valuation discount, plus some, potentially promising outsized returns a la lithium in 2022 and uranium more recently. That's an attraction few will be able to ignore.

So which companies offer the best risk-reward?

If we were to ask those sceptical sector analysts at UBS, their response would likely be to point in the direction of Evolution Mining ((EVN)), as your typical turnaround from past misfortunes story.

At the smaller end of the market, UBS holds a positive view on De Grey Mining ((DEG)) and Gold Road Resources ((GOR)).

Sector analysts at Canaccord Genuity, while having an overall supportive view on the local industry, considered too cheaply priced generally, recently highlighted Northern Star Resources ((NST)), Ramelius Resources ((RMS)), and Gold Road Resources as three favourable highlights.

Analysts at Goldman Sachs tend to favour Evolution Mining among the larger caps and Gold Road Resources and De Grey Mining among smaller caps.

The team of sector analysts at Morgan Stanley is probably the most cautious, only carrying one Overweight rating for the sector, with Regis Resources ((RRL)) the lucky stand-out.

Macquarie, on the other hand, has plenty of Outperform ratings spread across the sector, starting with each of Northern Star, Newmont Corp, and Evolution Mining among the larger players.

In the mid-cap segment, Outperform ratings have been given to Perseus Mining ((PRU)), De Grey Mining, Bellevue Gold ((BGL)), Gold Road Resources, Regis Resources, West African Resources ((WAF)), Resolute Mining ((RSG)), and Westgold Resources ((WGX)).

A popular prediction is to see the price of gold appreciating to US$2300/oz in the months ahead.

Rudi's View: (In Search Of) The Holy Grail

Apr 04 2024

On March 20 and 21 FNArena Editor Rudi Filapek-Vandyck presented respectively to the CPA's SMSF discussion group, online, and members and guests of the Australian Shareholders Association (ASA) in Sydney, in person on stage.

The video recording of the first presentation is available via the FNArena website and through Youtube: https://fnarena.com/index.php/fnarena-talks/2024/03/22/to-august-beyond/

To make the content of this presentation available to a wider audience, FNArena has decided to also publish a shortened, curated transcript, with limited illustrations from the slides used.

A full copy of the Powerpoint presentation slides is available for paying subscribers via the SPECIAL REPORTS section on the website.

Presentation: To August & Beyond, March 2024.

Welcome. With today's presentation I have tried to combine the short term with the long term.

This idea is also embedded in the title I have chosen. As investors in the share market, we always tell ourselves we are in this for the long term; we know investing is a marathon, rather than a short-term sprint.

In practice, we are constantly being influenced by the short term, also because of the sector and the media telling us all about the short term, what is happening, and what is not happening in the here and now.

Short Term: February Results

Let's start with the short term.

In Australia, we have two major corporate results seasons; in August and February, and a gaggle of companies reporting in between.

Last year, both February and August seasons proved quite disappointing. Twice the market rallied hard leading into each season, and twice results were simply not good enough and all those gains disappeared in full.

The situation at the start of February was not dissimilar. Again, we saw a big rally beforehand, but this time the gains have not disappeared.

Because expectations were low, the stats look ‘ok’. I think it’s probably correct to conclude the reporting season was ‘good enough’, I am not sure whether this also means it was ‘good’.

The macro-outlook has by now changed too.

As investors, we are now looking forward towards, hopefully, a trough in economic momentum, and we are in particular looking forward to central bankers cutting interest rates.

Consumer spending is hopefully holding up, that's the hope, and it is supporting the market broadly.

The big winner from the February reporting season is technology, and that was very much noticeable. We saw big spikes in share prices for some of the technology stocks. Some of those results proved absolutely mind blowing.

It didn't get that much coverage in the general media for the simple reason that technology is supposedly a US phenomenon.

But also, there are many more retailers and consumer-oriented companies listed on the ASX, that were equally meeting or beating expectations, so much more attention went to discretionary retailers.

Another factor is technology trading on above average PE multiples, and everybody, including the media, has a psychological problem with that.

Another sector that performed really well is building materials.

In general terms, the season was being saved by smaller cap companies, not so much the large caps.

The losers in February were the international cyclicals; mining and energy companies.

Those results generally were quite disappointing, and that translated into share prices going backwards. Both the energy and mining sector were at the bottom of performance tables over January and February.

Another sector that simply never seems to get it right is telecommunication, with exception, maybe, of a few small caps.

Plus the one sector that used to be a shoe-in for solid performances is healthcare and again, February did not deliver for healthcare.

Investors will have to be more patient when it comes to healthcare stocks.

The irony here is that what happens in February doesn't necessarily give us any guidance for what lays ahead.

For example, healthcare is seen as one the best performing sectors in terms of profit growth for the years ahead.

In terms of profits generally, the current forecast sees the average earnings per share (EPS) retreat by -5.5% in FY24. For FY25 consensus sees a positive gain of 4%.

The long-term average for Australia is positive growth of 5.5%, thus the general expectation is for below-average growth this year and in the next.

Needless to say, in a polarised market the outlook between sectors is very much diverse.

On the positive side, we find insurance, healthcare, and technology. On the negative side, we find commodities and the banks, for example.

All in all, it’s ‘good enough’ to retain an undercurrent of cautious optimism supporting the market.

<u>The Broader Picture</u>

Another observation is the index gained some 2% in total since the start of the year, some 0.80% all-in throughout February, but in the US gains are generally much higher.

And that difference in performance is not something that only happened this year.

If we zoom out and look at the broader, longer-term perspective, we see a huge gap has opened up between US markets and the local ASX.

It happened during the 1990s, when the main drivers were technology, the internet and internet infrastructure, but it didn’t last that long. Eventually both markets converged again, and Australia outperformed for a number of years. That came to an end with the GFC.

The gap has really opened up since 2015.

Reversion To The Mean?

Observation: the gap between Australia and US markets has probably never been this wide, and it has never been witnessed for this long. It’s been going on for 16 years now, and counting.

This raises a lot of questions. As one of popular approaches in finance is to position for reversion to the mean, we should be very excited in Australia.

The local market has a lot of catching up to do and this could potentially translate into many, many years of outperformance relative to the US.

Of course, there are many ways in which this can happen. It can also mean US shares tank and we don't – and all the scenarios in between.

Interestingly, if we take a very long-term perspective of one hundred years and longer, the performances of US shares and the ASX turn out relatively similar.

Both markets are in the Global Top Three of best performing share markets longer term. It makes the current outperformance of US markets even more remarkable.

So the key question thus becomes: is it feasible we will see a reversion to the mean?

To find the answer, we need to investigate whether there is a fundamental reason as to why the US is outperforming so strongly and for so long.

If we find that fundamental reason, and it remains in place, we might need to conclude there's no reversion to the mean on the horizon, not until underlying fundamentals change.

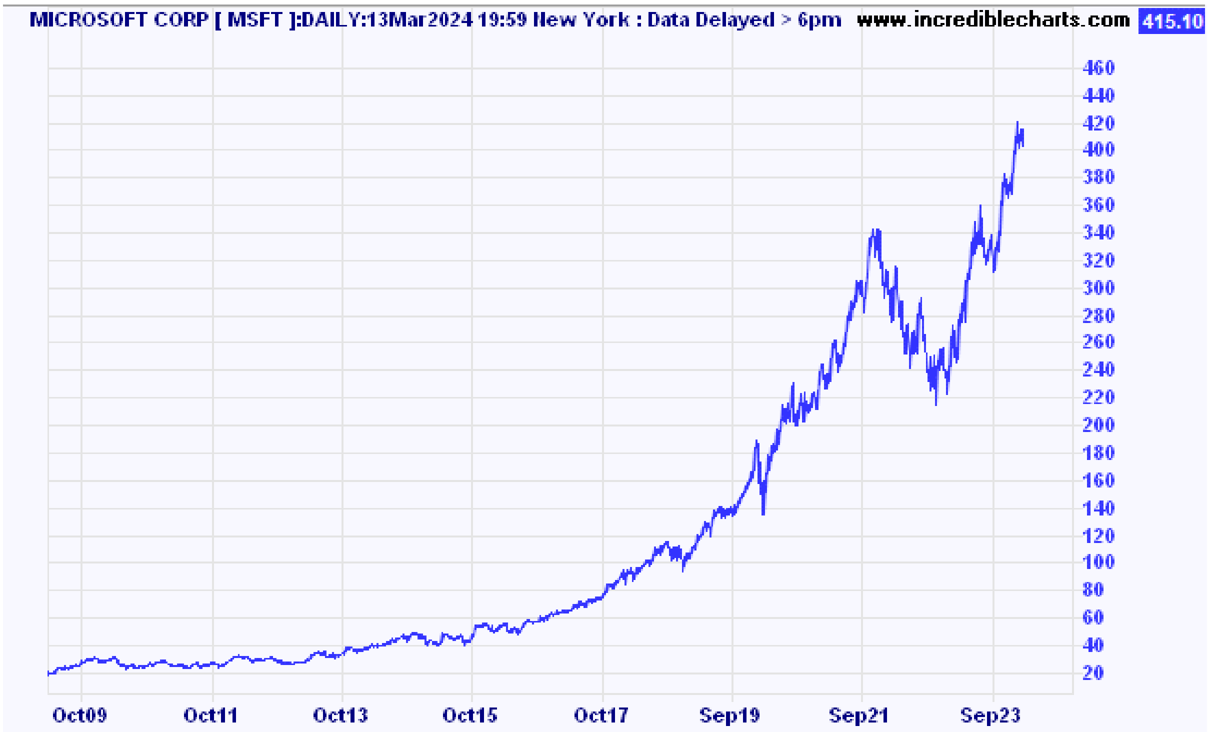
The Longer Term Picture

There are many different ways of investing and trying to make money from the share market.

For many people it consists of hopping on and off of stocks, buying and selling, trying to pick the troughs and peaks in share prices.

But let's just assume, for this exercise, we like to buy and hold for longer periods of time.

Within such framework, the stock I am showing you right now is nothing but the ideal proposition.

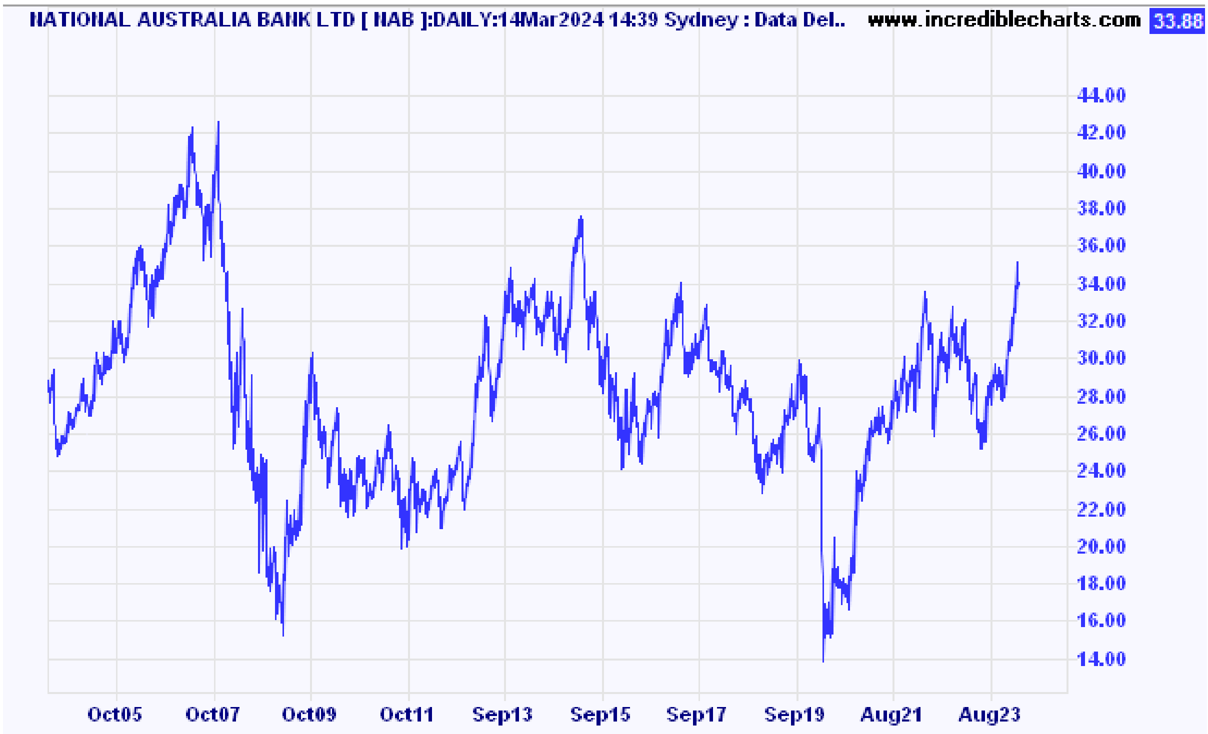


Yes, of course, there's the occasional bout of volatility, and there are sell-offs along the way, but ultimately the share price moves from the bottom left-hand corner on the price chart to the right hand corner near the top.

As a long-term investor, that's what we want to see. This is the sort of stock we like to hold in our portfolio.

This is Microsoft. Maybe Microsoft is showing us why US markets are outperforming Australia?

Let's compare, say, with one of our major index constituents. Let's look at a long-term price chart for National Australia Bank ((NAB)).



I'd like to think if I showed both price charts to a five-year old, the conclusion would be that shares on number one are going 'up' and shares on number two not so much.

Hence, NAB shares over 16 years have gone through a lot of volatility, as have Microsoft shares, but, ultimately, they've made no real progress over that time.

Could we possibly have found the explanation for the big gap in relative performances between both markets?

At the very least, I think we have discovered something that needs to be investigated further.

Some people might say Microsoft is a technology company. And NAB is a bank. That's your explanation right there.

"The outperformance in the 1990s was simply about technology and we are repeating the same story over and again."

So, let's stay inside the finance sector in Australia, let's compare the banks.

I've gone back to the bottom of the GFC, 6th of March 2009.

The worst performer in Australia among the Big Four is Westpac ((WBC)). If you held those shares from the absolute bottom until three weeks ago, you'd had made 4.7% per annum on average, plus dividends, and franking.

If we add dividends that'll bring total return up to between 9-10% per annum. That's not too bad, I think most investors would agree.

But we are measuring from the bottom of the GFC. If we measure from a later date, when share price levels were higher, that 4.7% quickly reduces towards zero. All that's left then, on the long-term average, are the dividends and franking.

Let's now compare with CommBank ((CBA)).

Same starting point, same length of holding period, and the average return is more than 22% per annum, ex-dividends.

The difference is enormous.

If I then broaden my perspective, and compare with Macquarie Group ((MQG)), not quite apples versus apples, but we are inside banks and financials nevertheless, the average return climbs to 68% per year. Plus dividends on top.

I guess what we are discovering here is this is not about technology versus banks.

Also, allow me to point out:

Westpac is the 'cheapest' of the banks. CommBank is the most 'expensive', not only at the end of the holding period, but CBA has been the most expensive throughout the whole 16 years.

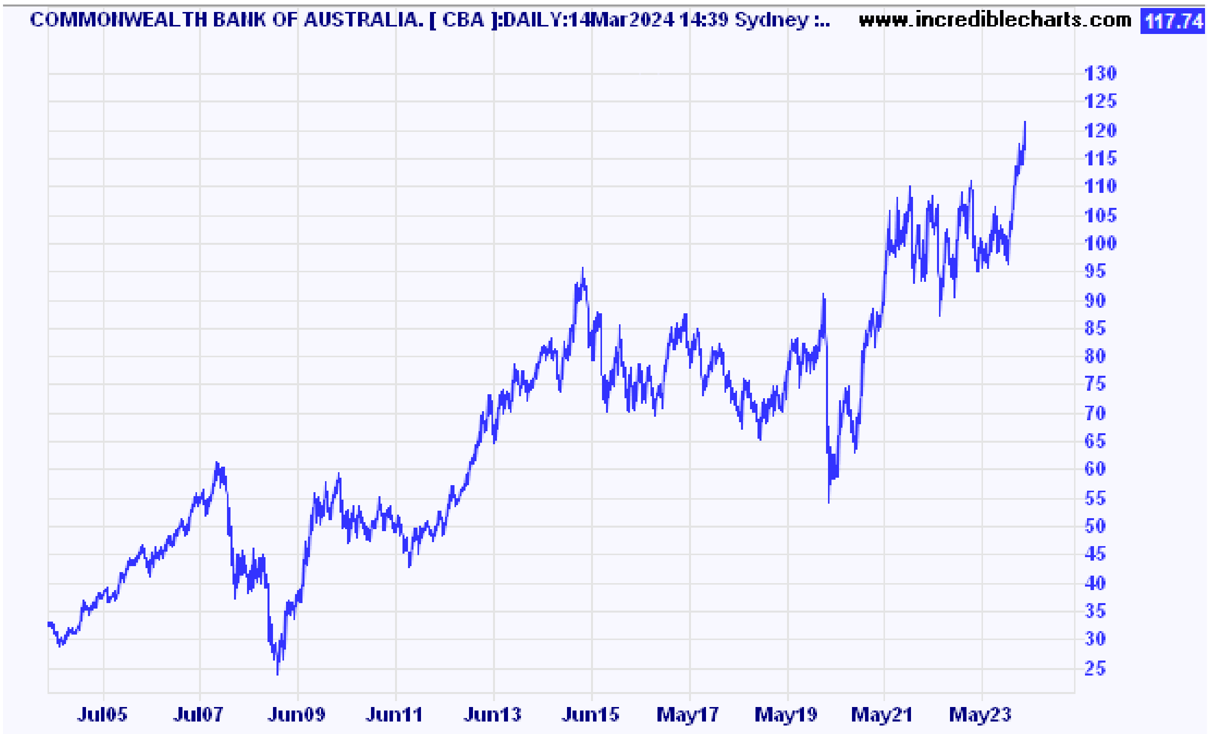
CommBank pays the lowest yield in the sector. Westpac pays the highest yield. Macquarie sits on both accounts closer to CommBank than to Westpac.

Observation: the cheapest stock has generated the worst return. The highest yield equals the worst return.

We might be onto something important here.

Compare all four of the Big Banks in Australia and I think we all agree, the price chart for CBA looks pretty similar to that of Microsoft, while the other three don't.

What we see is a sharp difference. What could potentially explain this?



The Quality In Businesses

From Warren Buffett's recent homage to the late Charlie Munger: Charlie taught me it's better to **invest in wonderful companies at a reasonable price** instead of in reasonable companies at a cheap price.

In my personal research, I focus on finding wonderful, great, high-quality businesses. But that's a very contentious concept: what makes a great company while others are not?

I discovered research conducted in the US and locally by Betashares on this matter.

The central question remains the same: what have companies in common whose price chart looks similar to CBA's, Macquarie's, and Microsoft's over a long period of time?

The research suggests a strong correlation exists between companies that invest and those that don't, or only a little.

The real gap becomes evident when we compare Nasdaq companies with those in the S&P500, while removing those from the Nasdaq that are also in the S&P500.

As a percentage of sales, investments by those Nasdaq winners are absolutely massive if one also considers how large some of those companies are, like Meta, for example, or Alphabet, or Microsoft.

So… what makes a great company, according to this research, is that it invests, on average, ten times as much as others, on developing new products, on reinforcing the moats, on strengthening market share, on improving and expanding products and services, etc.

<u>This Time Is Different</u>

There's a tendency in finance to joke about the four most dangerous words ever used: this time is different.

It's usually in reference to market bubbles and share markets at all-time highs.

But I've been arguing now for a number of years that this time <u>*is*</u> different.

At the macro-level, we are still operating inside a slow growth environment, and we have been for quite a while.

And probably the key change is that we are living through an almost unprecedented time of technological advances, innovations, and changes.

I believe those dynamics polarise the market, because not every company is adept enough to catch up.

This is also what we see in the share market, where since 2015 share prices have become polarised between the Haves and the Have Nots.

In February, one observation was that companies are increasingly mentioning and referring to artificial intelligence (AI), both in the US and in Australia.

AI has the potential to further polarise economies and companies.

It's not necessarily going to happen immediately; these are long-winded processes. But as investors with a longer-term horizon, I think this is most definitely something we should pay attention to.

In my own research, I pay attention to the concept of megatrends; trends that remain in place for a very long time. If companies are being driven by such megatrends, it means they have the wind in the sales for a very long time.

As an investor, we need to ask ourselves the question what is more important; the short-term valuation or the prospect to enjoy strong investment returns over an extended period of time?

<u>Valuing Companies</u>

Another element that is changing is how to value modern day businesses.

There are still people in today's share market who think they can simply put a backward-looking PE ratio on all companies, universally, and decide which ones are a good buy and which ones are not.

I say good luck with that, you are very well adjusted to the 19th century. Please, stop using backward-looking PE ratios; you're not doing yourself any favours.

Secondly, accept that valuing a company has become increasingly more sophisticated.

For those who'd like to research this aspect more, I happily refer to Aswath Damodaran, considered the Dean of valuing companies in our lifetime.

Website: https://pages.stern.nyu.edu/~adamodar/New_Home_Page/home.htm

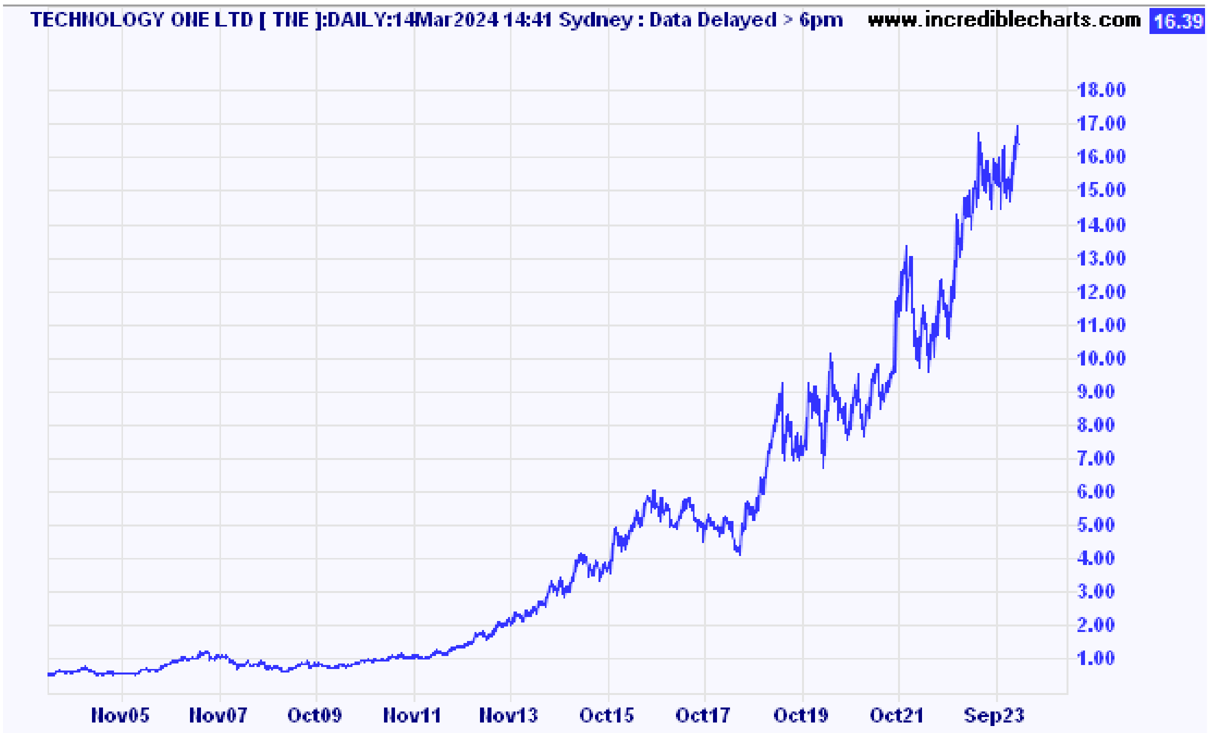
All-Weather Performers

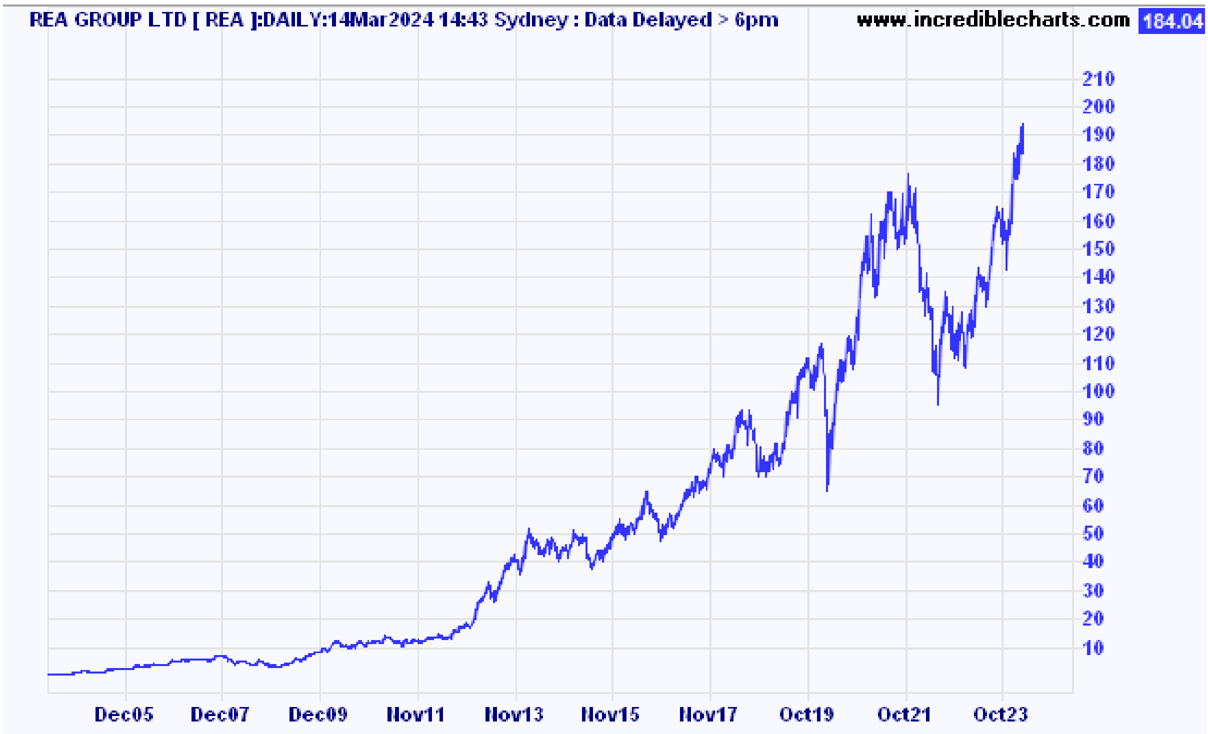
I started my research into high-quality performers on the ASX after the GFC and the subsequent bear market.

In essence, I got interested in figuring out why some companies perform so much better through tough times and downturns while others drop like flies.

Since that time, my research has identified a number of **All-Weather Performers** in the Australian share market.

Let's find out how some of my favourite companies compare against Microsoft & Co.

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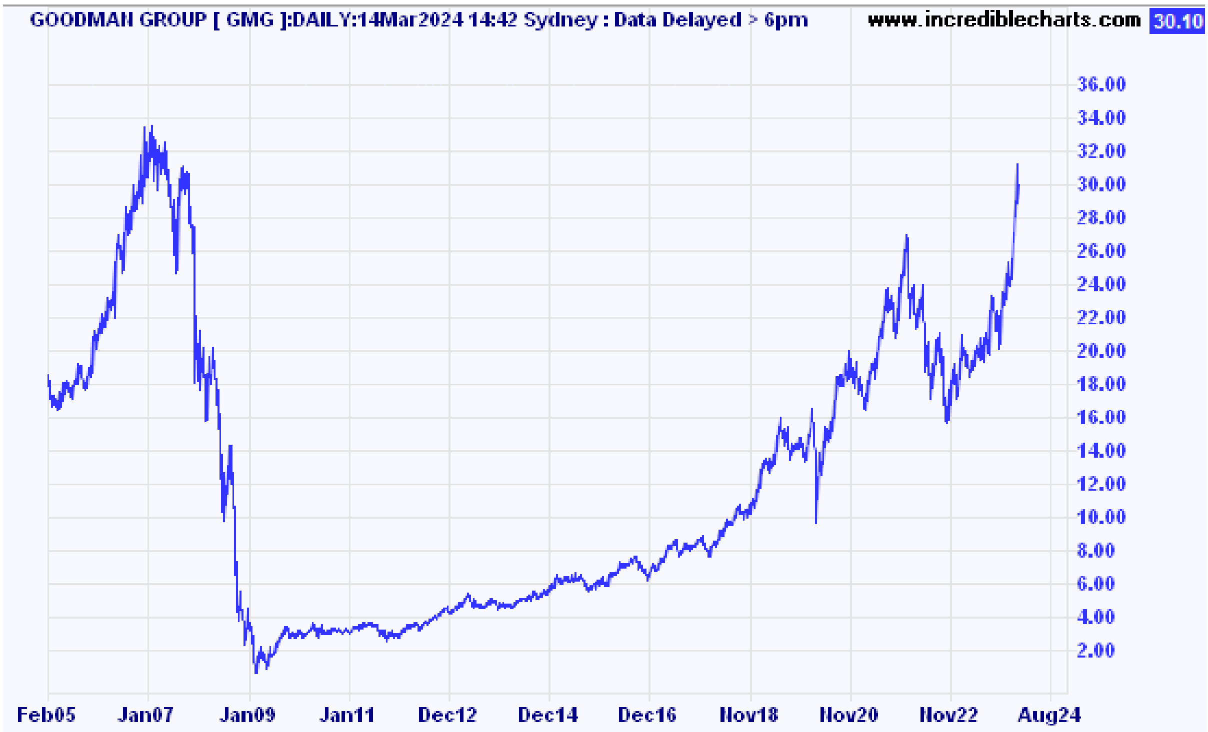
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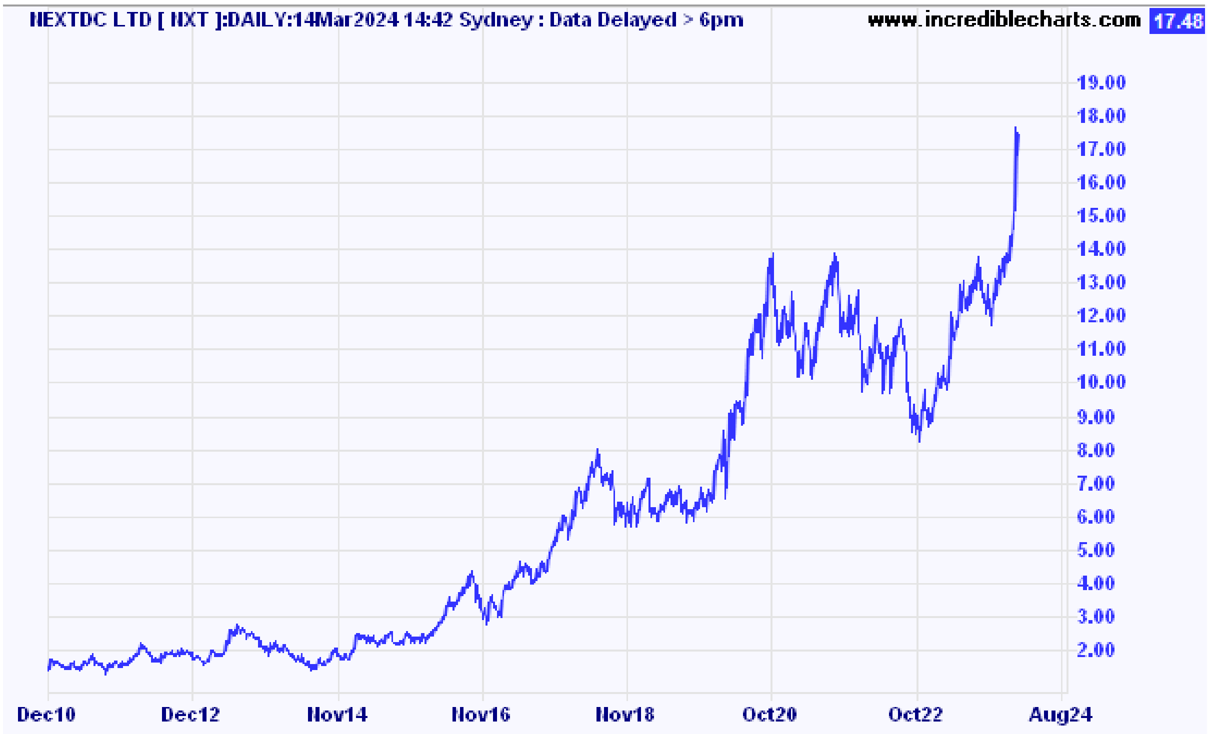

Maybe one observation to make here is that you can have US-type returns in Australia, as long as you have Microsoft-type companies in your portfolio.

And I am not referring to the technology component, but simply to the similarity on these price charts.

<u>Conclusion</u>

What I've tried to show you today is there's a lot we don't see when we're focusing on the short-term, but investing is a long-term endeavour and maybe we should pay more attention to the differences in between companies and the different dynamics that rule them?

The share market consists of a **small minority of exceptional performers** and a large majority of mediocre wannabes.

As an investor, I am happy to stick with the minority.

Rudi's View: Lessons & Observations From ASX All-Weathers

Apr 10 2024

By Rudi Filapek-Vandyck, Editor

The Global Financial Crisis of late 2007-March 2009 changed my life as an investor.

Those who have remained with us since no doubt still remember how FNArena rose above the parapet, declaring what was to unfold next was not your garden variety share market correction.

Sell the banks was not a popular opinion back then, but it proved extremely prescient, as was sell China (oil and gas and the miners) later in the same year of 2008.

For more reflections on what happened back then: https://fnarena.com/index.php/2018/10/03/rudis-view-ten-years-on-the-world-is-still-turning/

But what really (and truly) enlightened my understanding of how financial markets operate was the change in focus in my own research and market observations that started during those dour times.

It all began by asking that all-crucial question: why is it certain companies seem better suited to weather the darkest of times for your average stockmarket investor, while so many other share prices fall by -40%, -50%, -80%, and more?

This new journey eventually led to the concept of All-Weather Performers on the ASX; a small selection of companies that are, simply put, of a much higher level of corporate quality than your standard ASX listing, and thus exceptionally well-equipped to create shareholder value and benefits over an elongated period of time, irrespective of the ups and downs in the economy, interest rates, and bond yields along the way.

To your average value investor, and that's the large majority in Australia, be they retail or institutional, my quest looked incredibly silly. We all know successful investing starts with buying low and selling high, right? As if I could possibly identify something that hadn't already been considered and dismissed by the historic greats in the industry!

Yet, here we are, 1.5 decades later and the All-Weather Model Portfolio, which is based upon my specific research, has generated in excess of 10% per annum before fees since inception in early 2015. Over the past three years, total return pre-fees has been 13.84% on average, for the past twelve months up until March 31st that percentage is 19.17%.

Period Ending 31/03/2024								
Name	Code	Type	1 mth	3 mths	6 mths	1 year	3 years
All Weather Portfolio	M00701	Capital	0.79%	8.16%	17.72%	17.06%	12.26%
All Weather Portfolio	M00701	Income	0.30%	0.65%	1.02%	2.10%	1.58%
All Weather Portfolio	M00701	TR	1.09%	8.81%	18.74%	19.17%	13.84%
S&P/ASX Blended Equity and Bond - Conservative Index - Primary	CONSERVINDX	TR	1.87%	2.32%	7.89%	5.19%	1.66%
S&P/ASX 200 Accumulation Index - Secondary	XJO	TR	3.26%	5.28%	13.94%	14.03%	9.38%
S&P/ASX Bank Bill Index - RiskFreeRateIndex	SPBDABBT	TR	0.37%	1.08%	2.16%	4.19%	-3.40%

Admittedly, the Model Portfolio doesn't run multiple billions of dollars, which might have played to its benefit at certain times, but in the same vein, the strategy is very much Buy-and-Hold, which underpins the validity of the research and the specific companies selected.

Not About The Share Price

Let's be frank about this: it only takes one brief look at price charts for the likes of Aristocrat Leisure ((ALL)), Car Group ((CAR)) and REA Group ((REA)) to know owning these stocks has been extremely beneficial over the decade past.

And while the contribution from the likes of CSL ((CSL)) and ResMed ((RMD)) on balance has been non-existent post 2020, theirs was a completely different story in the years prior.

The noticeable loss of upward momentum for healthcare stocks generally, in underlying trend terms, has triggered the obvious questions from subscribers and investors alike whether such companies should remain in my selection and whether others with better recent performances should not be included instead?

To me, this simply highlights how much investor perceptions, and views, are being influenced by recent share price moves. Prior to 2021, virtually nobody dared to question the proven quality and track record of CSL. Three years of a less stellar trend on price charts later and general appreciation has deflated substantially.

This is an important observation for what makes an All-Weather Performer is not what happens to a company's share price, it's about what management achieves operationally. Difficult to understand it may be, but both do not by definition always run parallel to each other.

Divergences do occur, and they happen quite regularly because sentiment is all-important in the short term, and market influences are many.

Some companies have strong growth in the here and now. Others grow strongly over a number of years. But to be labeled an All-Weather Performer, it requires that extra level of 'special'; a moat, a defensible number one market position, a customer base that is sticky and growing naturally, the ability to find new growth time and again.

Needless to say, the list of true All-Weathers in Australia is a rather limited selection, and it hasn't changed much or often since I embarked on my research. Equally important; the concept of finding All-Weathers is easily discredited in case of too many disappointments or errors, so it's vital not to include any accidental performer less they undermine the quality of the core selection.

However, we are living through tumultuous times, with technologies and innovations disrupting moats and status quos. This not only increases the risks for All-Weathers, it also creates a whole new battery of high-quality, strong growing, emerging new market leaders.

Technology & Innovation

My research equally tries to identify which ones among those strong performers carry that extra level of corporate quality; the ability to perform better over a prolonged period of time, potentially creating a longer-term platform that, one day, might even lead to be included into the small selection of true blue All-Weathers.

My curated lists thus also include 'Emerging New Business Models' and 'Prime Growth Stories', where I grab the chance to highlight companies such as Audinate Group ((AD8)), Hub24 ((HUB)), NextDC ((NXT)), and Pro Medicus ((PME)).

There is no guarantee that by the middle of the 2030s any of these names will still be part of one of my selections, but for the years ahead growth is slated to be strong, as it has been for a number of years already.

Let's get this straight: the positive outcome of my research post the GFC is partially derived from my quest to identify the highest quality performers on the ASX, with the other part coming from the fact I also identified the current new era of technological transformation and incorporated this in my research.

When the world transitions, so do economies and individual companies. For investors this means: embrace the change. Don't cling on to the past. Tomorrow's new future should be your oyster.

Eventually, even some of yesterday's star performers might find themselves on the wrong side of societal changes. This outcome has been on my mind constantly, and it has previously led to the removal of Ramsay Health Care ((RHC)) from the core selection, but also the removal of Bapcor ((BAP)) from the list of 'Potential All-Weathers'.

More recently, I decided more changes needed to be made. I have thus created a new list; 'Trusty Defensives'. I no longer believe Amcor ((AMC)) or Brambles ((BXB)) deserve to be labeled All-Weathers, but they can definitely still serve a function as a defensive holding in a long-term, diversified portfolio.

Others, including Ansell ((ANN)) and Orora ((ORA)), have been removed altogether.

One lesson I have come to appreciate over the past decade or so is that, when it comes to sustainability and reliability of growth, company size matters. Smaller-cap companies are less robust in general terms because their operations are smaller.

The one obvious exception to this rule remains bull bar manufacturer ARB Corp ((ARB)) whose market capitalisation of only $3.25bn truly stands out against CSL's $135bn or Macquarie Group's ((MQG)) $74bn, or even in comparison to TechOne's ((TNE)) $5bn market cap, but maybe this simply shows how truly exceptional this decade-plus-long achiever is?

Gold & Dividends

All investing is ruled by narratives, rightly or wrongly, and I believe a portfolio portion should be reserved for gold. I also believe every portfolio deserves to have a section dedicated to income. In the share market, investing for income usually translates to buying weaker, lower-quality, more vulnerable stocks.

This is because the available yield is equally determined by the PE multiple a stock is trading on, and robust, strong, quality growers tend not to trade on low PE multiples. This section of my lists I find the hardest, it's also the selection that undergoes the most changes over time.

This is also a specific part of the portfolio that allows for specific, well-timed opportunities. In early 2021, Telstra ((TLS)) shares were trading a smidgen above $3 with the promise of asset sales and better industry conditions ahead. The inclusion of Telstra has been a profitable decision, but ownership of the shares remains under review.

Even though dividends seem poised for further increases in the years ahead, we shall not hesitate when we spot a better opportunity that offers more corporate quality and the promise of better and steadier growth.

Last year, we also jumped on Dicker Data ((DDR)) and HomeCo Daily Needs REIT ((HDN)). The latter's performance remains leveraged to future interest rate cuts and a fall in bond yields. Dicker Data's attractive yield, on the other hand, has shrunk as the share price has rallied post September.

Dicker Data has now been added to the list of 'Emerging New Business Models' because the operational momentum from megatrends including AI and cybersecurity is tangible and real, as also experienced by Goodman Group ((GMG)) and NextDC, and this should support Dicker Data's outlook for the years ahead.

Active Portfolio Management

When it comes to managing the All-Weather Model Portfolio, I remain of the view that limiting losses, if possible, remains an important feature of active management. The first nine years have only witnessed negative returns in 2022 when by June 30th the portfolio remained -2.59% in the red and by December 31st the losses had accumulated to -7.51%.

It was the global reset in bond yields that determined the direction of equities that year, in particular the higher-valued quality and growth stocks. The All-Weather Portfolio significantly increased its allocation to cash and gold that year and by doing so limited the losses that occurred.

While that decision also meant part of the subsequent upside was never included, the hard cold fact remains that a higher starting point implies better returns medium term. This too has contributed to the positive averages reported above.

Possibly the most important experiences and conclusions drawn from the past nine years include:

-a low PE does not equal great opportunity, while a high PE does not by default scupper further upside

-quality never trades cheaply and is equally never understood by your typical value-seeker

-using one universal valuation metric across all companies listed is, simply put, not very smart

-valuation is not a static concept; what looks 'expensive' right now can still be a bargain further out

-great companies have a tendency to surprise to the upside

-impatience is every investor's worst enemy

-know what you own, and why you own it

-investing is about growth, all the rest is second fiddle, at best

-positive share market momentum is good for the soul, but don't allow it to poison your head

-be an investor or a trader, make up your mind, don't confuse yourself

Probably the biggest challenge as an investor is to overcome one's inner resistence when attempting to get on board of some of the greatest and the best the ASX has to offer.

It takes lots of conviction, belief and experience, and that first big leap of faith, to buy into a stock that is trading at a significant premium to the majority of stocks listed on the exchange.

In my personal case, lots of reading, researching and market observations, plus a generally positive outcome from the Portfolio, certainly helped.

I also remain an avid user of the tools FNArena offers me and subscribers, and I try to use them in the most intelligent way possible by, for example, omitting the laggards when it comes to putting a price target on Goodman Group and the likes.

One harsh lesson I had to learn the disappointing way is it is much easier to be on board, and to stay on board, than to get on board.

So be careful when you decide it's time to sell. Might be better to at least keep half an allocation going (even if this means enduring more weakness short term). You might be praising your genius decision later on.

Instead of focusing on 'price' and 'cheap' valuation, I firmly believe most investors would do themselves a humongous favour by identifying first which companies are of the rarest kind. That will prove invaluable with identifying true bargain opportunities.

The All-Weather Model Portfolio considers Woolworths Group ((WOW)) a core long-term holding, and recently increased its allocation.

Rudi's View: Quality Reigns, And How To Identify It

May 01 2024

By Rudi Filapek-Vandyck, Editor

Quality Reigns, And How To Identify It

I used to think investors' biggest challenge was related to a cheaper share price not always presenting a better opportunity, or that built-in urge we all have to be part of the next share market rally -FOMO! by any other name- but as my experiences grow, and my daily observations accumulate, I am now of the view the biggest challenge is coping with change.

Given we are experiencing a once-in-a-lifetime period of innovative disruptions and technological breakthroughs, adapting to change may well become the all-important factor that separates the Winners from Losers, both in the real economy as among listed equities, but equally so for those investing in them.

GenAI and GLP-1s are now on everyone's radar given a strong presence among share market winners, but very few are equally aware about the small revolution that has taken place over the past two decades in terms of how to 'value' those companies and their brethren operating in cybersecurity, online retailing, and capital-light software and technology services generally.

Admittedly, in a market dominated by banks and resources companies, and with a large swathe of investors solely focused on franked dividends, there's never been too much urgency to catch up on modern day methodologies to value young-and-upcoming, fresh, modern-day business models. But even the ASX is changing noticeably.

According to my quick analysis, six of the ASX Top20 companies are now consistently trading on above-average PE ratios, while that number grows to eleven if I expand the focus to the ASX50.

The local market's sweet spot, companies ranked between 51 and 100 on market cap, offers plenty of growth achievers on higher multiples that look poised to develop into potential ASX50 members in the decade ahead.

But the likes of Car Group ((CAR)), Pro Medicus ((PME)), WiseTech Global ((WTC)) and Xero ((XRO)) do not only provide investors the opportunity to outperform the local benchmark, their ascendancy is also impacting on traditional measurements to determine whether the local share market as a whole is 'expensive' or not.

Simply put: drawing a straightforward comparison with how the index traded in the past should no longer cut it, if ever that was the case given BHP Group's ((BHP)) heavy weighting today.

Even if we ignore the counter-cyclical PE formation for Australia's largest index weight (high in downturns, low when the sun shines), the elevation of the likes of CSL ((CSL)), Goodman Group ((GMG)), Macquarie Group ((MQG)) et al means the average PE ratio for the Australian share market has by default increased vis a vis the lower references from the past.

So where exactly is today's 'equilibrium' in between undervalued and overheated? Since no such research has been conducted to date (not to my knowledge), we do not know the answer, other than it will be higher than the market's long-term average which is usually placed below 15x times forward earnings per share (EPS) projections.

The current average has already been impacted as the prior corresponding average was long quoted as 14.4x previously. My 'hunch' is today's number might be closer to 16x. Post August weakness, and the recent return of buyers, the average PE ratio for the ASX200 is now a smidgen above 16x.

My 'hunch' might not be too far off, or so it seems. Early conclusion: don't jump to the 'market is overheated' conclusion too quickly; the past does not offer apples with apples comparison (at least not on this widely used market valuation metric).

The same principle also applies to overseas indices, of course.

Value Versus Quality

A much more important change has taken place for investors' ability to identify winners and losers on the market. Still, the large majority thinks of low PEs when looking for opportunities, but there's a growing mountain of evidence suggesting **low PEs have no predictive powers when attempting to find tomorrow's winners** (beyond that brief rally).

Instead, achieving oversized investment returns over the past decade or so has been closely linked to High PE achievers such as the ones mentioned earlier. So, are we experiencing the next bubble waiting to burst? Is the late Benjamin Graham ringing alarm bells from his grave?

Hardly. Today's scholars will tell us the legendary Graham was much more flexible than his value-seeking disciples tend to be. What usually is ignored when investors base their investment philosophy on the principles explained and documented in *The Intelligent Investor* is that Graham never simply focused on buying 'cheap' assets – he'd also apply a quality filter.

'Quality', rather than 'Growth' or 'Value', has increasingly captured institutional investors' attention amidst changing market dynamics. There's one easily identifiable reason for this: those portfolios that own a variety of high PE achievers, be they on the ASX or on Wall Street, have significantly outperformed portfolios that stuck with AMP Ltd ((AMP)), Healius ((HLS)), Aurizon Holdings ((AZJ)) and other low PE 'value' opportunities.

Yes, indeed, share market dynamics have changed, posing enormous challenges for those investors not willing or unable to adapt. That sound you're hearing in the background is from Charles Darwin's grave.

The discovery of 'Quality' as a major defining factor has not happened overnight. Most indices and data providers, including MSCI and S&P, have compiled their own indices and stock selections representing 'Quality' and in most cases the outperformance of Quality over broader benchmarks looks pretty straightforward.

As we're talking about stocks trading on above-average PE ratios, times of significant bond yield resets are not favourable, but outside of 2022 and comparable periods, Quality indices typically outperform during tough times, either economically or because of elevated risks, and during times when 'Growth' outperforms 'Value', when 'Momentum' trades dominate, and when bond yields embark on a downtrend.

Most importantly; unlike 'Value' and 'Growth' which each tend to have specific periods of (out)performance, Quality works under most circumstances, most of the times. It's not difficult to see the attraction for investment portfolios that like to stay with the winners and avoid as much as possible the losers, without having to churn excessively.

The problem is, however, there is no universal concept or definition of what defines a Quality company, as also illustrated by the observation that all Quality indices and selections available are based on different filters and methodologies.

In a general sense, most filters to find and identify Quality companies revolve around businesses with a leading market positioning, preferably protected by a big moat, generating lots of cash flow, making regular investments, have no leveraged balance sheets, and are highly profitable and consistent in their growth.

Financial metrics used to solidify those characteristics include return on equity (ROE), return on invested capital (ROIC), high margins that remain relatively stable, size of investments made, and measured volatility in revenues, profits and those metrics used. Fundamental analysts will also include industry structure and outlook to determine true competition and threats.

As consistency and predictability play a central role, companies that comply with all filters applied are usually not from ultra-cyclical sectors such as resources (mining & energy) or discretionary retailing, and neither are sectors such as financials, utilities, telecommunication, or real estate (REITs) popular hunting grounds.

Sectors that tend to generate most Quality contenders are healthcare, technology, and consumer staples, as is also apparent from my own research into **All-Weather Performers** (see further below).

<u>Macquarie's Quality Compounders</u>

The team of **quant analysts at Macquarie** recently conducted another in-depth exercise in an attempt to provide additional insights into the merits of and the methods used to identify what they labelled as **Quality Compounders**; businesses that have distinctive competitive advantages, supported by robust cash flows, a steadfast balance sheet, a high and dependable return on capital, and promising growth prospects.

Their at face value observations match those of myself and other analysts that have conducted similar analyses in the past; Quality equals long-term outperformance, even with valuations standard at a (sizeable) premium to the rest of the market.

As a matter of fact, one of the highlighted observations from the Macquarie research report is there's no observable connection between cheap/high valuations and investment returns from Quality performers. The suggestion made is this is because Quality tends to outperform expectations, in a general sense, and share prices tend to underestimate future growth potential, even if they seem highly priced in the here and now.

One of the most important characteristics when it comes to finding Quality Compounders, according to the Macquarie research, is **persistently high profitability**. The analysts identified this as the most powerful distinguisher of truly Quality performers and apply this aspect by measuring whether a company was in the top 33% of stocks by profitability at least four times in the past five years.

Removing companies with a low growth forecast also substantially improved the value of the analysis conducted.

In the end, the search for a better identification method for Quality Compounders has significantly exceeded Macquarie analysts' expectations, with stock selections ending up smaller, but higher-performing in backtesting modeling.

From the MSCI World Universe, Macquarie's additional filtering generated a list of 93 Quality Compounders, including household names such as Alphabet, American Express, ASML, Eli Lilly, Ferrari, LVMH, Microsoft, Nike, and Procter & Gamble.

Lesser-known names included are Automatic Data Processing (ADP), Cadence Design Systems, Sherwin-Williams, FactSet Research, Paychex, Service Now, and Wolters Kluwer.

In Australia, the ASX300 has generated a short-list of 15 companies selected, plus a further 11 that narrowly missed the boat (like CSL, for example, because of post-covid interruption). Those two lists are displayed further below.

All in all, Macquarie's research has a large overlap with my own post-GFC analysis into All-Weather Performers, but it equally comes with more details to digest and to possibly take on board, plus a number of fresh names that have not been on my personal radar up until now.

Most importantly, I'd argue, the research has delivered yet more empirical evidence that Quality matters, it possibly matters more than 'Value' or a cheap share price. It's up to you, self-researching and self-managing investors, to draw conclusions, and take this on board.

Unless, of course, one is inclined to think the decade ahead will be fundamentally different from the decade past, which certainly is not my base case forecast (*au contraire*).

Macquarie's ASX Quality Compounders

The highest quality 'compounders' as identified by Macquarie quant research inside the ASX300:

-James Hardie ((JHX))
-Cochlear ((COH))
-REA Group ((REA))
-TechnologyOne ((TNE))
-ResMed ((RMD))
-Data#3 ((DTL))
-Pro Medicus ((PME))
-Jumbo Interactive ((JIN))
-PWR Holdings ((PWH))
-Netwealth Group ((NWL))
-Aristocrat Leisure ((ALL))
-Spark New Zealand ((SPK))
-Codan ((CDA))
-Clinuvel Pharmacauticals ((CUV))
-Redox ((RDX))

Given Macquarie's research strong leaning on the past five years, with high barriers to match, the following 11 companies fell just outside the above list:

-Fisher & Paykel Healthcare ((FPH))
-Medibank Private ((MPL))
-Coles Group ((COL))
-The Lottery Corp ((TLC))
-Lovisa Holdings ((LOV))
-CSL
-IDP Education ((IEL))
-Pinnacle Investment Management ((PIN))

-ARB Corp ((ARB))
-Breville Group ((BRG))
-Johns Lyng ((JLG))

My research and All-Weather stock selections are 24/7 available for paying subscribers: https://fnarena.com/index.php/analysis-data/all-weather-stocks/

Generative AI, Investing In The 21st Century Megatrend, Part One

May 02 2024

Fierce rallies in technology related share prices are eliciting calls of a new investment bubble a la Nasdaq 2000, but are such fears justified?

Part One: A bubble or just a "natural comparison" to the dotcom bust?

-A narrow concentration of strongly performing big tech stocks
-This time is same but different?
-Valuations are high but not historically extreme

By Danielle Ecuyer

Much has been written on Generative Artificial Intelligence (Gen AI), not least of which is the *cri de cur* of "bubble" with analogies to the 2000 dotcom bust.

The run up in Big Tech or the Magnificent 7 (Apple, Amazon, Google, Microsoft, META, Nvidia and Tesla) over 2023, spurred on by the posterchild of the Gen AI mega trend, Nvidia, which rose 50% in the first two months of 2024 has brought the bears out in force.

The Mag7 delivered an average 100% return in calendar 2023, and numerous factors including the narrowness of the market rally, the technology thematic and the impact of a new secular trend were sufficient for many to draw a comparison to the dotcom boom and bust of the late 1990's/early 2000's.

Analysing the bubble' proposition, Burton G. Malkiel, author of *A Random Walk Down Wall Street* wrote in Barrons in March, that while the US market is not cheap on a cyclically adjusted price/earnings or CAPE ratio of 34 times, twice the historical average, the ratio is nevertheless still -10 points below the 44 times level in 2000.

Equally, Malkiel highlights the Mag7 are trading at a trailing 12-month multiple of circa 42 times, compared to Cisco (the Nvidia of the dotcom bust) which traded at a triple digit price-to-earnings multiple both on a historical and prospective basis in 2000.

Cisco is often used as the example of a bubble bursting in a secular trend. The stock price fell -90% post its 2000 highs and to this day has not recovered.

In a recent podcast *Decoding the Magnificent Seven: Profitability, Fundamentals and the Future*, Alan Pullen, Portfolio Manager at Magellan explains the difference between a "natural comparison" and what he refers to as the "fundamentals".

Although Pullen doesn't see Tesla as the same fit in the Mag7, he stresses the combined group has generated an average 17% p.a. compound growth in revenue from 2017 to 2024 (including current year estimates).

When combined with the net cash balance sheets, strong cash flow generation and strength of margins, the combined group has produced EPS growth of 21% p.a. over the same period (including buybacks).

As Malkiel highlighted, the valuations on average for the Mag7 at circa 34 times earnings is not cheap but remains favourable in comparable to the dotcom 5 – Cisco, Microsoft, Oracle, Intel, and IBM at 80x prospective earnings and Cisco and Oracle at 120x forward earnings back in the early 2000's, emphasises Pullen.

Chief Investment Strategist at UBS Investment Bank, Bhanu Baweja explains the correlations between the current investor exuberance' and the mid 1990's until March 2000 in the UBS Global Research Pod Hub, *How similar is today's rally to the 1990's bull run?*

His analysis of history divides the US technology bull market into two phases. The first from January 1995, post a robust 300 basis point rate hiking cycle from the Federal Reserve until June 1998. Baweja states that rally was relatively orderly and broad based.

In contrast, the next phase from October 1998 until March 2000 was characterised by an "explosive and narrow move" of technology and cyclical companies.

Baweja draws three similarities between these periods and the recent outperformance of US technology giants:

– the leadership of technology companies

– the narrowness of the rally (the Top 10 stocks underpinned 34% of the S&P return in 2023)

– and the CAPE valuation at 34 times, which is in the 96th percentile and only -10 points below the peak of the dotcom valuations.

On further investigation, Baweja also notes the current cycle is notable for three major differences:

– the quality of the companies leading the rally are far superior in terms of investor returns, profitability and cashflow generation

– the investor exuberance of the late 1990's leaked into small cap companies

– the IPO market in the late 1990's registered 475 listing p.a. on average, compared to 133 listing p.a. post covid

It is easy to see how those who only watch the share price charts, could be drawn to the comparison of the last major technology boom and bust.

The excitement and potential impact on economies of a new technology (Gen AI) has clear correlations to the internet era and that of mobile telephony and smart phones.

But as Magellan’s Pullen explains, the expected revenue growth for the Mag7 is 11% p.a. compound for the next five years. When combined with efficiency gains and productivity improvements, EPS is forecast to grow 14% p.a. over the same period.

This is a far cry from what Pullen describes as a speculative bubble (dotcom) that ultimately collapsed under its own weight.

Part Two: Generative AI, Investing in the 21st Century Megatrend

May 09 2024

A Megatrend like Generative AI creates an appealing top-down narrative, but how do investors understand the scope and size of the Generative AI market alongside the opportunities versus the risks?

– Enablers versus Adopters
– How BIG is the Generative AI Megatrend?
– Limitations to growth
– The Edge and Software growth levers

By Danielle Ecuyer

Breaking Gen AI down into "Enablers" versus "Adopters"

Citi's report *Unleashing AI: The AI Arms Race*, breaks down Gen AI into two major "Technology Value Stacks", referred to as the "**enablers**" and the "**adopters**"

The enablers — Silicon (semiconductors and chips); Infrastructure (data centres/hyperscalers multiple connected data centres); Models and Software Applications and Services (automation) facilitate the infrastructure to allow GenAI to work (large language models – compute) which are in turn transferable across multiple industries and sectors – adopters.

Citi rates the impact across sectors as Financials and Fin-tech at the top of the stack, followed by Consumers, Healthcare, Industrial and Mobility down to Natural Resources and Climate Tech.

The broker separates Tech and Communications, as these sectors are both enablers and adopters (more on this in the Edge section).

In an ideal world the adopters employ GenAI to generate better processes and outcomes in terms of productivity/efficiency gains and improved client/service experience. Ultimately the success of GenAI will depend on the successful monetisation of the investment.

This means transcribing the potential size of the future market into the present will vary depending upon the scale of the roll out of enablers and the success of the adopters.

Citi highlights GenAI is the "latest inflection point" of artificial intelligence and emphasises the take up rate of ChatGPT was the fastest in history.

It took only 2 months for 100m users to use ChatGPT, against 9 months for TikTok, 2 years for the Apple App store, 2.5 years for Instagram, 3.5 years for WhatsApp, 4.5 years for Facebook, 5 years for Twitter, 6.5 years for iTunes and 7 years for the World Wide Web.

Equally, GenAI is being used across the globe.

Just how BIG is the Generative AI Megatrend?

The Bloomberg Intelligence report "*Generative AI to become a $1.3trillion Market by 2032, Research Finds*" states the GenAI market could compound at a 42% annual growth rate from some US$40bn in 2022 to US$1.3trn by 2032.

Infrastructure as a service (enablers) to train the large language models are expected to be the largest component at US$242bn.

McKinsey & Company's report "*The economic potential of generative AI: The next productivity frontier*" explains the new technology could add between US$2.6trn to US$4.4trn in economic benefits annually for its use cases. The total economic value is estimated at US$11trn to US$17.7trn.

Compared to global GDP per country, GenAI has the potential to rank as the third largest, after the US and China.

The market is moving so swiftly though, that even 2023's estimates are being blown away. **Beth Kindig**, I/O Fund CEO and Lead Tech analyst has a long track record in this space and recently discussed on the Real Vision podcast "*Unlocking the AI Megatrend*" that McKinsey & Co has since upgraded the GDP impact from GenAI to US$25trn.

Kindig places this number in perspective by comparing it to the impact of mobile technology on GDP, which at the upper end is circa US$5trn, including hardware, apps and services, etc.

McKinsey's updated projection is five times larger and helps wrap some numerical scale around the potential size of the GenAI market impact. Kindig explains when the technology is interlinked as a problem-solving service and matched with the correct product placement, there is a potential "hockey stick" growth potential in earnings for the winners.

Sam Altman's analysis also gives colour to the scale of the technology.

Altman was quoted in Morgan Stanley's report "*Tech diffusion and Gen AI*".

"Look, I think compute is going to be the currency of the future. I think it may be the most precious commodity in the world. And I think we should be investing heavily to make a lot more compute.. But compute is different, intelligence is going to be more like energy, where the only thing that makes sense to talk about is that at price 'X' the world will use

this much compute and at price 'Y' the world will use this much compute. Because if it's really cheap, I'll have it reading my email all day, giving me suggestions about what I should think about or work on and trying to cure cancer. And if it's really expensive, maybe we'll only use it to try and cure cancer."

Within this context, Morgan Stanley's expectations of high growth in computing will benefit the largest players in the market; those companies with the size, scale and cashflow to enable the necessary investment. Google, Microsoft, Meta, and Amazon exemplified the investment horizon in their latest quarterly results (more on this in Part Three).

Morgan Stanley expects capital expenditure in data centres will reach US$155bn in 2024 and grow a further 13% in 2025 to US$175bn. The cost of GPU's (graphic processing units) for a 100MW data centre using Nvidia's B100s or H100s is estimated to cost circa US$1.5bn.

As noted in a recent Reuters report, Microsoft and OpenAI are in discussions around a US$100bn data centre to house Stargate, a supercomputer for large language models and potentially a new form of compute, referred to as "**The Tree of Thoughts**".

"The Tree of Thoughts" research by Google Deep Mind and Princeton University points to software architecture that would enable computational functions more akin to the human mind's process of problem solving versus current models.

Morgan Stanley and Beth Kindig both argue the scale of the compute and the data requirements for the LLM's make formidable barriers to entry and the hyperscalers (Google, Microsoft, Amazon, and Meta) have a significant advantage through their pre-existing scale and business models.

Nvidia and the likes of other chip (GPU) manufacturers like AMD, Qualcomm, Broadcom, and Intel are integral enablers for the compute across infrastructure as a service and device applications (robots, smart phones, autonomous vehicles etc).

ASML, the Dutch behemoth producer of lithography machines, and TSMC, the world's largest chip manufacturer foundry, are also integral parts of the GenAI enablers.

<u>Obstacles and potential roadblocks to growth: Is Nvidia the canary in the coal mine?</u>

Drilling down into the feasibility of scaling the data centres, it is apparent the affordability and availability of the GPUs is material for not only the developers, but also suppliers like Nvidia.

Morgan Stanley's in-depth analysis in the aforementioned report concludes:

"There are risks that NVIDIA's ability to rapidly lower the cost of compute shrinks the market, but this is not new. Our view is that as long as NVIDIA's customers are

innovating on model architecture to achieve higher levels of performance, we will see greater spending."

The growing cost of development will limit the number of customers, highlights Morgan Stanley, to fewer, larger customers. The authors explain the scale of GPU demand outside of the larger, more competitive enablers to the likes of software applications, raises the risks of a decline in demand, if the monetisation of the investment is not achieved.

In other words, upfront strong demand creates a pull through of earnings for companies like Nvidia and the analyst community remains cautious on the durability of demand growth.

By contrast, Beth Kindig applies a different rationale to Nvidia.

Her assessment is semiconductors are the way to play GenAI and these companies (Nvidia, AMD, Qualcomm, Broadcom, etc) will represent 50% of the AI spend compared to 20-30% in the mobile market.

Kindig stresses the recent tie up between Nvidia and Apple with their Vision Pro, in cloud omniverse software, exemplifies the overlay of GenAI software on GPUs as a source of revenue growth and value add.

Kindig posits it is almost unheard of for Apple to collaborate on software engineers.

When asked about the potential Nvidia valuation, Kindig opines the stock is at the same valuation as the October 2022 low or "eerily low" and the upside potential is as high as US$10trn in market capitalisation by 2030, subject to all the uncertainties around AI adoption, the tech sector, and the S&P500 performance.

The premise lies in not only the GPU story for the stock, but the yet unrecognised potential for the growth in GPU AI software, such as the Apple Vision Pro application. Kindig envisages the GPU component of Nvidia's market capitalisation will be between US$3trnUS$4trn, with the remainder in software.

These are enormous numbers, with multiple ifs and buts' along the way. Nevertheless, Kindig remains resolute this company is a winner in the GenAI megatrend, with entry points subject to pullbacks and valuation.

<u>Moving to the Edge: what will AI bring to your device?</u>

Beth Kindig is one of many commentators highlighting the potential AI applications in "Edge" computing.

"Edge" refers to running AI algorithms locally, directly on the user's device, such as smartphones, notebooks, wearables, drones, AR/VR and Autos, as the major data sources, notes Morgan Stanley's report "*Tech Diffusion: Edge AI's Growing Impetus*".

An estimated 30bn devices will in use by 2030, and at the Edge' of networks offers multiple benefits to AI computation including lower costs and latency, personalisation, and improved security and privacy compared to centralised cloud computing (data centres/hyperscalers). Morgan Stanley points to research from Gartner that 50% of enterprise data will be created at the Edge by 2025.

Musk's evolving Full Self Driving (FSD) is an example where data collation occurs from real life users through camera sensors. The data are then analysed to create the algorithms for FSD software.

Tesla expert, Adam Jonas from Morgan Stanley wrote recently in "*Crossing the Chasm: 5 Thoughts on Tesla's Confusing Metamorphosis*" the EV market is transitioning from what has become a commoditised "dark age" to an AI and robotics "renaissance".

Jonas is referring to camera systems on devices to produce real world data for the evolution of robot learnings via large language models and vision language models. He infers this form of data collation will allow robots (in all different forms) to learn more swiftly and efficiently compared to the pace of GenAI and the growth of Nvidia-equipped data centres.

Ultimately, Jonas asserts increasingly cameras attached to all forms of devices will be used as data collection points to train neural networks.

The obvious breaks on Edge devices and networks include battery life/power consumption; processing capabilities and memory, to name a few. Ultimately, hybrid systems between the cloud and the Edge could facilitate what is termed as the **Internet of Things** (smarter devices with AI computational power)

Morgan Stanley identified six companies that will be at the forefront of "at the Edge" networks, including Apple, Dell, Qualcomm, and Xiaomi. Apple's **Worldwide Developers Conference on June 2** is expected to outline how the company is looking to embed artificial intelligence into Apple devices, above and beyond what has been a disappointing Siri experience over the last decade.

<u>The energy conundrum, bigger isn't always easy</u>

Data centres and hyperscalers will demand exponentially greater amounts of energy off the electricity grid. The European Utilities team at Morgan Stanley expect AI data centre energy usage will rise from 1.5% to 4% of total power consumption by 2025, and data centre electricity consumption will move from 3% to 8% of total US energy production by 2027.

Another forecast from Morgan Stanley is that by 2027, Gen AI will be using as much energy as 80% of the all the data centres in 2022.

Morgan Stanley goes further to assess the barriers to entry will be heightened by problems sourcing power supply, and the analysts propose large-scale data centres, like the mooted Stargate project, will be placed near nuclear power plants.

Another issue is how data centres will accommodate increasing power density from higher density chips (more compute), resulting in cooling and storage problems (more racks, and servers). Companies exposed to data centre solutions such as connected racks, switches and cooling are referred to as the “picks and shovels” to power GenAI.

The risks associated with the development of new data centres, including power constraints, is one reason why Morgan Stanley is cautious on future chip (GPU) demand, as delays to the infrastructure roll out could result in stockpiles of unused chips.

The warning: *“Given the multiple years, and risks, relating to planning new data centers, we believe there is significant risk that not all of the GenAI chips being purchased over the next few years will be rapidly deployed.”*

Software solutions in the Gen AI arms race

RBC Capital Markets Report “*The Software Investors Handbook to Generative AI”* makes the salient observation that investors are “overestimating” the short-term impact from AI and “underestimating” the long-term impact.

RBC explains the current beneficiaries include companies that can leverage and utilise their data and distribution, thereby capitalising on the technology without having to source the data or network. Microsoft is an example of a large company moving swiftly to take advantage of its existing structure.

Secondly, the analysts refer to “vertical software leaders” that have both data and the ability to generate AI solutions across multiple industries. LLM’s start as a “blank canvas”, meaning those companies that can offer software solutions to train them to be industry specific have “winner-take-all” potential.

Thirdly, RBC explains there are mid-market companies which have the potential to move ahead of the larger companies, such as legacy software companies using GenAI to improve the service offering.

Companies which are selected as potential winners in the software space include the likes of Adobe, MongoDB, Microsoft, CrowdStrike, Pro Medicus ((PME)), Xero ((XRO)), and Zoom Video Communications.

Conversely, RBC points to four categories of companies that are at risk, including “Legacy, on-premise software companies” that are not on the cloud and have an inherent disadvantage of not being able to leverage GenAI.

Companies that don't adopt Gen AI and re-architect their businesses around it; or that claim to be AI but in fact only use analytics, and companies in the basic "work/task management space" risk being made redundant in the future.

RBC puts US companies Asana, Palantir, Smartsheet, and Zoominfo Technologies in the 'at risk' category.

Part Three: Generative AI, Investing in the 21st Century Megatrend

May 14 2024

How are global Generative AI tailwinds impacting on Australian companies, and which stocks are in the sweet-spot to benefit?

-Tailwinds from BigTech earnings
-NextDC and Goodman Group are just two of the winners
-Key takeaways from Global Portfolio Manager at Alphinity Investment Management

By Danielle Ecuyer

Stock prices only tell part of the macro story

Differentiating between the stock price moves of companies associated with artificial intelligence versus the growth and potential size of the total addressable markets will be an ongoing challenge for investors.

Comparisons can be drawn between previous secular trends such as electrification, mobility, telephony, the internet, and industrialisation, but like most historical precedents, the present circumstances are similar but different.

The clean energy transition is a case in point. Despite the billions of dollars being committed to the transition, including major incentives such as the US Inflation Reduction Act, the top-down secular growth in clean energy/decarbonisation has been far from a straightforward investment proposition for investors.

FY24 results for Macquarie Group ((MQG)) highlight the short term versus longer term challenges of investing in a megatrend. Demand for the clean energy assets owned by Macquarie Asset Management is proving to be more cyclically impacted than forecasts due to the higher interest rate environment.

Tesla is also case in point. As the electric vehicle market grew, competition, particularly from the subsidised Chinese manufacturers commoditised the product.

Secular megatrends do not grow in a straight line. Electric vehicles will ultimately replace internal combustion engines, however, the path to transition is likely to exhibit some of the normal cyclical demand and supplier drivers.

Top-down analysis of a total addressable market (TAM) to company specifics makes for a strong narrative, but ultimately the driver of stock prices will be revenue and earnings growth, alongside strong cashflow generation to support new investment.

The question of whether earnings are pulled forward or front loaded into the present should also be at the forefront of investors' minds. The market will set earnings expectations and compare against actual results. Strong growth can be either rewarded or punished depending on expectations and recent performance.

"We encourage investors to do thorough due diligence on the technology underpinnings of these companies and differentiate real AI winners from the short-term AI beneficiaries likely to end up short in the long term." The quote is from *RBC ImagineTM: The Software Investor's Handbook to Generative AI*

Big Tech's latest earnings offer insights into artificial intelligence investment trends

The latest quarterly results for the Magnificent 7 revealed impressive 43% growth in earnings compared to 14% a year ago, which includes the not so hot Tesla and META earnings, and also includes forecast earnings from Nvidia (to be released on May 22).

RBC Capital Markets analysis of the recent US big tech companies' quarterly results extrapolates the trend to Australia's data centre and ancillary service companies, noting hyperscalers are emerging from a period of consolidation and re-entering a growth phase.

Amazon Web Services (AWS), owned by Amazon, is the world's largest hyperscaler with revenues split 60% from America, 23% internationally and 17% for AWS.

AWS reported better than expected 1Q24 results including revenue growth of 17% on the previous corresponding period, with a 400-basis point acceleration in growth via its AI expansion.

Management guided to ongoing growth between 7% to 11% in net sales growth for 2Q, or US$144bn to US$149bn.

Amazon's commentary confirmed the company's ongoing commitment to artificial intelligence through multiple levers, including Amazon Q, an AI powered assistant for software development; the flywheel effect from AWS growth and demand, and over 100,000 of Amazon's selling partners are using one or more of their GenAI tools'.

Microsoft also delivered 1Q standout results. Revenue was split 43% from the "Intelligent Cloud", 32% from Productivity and Business Processes, and 25% Personal Computing.

Microsoft's Azure is the second largest cloud operator/hyperscaler after AWS and reported 31% growth versus consensus expectations of 28%, against the previous corresponding period.

Revenue growth for Intelligent AI' rose 21% to US$26.7bn. Looking ahead management expects revenue to expand between 19% and 20% in constant currency.

Like its competitors, capital expenditure will continue to be driven by strong demand. Azure has continued to take market share and recently announced a US$1bn plus multi-year deal with Coca-Cola, with 88% year-on-year (yoy) growth in US$100m-plus sized Azure contracts, plus a doubling in the US$10m-plus segment.

Github reported 45% growth yoy and over 90% of the Fortune 500 is using the product.

The third largest hyperscaler after AWS and Azure is the Google Cloud Platform from Alphabet.

Alphabet generates 78% of revenue from Google Advertising, 11% from Google Cloud, and 11% from other sources.

Google Cloud reported 1Q revenue growth of 28% on the previous corresponding quarter to US$9.6bn, 2.4% above market consensus, and up 26% on the December quarter.

Management noted a doubling of capital expenditure to -US$12bn from -US$6bn compared to the previous corresponding quarter, driven by data centre demand.

Google is working across multiple artificial intelligence platforms including Nvidia GPUs with Google's own TPU or application-specific integrated circuit (ASIC) in its neural networks; it added AI features to pixel, photos, Chrome, messages as well as Gemini (formerly Bard, the LLM) via a Gemini App on Android and the Google app on IOS.

"We have developed new AI models and algorithms that are more than 100 times more efficient than they were 18 months ago."

In reference to Meta, this company reported a 12% rise in capital expenditure to -US$37.5bn for FY24 from -US$33.5bn previously, due to rising investment in AI related infrastructure.

RBC research concludes that even a snapshot from the 1Q big tech results are all **positive tailwinds for Australia's data centre exposed companie**s, as the trickle-down impact from higher investment feeds through.

Catching the Big Tech cloud investment tailwinds, which Australian companies are in the sweet-spot?

Morgan Stanley takes a more in-depth and nuanced approach to the domestic data centre industry in its research.

With a base case of an 8% compound annual growth rate (CAGR) out to 2030 for the Australian data centre market, and a bull case of a 20% CAGR, the outlook looks structurally robust.

Australia is already the fifth largest data centre operator globally, in line with London (after US, Europe, Northern Virginia and Beijing/Shanghai). The market is forecast to expand from 1050MW currently to 2500MW by 2030, at a 13% annual rate.

Citi observes Australia has circa 1GW of live data centre capacity. Sydney is the largest market locally having expanded 2.5 times in the last 5-years and is in the top 20 globally.

Melbourne capacity has doubled in the same period and the research indicates Melbourne has little available capacity.

The demand from government for the digital and cloud first strategy, as well as data sovereignty requirements, are driving the forecast 14% compound average growth to 2030 of some 2.5GWs.

Morgan Stanley estimates there could be revenue uplift of between $5.6bn to $8.4bn p.a. on the back of an estimated total spend between $21bn to $28bn in data centre development over the next 8 years.

Against such a favourable backdrop, how does the earnings outlook shape up for NextDC ((NXT)), Megaport ((MP1)), and Goodman Group ((GMG))?

Some highlights from Morgan Stanley's analysis:

–**NextDC** has a domestic and growing international presence as an owner and operator of data centres and is one of the largest domestic players, alongside of US operator Equinix, AirTrunk (unlisted), Digital Reality, Global Switch (not listed), Canberra Data Centres (not listed), Macquarie Technology ((MAQ)) and hyperscalers Microsoft and Amazon.

-Higher development and land costs are expected to push down the internal rate of return (IRR) on its development pipeline from over 20% to between 10%-12%. The IRR is forecast to exceed the expected average cost of capital (estimated at 7.7%).

-Longer term increased competition has the potential to push down pricing, but for now demand remains robust.

-Traditionally, NextDC has traded at a premium valuation to international peers, like Equinix and Digital Realty Trust, which the analysts attribute to the higher growth rates and the very regulated domestic markets. Post an adjustment for growth, the valuation is relatively not as high.

-NextDC has a total build capacity of 960MW of which 420MW are incorporated into the broker's core earnings forecasts and 560MW from the land bank.

-The target price is lifted to $20 from $17, accounting for a $16 per share valuation for the existing data centres and those under construction, plus $4 per share for the future land bank.

Citi is also a fan of NextDC and considers it as the optimal direct investment play in the artificial intelligence in APAC, due to its strength and leadership in the market.

Although the recent equity raising was sooner than expected, the cash raised frees up development opportunities and removes the overhang of further equity requirements.

The broker estimates contracted utilisation (MW) to expand almost twice in the next three years. Citi has a Buy rating with a $20.10 target price on the stock.

–**Goodman Group** revealed in August last year a 3.6GW portfolio of industrial sites with power either secured or close to secured, referred to as a power bank, with another 1-2GW in different planning stages.

-Morgan Stanley estimates the 3.6GW power bank, depending on how Goodman decides to advance the assets, could realise another $20bn in valuation for the group versus the current market capitalisation of $64bn.

-The flexibility of the business model allows for three forms of earnings accretion including development profits, rental income on the completed assets, and management fees for the Goodman funds.

-Currently the group has a $4bn exposure to data centres versus the $79bn portfolio. Morgan Stanley forecasts this could grow to $28bn by 2030 as a base case.

-Importantly, capital expenditure can be funded by cashflow or, if necessary, some smaller asset sales.

-Management recently upgraded guidance, noting the upside potential for the data centre business pipeline which has increased to 3.9GW from 3.6GW.

Goodman Group is rated Overweight with a $36.65 target price by Morgan Stanley.

Powering the growth in domestic data centres

The lastest update from Morgan Stanley research reveals Australia has sufficient capacity in its existing power system for the data centre developments up until 2030. Data centre power demand is forecast to expand to 8% of the grid's generation capacity by 2030 from 5% currently as a base case.

Water usage is also important.

The growth in data centres is viewed as macro tailwind for both AGL Energy ((AGL)) and Origin Energy ((ORG)) via power prices on the back of higher energy demand and the development of renewable energy projects.

Other companies set to benefit

The artificial intelligence tailwinds are not exclusively for the above-mentioned cloud/data centre beneficiaries, **Pro Medicus** ((PME)) has been highlighted by both RBC and Goldman Sachs as a potential AI winner.

Goldman Sachs initiated coverage on Pro Medicus with a Buy rating and $134 target price on the growing significance of Gen AI enhanced software services from the cloud-based radiography diagnostics specialist.

The broker sees multiple opportunities for Pro Medicus. AI is expected to reach 9% of the company's revenue by FY30 from less than 1% in FY25. Revenue is already being produced from the Visage breast density AI algorithm. The analyst also envisages the company has scope to diversify into Cardiology.

Megaport ((MP1)) is also a slated beneficiary by RBC from the growth in data centres, with its software solutions offering business connections and access points for data transferal in and within data centres.

Citi is also positive on Megaport as a global leading data centre and cloud-on-ramp service provider. The broker views the growth in inference workload as offering more upside potential than artificial intelligence connectivity. There is a Buy rating and a $16.05 target price.

Let's not leave **Macquarie Technology** ((MAQ)) out of the mix with the hyperscalers as anchor tenants of its five data centres. Management is expanding the capacity of the Macquarie Park Data Centre Campus to reach 56MW from 50MW with power availability up to 63MW.

Also: NZ-headquartered **Infratil** ((IFT)) is a major shareholder in Canberra Data Centres ((CDC)). Macquarie Group and **Global Data Centre Group** ((GDC)) are equity owners of AirTrunk.

Addendum: Key takeaways on Generative AI from Global Investment Manager, Trent Masters at Alphinity Investment Management

"In terms of Ai, as the saying goes "history doesn't repeat itself, but it often rhymes". I think we are seeing this in Ai with the parallel being the Internet era starting in 2010. There we saw stock outperformance begin with the enablers like semiconductors, then saw it shift into infrastructure/devices before the final move into software and services. In terms of stocks, this saw the outperformance start with Qualcomm/ARM before shifting to device makers such as Samsung and Apple before the enormous value creation in software enabled businesses such as Google and Amazon.

"Comparing that to today, the leading enablers this time are Nvidia, AMD and memory players such as SK Hynix and Micron. We have seen significant outperformance already wash through these businesses, and I think there is still some room to run. In terms of the infrastructure level, we are seeing this emerge particularly in cloud players (the recent results for Azure, AWS and GCP were all strong) while the devices element around Ai on device for PC's and smartphones is just starting to emerge. In software and services, it is still very early and trying to pick winners in this area given the speed of evolution in Ai can be fraught. We've seen companies such as Adobe and SNOW swing from potential winners to losers in quick time as the landscape rapidly shifts.

"What I think is different this time at the software and services level is that the Internet era created fertile ground for disrupters to create completely new business models. The foundational tech of the internet was largely free, and an avenue for companies like Google and Amazon to create new businesses and disrupt incumbents. But with Ai, given the inherent cost in compute requirements this will at least in the initial stages see the benefits flow to incumbents until some real breakthrough use cases emerge.

"In terms of stocks, where this leaves us is more comfortable where we can touch and feel the earnings inflection. This is in the enablers such as Nvidia where the size of the accelerator market continues to be revised up as evidenced by the robust capex spend from cloud players in recent results. Companies such as memory business SK Hynix also benefit from High Bandwidth Memory requirements for Ai.

"In the Infrastructure layer, it really is all about the cloud players at this stage, with Microsoft as the standout. Not only is Microsoft Azure taking share due to their Ai capabilities, but Microsoft also has the potential software and services inflection from being able to distribute Ai services into a 450m commercial customer base.

"Also benefiting in the infrastructure layer is network business Arista networks, along with some signs of inflection in what are considered "old world" businesses such as Dell.

"In software and services, as discussed it is still early (true software and services company outperformance only emerged around 3yrs into the Internet era) and fraught to try and pick early winners. As such the preference remains for those companies that can push Ai product extensions into a broad existing customer base. It isn't so much about having the "best model" but about the application created from it and the channel through which to distribute it in the initial stages. However this software and services area is where potentially the next Google or Amazon for the AI era could emerge"

The author owns shares in Goodman Group, NextDC and Pro Medicus.

Rudi's View: Opportunity In Data Centres

May 08 2024

By Rudi Filapek-Vandyck, Editor

The concept confounds many an investor, and market commentators too; from the moment the market understands there's a whole lotta growth up for grabs on the horizon, share prices move to above market-average multiples which, at face value, makes the stocks in question look 'expensive'.

But are they really? Is the opportunity already gone?

In many cases the answer is: no, the opportunity is still there. If the promised growth comes through, and management executes on the opportunities available, there's often plenty of room left for upside surprises, which, when looking back with hindsight, only makes that share price from the past, 'bloated' though it may have looked in-the-moment, actually a cheap 'bargain'.

One such prime example from the recent past has been delivered by healthcare imaging services provider, Pro Medicus ((PME)) whose share price has been trading on forward-looking multiples above 100x. But as the emerging global leader in its field added new contract after new contract, it forced analysts to regularly upgrade already bullish forecasts, with forward-valuations and price targets rising further on the back of it.

In simple terms: Pro Medicus shares looked 'expensive' back in 2020, when the price crossed the $30 mark. Last week they surged above $110. And while most analysts have valuations that are well-below that price level, Macquarie believes they are being too conservative. AI and new services and customers are still on the horizon. Macquarie has set a price target of $120. For now.

Goldman Sachs sits on $134.

In investment terms, Pro Medicus shares gained 52.8% in 2020, followed by 82.8% in 2021, then retreated -13.4% in 2022, only to advance a further 77.2% in 2023 and, thus far in 2024, another 15%. That's one helluva return for a stock that along the way attracted comments ranging from 'absolutely crazy', to 'bubble', to 'egregiously overvalued'.

For good measure: nothing from the past four years indicates this company will not encounter a growth hiccup at some stage, or worse, and its shares might well come back down to earth if that happens. But shouldn't investors equally be aware that such concerns, and calls of 'the next example of irrational exuberance', have been expressed way too liberally, and way, way too early?

For all we know, this company is nowhere near to about to run out of growth. Certainly, management at the helm thinks so. Thus far any weakness in the share price has been but an opportunity to get on board.

Never ask a barber whether you need a haircut. Never ask a value investor whether to invest into the next emerging growth opportunity.

Data Centres Are In Strong Demand

A similar dilemma has opened up with the emergence of generative artificial intelligence (‘GenAI’), mostly in the US, and in the slipstream of the next tech (r)evolution, the surging demand for data centres.

Already, fund managers have been taking profits on their Goodman Group ((GMG)) shares that have appreciated by 45.7% in 2023, and by a further 33.6% in the first three months of 2024. Shares in NextDC ((NXT)) have gained 52.7% and 29.6% respectively and have been described as ‘overvalued’.

But what if both companies are still only at the early stage of a strong demand growth period that has many more years to run? Might those elevated valuations in the here and now mirror Pro Medicus shares from years past?

A fresh **research update by analysts at Morgan Stanley** is certainly challenging all who are questioning the ongoing opportunity on offer.

With the local market for data centres to more than double by 2030 (150% projected growth), it’s rather difficult not to expect a whole lot more upside for companies leveraged to that demand, assuming, of course, management teams execute and the global landscape does not come irrepairably unstuck, like through war or much higher bond yields.

Three things make this research exercise unique:

-it incorporates the latest updates and insights from US companies, today’s heartland of GenAI and data centres

-the research is a deep, multi-disciplinary collaboration between analysts across technology, media and telcos (TMT), REITs, Utilities & Sustainability, and Mining/Resources sectors

-the research is uniquely focused on the Australian market

Let’s start with the basic outcomes. Morgan Stanley’s 12-month price target for data centres operator NextDC has been raised by 13% to $20 (Monday’s share price $17), while the target for Goodman Group has lifted to $35.30 ($33.94 on Monday). The target for Macquarie Technology ((MAQ)) is $100 ($84 on Monday).

Supporting these upgrades is US feedback that growth in AI and GenAI, and the associated rapid rise in demand for computing power, is accelerating. This, in return, boosts demand for data centre capacity. Conclusion: a golden period has opened up for companies such as the three mentioned. Those worried about capacity catching up will have to wait many more years, all else remaining equal.

Not many investors would be aware, but Australia already is a global Top Five data centres hub, with capacity similar to London, but lagging the US, Europe, the Data Centre Alley of North Virginia, and Beijing/Shanghai.

Morgan Stanley's current projections imply additional investments made in new data centres will total between $21bn-$28bn over the next eight years, providing companies with an incremental revenue opportunity of $5.6bn-$8.4bn per annum. These numbers, states the report, could well prove conservative.

One major challenge Australia faces is the additional stress on local power supply networks from this robust surge in demand. Data centres, in particular the larger and more expensive hyperscalers, are power-hungry beasts. The report estimates data centres currently consume circa 5% of Australia's total power generation. This is forecast to increase to between 8%-15% by 2030.

Can the country manage this? Yes, states Morgan Stanley, but by 2030 network limitations and problems might start to impact. As most data centre operators opt for 'green' energy when offered, there's an obvious catalyst for more green energy and renewables, as well as, maybe, for uranium (as is already the case internationally).

Both AGL Energy ((AGL)) and Origin Energy ((ORG)) are expected to benefit from the extra demand for electricity. In terms of increased demand for commodities, the collaboration has identified copper as the most likely greatest beneficiary from building additional data centres; not just locally, but globally.

More data centres should equally result in additional demand for lithium (batteries) but Morgan Stanley's projections suggest lithium will continue to suffer from market surpluses until 2027, so no enthusiasm here. Similarly, any increase in the popularity of uranium reactors won't be felt until into the next decade.

For good measure: today's developments and forecasts made remain a moveable feast, and Morgan Stanley's research report acknowledges as much. Investments into AI and IT generally could slow down, in case of an elongated economic recession, for instance, or due to other, unforeseen causes.

A scenario that pushes up global bond yields to much higher levels could derail everything, in particular if those bond yields would then remain (much) higher-for-longer, because access to finance and future returns from investments would be negatively impacted.

Other potential threats include energy and power capacity constraints, overinvestments that create a surplus in capacity, which then leads to price discounting and lower sector returns, supply chain disruptions causing delays, but also: hyperscalers that build enough capacity for themselves and stop leasing capacity from third party data centres.

As things are stacked up right now, it looks like the bias leans towards much higher demand growth for data centres globally, for years to come, and Australian companies should be among major beneficiaries. There are, however, key differences in how companies might grab the opportunity.

A brief summation:

NextDC is part of the local Top Three for data centre capacity, with the two key competitors not listed. AirTrunk is currently owned by Macquarie Asset Management ((MQG)) and PSP Investments. A consortium led by MAM took a controlling interest in 2020, at that time valuing the company at $3bn. Currently the shareholders are reportedly looking for a buyer who's willing to pay $12bn.

Canberra Data Centres (CDC) remains equally unlisted to date. International industry giant Equinix owns and operates a network of 260 data centres in 71 major metros around the globe. To date, Equinix's capacity locally makes it the fourth largest player in Australia.

NextDC is expanding its footprint locally, with more expansion plans under consideration, and has already moved to New Zealand, Japan and Malaysia. Its business model is to lease out capacity to both businesses (consumers) and other data centre owners; hyperscalers such as Microsoft, Google and Amazon.

NextDC's future profits depend on management's ability to access fresh capital, acquire land and build centres, then fill capacity with new customers and contracts, in an environment of much higher costs than in the past. Morgan Stanley forecasts an internal rate of return of 12% which remains well above the estimated weighted average cost of fresh capital at 7.7%.

As different types of customers pay different prices, future return estimates are at best an educated guess, with any difference in mix altering the numbers. Data centre operators are able to pass on higher power costs. Were the broker's bull case scenario to unfold, the value of NextDC shares increases to $28 instead of $20.

A research report issued by stockbroker Morgans in April suggested a positive outcome in the years ahead could well catapult shares in NextDC to $40 in seven years' time.

Goodman Group has many more options available as it can finance and develop new centres on its own, in cooperation with third parties/customers, or on behalf of data centre owners and users. Generally speaking, the options that require larger upfront investments offer higher returns, but not as quickly as less-costly developments.

How much of the pie will descend into shareholders' pockets will depend on which options are chosen, and when projects might be finished, etc. The key attraction for Goodman shareholders is data centres raise the company's profit margin, and this already has triggered a re-rating for the shares.

Morgan Stanley can see more than 25% upside to current market consensus EBITDA projections by FY28, and it'll be all about data centres becoming a more important source of returns for the company. Goodman Group is generating high margins on data centre developments thanks to its pre-purchased land bank.

Morgan Stanley estimates Goodman Group can derive $20bn in additional value from its pipeline of data centre developments in the years ahead. It is equally assumed the company can fund its share of developments without additional capital, and there's always room to sell some assets, if need be.

Were the broker's bull case scenario to unfold, Morgan Stanley's valuation for Goodman Group shares would climb to $45.70.

In the wake of the data centres deep dive (82 pages), Morgan Stanley analysts reiterated their view shares in Macquarie Technology are undervalued, trading at around $84 on Monday. The broker's price target is $100. Macquarie Technology is not a pure play, combining data centres with more traditional telecommunication operations which also include a cloud & government business which is equally growing strongly, points out the broker.

Companies not mentioned in the report that might also benefit from demand for additional data centres in the years ahead include Global Data Centre Group ((GDC)), which is part owner of AirTrunk through the Macquarie-led consortium, and Megaport ((MP1)).

Rudi's View: It's Special vs Cheap, But Who's Most At Risk?

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By Rudi Filapek-Vandyck, Editor

From the moment one starts looking for that 'special' corporate quality on the ASX, it is but a matter of time before the focus zooms in on IT services provider TechnologyOne ((TNE)).

Last week's interim financial update provided plenty of input as to why this Brisbane-headquartered, $5.7bn market capped member of the ASX100 is hands down one of the highest quality companies listed on the local exchange.

Rather than dissecting the finer details from the H1 financials, not necessarily all positive, I think it is of much greater importance to explain, in broad terms, what makes this local gem of such high quality.

It might help others, like you maybe (?), to understand what exactly makes this company so special, which might also help in discovering other 'special' companies or rejecting their claims to similar greatness.

An Exceptional Track Record, What Is The Secret Sauce?

In a world that is eagle-eyed focused on growth, TechOne's track record has been exceptionally consistent, growing earnings per share at around 15%, year-in, year-out. It was this consistency that attracted the attention of a short report in 2020, claiming management surely was cooking the books, because, well, no company is able to grow at such consistency for such a prolonged time.

Well, it's 2024 now, and TechOne's still doing it. That malicious short report is long forgotten about, and the share price recently rallied to a fresh all-time record high, intra-day, above $18. When the shorters stood ready to attack in 2020, the price temporarily sank below $8.

The share price, up from below 50c in 2004, is only what is visible to investors every day. The real story that lays underneath is the business approach that prioritises building close relationships with customers, and then making certain the service and products provided suit their needs.

In the fable of the hare and the tortoise, TechOne very much resembles the tortoise. Growing 15% per annum doesn't seem extremely appealing when others can do 100% and more, but can they do it consistently over two decades? TechOne has, and the market has increasingly been paying attention.

When a company grows at a pace of 15% per annum, it doubles in size in less than five years. By 2009, that share price was ready to surpass $1. By 2014 it was trading above $3. By 2019 the price was above $7. At last week's interim release, management gave indications growth is likely to accelerate in the coming years.

Analysts, or at least most of them, got the message and are now projecting 17% EPS growth for the years ahead. Some continue to see potential for further upside surprises, in particular since the UK business hasn't genuinely started contributing just yet. The magic ingredient of the TechOne business achievement is customers are increasingly happy to purchase more products from the same company.

What is usually pointed out about TechOne, including by myself, is its customers, mainly local governments and higher education institutions, are extremely "sticky" with last week's published churn percentage of 1.8% somewhat of a shock. History sees this percentage seldom rise above 1%. Don't worry, management is confident that number will be back below 1% shortly.

TechOne is far from the only company that can rely on customer loyalty, but it has been able to turn that loyalty into a sustainable platform for growth by selling existing customers more products. Not sustainable, I hear you say? Management remains confident there's still a lot more that can be achieved from the same database of prospects and existing customers.

Consistent Investing Builds Success

There's an easy argument to be made the real growth driver stems from the company investing circa one quarter of its revenues in new product development and improved services year-in, year-out. It's these new products that lift the take-up among existing customers.

It's not difficult to see here is a circle of trust at work and TechOne does enjoy a positive reputation in its core markets, also illustrated by the fact the company seems to have established itself as provider of the highest level of cybersecurity among ERP peers in Australia; not an unimportant halo to wear when dealing with government and local councils.

What always strikes me when reflecting on quality success stories such as TechOne's is management's ability to incorporate long-term benefits in the specific business strategy. In TechOne's case, since implementing ERP systems at companies can be very cumbersome, expensive and potentially time-consuming, the company has decided to lower the barrier and take full responsibility for the system implementation, in exchange for a higher subscription fee over the duration of an initial five-year contract.

Potential negatives: costs and any operational mishaps are the company's responsibility at first, the subsequent financial benefits accrue later. It is this strategy management has taken to the UK where the market leader in UK Student Management is still relying on an old-fashioned on-premise software solution which surely must be looking as of Dinosaur-vintage against TechOne's cloud based, all-inclusive ERP suite of products.

The UK is a much bigger sized market than is Australia (by a factor of three) and repeating the success-story of the past two decades over there could well guarantee a much extended runway for growth, but management has to date stuck to its measured approach. TechOne's presence in the country was enlarged with the acquisition of Scientia in FY21. Last year management spent $2m on an acquisition that was not pursued (also a sign of quality).

It is widely believed management has some form of M&A on its mind, likely to add a new customer base or speed things up in the UK. Thus far, only circa 10% of TechOne's annual recurring revenues (ARR) are derived from the UK, but it's growing faster than elsewhere.

Not Everyone's A Fan

I could go on but maybe I should also point out not everyone is equally convinced about TechOne management indicating growth is most likely to accelerate in the years ahead. **Morningstar analyst Roy Van Keulen**, for example, has his doubts, arguing growth has been achieved on the back of increased government spending post-covid, but this won't last.

Van Keulen suspects TechOne will have to increasingly spend more to achieve incremental revenue growth. As retail broker Ord Minnett whitelabels Morningstar research, Van Keulen is responsible for that broker's Lighten rating alongside a fair value estimate of not more than $14.50.

And he's not the only one. Back in October 2022, analysts at **Morgan Stanley** initiated coverage on ten mid-cap and smaller cap ASX-listed technology companies, only to conclude the trio of Megaport ((MP1)), Hansen Technologies ((HSN)) and Pexa Group ((PXA)) had superior growth prospects built on sustainable competitive advantages, scalable business models, and defensive characteristics, backed by strong balance sheets.

Morgan Stanley found TechOne's business model based on customer relationships would by nature limit its growth prospects and prevent it from ever expanding successfully in other geographies where much larger, much more sophisticated global competitors are in charge.

Interesting, more recent research updates from other analysts are suggesting TechOne's everything-in-house approach, without external consultants, makes it a positive stand-out in the industry which is greatly appreciated by customers and contributing to its quality image.

Equally interesting, out of the three nominated superior choices, only Megaport has outperformed TechOne's performance since November 2022 and it can be argued the starting point was always in Megaport's favour as it followed a significant sell-down in the shares. Both Hansen Technologies and Pexa Group shares are sitting on a negative performance since.

TechOne shares are up 44% in surely what must be the ultimate proof that the tortoise tends to win the race, as long as the contest is spread out over many years?

This has not stopped those Morgan Stanley analysts from sticking to their view. Last week's research update came with an Equal-Weight rating and $13 price target.

The Ever-Recurring Investor Dilemma

Even if we adopt a less skeptical view than Morningstar/Ord Minnett and Morgan Stanley, there's no arguing with the fact TechOne shares are not cheaply priced, even if FY24 and FY25 results were to beat current market forecasts. This is also reflected in **RBC Capital** initiating coverage with a Sector Perform rating and a price target of $18.

For investors still waiting to get on board, it is equally worth pointing out TechOne shares are highly unlikely to genuinely trade on low PE multiples, unless something seriously goes wrong, or the macro outlook changes dramatically, like it did in 2022 when global bond yields rose sharply as central banks started tightening on the back of the post-covid outbreak in inflation.

It can even be argued the prospect of economic recession should not have a major impact on the business, which is backed up by its track record from the past two decades.

Which is why I tend to advise investors to have a wish list for the great quality compounders the local bourse offers, and wait for opportunity to present itself. Another strategy might be to build a long-term portfolio exposure through smaller increments.

The **FNArena-Vested Equities All-Weather Model Portfolio**, in which TechOne shares are considered a cornerstone exposure, has in the past used share price weakness to buy or add to today's success stories in Goodman Group ((GMG)), Car Group ((CAR)), Hub24 ((HUB)), WiseTech Global ((WTC)), and REA Group ((REA)), to name a few.

The share market being what it is, a public forum where all kinds of opposing narratives converge, the next reason for a share price to weaken is seldom out of reach for too long. But one has to know in advance which stocks are on the personal wish list, and be ready to execute when the opportunity presents itself.

Corporate Signals In May

Another observation is that while high multiple, quality growth stocks seem to be performing well, judging from recent market updates by the likes of Xero ((XRO)), Webjet ((WEB)), Aristocrat Leisure ((ALL)), and, yes, TechnologyOne too, the opposite has been happening for the more vulnerable, cyclical alternatives that are trading on much cheaper valuations, but whose market updates are increasingly exposing operational disappointment and weakness.

Think, for example, Nufarm ((NUF)), recently, but also Elders ((ELD)), GrainCorp ((GNC)), Michael Hill ((MHJ)), Telstra ((TLS)), and including Dicker Data ((DDR)). While for some of these companies a valid argument can be made that things will look better in twelve months' time, there's equally a good chance economic momentum is set for more weakness first, before the next recovery announces itself.

In a share market that remains as polarised as ever, I see two different types of risk and, given the deteriorating trend this month, the bias may remain towards more profit warnings than weakness in sturdy, reliable 'champion' stocks.

The local confession season starts in June (next month). I stick to my self-manufactured habit of looking at the share market in terms of the 'vulnerable' (cheap) and the 'strong' (not cheap), which might be the more appropriate way of looking at companies in the run-up to the August results season.

Correct or not, the proof will be there for all to see.

Rudi's View: GenAi, The Super-Megatrend, Part 1

Jun 19 2024

"In times of change, learners inherit the earth, while the learned find themselves beautifully equipped to deal with a world that no longer exists."
[Reid Hoffman, co-founder of LinkedIn]

By Rudi Filapek-Vandyck, Editor

Every experienced investor knows it pays dividends to be sceptical when all around us are getting excited.

We only have to look back in history to find plenty of examples of temporary share market excitements that had investors scrambling to get on board, only to find themselves on top of a sinking barge not long after. Remember 3-D printing? BNPL? Cannabis?

The commodities sector offers multiple examples just about every single year; from rare earths, to nickel, graphite, lithium, and coal companies... the swing from Zero to Hero to Zero status is usually swift and brutal, and it won't be any different in the future.

None of these experiences negate the fact today's world is changing on a regular basis and some of the changes occurring leave a significant imprint on businesses and society at large.

For investors, the importance comes through separating Winners from Losers, as the distinction will ultimately become irrefutable, either inside the investment portfolio or on the ASX, for all to see.

For some, investing will always revolve around picking up the pieces after disaster strikes. The share market has a habit of pushing excitement too far ahead of fundamentals, and disappointment too low into the abyss. So, there's always a fresh investment case assuming things don't get a lot worse.

For others, long-term investing is about tapping into growth, and enjoying the rewards of a multi-year uptrend. These investors know success is closely linked with 'growth'. Growth pulls oxygen into the business and its share price. Without growth there are no long-lasting, sustainable rewards.

Over the past decade, investors looking for growth in the share market have gradually converged around the theme of Megatrends; societal changes that play out over extended periods of a decade or longer, creating Winners and Losers throughout the process.

For investors in growth, the importance seems obvious: better to own the Winners.

This doesn't mean others can afford the luxury of ignoring what is happening at the macro-level.

A blueprint from the past

Back in the year 2000, News Corp ((NWS)) shares represented 13% of the ASX200. More than BHP Group's ((BHP)) importance post abolition of the UK-listing. Today, News Corp draws most of its 'value' from the equity it still owns in online real estate portal REA Group ((REA)). Any moves in the share price are pretty much inconsequential for the index overall.

That pretty much sums it up for the local media sector generally. Online competitors REA Group, Car Group ((CAR)) and Seek ((SEK)) have only grown in size and importance over the past 24 years while their traditional brethren have shrunk and sunk deeper and deeper into the shadowy corners of the local bourse, where daily trading volumes evaporate and general investor interest dies.

Nine Entertainment ((NEC)), with a much deflated market cap of $2.2bn, is still part of the ASX100, but only until June 21st after which it will be relegated to the ASX200 and All-Ordinaries only.

In the world of institutional investors this means the once mighty Fairfax newspapers empire is about to become a 'small cap'. No surprise, market rumour has it private equity is running the ruler over a business that combines old and new media, with no longer any 'value' incorporated for the print and radio media assets.

Southern Cross Media Group ((SXL)) is no longer in any index. Seven West Media ((SVW)) and ARN Media ((A1N)) can only be found in the All-Ordinaries. Others have disappeared. Sure, there have been times when any of these share prices went up, but one would find it hard to locate an investor who uses "great return" and any of these names inside the same sentence.

In contrast, WiseTech Global ((WTC)), which runs a digital service assisting companies with organising their complicated logistics, will be added to the ASX50 after the close of trading on June 21. WiseTech shares only listed on the local bourse on 11 April 2016, a little over eight years ago.

The past decade has seen multiple Megatrends being identified by investors, ranging from businesses and consumers going digital, to cloud computing and the emergence of a middle-class consumer in Asia. In the slipstream of these major changes, new businesses have been created; not all have been successful.

Those that did prove themselves as a true Winner have generated truly copious rewards for loyal shareholders. Examples include Altium ((ALU)), Audinate Group ((AD8)), and Xero ((XRO)), as well as the aforementioned WiseTech Global, REA Group, and Car Group.

Among the conclusions that can be drawn from past experiences, it is those tectonic shifts don't move in a straight line, there will be interruptions and pauses; investors tend to become over-excited in the short term, while under-appreciating the potential further out; and there will always be plenty of 'pretenders;' and 'wannabes'.

Eventually, the true Winners will rise above the pack, but their status may not always be as apparent from the get go.

GenAi: too good to be true?

So where does artificial intelligence, or more precisely generative Ai, its youngest technological breakthrough, stand against the background of all these past experiences?

It's easy to open the traditional 'value' investors' lexicon and roll out the criticisms: "investor exuberance"; "the next bubble"; "at these valuations and multiples, things will come crashing down next, just wait for it".

On my observation, most of such declarations, and they are being made by many on a daily basis, are largely based on share price moves, without paying attention to the real growth that underpins these moves, or they come from the view there's no lasting substance to this latest new technology. It'll all burn out by the time investors realise GenAi is simply the next hula hoop.

Back in the 1960s, the Wham-O Toy company sold an estimated 25 million hula hoops in the first four months after launching its brand new toy, but that was the peak and most enthusiasts soon moved on to the next big thing.

The simplest counter-argument is GenAi offers businesses real, tangible benefits through either increased efficiency (higher margins translate into higher profits) or an additional source of revenues, or both. More precisely: GenAi offers the *potential* to obtain these benefits. No gain without first the pain. Any business aiming for future Ai benefits needs to make some **sizable investments first**.

Here's where things really become concrete and real. These investments *are* being made. First in tens and hundreds of millions, accumulating into billions. Won't be long before the numbers grow into trillions of dollars spent.

Sounds too good to be true?

Time to start paying attention to results releases and investor briefings by companies including Microsoft, Amazon, Alphabet and Equinix on Wall Street. They all are assuring us the investments made by governments and businesses around the world are real, they are significant, and they are only moving in one direction – up!

Mind you, all those investments come in addition to money spent by Big Tech, which is Big, really BIG.

Locally, the same insights can be gained from experiences and trading updates from first-hand beneficiaries such as Goodman Group ((GMG)) and NextDC ((NXT)). The first builds new data centres in partnership with or under contract for data centre operators. NextDC's business is to own and operate data centres to facilitate the explosion in demand (not an exaggeration) for data storage and cloud computing power.

On current estimates, investment in Ai will reach US$200bn globally by next year. But things are moving so fast, these numbers are constantly revised upwards. Analysts at Morgan Stanley recently estimated additional investments made in new data centres in Australia alone will total between $21bn-$28bn over the next eight years. While stating these projections might well prove conservative, in practice this implies the local industry will at least double in size over that period.

Judging from these numbers, it looks like the industry's biggest challenge is not a potential drop off in demand, but facilitating and servicing demand without delays, project failures, supply bottlenecks, and significant cost over-runs. And let there be no misunderstanding: the challenges are as tangible and real as is the surge in demand.

As one analyst from T Rowe Price explained during an online seminar recently: the latest graphics processing unit (GPU) from Nvidia requires (almost) as much power as your average US household. This implies the industry is adding the equivalent of a newly built Las Vegas every few months. Can anyone imagine the burden this represents for the country's power grid?

Change happens in phases

The adoption and roll-out of new technologies proceeds through distinctive phases. Ai is no different. In the first phase, all the benefits (and attention) are reserved for what we can colloquially describe as the 'picks and shovel' providers; companies that deliver the hardware, the software, and anything else that is required to build the global infrastructure required.

Think semiconductor designers and manufacturers line Nvidia, TSMC and AMD, and their adjacencies. And data centre operators, including Amazon, Microsoft, and Equinix, and their adjacencies. As it has dawned upon investors Ai will require a whole lot extra in power generation, share prices in North-American utilities have equally enjoyed solid investor buying.

In Australia, the two most obvious beneficiaries have been identified in Goodman Group and NextDC. Both share prices are up more than 100% since the market's low in October 2022 and are now trading on what most investors would regard as elevated multiples.

Upon deeper analysis, and assuming no major macro-economic or other disasters on the horizon, both companies are likely to enjoy very favourable growth dynamics in the years ahead, meaning their share prices, all else remaining equal, should appreciate to much higher levels. As per a recent modelling conducted by stockbroker Morgans, NextDC's share price may well reach $40 in three years from today.

Even if that $40 projection proves too optimistic, with the shares rallying to a fresh all-time high last week above $18, the explicit message is there's a lot more upside forthcoming. The outlook for shares in Goodman Group does not look fundamentally different. This will be one of the key challenges for investors who are not yet on board of these early-phase beneficiaries.

My personal view is such share prices will likely remain well-supported as long as the prospect for strong growth remains intact and believable.

Ai is offering Goodman Group a once-in-a-generation opportunity to generate super-profit margins, which accelerates its growth path, as the developer owns a sizable landbank that was build up to develop sophisticated warehouses and other industrial assets. Goodman is now able to tap into this resource on unprecedented demand for data centres.

On Friday, Citi analysts added Goodman Group shares to the broker's Pan-Asia Focus List (essentially a selection of High Conviction Recommendations) while lifting the price target for the year ahead to a market-leading $40. Citi's conviction relies on a forecast of double-digit annual growth for the medium term.

NextDC had already been adding extra capacity as the **demand for data storage is a Megatrend** in itself. The company has plenty of unallocated capacity, with more new data centres under development, implying lots of room to reap the benefits from the surge in demand.

Other companies are not by default in the same favourable position as Goodman Group and NextDC, but they will benefit too, and thus their share prices have equally been in demand. Additional beneficiaries include Macquarie Technology ((MAQ)), Global Data Centre Group ((GDC)), and Infratil ((IFT)), through data centre assets, as well as Megaport ((MP1)) and Southern Cross Electrical Engineering ((SXE)).

Macquarie Group ((MQG)) owns data centre operator AirTrunk, in which Global Data Centre Group holds a small equity stake too, and is currently shopping around for an eager buyer. Macquarie stands to make a multi-billion dollar profit from the sale.

It is not yet clear what the exact impact might be for listed utilities AGL Energy ((AGL)) and Origin Energy ((ORG)), and the same question mark applies for pipeline operator APA Group ((APA)). It is best not forgotten that if these facilitators need to make large investments first, any benefits will only come through (much) later.

I'd say the same logic should be adopted for telcos Telstra ((TLS)) and Chorus ((CNU)) for which GenAi represents both opportunity and threats (more on that shortly).

If strong demand for data centres means power prices will be permanently higher in the years to follow, one would be inclined to think AGL Energy and Origin Energy should be among the domestic beneficiaries.

From the latest industry insights released by analysts at RBC Capital:

-We believe data center supply should remain tight, amidst strong demand from cloud computing, generative Ai, social networking, software, and other verticals

-Energy-related and permitting constraints across many metros, coupled with long lead times on data center equipment and construction, are limiting the velocity at which new supply is coming online

-This in turn should drive continued favourable pricing and renewal spreads for those developers who are able to secure resources

-As energy transmission constraints are addressed, a process that can take up to several years, energy-related supply constraints could lessen over the medium to longer term

Rudi's View: GenAi, The Super-Megatrend, Part 2

Jun 20 2024

By Rudi Filapek-Vandyck, Editor

Next phase: more beneficiaries

Apart from Nvidia, which has managed to position itself at the heart of the GenAi revolution (think about it), the second largest beneficiary at this point in time has to be Microsoft, itself one of the earliest investors in the technology. Contrary to most companies, Microsoft has a vast network of sticky customers who purchase and renew subscriptions to its suite of software programs around the globe.

Microsoft has thus already been able to start monetising GenAi through its regular channels. Things move fast in 2024 and competing manufacturers of PCs, laptops and mobile devices have equally launched their own GenAi products, including Acer, HP, Lenovo, and Apple.

Apple and Google (Alphabet) have their own global networks and are equally eager to monetise their own Ai investments. With GenAi promising a much improved user experience versus Google search, the latter behemoth will be going through a fundamental transformation.

How quickly will we all jump on the bandwagon and start upgrading and renewing our current hardwares?

That question is not easy to answer at a time when many a household budget is under pressure, and the same squeeze applies to small and medium-sized businesses in many developed and developing economies.

But analysts in Australia have been reporting Wesfarmers ((WES)) is optimistic about the boost GenAi products are poised to deliver for Officeworks. Dicker Data ((DDR)) too expressed an oversized dose of optimism in its most recent share market update.

Macquarie analysts already calculated if GenAi shortens the average renewal cycle for computers by one year (to five from an average six), the benefit for the industry will be significant. On the broker's calculations, shortening the replacement cycle by one year, and assuming prices go up by 15%, would result in a 34% increase for the PC market locally in 2025.

It remains to be seen if and when exactly such benefits materialise, but if we, as a society, are going to migrate towards GenAi, those who sell the products will benefit.

In Australia, the obvious beneficiaries will be JB Hi-Fi ((JBH)) and Harvey Norman ((HVN)), for sales to consumers, and Officeworks, Dicker Data and Data#3 ((DTL)) for sales to small and larger businesses.

The big unknown: corporate execution

GenAi is promising the next modern day industrial revolution, but ultimately its success will come down to execution. The jury is still out on whether that promise will be delivered, when exactly and what its shape and practical outcome might be exactly.

The arrival of the Internet, and later the smart mobile, has had a tremendous impact on corporations and society, but no-one could anticipate the many new businesses that have been established on the back of these technological breakthroughs, or predict which businesses would succeed or fail.

For each sector specifically there are many moving pieces in play, which makes forecasting extremely difficult at this early stage. In some sectors, benefits might be achieved eventually but subsequently competed away for a no net advantage to the business, irrespective of the effort and investments made.

Note how the latest initiative by the Albanese government intends to force local banks into more transparency for financial products, at the same time as it will be easier for customers to switch to a competitor.

All of this also points to another strong motivation for businesses to join the trend: the competition cannot be allowed to obtain a GenAi advantage.

History shows not every business will be equally successful. Not every business, not even every sector will be able to adopt and adapt easily. There will be Winners and Losers. Some businesses will fail miserably.

For your typical 'value' investor who likes to snap up beaten down, cheaply priced assets this opens up a whole new set of risks, as companies that won't be able to make these investments, or cannot use this new technology to their financial benefit, will be priced at a valuation discount by a share market that only reasons in black and white.

Owning these assets in the investment portfolio might only pay off when the market's assessment is wrong, as happened in the year past with shares in CSL ((CSL)) and ResMed ((RMD)) on speculation their businesses would be heavily impacted by the GLP-1 obesity breakthrough by Eli Lilly and Novo Nordisk.

In all other cases, those who fail in tomorrow's GenAi contest are most likely to repeat the trajectory seen for News Corp, Nine Entertainment, et cetera since 2000.

Another type of risk has become evident through recent market communications from the likes of Westpac ((WBC)) and the ASX ((ASX)), warning investors the pace of necessary investments will be of much greater magnitude in the forthcoming years.

Such acknowledgment not only weighs on growth prospects generally, there can be consequences for a company's ability to pay dividends.

The ASX, which admittedly has a series of concerns that need to be dealt with, is expected to pay out a lower dividend for the third consecutive year in FY24. The broader question is whether the general corporate culture in Australia, preferencing dividends for shareholders above making investments in IT or growth, is simply not suitable for your typical old economy stalwarts to deal with the requirements in a new Ai-inspired technological era.

A time bomb ticking for boards asleep at the wheel?

During times of technological advancements, buying 'cheap' can lead to a whole different investment outcome than has been the case in the past.

Having said so, the market is certainly not always right and thus there's always an opportunity for the contrarian investor who knows better. With shares in search and data services provider Appen ((APX)) trading below 50c, a level last witnessed eight years ago, the obvious GenAi contrarian idea on the ASX seems to already present itself.

According to some, including management at the company, Appen will be a net beneficiary of GenAi. The market certainly shows no appetite for revisiting Appen's future potential prior to tangible evidence of that thesis emerging.

Identifying future beneficiaries

Having said all of the above, GenAi very much favours digital and online businesses, and this makes some businesses better positioned to adopt and integrate the new technology than others. GenAi also thrives on databases filled with data, so businesses with proprietary data have an instant advantage.

Logistics services provider WiseTech Global looks ideally placed to incorporate the new technology in its network, and achieve tangible benefits both for its customers and its bottom line.

A recent report by Morgan Stanley states GenAi might allow the company to reach into key adjacent markets such as customs, compliance, warehousing, and land-side logistics, effectively adding additional revenue streams.

GenAi also offers the option of better and enhanced product offerings, and the ability to integrate new acquisitions faster. WiseTech already is seen as the superior operator in its field (just ask the analyst at Morningstar). Through GenAi the company might be able to truly differentiate itself from the competition.

To illustrate the importance of GenAi when integrated successfully, look no further than Morgan Stanley's modeling. The broker's price target for WiseTech Global shares currently sits at $95. GenAi success would instantly shift this target to $125.

Other ASX-listed companies that might equally be at the forefront of tomorrow's GenAi revolution in Australia include Pro Medicus ((PME)), Life360 ((360)), Sonic Healthcare ((SHL)), Transurban ((TCL)), Temple & Webster ((TPW)), Xero ((XRO)), SiteMinder ((SDR)) and, in theory, virtually every 'quality' online business.

In a preliminary attempt to set out the parameters for identifying future GenAi Winners, analysts at Morgan Stanley put forward a three-pronged approach, directing investors to look for companies with:

1. A track record of innovation
2. Deep engineering capability
3. Proprietary data advantage

Combining all three conditions, Morgan Stanley nominated Breville Group ((BRG)).

GenAi holds the promise of a decade-long global transformation

The emergence of GenAi already has had a big impact on financial markets. When the Federal Reserve and other central banks embarked on the steepest tightening cycle in history back in 2022, the general fear was this would drag global equities into a nasty, long-lasting bear market a la GFC.

GenAi is certainly not the only reason, but its emergence as the next technological breakthrough is one of the key factors as to why such a scenario has not materialised (at least not at the top end of global equity markets).

Similarly, if economies around the world prove stronger-than-feared throughout 2024 (i.e. no recession) then GenAi is yet again at the very least co-responsible, as it probably also is for higher-for-longer inflation readings.

This raises all kinds of questions about the way forward for central bank policies and bond yields. What if the next decade consists of higher inflation and higher bond yields in comparison with the decade past? Won't companies on higher PE multiples face significant de-rating just like what happened in 2022?

I think not, unless we're talking doom and gloom with significantly higher inflation and bond yields. While nothing is per definition impossible, it's hard to see how such a scenario can be anyone's base case outlook.

Investors can draw their own conclusion from the fact share prices in GenAi beneficiaries are making new all-time highs this year with bond yields significantly higher, albeit, admittedly, on the general expectation central banks will soon all be cutting rates (with a few exceptions) as inflation and bond yields will continue to trend lower.

The one key lesson history teaches investors is that 'growth' pretty much heals and conquers everything, over time.

GenAi holds the promise of a decade-long global transformation, with significant rewards for companies operating in the right place, with the right tools, and the right products and services.

History also shows all of the above will most likely accumulate into the next financial bubble, just like what happened prior to the 1930s and throughout the late 1990s. But should this outcome be on investors' mind already?

One hundred years ago, equities would only be in the second year of a fresh bull market that would ultimately stretch out for another seven years. What we are experiencing in 2024 is arguably still the embryonic phase of a process that will take many more years to unfold and develop.

The time to worry about bubbles forming and bursting will come, but now seems way too early for that. This won't stop many from calling out "bubbles", "irrational exuberance" and "the next crash forthcoming". If, however, the end of the Ai-driven uptrend arrives in 5, 7, or 10 years from today, can these voices still claim to have been "correct"?

Viewed from a positive angle, GenAi is the modern day Super-Trend that is injecting fresh stimulus into existing Megatrends that had already been beneficial to companies such as Goodman Group, NextDC, REA Group, WiseTech Global, and others, also including the already favourable outlook for commodities due to the global decarbonisation and electrification, and the transformation of the global energy sector.

There will be many Winners and beneficiaries, through a variety of sectors and applications, and there will also be many laggards and Losers.

Let's make sure we will enjoy the journey ahead.

Rudi's View: Traditional Value Is A Flawed Narrative

Jun 26 2024

The decade past has challenged the narrative that buying 'cheaply' priced equities are a starting point for guaranteed success. Why would the decade ahead be any different?

By Rudi Filapek-Vandyck, Editor

We don't need to read Yuval Noah Harari's '*Sapiens*' to understand how people unite behind narratives.

It happens in financial markets all the time.

Not that popular narratives are also required to be accurate or able to withstand the test of time. The US has been on the verge of going bankrupt for multiple decades now, and the end of the US dollar as the world's reserve currency has been "imminent" for all this time.

Another popular prediction sees a replay of the stagflation 1970s, with bond yields reverting back into the double-digit percentages as the price of crude oil jumps to US$200/bbl and those mean-spirited central bankers can no longer contain inflation.

Not all narratives are equally flawed. If they were, we'd probably be no longer treating them as gospel, though maybe I am now putting too much faith in the intelligence of my peers and contemporaries. Certainly, social media has been a genuine eye-opener.

The most dominant narrative in the world of investing is that, in order to achieve the best return in the long run, we must buy assets at a discount. Buy something that's worth a dollar for less, preferably a lot less, so the adage goes, and you cannot go wrong.

It's what a smart investor does, as opposed to those who simply chase market momentum.

So ingrained is this narrative in the share market's psyche that many will never, ever question it. It's like religion. You believe. You don't doubt. It's simply the way it is.

The problem is, however, a 'cheap' valuation is not the same as a low PE. Never has been. Even more important: sometimes the world changes so dramatically, it makes a mockery out of old ways and habits that used to work well during the Halcion days.

The past ten years have been such a time. One need not look any further than the latest marketing campaign by investors in 'growth' stories at Hyperion, part of the Pinnacle Investment Management Group ((PNI)), which is proudly showing off the 17.1% per annum average return from the Hyperion Global Growth Companies Fund since 2014.

Let's not beat around the bush, your average 'value' investor fails to beat the local index which has done a little better than half that return over the period (circa 9%). By anyone's measurement, that's a significant difference.

A quick glance over the individual stock performances for the decade past easily explains why buying cheap & undervalued stocks has failed to keep up: many of the familiar household names have significantly underperformed, including all the banks (ex-dividends), energy retailers, small industrials, and large swathes of the energy and metals sectors.

While many a local investor might argue total return for banks and other market segments has kept up with the index, broadly, when taking into account the large dividends and franking attached, the gap with those stocks that have performed over the period is nevertheless mindbogglingly large.

We are talking three-four times the average index return without taking into account any dividends on top. Those are merely broad averages; many 'Growth' stocks have done significantly better.

You all know the names too: Altium ((ALU)), Aristocrat Leisure ((ALL)), ARB Corp ((ARB)), Cochlear ((COH)), Fisher & Paykel Healthcare ((FPH)), Pro Medicus ((PME)), REA Group ((REA)), WiseTech Global ((WTC)), et cetera.

Even CSL ((CSL)) and ResMed ((RMD)), whose share prices have encountered more headwinds in recent years, have still outperformed the ASX200 accumulation index by a factor three and four respectively.

For good measure: the select list of significant outperformers also includes a number of commodities-related companies, including BlueScope Steel ((BSL)), Fortescue ((FMG)), Mineral Resources ((MIN)) and smaller peers like Chalice Mining ((CHN)), Evolution Mining ((EVN)) and Paladin Resources ((PDN)), but this segment always generates a few Heros among many more Zeros.

Making the observation is an eye-opener, for sure, but how will we respond to this?

On my observation, most people, whether they are in Finance or otherwise, find it incredibly difficult to deal with 'change'. We rather stick with what we know from the past, and wait for things to revert back to how they were. For many, that's the easiest path to choose.

But what if there's no quick reversion on the horizon?

When the world changes, it doesn't happen overnight. These are long, elongated processes. The past ten years have not been without major events and markets violently swinging in either direction. We've seen Europe in crisis, oil prices slump and rise, a global pandemic, wars in the Ukraine and in Gaza, negative real bond yields, and the steepest tightening from central banks ever… and yet, there is a *gigantonormous* gap in performances between those who benefit from change and those who don't.

Most importantly, 'Growth' and 'Quality' have been out of favour multiple times -think the second half of 2016 and the whole of 2022- but those stocks still come out on top when the long-term calculations are made.

Frustrating as it may be for your dyed-in-the-wool value investors, solely looking out for low PEs and companies trading at intrinsic discount may not be the most appropriate strategy in a time when new technology, disrupters, innovators, 'Quality Growth' and 'structural growth' rule the financial landscape.

Time to highlight one of the market observations that have coloured the decade past (it is repeated by all kinds of investment experts regularly across my social media forum): a stock trading on a low PE is not by definition 'cheap' or even 'attractive', while a stock trading on a high PE can still be 'cheap' and 'attractive'.

The counter narrative thus becomes: don't look for the one dollar stock to buy at 70c or 60c, look for the stock that will go to one hundred dollars and you can buy it at $10, at $20, at $40, even at $80, still. And when you arrive at $100, consider it might yet have a lot more upside in store, still. The past ten years (and beyond) have offered plenty of examples to make that strategy work.

I can report the **FNArena-Vested Equities All-Weather Model Portfolio** has used this strategy successfully, most recently when shares in Audinate Group ((AD8)) sold off from above $21 to below $15.

Ironically, confidence in the future growth path of this high quality small cap emerging conqueror of the global wireless AV market has been backed up by an initiation of coverage by Morningstar, which tends not to lead when attempting to value such emerging strong growth stories.

This time, however, Morningstar's $23 fair value estimate (whitelabelled by Ord Minnett) is even higher than your traditional technology enthusiasts at Morgan Stanley (target $22).

Now that I am thinking about it, the All-Weather Portfolio's exposures to successful and strong growth achievers such as Hub24 ((HUB)), REA Group ((REA)), and WiseTech Global ((WTC)) have all been purchased following a pull-back in the share price.

It always raises the question: how deep should the pullback be?

There's no golden rule when it comes to playing the share market. One has to deal with what the market offers. I am an avid user of the data and tools on the FNArena service. I look at price targets and where the share price trades. I try not to be too greedy, but I am equally aware investing is not about being perfect.

I always remember anecdotes like that investor who'd only buy CSL below $90 or Wesfarmers ((WES)) below $30. In both cases the price didn't quite get there, and thus no purchases were made. Now look at where those share prices are trading, and make sure next time it won't happen to you.

Goes without saying: trends from the past do not continue into eternity. There is equally a valid argument to be made that GenAi has the power to significantly re-shape the world in the years ahead, and that process has only just started.

GenAi won't be the only source for growth (and disruption) either.

Rudi's View: Diverging Risks In A Polarised Market

Jul 03 2024

By Rudi Filapek-Vandyck, Editor

Diverging Risks In A Polarised Market

One of the proprietary data insights from FNArena is the balance between Buy-Hold-Sell (and equivalent) ratings for those stockbrokers we monitor daily.

As one would expect, apart from collating the data, it's just as important to pick the correct background and context when interpreting these data. Financial markets change on a daily basis, but their indicators are not per definition a static insight either.

According to our data, the local share market changed in character during the global covid pandemic, and it's never been its old self since.

Traditionally, the brokers we monitor carry around 9-10% in negative ratings for individual stocks, think Sell, Underweight, Avoid, and all other possible variations.

This leaves Buy and Hold/Neutral ratings vying for the bulk of ratings. As these ratings are usually strongly correlated to share prices, and thus to intrinsic valuations, the definition of a bull or bear market phase is usually rather straightforward:

-if the highest percentage consists of Neutral/Hold ratings the share market is having a jolly great time, otherwise known as a bull market

-when the highest percentage shifts to positive ratings (Buy, etc) the market is trading sideways at best for a prolonged period of time, but probably losing altitude

Do note these data shifts don't provide any sense of timing or predictions; they are merely the result of what is happening in the share market already and might, at best, confirm the conclusion that is already apparent from share prices and more timely, technical indicators.

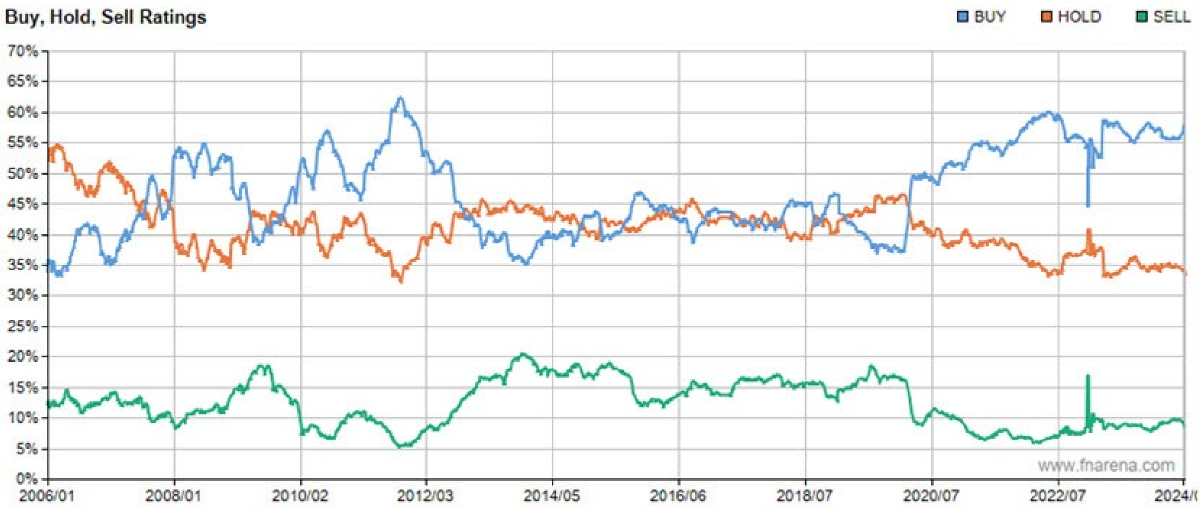
As said, any correlation from pre-covid is no longer relevant today. From early 2020 onwards, the percentage of Buy ratings jumped from below 40% to over half of the total, and has since stubbornly remained above 50%.

There's one important element that needs to be taken into account: FNArena changed the composition of the basket of brokers we monitor daily. As every broker has its own methodology and in-house approach, this will always impact on the numbers. For example: Shaw and Partners, as a relatively smaller broker that researches less stocks and serves predominantly retail investors, traditionally holds a large skew towards Buy ratings.

Shaw's skew towards Buy ratings is by far the largest among the eight brokers FNArena monitors. But the discrepancy post-pandemic is so large, it cannot be simply ascribed to the inclusion of Shaw or the change in underlying mix.

As things currently are, more than 58% of all ratings for the eight brokers monitored is a Buy-equivalent, while Sell ratings are below 9% and Hold/Neutrals represent the remaining 33%.

As per the graphic overview below, the gap between Buys and Holds has never been this large for such a long period of time. Equally noteworthy: the share market is not in a prolonged bear market a la GFC or the March 2000 Nasdaq meltdown.



So what is happening exactly?

A Polarised Landscape

Were we to stick with our traditional, pre-covid interpretation, we'd say the share market is in a prolonged bear market that has been masked by a small number of companies that have performed exceptionally well and kept major indices on a positive up-trend.

This is not dissimilar from observations and analyses made about equity markets in the US, for example, where the large majority of index constituents has failed to make a positive contribution despite indices rallying to new all-time record highs.

Most investors don't like to talk about bear markets, so let's switch this conversation to a more positive starting point: equity markets are enjoying a new bull market -see also those fresh new records- but large swathes of stocks are not participating. The post-covid bull market is characterised by a narrow base of Big Winners and a larger group of share market laggards.

It is this polarisation, I believe, that is reflected in the large overweight in positive ratings because, well, many more companies look 'cheaply' priced, while indices are seen trading on elevated multiples.

The same underlying polarisation becomes obvious when we compare the performance of various indices for US equities at mid-year 2024.

Year-to-date, the S&P500 has gained 15.29% over the first six months, but the S&P SmallCap 600 index is down -0.72% for the period, while the S&P MidCap 400 index is up 6.17%. The Dow Jones Industrial Average only beat the small caps over the period, advancing only 3.79%.

The Nasdaq100 outperformed all with a total return of 16.98%. The equalweighted S&P500 has returned 5.08%.

In Australia, the dynamics have not been fundamentally different.

The ASX200 Accumulation Index year-to-date has returned 4.22%, of which half from dividends. The Small Ordinaries only returned 2.75% and the MidCap50, traditionally the best performing segment locally, sits in between with a return of 3.42%.

The Top50 companies on the New Zealand stock exchange have lost -0.45%. NZX Small Caps are down -16.74%.

Is ‘Value’ Ready To Catch Up?

I am sure we can debate for hours whether ‘bull market’ is the appropriate label for those numbers, but it’s not difficult to see why investors would be more inclined to seek ‘value’ among the laggards, given the large gaps in share price moves and also amidst widespread concern about too much exuberance in popular stocks.

The problem with such a simplistic, value-based approach is that economies are slowing, and cracks are appearing in household spending and small business segments, while central banks are not yet ready to provide stimulus and relief through lower interest rates.

What this means is share market laggards might look ‘cheap’ and ‘attractive’ for good reason, and that reason might be a deteriorating outlook, implying share prices are heading lower first, before they can start trending higher.

Last week, share prices in discretionary retailers Cettire ((CTT)) and Mozaic Brands ((MOZ)) faced downward pressure as management teams had to ‘confess’ things were not going according to plan. Concerns about sales momentum in the months ahead equally overshadowed the FY24 releases from Collins Foods ((CKF)) and from Metcash ((MTS)).

Companies including KMD Brands ((KMD)), Fletcher Building ((FBU)), Healius ((HLS)), Sims ((SGM)), Sonic Healthcare ((SHL)), and Star Entertainment ((SGR)) have proved the bad news doesn’t necessarily stop with one profit warning.

The Materials sector is down -11.69 year-to-date of which -6.49% happened in June.

I'd say, investors are all too aware that risks are rising. In the same vein, recent investor briefings and market updates from companies including Aristocrat Leisure ((ALL)), Insurance Australia Group ((IAG)), and Steadfast Group ((SDF)) certainly re-confirm not all companies are operating under a cloud of uncertainties.

A recent report by JP Morgan suggests local fund managers have been sharply reducing their exposure to the materials sector with JP Morgan analysis suggesting the third largest outflow on record occurred in May (most recent sector data available).

Local fundies remain heavily underweighted Australian banks, but they also have started yet again to embrace defensive supermarket operators Coles Group ((COL)) and Woolworths Group ((WOW)).

Earnings Risk Is Tangible, And Rising

In a market characterised by extreme polarisation, as are shares markets currently, the risk profiles for Winners and Laggards appear diametrically opposed. What should investors worry about most? Is it that certain share prices might have become too bloated or is it about the next profit warning waiting to be revealed?

Within this context, it's good to know the technology sector traditionally enjoys solid support from investors in July (not exactly clear as to why) with Pepperstone Head of Research, Chris Weston reporting the Nasdaq100 has posted gains in July 15 times out of the past 15 years.

It is also not difficult to make the argument that many of today's share market Winners are in excellent shape, and performing well operationally, maybe with the notable exception of Australian banks.

Witness, for example, the recent share market updates by the likes of Aristocrat Leisure, Xero ((XRO)), Gentrack Group ((GTK)), Webjet ((WEB)), Tuas ((TUA)), and TechnologyOne ((TNE)), to name but a few positive stand-outs.

Given many of today's Winners are carried by investor optimism on GenAi, with US markets in pole position, maybe the time to start worrying about share prices in Goodman Group ((GMG)), NextDC ((NXT)) and WiseTech Global ((WTC)) is when Nvidia et al experience a serious correction?

Meanwhile, owning shares in companies that are unable to meet expectations, either this month or in August, can be quite a deflating experience. Within this context, I note shares in Fletcher Building have now lost -46% over the past twelve months, of which -29% occurred in the past three.

Shares in Orora ((ORA)) are down respectively -36% and -27%, while for Eagers Automotive ((APE)) the corresponding numbers are -22% and -26%. Shares in Cettire last week more than halved in the immediate response to management's downgrade.

They have since rallied off the low point, but are still substantially below the share price pre-profit warning.

Macquarie's Warnings

Confession season in May and June suggests two sectors at higher risk are housing construction and discretionary spending related companies. Even though some analysts believe tax cuts and budget relief should benefit retailers.

Strategists at Macquarie recently advised their clientele it's probably best to remain more circumspect about cyclical housing related companies, in particular if they have significant exposure to New Zealand, as well as to those companies that need an above average pick-up in the second half to achieve their forecast for FY24.

Macquarie also suggested a third group of companies that is probably best avoided: stocks enjoying positive momentum without support from earnings growth. The strategists specifically mentioned Australian banks and Wesfarmers ((WES)).

Another category involves those companies suffering serious negative revisions to earnings forecasts. FNArena's **Australian Broker Call Report** offers daily updated insights, as does our weekly update on the matter, available every Monday morning: https://fnarena.com/index.php/2024/07/01/weekly-ratings-targets-forecast-changes-28-06-24/

This week's update reveals significant downgrades for Healius, City Chic Collective ((CCX)), KMD Brands, Baby Bunting ((BBN)), and Mirvac Group ((MGR)). I don't think any of these inclusions will come as a big surprise.

Macquarie points towards Sonic Healthcare, IDP Education ((IEL)), Domino's Pizza ((DMP)), Nufarm ((NUF)), Eagers Automotive, and Star Entertainment; all companies having suffered from analysts downgrades in recent weeks.

Regarding exposure to housing construction in New Zealand, Macquarie's research has identified Harvey Norman ((HVN)), oOh!media ((OML)), GWA Group ((GWA)) and ARB Corp ((ARB)) derive at least 10% of sales from across the Tasman sea, and there is a correlation with the housing market.

Companies that need a strong pick-up in H2 include Downer EDI ((DOW)), Ramsay Health Care ((RHC)), and Reliance Worldwide ((RWC)). Healius would have been Macquarie's number one company most at risk, but management duly delivered yet another profit warning last week.

Goodman Group, Macquarie strategists point out, continues to screen as a potential candidate to upgrade guidance. Bell Potter analysts would add the same upgrade risk remains alive for TechnologyOne.

Macquarie research also suggests FY25 prospects have been improving for a select number of companies, without share prices responding accordingly. Companies that fit in this category, according to Macquarie research, include ResMed ((RMD)), BlueScope Steel ((BSL)), and Block ((SQ2)) alongside small caps Coronado Global Resources ((CRN)), IPH Ltd ((IPH)), De Grey Mining ((DEG)), and Auckland International Airport ((AIA)).

Another category still at risk of suffering negative news remains the local REITs sector, specifically for Office assets. Analysts remain convinced the outlook for Office rents is not great. While growth might remain positive, its pace looks set for a much lower trend than has historically been enjoyed.

As the sector analysts from Morgan Stanley stated recently: “Given the lower income growth outlook, there are reasons to think that the cap rate spread should be higher than long-term average in the foreseeable future.” This is why Morgan Stanley is still not a fan of Dexus ((DXS)), Centuria Office REIT ((COF)), or Mirvac Group.

This is also the reason as to why some analysts are still hesitant to get too enthusiastic about a “cheaply priced” Charter Hall ((CHC)) in the short term.

As also pointed out by sector analysts at Barrenjoey recently, the tremendous drop in cap rates is still unwinding and Australia has been slower to reprice than the US and Europe.

As a result of this, independent valuations could take another 6-12 months to fully adjust, which means more negative adjustments to valuations need to be made.

Bottom line: cheaply priced assets might require a lot longer before narrowing the gap with the top performers in today’s share market, this in particular will prove the case if economies slump more deeply than expected and/or central bank rate cuts will be pushed out further into the future.

Rudi's View: All-Weather Portfolio in FY24; Growth Not Value

Jul 10 2024

By Rudi Filapek-Vandyck, Editor

We all experience the share market through our own portfolio, which might explain why so many voices remain downbeat, if not straightforward negative about the local market and its prospects.

In contrast to general sentiment, the ASX200 just clocked off its second successive double-digit financial year return, coming in at 11.78%. One year ago, FY23 returned 14.80%.

Total return over the past ten years has averaged no more than 8.06%, and that number includes the past two years, so the absence of the sound of champagne corks popping seems a bit odd. But share prices have been more volatile than many can bear during the best of times.

Above all: the bifurcation underneath the headline performance remains extreme, with many more stocks not performing and a select group of popular names generating all the rewards. Investing in the share market is seldom a walk in the park. Whenever it is, the sunny conditions don't last for long.

Outside of the Winners circles, Australian equities have been overwhelmingly frustrating, deflating, gut-wrenching, and, at times, de-moralising. Unless one's portfolio owned plenty of supercharged Winners. But even then, the optics remain important and Australia looks bleak against the outsized gains yet again achieved in the US.

The Nasdaq100 index, as its website proudly shows, has returned 55% over twelve months, 177% over five years, and 419.34% over ten years (all data as of 4 July 2024).

We need not look any further as to why general sentiment is far from ebullient among local investors. But as said, total return has been above average for the second year in a row, and the all-important banks have been among the strong outperformers.

The **FNArena-Vested Equities All-Weather Model Portfolio** does not invest in popular banks or resources companies, but instead attempts to identify local companies of higher quality, with robust growth prospects, underpinned by continuous re-investments and a leading market position.

This focus has served the Portfolio well. Total return pre-fees for FY24 has been 18.28%. Last year, total return slightly underperformed on 12.71%. The year prior, in FY22, the

Portfolio kept the damage limited to -2.59% for an average three-year return of 10.43% p.a. against the ASX200 Accumulation index's 6.27%.

Period Ending 30/06/2024							
Name	Code	Type	1 mth	3 mths	6 mths	1 year	3 years
All Weather Portfolio	M00701	Capital	3.10%	1.85%	10.15%	16.32%	8.80%
All Weather Portfolio	M00701	Income	0.13%	0.34%	0.94%	1.96%	1.63%
All Weather Portfolio	M00701	TR	3.23%	2.19%	11.09%	18.28%	10.43%
S&P/ASX Blended Equity and Bond - Conservative Index - Primary	CONSERVINDX	TR	0.92%	-1.04%	1.26%	6.12%	0.09%
S&P/ASX 200 Accumulation Index - Secondary	XJO	TR	1.01%	-1.04%	4.18%	11.78%	6.27%
S&P/ASX Bank Bill Index - RiskFreeRateIndex	SPBDABBT	TR	0.34%	1.08%	2.17%	4.37%	-3.02%

Many Lessons To Be Learnt

What usually happens is I start now highlighting the Big Winners that have contributed to the sizeable Portfolio outperformance, but maybe it's equally important to acknowledge not all Portfolio constituents have been a Winner over the past three years.

As per always, disappointments do occur and the biggest disappointment for the All-Weather Portfolio has been education services provider IDP Education ((IEL)).

When asked in late 2022 about my favourite stock for the year ahead, I had little hesitation to nominate IDP Education. The company is a global market leader in its field and benefiting from the desire of parents in emerging countries such as China and India to send their offspring to universities in the UK, Canada and Australia.

Competitiveness has increased in the sector, but what really changed sector dynamics is a deliberate push back against student immigration by governments in those destination countries. Instead of reaching for new highs, the share price has more than halved over the past 17 months.

Observation number one: this has not prevented the Portfolio overall to put in a market-beating performance. Other inclusions like CSL ((CSL)) and ResMed ((RMD)) have equally not kept up with the index in recent years, but none of this means the Portfolio cannot still (out)perform.

Harry Hindsight is a wise man, of course, and always knows best after the facts. Admittedly, if I'd known with 100% certainty these share prices were heading for much lower price levels I would not have hesitated to sell and get back on board near ground zero, but investing is seldom that straightforward, just ask the many shareholders in large swathes of micro- and small-caps and in lagging value stocks today.

To my own credit, while I might have held on for too long to a share price that was ultimately only going lower, and lower yet again, I did acknowledge the increasing risks involved and therefore kept overall exposure small. An important part of risk management is making sure one IDP Education disappointment does not destroy the Portfolio performance entirely.

I've read and heard too many stories throughout the years past of investors doubling down on share prices that only kept falling further, upgrading one unfortunate slip-up into a major disaster. Doubling down, in my book, is only for traders with high risk appetite.

Running an investment Portfolio of, say, twenty stocks means there are always Winners and Laggards, in the moment. But one can have a broad assessment of where available cash is best allocated. Simply adding more to a share price that has fallen might seem instinctively the most logical decision to make, in practice it seldom is.

It is much better practice to try to assess what the risks are, and be cognisant that risk changes regularly. After shares in Woolworths Group ((WOW)) weakened from $40 to below $31, the Portfolio did purchase more exposure, but the consideration was not to get the average purchase price down, but to jump in at a great entry point on a longer term view.

The experience with IDP Education also shows it's dangerous to rely on 'value' when a company operates under tough market dynamics. In this particular case, new pressure points kept popping up, putting additional pressure on forecasts and on apparent 'valuation'. With the shares trading near $14, there are no fans left and all former friends have left for greener pastures elsewhere.

IDP Education shares remain the second most shorted on the ASX.

The Portfolio hasn't sold and will continue to re-assess. What matters right now is not at what price we bought the shares; that is 100% irrelevant. What matters now is whether better times are around the corner, creating the platform for a renewed trend upwards. If this proves the case, the Portfolio might buy more shares. There is no hurry and plenty of other stocks deserve our attention too.

As investors, we are always influenced by daily share price moves, whether we want it or not. The Big Challenge is to keep our focus firmly on the underlying company fundamentals and accept that sometimes shares do not reflect what is happening inside the business, and sometimes our judgment is wrong.

The All-Weather Model Portfolio has stuck with ResMed shares on the ongoing belief GLP-1s did increase long term risks, but shorter term volatility is mostly related to market sentiment (and traders creating mayhem). CSL is the largest holding as we firmly don't believe share price action post-2020 is reflective of what the future holds for Australia's largest and most successful biotech.

Time To Sell The Winners?

The Portfolio is an extension of my personal research into All-Weather Performers, which, apart from the highest quality names on the ASX, also involves identifying those emerging growth companies that enjoy structural benefits with higher quality than the majority of peers.

A quick glance over the selections made in years past quickly reveals most of these stocks have been on the beneficial side of share market momentum. ARB Corp ((ARB)) shares are up 33% since June 2022. Total appreciation for Cochlear ((COH)) shares is 67%. Carsales has done 92%. Pro Medicus ((PME)) is displaying a whopping 239%.

Note: the All-Weather Model Portfolio does not own all stocks in my selections, but this is its main focus.

Ai-related beneficiaries in particular have been in focus throughout the year past. Shares in Goodman Group ((GMG)) have rallied 37% in the past six months. They are up 72% over twelve months, and 95% since mid-2022. For NextDC ((NXT)) the corresponding numbers are 28% to date in 2024, 41% and 66%.

I could go on and on, but the numbers speak for themselves. The contrast with the likes of BHP Group ((BHP)), Aurizon Holdings ((AZJ)), Elders ((ELD)), Lendlease ((LLC)), Metcash ((MTS)) et al is very stark. And these are by far not the worst performers.

The first dilemma that pops up after such a sharp polarised outperformance is whether it is time to sell the Winners and re-allocate into the share market Laggards? Yet again, what seems but logical instinctively may not be so straightforward at all.

For starters, many of today's outperformers are carried by ongoing strong growth prospects. Think, for example, Goodman Group and NextDC in relationship to an explosion in global demand for data storage and data centres. While market crowding and short-term multiples might suggest the risk is for a sharp pull back in share prices at some point, medium to longer term those share prices should have a lot more upside.

Maybe the best comparison to make is with property prices in the major cities throughout Australia. Ten years ago, properties looked over-priced changing hands for, say, $2m. Ten years earlier, they'd only cost $800,000. Today, you cannot buy a decent house unless you're willing to fork out $4.5m, and beyond.

Properties are by no means the equivalent of listed equities, but the underlying dilemma is the same: selling at $2m because you made a big gain from your $800k purchase doesn't seem very smart when judging from today. In similar vein, shares in Pro Medicus looked over-priced at $50 in 2021, and yet again at $85 in 2023. Today they are trading above $130 and yes, there have been plenty of pullbacks along that trajectory.

While the general expectation is that share market momentum should broaden to those parts that as yet have not participated in the market upswing, weaker economic momentum both locally and overseas means the risk for profit warnings and operational disappointment remains high, and that risk applies more to cyclical, lower quality businesses, aka today's share market Laggards, than it does to the Winners.

<u>What Could Go Wrong?</u>

If central banks are forced to wait for longer before starting to reduce interest rates, as has probably already happened for the RBA locally, this could well prove another delaying factor in the broadening of the share market momentum.

If economies weaken a lot before interest rate cuts are starting to stimulate growth, this would add yet another negative for most of today's share market laggards.

Equally important: I remain of the view that during times of spectacular new growth avenues, as the world is experiencing in the current decade through GenAi, GLP-1s and multiple other megatrends, quality and sustainable growth companies can certainly fall out of fashion, but they don't stay in the doldrums for long.

In recent years, we've all witnessed the pendulum swinging away in 2021, only to roar back from the moment bond markets stopped rallying. The second half of 2018 and of 2016 were equally times when the pendulum swung from Winners (Growth/Quality) to Laggards (Cyclicals/cheaper Value), but it never lasts for more than a number of months.

Sure, it's an excruciating process when in the midst of it, but every time has been nothing but a temporary nuisance as far as the macro trend is concerned – and, need we all be reminded, simply an ideal entry point for the next upswing.

So, when I get asked: the share price has run a lot, should I sell? I advise investors to take all of the above into account. Don't underestimate the psychological barrier that opens up once you've sold all your shares in, say, that high quality growth company that is ready to double in size over the years ahead.

If the share price doesn't fall as much as you expect, and the rally starts without you being back on board, you're now at risk of blaming yourself for appearing smart for five seconds, and missing out on the next grand opportunity.

I know what I am talking about. This is how and why the All-Weather Portfolio no longer includes Pro Medicus, while it had to wait until September last year to get back on board Hub24 ((HUB)), REA Group ((REA)) and WiseTech Global ((WTC)).

Sometimes the best course of action is simply staying the course, and maybe only make adjustments at the margin.

Unless we identify a significant change in market dynamics, that's exactly what we intend to do with the All-Weather Portfolio.

Rudi's View: How To Invest Allan's $300k

Jul 24 2024

By Rudi Filapek-Vandyck, Editor

How To Invest Allan's $300k

Last week, one of FNArena's many loyal subscribers, let's call him Allan, sent in the following question: (I am paraphrasing) *Rudi, I've sold a commercial property. Now have $300k in the bank. I want to invest, but can you provide me with some inspiration?*

We all know where Allan's reticence stems from. The ASX200 is weakening, but has been on a tear lately, setting a fresh all-time record high less than one week ago.

Lot's of talk around of 'bubbles' and inflated share prices, as well as about The Great Rotation into share market laggards that haven't had much momentum over the past 18 months or so.

First Things First

I can see a lot of similarity with late 2014-early 2015 when shares rallied hard, in particular those that offered yield at that time. There we were, starting up the FNArena-Vested Equities All-Weather Model Portfolio, having 100% cash ready to invest, and already battling with our very first Grand Dilemma.

It is from this experience I can share my first piece of advice: do not put any pressure on yourself. If you do, you will make mistakes and the one thing you should aim for is to not force yourself into anything you might come to regret later on. I know this is not easy, but try to dislocate from what happens in the share market right now.

Irrespective of that money sitting idle in the bank, you should be in no hurry, no hurry at all. Give yourself six months (I am not kidding), longer if circumstances require so, and be the patient decision-maker with a longer term horizon. You'll thank yourself for it whenever you are able to reflect back.

Back in 2015, that strong rally came unstuck after less than six months. By July banks and cyclicals were in a fierce draw-down that would last until February the following year, and then still required another seven months to grab market leadership from what by then had become known as the Expensive Defensives.

I am not suggesting the playbook for 2024 looks similar, but things can change in a matter of weeks, or even days. Share markets, at least at face value, have performed above expectations for the first seven months of 2024. The Great Rotation is, at this point, not more than a fictional scenario for which the necessary building blocks are not in place.

Advice number one: take a cold shower if necessary. Block those eternal bulls on X (formerly Twitter). Convince yourself you are about to take the first steps in a journey that will involve thousands more steps. Do not hurry!

I am genuinely looking forward to sharing this exercise with Allan and all readers of Weekly Insights, but first I must share the basics that underpin my own research and investment approach, to make sure everybody understands the How and Why of my considerations and choices.

Quality Above Value

There will always be room for disagreement and different personal preferences, of course, but sharing my observations and conclusions first might lead to a better understanding when we arrive at my various ideas and choices.

First up; while just about everyone is constantly focused on figuring out where the next 'cheaply priced' opportunity is hiding, my personal observation is, over a longer-term horizon, **corporate quality is much more important.**

In simple terms: your typical value investor will always tell us to find an asset that is worth $1 and buy it when it is on sale for 30c (or something similar).

The problem I find with that type of investing, is most of the time the value won't grow beyond $1, not even if we let time do its work. Thus while the upside seems pretty straightforward, once achieved it is time to move on, and that's assuming the market will ever push that share price to its full value.

This becomes even more questionable in case of low quality business models, in particular when heavily reliant on the economic cycle. Low quality businesses tend to generate more disappointing newsflow, which might well push out the recovery further, or lead to a much lower share price first.

Bye Bye Alumina

One ASX-listed company that is heavily dependent on the commodities cycle is Alumina Ltd ((AWC)).

Alumina is one of the longest listed companies on the local bourse, and it is about to disappear with partner Alcoa Inc acquiring the business in full shortly.

This provides me with one last chance to illustrate what the price history of Alumina shares looks like (before it disappears from all price systems' memory).

The price chart below depicts the annual share prices for Alumina Ltd going back to the early 1980s. It can be argued, because these are annual prices, a lot of the in-between noise is absent and what is left is the long-term trend in its roughest format.

Let's be brutally honest about this: apart from temporary rallies, there's no uptrend. Investing in Alumina shares has been all about picking bottoms and getting out before the next downturn announces itself.

The Grand Super-Cycle -Higher-for-longer, remember?- was a great time for shareholders, but the shares never recovered from the subsequent fall from grace.

To show the difference, I am not even countering that observation with one of my personal favourites. I've simply applied the same annual price dynamic to CommBank ((CBA)) shares since the early 1990s when it listed on the ASX.

I think we can all agree the trend on display looks fundamentally different. The banks in Australia are not without their own pitfalls, and the valuation of CommBank in particular is a constant trigger for debate, but at the very least everyone can see that buy and hold for CBA shareholders has worked really well over the past thirty years.

Plenty Of Examples

Lower quality versus higher quality is not by default a pitch of cyclicals versus others. I have long made similar observations between Domain Australia Holdings ((DHG)) and REA Group ((REA)) and between ANZ Bank ((ANZ)), National Australia Bank ((NAB)) and Westpac ((WBC)) versus the aforementioned CommBank.

If the past two decades have shown us one thing it is that a cheaply priced, lower-quality stock can certainly outperform in the here and now, but it is unlikely to do so over a longer period of time.

This also applies when a sector goes through a severe downturn. Just look at the differences in set-backs for Sonic Healthcare ((SHL)) and Healius ((HLS)). While shareholders in Sonic haven't had much to crow about post-2021, they would never swap places with those holding shares in Healius.

There has been an equally obvious proposition among upcoming disruptors in the local financial platforms industry. Previously, this was the territory of large, established financial entities, but the past two decades have seen smaller-sized disruptors emerging to steal clients and market share.

In particular the past ten years have seen this process accelerate and all and sundry are now talking about a trend that is likely to last for a lot longer. Again, investors who saw this process unfold and jumped on board have done exceptionally well… as long as they did not fall for the 'cheaper priced is better' fallacy.

When Vested and FNArena decided to launch the All-Weather Model Portfolio we chose one of the smaller platforms to align us with; Praemium ((PPS)). This gave me first-hand experience into a small business that clearly could not cope with the growth it was exposed to.

It was mayhem and chaos at times, not helped by the fact staff turnover was extremely high in those days. The All-Weather Portfolio no longer runs on Praemium. I assume their service is much better these days, but even without my personal experience, I never felt Praemium is even close to the quality and solidity offered by Netwealth Group ((NWL)) and Hub24 ((HUB)).

It is difficult to argue with that when comparing key financial metrics for all three operators. Simply look at the steady increases achieved by Netwealth in terms of revenues, EPS, and dividends (all available through Stock Analysis on the website) or the -literally- growth explosion for Hub24 in recent years. And these are businesses of

$5.5bn and $3.7bn in market caps, respectively, offering many more years of fast growth.

In the opposite corner we find the likes of Insignia Financial ((IFL)), that on Monday surprised through faster and more rigorous cost cutting, but which has been on the receiving side in this industry for many years now. And there's Praemium, of much smaller size, but nowhere near the market grabbing forces as represented by Netwealth and Hub24.

In contrast, Praemium's key financial metrics are all over the shop with a zig-zagging net profit margin the obvious stand-out. What Praemium does offer is a 'cheap' valuation and this might, one day, lead to that rally that outperforms its better-positioned peers. Because it looks 'cheap' it might also more likely attract a suitor.

Fact remains, on a longer term price chart Praemium shares look more like the heart beat of a terminally ill patient, with the occasional big spike, but otherwise a flat pattern. Investment returns are 100% correlated with picking the bottoms and knowing when to jump ship.

Strictly taken, there's nothing wrong with picking bottoms in cheaply priced stocks and then ride the next rally, whenever it arrives. Whoever managed to get in at the low in early 2020 is still up more than 100% today. In practice, though, investors might find it easier to own higher quality alternatives for which more time owned usually results in more returns accumulated.

Over the past two years, Hub24 shares have rallied 129% and Netwealth shares 82%. Over the past financial year both shares are up respectively 82.9% and 60.2%. After such strong gains, it seems but logical a period of consolidation must follow. There might even be a pullback at some stage.

This might give Praemium and Insignia the chance to finally shine in comparison. The longer horizon in mind, however, I stick with the proven quality, because stronger growth from a better quality company is what wins the marathon, time and again.

August Is Beckoning

Another thing to keep in mind is quality growth in time only accumulates more and more value for shareholders, unlike the Alumina Ltds, the Praemiums and the Insignias mentioned previously.

Within this context I can still vividly remember the mental barrier I had to overcome to add Xero ((XRO)) shares to the All-Weather Portfolio. From memory, I bought the shares below $30. They're around $135 today and have been as high as $150. In similar fashion, Wesfarmers ((WES)) shares looked 'expensive' above $30, and definitely when they crossed $40. Today, these shares are trading above $70.

I am by no means suggesting these shares cannot fall, or they can never be too expensively priced, but it's great comfort for the mind to understand these share prices can go a lot higher, in time. It places any short-term anxiety duly in perspective. NextDC ((NXT)) shares are likely *en route* to $30 and beyond. CSL ((CSL)) shares are laying the ground works for $400-$500. Others have already done the calculations, as reported previously.

(Xero shares are no longer held in the All-Weather Portfolio, but this might be a temporary absence as the shares most definitely remain on the radar).

Equally important is to understand that, as analysts are in the process of updating their projections and assumptions, in preparation of the August reporting season, in most cases this translates into additional valuation upside (as this is how continued growth accumulates into added valuation when put through modeling).

Within this context, I note UBS, Citi and Morgans all increased their price target for Car Group ((CAR)) recently. Hub24's targets were raised by Citi, Morgans and Ord Minnett. There will be a lot more of that happening once the August results are out (assuming no disasters).

With all these things in mind, the next step is to actually put together a hit list of stocks you can buy at current prices, and another selection of stocks you might want to add at cheaper levels in the months ahead.

Rudi's View: How To Invest Allan's $300k, Part 2

Jul 25 2024

By Rudi Filapek-Vandyck, Editor

Dear Allan,

if one is an investor in Quality and Growth, as am I, there is always the danger of a brutal swing in market momentum to the other side where our portfolio has no exposure. The key reason for this happening is usually related to market positioning.

Lots of investors like to 'hide' in the Winners, while plenty of others like to curse the Winners and hide in the Laggards instead. Sometimes the Winners have been on a winning streak for too long and momentum reversal becomes the easiest way forward.

There have been multiple of such attempts over the past ten years or so, and when you're in the midst of it happening it's incredibly frustrating, but it's always good to keep in mind these momentum switches have tended to be temporary phenomenons only. The longest duration I can remember was about four months, late in 2016.

Most investors don't think in the same way as I do, but my view remains that, given the multiple strong megatrends at work in the current era, Growth and Quality are never going to remain out of favour for long. The post-GFC era thus far is proving exactly that.

Now that I've explained the basic pillars underneath my personal views and investment approach, let's take a closer look into what I would do if I were in your position.

Healthcare & All-Weathers

The covid pandemic has thrown the healthcare sector into a multi-year bear market. Who would've thunk it? This is not an Australian phenomenon, it applies all around the globe, with a select group of exceptions like GLP-1 innovators Novo Nordisk and Eli Lilly.

Given the quality of companies in this sector, and ongoing robust growth profiles, this is not a sustainable set-back for this industry and recent price movements suggest the **Quality Growth companies in the healthcare sector** are coming back to life. This is extremely exciting, if you're a similar enthusiast as I am for this type of companies.

My five cents worth is the Quality in healthcare will start performing first, and the rest might catch up at a delay. A lot will depend on corporate margins and profits, but it's more than feasible, I think, the August reporting season locally might mark the turnaround for the likes of Cochlear ((COH)), CSL ((CSL)) and ResMed ((RMD)).

There's a good argument to be made those share prices are performing already with CSL shares back at $310 and ResMed's above $31. I'd definitely be looking to get on board this new uptrend (if I weren't already). They all have pros and cons and ResMed's threat from GLP-1s is probably the most obvious (I understand not everyone is comfortable with it).

If you're the type that can only find comfort in buying into stocks that haven't performed as yet, I'd suggest taking a look at Sonic Healthcare ((SHL)) and/or Ebos Group ((EBO)). Shares in Fisher & Paykel Healthcare ((FPH)) have rallied hard already and it's everyone's guess when Pro Medicus ((PME)) runs out of puff, so I'd keep both on my Wish List, for now.

On the more speculative side of the sector, assuming you have the stomach and the patience for it, Telix Pharmaceuticals ((TLX)) seems destined for wonderful things, and so does PolyNovo ((PNV)).

I am absolutely no fan of Ramsay Health Care ((RHC)) or Healius ((HLS)), no matter how cheap those share prices become. You'd know by now, I don't engage in bottom-of-the-barrel fishing.

One extra thing you might take on board: when investing in a new exposure, you don't have to move in with a full allocation immediately. Nobody likes to start off with a negative feeling, which is what happens when a share price weakens after we bought in. The alternative is to cut your average allocation into halves, thirds or even quarters.

If you start off with a small allocation, you're on board, so step one is in the bag. If the share price does weaken, you have plenty of allocation left to improve on the situation. If the share price runs away from you, you're already making a profit.

My research into All-Weather Stocks is not limited to the healthcare sector, of course, and I'd be giving the full list some serious consideration. Very bullish sentiment is once again building for Macquarie Group ((MQG)), for example.

The one caution I have relates to Seek ((SEK)), for which the end of negative newsflow may not yet be in sight. This probably also explains why the share price is hovering above $20.

Gen.Ai & Megatrends

Modern day Megatrends have more than proved their wealth creation capabilities, and no Megatrend is currently as dominant as is Gen.Ai. I sincerely think every serious investor has no choice but to get on board. The most obvious phase one beneficiaries on the ASX, Goodman Group ((GMG)) and NextDC ((NXT)), have -understandably- run extremely hard, but there should be a lot more upside in the years to follow.

How and when you get on board, assuming you currently are not, is more of a personal choice. Do you wait for the pullback that eventually will happen, or do you take a small bite and observe further developments?

Other beneficiaries include Macquarie Technology ((MAQ)), Infratil ((IFT)), Global Data Centre Group ((GDC)) and Southern Cross Electrical Engineering ((SXE)). There will be many others as this process will migrate into phase two, and three, etc.

Download FNArena's Special Report on **Investing in Gen.Ai, the Fourth Industrial Revolution** and make sure this exciting new development holds no obvious secrets from you. Make sure you keep reading and following what comes next.

My five cents worth is those who sell the new revolution to small businesses and consumers will be outed as the next obvious beneficiaries in the not too distant future. Think JB Hi-Fi ((JBH)), but also Wesfarmers ((WES)), Dicker Data ((DDR)) and Data#3 ((DTL)).

The aforementioned healthcare sector looks like an obvious beneficiary from Ai, but it'll be a number of years still before any material benefits show up on bottom lines. Unless things move quicker than anticipated, of course.

Equally important: there will be hiccups. This is a long-term phenomenon. Better to treat it as such.

Small Caps

Small caps do not by definition offer higher returns. *Some* small caps do, but it's a lot harder to identify those than one is made to believe. I don't specifically focus on small caps, because I like to identify sustainable growers and All-Weathers and part of that assessment includes a successful track record.

Unless you're looking for a quick pounce-and-run type of investment style, I like to focus on smaller capitalised companies that come with a lot of promise under the belt and a proven track record. Names that come to mind include Breville Group ((BRG)), Steadfast Group ((SDF)) and PWR Holdings ((PWH)).

Again, share prices in strong performers have already outperformed this year, but there's no question there's a lot more growth on the horizon for the likes of Life360 ((360)), Hub24 ((HUB)) and Netwealth Group ((NWL)).

Among this year's laggards I still very much like Audinate Group ((AD8)), while I also continue to believe IDP Education ((IEL)) will come good.

A Punt For The Punters

If you are a true Australian, you obviously like to include the occasional higher-risk punt. After all, pulling it off successfully is what makes investing fun, no matter what the left hand side of the brain tells us!

However, if you're the kind of person that feels the adrenaline pumping before you jump off that bridge or off the roof of a 14 floors tower, you're way, way, way out of my league.

One wild water rafting trip on a sunny day is more than sufficient for my little heart. I seem to have a natural dislike of losing money for frivolous reasons, including inside a casino.

Hence, for more risky positioning with potentially much higher rewards, my attention would go out to smaller cap resources, with each of gold, uranium and lithium to be put under the microscope. The FNArena-Vested Equities All-Weather Model Portfolio prefers to have exposure to gold, not to gold producers, and that has worked out well over the years past.

But a time will come when those lagging producers will outperform in significant fashion.

Uranium is back in a multi-year uptrend. You're not noticing it thus far in 2024 because the price of uranium is deflating somewhat after that strong rally from last year. But this will reverse in due course, plus companies like Paladin Energy ((PDN)) and Boss Energy ((BOE)) will soon ramp up the volumes (fingers crossed they do not encounter too many operational challenges).

The really big rewards will come when lithium reverts back to its prior uptrend. Admittedly, that might still take a while as the industry is moving through a period of too much optimism with too much production available while demand is no longer growing.

In all three cases, I'd recommend you try to identify the higher quality exposures with less risk of painful failures. FNArena's Stock Analysis might be the ideal starting point.

Equally important: in all three cases I'd highly recommend smaller proportions in allocations.

One important consideration to make is whether putting all of the $300k in the share market is the best strategy long term. Diversification outside of equities is probably worthwhile exploring, including credit (corporate bonds), government bonds, unlisted alternatives and even real assets. (You can add cryptos to that as well).

ETFs are a viable option as well, including for foreign equities, but never forget rule number one: do your homework first! ETFs can also be used for a lower-risk exposure to the three commodities mentioned.

A man has to know his limits and for those alternatives I suggest you best seek advice elsewhere. I nevertheless enjoyed this little exercise, and I hope you get lots and lots of "inspiration" out of it.

Rudi's View: Plenty Of Traps In Equity Valuations

Sep 18 2024

By Rudi Filapek-Vandyck, Editor

Financial markets operate in a constant flux because of changes in geopolitics, monetary policy, societal progression and technological innovation. As investors, it's probably best we keep a watchful eye out for any lasting changes, lest we be guided by the past rather than the future.

One of such changes that has not yet received enough attention is the fact the local share market has become noticeably more 'expensive' throughout the post-GFC years.

As was highlighted in a report by Morgan Stanley last week, the long-term average PE ratio for the ASX200 is now 14.7x, which is higher than the 14.4x that once served as the multi-decade average stretching back to the early nineties, but the average for the past decade sits at 15.9x.

That increase of almost 1.5x has happened without mining and energy being sustainably upgraded, which tells us a lot about a share market wherein these sectors represent some 30% of the index.

The observed increase in the average market multiple is partially attributable to changes in the composition and weightings of the index itself. CSL ((CSL)), which constantly trades on above-average multiples, is now the third largest constituent, while the likes of WiseTech Global ((WTC)), Block ((SQ2)), Pro Medicus ((PME)), Hub24 ((HUB)), REA Group ((REA)) and Car Group ((CAR)) have gradually climbed up the local ranks.

But it's not just that. The number two in the index today, CommBank ((CBA)), is trading on 24x times FY25 earnings per share, which is quite unprecedented for such a large bank on, equally important, rather small forecast increases in EPS and DPS for the two years ahead.

The latter is illustrated by the fact the PE multiple for CommBank is only falling to 23.3x on FY26 forecasts, with the forward-looking dividend yield only increasing to 3.4% from 3.3% in FY25, ex-franking.

The average PE multiple for the ASX100 in 2024 has blown out to 17.3x, making some investors nervous and triggering the conclusion from Morgan Stanley that local share prices have disconnected from underlying earnings growth.

Outside of the 1990s dot com boom and the covid-impact four years ago, the local market usually doesn't trade on such an elevated multiple. But then neither do CBA shares and, given CBA is the local number two, it's difficult to argue there's not a close correlation between the two.

Trading above $142 on Monday, CBA shares are displaying a 30% premium vis a vis the consensus price target as calculated from six leading stockbrokers monitored daily by FNArena. That's a pretty big number by anyone's standards.

Banks, including CBA, were among the positive surprises throughout the August results season locally, but any 'beats' delivered look rather small when compared with the numbers mentioned. Both National Australia Bank ((NAB)) and Westpac ((WBC)) shares are nowadays enjoying a multiple of around 17x, which previously had been the ceiling for premium CBA.

ANZ Bank ((ANZ)) is today's sector laggard trading on 14.2x times FY26 forecast EPS, which is lower than this year's estimate, which also explains the lower premium priced-in. The fact ANZ's risk profile includes more exposure to falling interest rates in Asia and to a significantly weaker economy in New Zealand doesn't by default imply the shares are of better 'value' than its peers.

Following what seems to have been a one-off 20% lift in dividend payout in FY23, ANZ's dividend is forecast to slide yet again, and stabilise in FY25 rather than rise. Already, ANZ Bank's dividends are no longer 100% franked.

The numbers cited will keep the public debate alive whether Australian banks are appropriately priced or egregiously expensive, and about the outlook for the share market generally.

All of this also highlights the dangers of relying on generalised PE ratios alone to make investment decisions and assess whether the stock market is too expensive or attractive.

When it comes to individual companies, those widely used PE multiples can be just as tricky, if only because it's so easy to make mistakes. Time to zoom in on the most commonly made errors, and why they are faulty.

Backward-looking reference points

Backward-looking data and multiples can have a function, within the right context and predominantly for share markets, as markets don't tend to grow as fast as individual companies.

But anyone trying to find an entry point on reasonable looking multiples for a fast growing Nvidia in the US, or Goodman Group ((GMG)), Hub24 ((HUB)) or WiseTech Global ((WTC)) closer to home, would have found it impossible on the basis of data and multiples from the past.

I cannot think of any better example as to why investors need to keep focusing on what likely lays ahead. Markets are constantly forward-looking, even if they are imperfect, as are those analysts' assumptions and projections that guide share prices (most of times).

Forecasts and multiples are not a static indicator

Probably the most often made mistake is to treat today's multiples as if they are set in stone. On-the-ground conditions are dynamic, which means things can change, in either direction, and turn today's set-up into a false or misleading proposition.

One such positive example is provided by Goodman Group, for whom consensus forecasts have steadily grown since the release of FY23 financials twelve months ago. Anyone who sold out because the multiple might have looked unattractive at that time has missed out on one of the most profitable opportunities the local bourse has offered over that period.

Goodman Group shares have appreciated from circa $20 in September 2023 to circa $36 today.

One prominently negative experience has been provided by Platinum Asset Management ((PTM)) for whom key financial metrics have continued to decline over the years past. This has reshaped this often 'cheap' looking proposition into a nasty value trap which will only turn around successfully if those key financials can be sustainably reversed onto a positive trajectory.

Shares in the local fund manager were trading around $5 only 3.5 years ago, they are below $1 in 2024. Analysts are yet to be convinced FY26 won't be another down-year.

(Addendum: it has since emerged that Regal Partners ((RPL)) is interested in acquiring Platinum Asset Management).

Look for broader context

Every indicator needs context, and when it comes to assessing the valuation of an individual company it often pays off to look beyond the one year ahead to avoid being hoodwinked by one-off impacts.

Insignia Financial ((IFL)), for example, has had a terrible few years that saw this financial services provider report a huge loss for FY24. For the current financial year its EPS is projected to improve by nearly 200%, but that tells us more about how bad the past has been. Current consensus forecast for FY26 sees EPS growing by no more than 2.1%.

That latter number explains why the PE ratio sits no higher than 7x. Having been hit by disappointment too often, the market has grown ultra-sceptical about when management will/can successfully guide this troubled ship onto a more prosperous course once again.

On the other side of the ledger, once the market sees a robust multi-year growth story, shares in those companies will no longer look 'cheap' ever again, unless that trajectory loses visibility or comes unstuck. This principle applies to today's data centre beneficiaries, including NextDC ((NXT)) and Macquarie Technology Group ((MAQ)), but equally so for companies including REA Group, WiseTech Global, Pro Medicus, and others.

While such sustainable growth stories have continuously traded on multiples well above the market average, shareholder returns have equally been well-above average. Within this context, the better strategy might be to use additional tools such as consensus price targets as calculated by FNArena.

Shares in REA Group, for example, are currently trading on 47.5x times the FY25 forecast EPS and 40.2x times the FY26 forecast EPS –well above the earlier highlighted market averages– but most analysts' price targets are suggesting double-digit percentage upside for the share price .

No one-size fits all

The example of REA Group also highlights one extremely important feature of the share market; different valuation dynamics apply for different sectors and even for different companies inside the same sector. Simply applying Peter Lynch's rule of thumb as published in the 1990s seems but ill-informed in today's context.

As almost perfectly illustrated by the local banking sector over the past two decades, some companies enjoy a premium valuation, often linked to classifications of quality and market leadership, and avoiding them out of fear they might lose their premium appreciation often means missing out on the better opportunities.

CommBank shares have steadfastily traded on a premium versus the rest of the sector, and they have by far generated the superior return for shareholders. A common saying among investors is that sometimes a stock is 'cheap' for good reason. The experience for CommBank shareholders is that sometimes a stock looks 'expensive' for very good reason, and that reason is linked to operational superiority and outsized returns.

Of course, once a company enjoys exceptionally quality status and a premium valuation, it needs to maintain that status or else lose the premium, with negative consequences. One good example is private hospitals operator Ramsay Health Care ((RHC)), widely revered until 2016, but traveling through struggle street since.

The result is Ramsay's share price today is lower than where it was ten years ago. The privilege needs to be earned time and again.

Equally important: PE ratios work the other way around for highly cyclical commodity stocks, i.e. BHP Group ((BHP)) shares trading on 80x times the forecast FY16 EPS in February of 2016 did not indicate the shares were 'expensive' as the signal might have suggested for a bank or a supermarket operator, but it indicated those shares were dirt cheap.

As many might remember, BHP shares sank briefly below $13 in those days. They have since revisited the $50 level.

That BHP experience also highlights a common mistake that is all too often made: a share price that is sold down post major negative development does not by definition trade on a reduced PE multiple. More often than not, the multiple will rise as investors anticipate a recovery on the horizon.

It is only when investors give up on such prospect that a weak share price combines with a low PE multiple, but this is one big red flag for investors, not a screeming buy signal.

Returning to the cyclicals, shares in BlueScope Steel ((BSL)) trading on no more than 3x times forward-looking EPS back in mid-2021 did not signal a 'cheap' and attractive proposition at hand. The shares subsequently weakened from $25 to $15 and as forecasts were cut too, the PE multiple doubled to 6x.

Today, BlueScope Steel's multiple is 15.5x and consensus price targets are suggesting double-digit percentage upside is possible.

Also important: PE ratios simply do not apply to large segments of the share market, including stocks that trade in close relationship with bond markets, also referred to as bond proxies. Exceptions include APA Group ((APA)) and Transurban ((TCL)), as well as just about every listed A-REIT.

There's a fair argument to be made that a company like Telstra ((TLS)) also should not be judged on its PE multiple. Similar as with APA and the REITs, it's all about yield, dividend sustainability, and relative attraction vis a vis the credit and bond markets.

One fairly modern methodology to value technology companies is the Rule of 40 which dictates revenue growth plus EBITDA margin need to sum up to 40 or higher. This method too, including its multiple variants, doesn't always compare well with the old fashioned PE multiple.

For those reasons, I tend to also pay attention to consensus price targets, interpreted in an intelligent manner, as well as trends in forecasts and the broader macro picture. The latter two factors have the ability to impact heavily on the outlook and the financial metrics of companies.

Underlying lives the understanding not everything can be forecast or anticipated. Plus too much risk will spoil the party at some point, even though that is not directly related to the PE multiples in the portfolio.

Rudi's View: Growth Is Not A Dirty Word

Sep 25 2024

By Rudi Filapek-Vandyck, Editor

It was by no means a universal outcome, with some of the smaller cap companies delivering unexpected negative surprises, but the Technology sector crowned itself as the best performing segment on the ASX throughout the August reporting season.

It wasn't just about WiseTech Global ((WTC)), whose share price has been handsomely rewarded this year (40% up post August result), but equally about Car Group ((CAR)), Hub24 ((HUB)), Pro Medicus ((PME)), REA Group ((REA)), ResMed ((RMD)) and smaller cap companies such as Bravura Solutions ((BVS)), Breville Group ((BRG)), Codan ((CDA)), DUG Technology ((DUG)), Electro Optic Systems ((EOS)), Life360 ((360)) and Temple & Webster ((TPW)).

Not all of these names are part of the local Technology Index, but respective core businesses very much revolve around new innovations and keeping up with the latest developments in technological advances and breakthroughs. In extension, we might even include some of the direct beneficiaries of Gen.Ai, Goodman Group ((GMG)) & Co, which are not technology companies *in se*, but their growth momentum and attraction is very much related to the latest megatrend, which is technology-driven.

For most of these companies, in particular the large caps, August has not been a one-off. Anyone opening up a 10-year historical price chart, or longer, can easily see how strong, consistent and prolonged the rewards for loyal shareholders have been.

Taking into account how both banks and resources tend to go 'missing' for long periods of time, there's but a fair argument to be made achieving positive returns from the local bourse has become a lot easier through Technology in the post-GFC era, which still continues.

As I have observed on multiple occasions over the years past: the local Technology sector offers Nasdaq-alike returns, or better. Yet, your average Australian investor might be forgiven for completely missing that point.

From mainstream media to local newsletters and tip sheets, most reports and commentary revolves around banks and other financials, and about mining companies and energy producers, China, coal, lithium, housing, dividends and franking.

Only occasionally there's time and space left for your typical high-achieving local Technology champion.

Why is this so?

At the recent *Livewire Live 2024 conference*, **Dushko Bajic**, head of Australian equities growth at **First Sentier Investors**, suggested Australian media, and by extension Australian investors, are mis-guided by their perception of what makes an attractive investment.

Most commentary around local Technology companies focuses on the elevated Price-Earnings (PE) ratios these stocks trade on, and that's usually where the attention stops.

Indeed, if a high PE automatically translates into dismal investment returns ahead then the companies mentioned have collectively done an excellent job in proving otherwise.

Bajic also made the point the Australian share market harbours some of the best Technology companies in the world. His number one favourite? WiseTech Global, still.

Others with dedicated interest have throughout the years past expressed similar views, including myself. This does not change the fact your average Australian investor is constantly directed towards 'cheap' looking small cap cyclicals and dividend-paying financials, away from the better performing, 'expensive' looking segment.

To help those who'd like to overcome their natural inhibition against investing in higher-valued, champion performers, let's address some of the issues seldom discussed or explained.

Our starting point is by acknowledging Technology stocks on the ASX do trade on PE multiples that are well above the market average, not to mention banks and resources that usually trade on below-average multiples, making stocks like Pro Medicus or WiseTech Global look extremely expensive.

Equally important, when comparisons are made with international peers, usually in the USA, multiples on the ASX tend to be noticeably higher as well. The usual complaint made is something along the lines of: I can buy Microsoft or Apple while trading on much lower multiples, why would I bother with WiseTech shares or Pro Medicus on such high multiples?

An expert like Bajic would defend the local choices by stating they are among the highest quality performers globally, often grabbing market share and exerting dominance in sectors and sub-sectors that offer faster growth with less threats from regulatory intervention, while allowing for higher margins behind a solid operational moat.

A recent study by analysts at **Canaccord Genuity** backs up that view, concluding the better equipped Technology performers on the ASX offer world-leading financial metrics, placing them among the best of the best, globally.

It is equally true the ASX offers less choice for institutional investors who'd like to stock up on exposure to high-quality growth performers, and this probably means these investors have to accept that seeking out quality growth locally comes with a higher price tag.

The latter is often highlighted by your typical value investor as a stern no-no, but it's important to also highlight the first factor, as well as the fact none of the above has prevented the local sector from delivering above average returns over extended periods of time.

Just like CommBank's ((CBA)) premium valuation has not prevented Australia's largest bank from delivering superior returns vis a vis the rest of the local sector over the past 15 years.

Within this context, Bajic referred to WiseTech Global shares that IPO'd on the ASX at $3.35 in April 2016 and have traded on an average PE of 75x since. Sounds expensive? The share price today is $133 for a total market cap of $43.68bn, making WiseTech a Top20 member locally by company size.

For those who like to see numbers: the total return over 8.5 years is 3,870.15% or 47.22% CAGR per annum.

Others have equally provided outsized returns, be they Hub24, Pro Medicus, REA Group, TechnologyOne ((TNE)), Car Group or Xero ((XRO)), and over longer periods of time as they listed much earlier.

One observation to add is the number of IPOs has pretty much dried up in recent years while numerous promising names have left the ASX, including Altium, Elmo Software and Nearmap while others such as ReadyTech Holdings ((RDY)) and Bigtincan Holdings ((BTH)) might soon succumb to take-over interest.

The good news is expectations are building for a pick-up in fresh IPOs which should add new ideas to the bourse for investors. Canaccord analysts report the relative higher valuations on the ASX make it extra-attractive for technology companies to list locally.

Which brings us to the most tricky part of this story: if not by PE ratio, how does one 'value' these high-performing, high-quality, sustainable growth companies?

I often refer to consensus price targets myself, but many of these companies have repeatedly, if not persistently, traded above targets set by analysts, which yet again feeds into the perception these stocks are always too expensive, keeping investors at bay.

As such companies' valuation typically benefits from lower bond yields, I'd wager some additional premium is built-in because of bond markets pricing-in aggressive cutting from the Federal Reserve & Co (though continued robust growth is what ultimately makes the share price trend upwards).

The study by Canaccord Genuity concludes the best valuation methodology remains the so-called **Rule of 40**, whereby revenue growth and EBITDA margin combined sum up to 40 or more. Companies that outperform are typically those that can accelerate either top line growth, or expand their margin, or both.

Looking back at FY24 results in August, Canaccord Genuity has highlighted Bravura Solutions, Catapult Group International ((CAT)), Domain Group Australia ((DHG)), Superloop ((SLC)), Objective Corp ((OCL)), Praemium ((PPS)), Megaport ((MP1)), Nuix ((NXL)), Smart Parking ((SPZ)), hipages ((HPG)) and SiteMinder ((SDR)).

The obvious observation to make is most of these companies are still loss-making or making a come-back from not-so-great times. This means their current momentum might not last and prove temporary only.

Also, as witnessed in August, smaller cap growth companies are more at risk for succumbing to the unexpected hiccup than the larger cap peers mentioned.

Think Audinate Group ((AD8)), for example, or Hansen Technologies ((HSN)).

Also taking into account a company's **return on invested capital** (ROIC) refocuses the attention towards the better capital allocators. Canaccord's study highlights some with the highest ROIC: Netwealth Group ((NWL)), Pro Medicus, Jumbo Interactive ((JIN)), RPMGlobal Holdings ((RUL)), TechnologyOne, and REA Group.

For those who'd like to still get on board some of Australia's prime success stories, but do not want to overpay for the privilege, the strategy that suits best might be to draw up a short list of desired exposures, and wait for that calamity that eventually will impact on the share price.

Another strategy might be to start nibbling but keep enough powder dry to purchase more exposure over time. If share prices rally higher, you may not have the full allocation, but you are benefiting already. If the share price falls, you're averaging in with a longer-term focus.

The **FNArena-Vested Equities All-Weather Model Portfolio** has used similar tactics to initiate and renew exposure to companies including WiseTech Global, ResMed, REA Group, Hub24 and NextDC ((NXT)).

Rudi's View: Ten Highflyers With More Upside Potential

Oct 02 2024

By Rudi Filapek-Vandyck, Editor

Ten Highflyers With More Upside Potential

Almost thirty years of closely following financial markets has guided me to one all-important share market observation: there's no such thing as 'the investor'.

Sure, it remains important to distinguish those with a limited, short-term, higher-risk attitude in markets –the traders– from those who chop and change less and keep an eye on the longer term potential, or at least are trying to do exactly that.

But when it comes to identifying the latter market participants, the investors, it's equally all-important to realise this is by no means an homogeneous group.

Using a very broad brush and no nuances or room for further details, what is commonly referred to as 'the investor' essentially consists of two opposing strategies and philosophies: there's your typical 'value' investor and then there's the 'growth' investor.

Both invest in the same market and call themselves investors, not traders, but that's mostly where the comparison ends. So, in order to become successful as an investor in the share market, it's important we know where we 'belong' ourselves, lest we get confused by trying to mix and mingle what are two very different ways to read and decipher markets and all their idiosyncratic intricacies.

If you happen to be a typical 'value' investor, you're probably enjoying the revival of mining stocks this month, keeping your fingers crossed authorities in Beijing will continue to stimulate and revive the moribund Chinese economy.

This should support further upside for companies including BHP Group ((BHP)), Rio Tinto ((RIO)) and Fortescue ((FMG)), but equally so for the likes of ALS Ltd ((ALQ)), Austin Engineering ((ANG)), Imdex ((IMD)), Orica ((ORI)) and dozens of smaller-cap names across the mining and related industries.

Up until not that long ago, you were feeling a little bit frustrated because long-held positions in the likes of Aurizon Holdings ((AZJ)) and Dexus ((DXS)) are yet to deliver, and some of the more risky punts in Healius ((HLS)), Insignia Financial ((IFL)) and the lithium sector have been truly gut-wrenching. At least most coal producers pay out an outsized dividend while the banks have truly surprised friends and foes over the year past.

Naturally, also, your other key worry is the potential for economic recession in the US and globally, but hopefully Chinese stimulus and interest rate cuts from central banks around the world (ex-Australia) will keep economic growth in the positive.

If, on the other hand, you're more affiliated with investing in your typical growth companies, your portfolio might have taken a few hits recently, but you're not genuinely worried given returns from holdings in Pro Medicus ((PME)), WiseTech Global ((WTC)), Goodman Group ((GMG)), Hub24 ((HUB)), Xero ((XRO)), Life360 ((360)) and TechnologyOne ((TNE)), among many others, have been truly a finger-licking delight.

Equally noteworthy: many disciples of the 'value' church are worried markets are repeating the bubble mistakes from the past. Who knows what might provide the spark that initiates the next share market correction from current exuberant investor optimism?

Surely, this cannot continue indefinitely?

It's worth noting those with a habit of owning quality sustainable growth businesses seem noticeably more relaxed about the world, the status and outlook for financial markets.

If you happen to play the market with a ferocious appetite for risk, you're probably smiling right now. You just quadrupled your position in a company most market participants didn't know was listed (or even existed). You simply do not care about any of the above, underneath or beyond; there's always something that's moving, and that's where you live and breathe.

For most institutional investors who often operate under a specific, pre-defined mandate, the distinction between the various 'religions' is never in question, but most retail portfolios might own a cross-over combination of stocks on both sides of the divide.

Here the challenge is knowing when to listen to our inner 'value' voice and when to ignore it. This in particular becomes more pertinent when those quality growers in the portfolio have already delivered such wonderful returns.

Our inner 'value' voice tells us nobody has ever regretted pocketing profits made but on the flipside lives the eternal regret of selling out too soon and missing out on much larger gains.

So this week, to assist all of you with at least some 'growth' in the portfolio (or the ongoing desire to add more of it), I decided to zoom in on some of the optimistic views and scenarios out there.

Whereas your typical 'value' approach starts with a view that all exciting business stories must come unstuck at some point, the heart of the optimist beats inside the body of the growth investor who has plenty of personal anecdotes to prove success often equals staying with the winning trend.

It just so happens my personal radar has spotted exactly ten examples worth highlighting (in alphabetical order).

Aristocrat Leisure ((ALL))

Shares in global gaming royalty Aristocrat Leisure are not everyone's cup of tea, but what cannot be denied is their phenomenal return over the past twelve years which, at more than 28% CAGR per annum, is both hard to beat and incredibly hard to ignore.

Now with a market cap in excess of $36bn, Aristocrat is one of the largest companies on the local bourse, and growing at double-digit speed year-in, year-out.

Those familiar poker machines that populate large corners of global casinos as well as local pubs and clubs in Australia are now complemented with a digital business. The combination has proven extremely favourable for shareholders.

But everything has a price, surely?

Of course, but UBS analysts have just returned from a visit to the USA. Their confidence in Aristocrat's fortune has only increased further. More US states are opening up to allow online gaming and this, naturally, opens up even more growth avenues for Aristocrat.

On the potential upside surprises to be delivered in the years ahead, UBS has lifted its twelve months price target to a market topping $63.50 which suggests more room that can be justified for an already buoyant share price.

Brambles ((BXB))

To state that Brambles has had a number of difficult years is not doing justice to the challenges that weighed on the pallet company's performance, but things have improved, noticeably, and market enthusiasm is definitely making a come-back.

Brambles was once a blue chip one simply had to have in portfolio, but three-four periods of subpar performances have changed investor's perception and dragged down long-term performance numbers.

The shares have doubled in price since early 2022. Confidence is back for management and analysts to project double-digit percentage growth ahead for the years ahead. Management is using modern technology, including AI, to optimise and streamline operations while better servicing customers.

Ord Minnett's price target of $20.80 is the current high-marker on optimism those in-house initiatives will pay off in the years to come.

Car Group ((CAR))

Car Group is the prior Carsales.com.au renamed. While its local platform in Australia remains the dominant market leader for those looking to sell second hand vehicles, smart international investments are increasingly adding to the company's growth potential.

Shares in Car Group have returned over 17% CAGR per annum post 2012, and there remains plenty to be excited about for the years ahead.

Plenty of target prices that are situated above today's share price, but Goldman Sachs is the current high-marker at $40.90, suggesting double-digit percentage further upside, even after this year's strong performance already.

Cochlear ((COH))

Australia's leading global cochlear implant company, Cochlear, features prominently in John Addis' freshly published book *How not to lose $1 million* as one of investments at Intelligent Investor that was sold way too early.

Cochlear has developed into the CommBank of the local healthcare sector; always trading at a premium, and still generating solid returns for those who understand a premium valuation does not by default translate into disaster and dismal returns.

Management first upgraded FY24 guidance and then followed up with a disappointing subdued outlook for FY25. No surprise thus, the share price has weakened noticeably from the dizzying levels witnessed earlier in the year, but Cochlear shares can still show off with a CAGR return of more than 17% per annum over the decade past.

One of the company's supporters who is not swayed by any of this year's set-back is Wilsons, which is keeping a market-beating price target of $345 on ongoing confidence the future looks favourable, spectacular and robust, as has been the past.

Macquarie Group ((MQG))

What is Macquarie's secret? Maybe it can best be summarised as never change a winning formula.

All those who have been closely following the Millionaire's Factory throughout the post-GFC years know this institution is so much more than simply one of the largest asset managers globally.

The share price got thrashed during the GFC bottoming not that far off from $10 but today's price is closer to $230 for an annual CAGR return in excess of 19%, dividends not included.

Even on today's lofty PE multiple, the implied forward-looking yield is still 4% before franking. Macquarie is, of course, a true champion in asset recycling, i.e. buying assets now and on-selling them at much higher values later on. Plus: this is THE beneficiary locally if forecasts for an uptick in global corporate actions (IPOs, M&A) prove accurate.

Morgan Stanley's unwavering confidence has resulted in a price target of $250.

Pro Medicus ((PME))

Some are calling Pro Medicus the highest quality company on the ASX. Such views are often expressed in line with the share price performance, which has been phenomenal, no discussion about it.

Even as late as 2018, the shares were still trading below $10. Indeed. Difficult to envisage such level when the shares are flying towards $174 to date for a return in excess of 2000% over the past six years.

Pro Medicus has developed into the global leader in digital imaging for medical scans in hospitals and that extended runway of growth seems to have a long chapter ahead, still.

What could possibly go wrong? That's your inner 'value' voice speaking; you better tune in with the 'growth' voice inside your brain.

Most price targets are sitting well below today's share price, but Goldman Sachs disagrees and stands out with a target of $193. That target, explains the broker, is justified by the revenue/margin outlook, unique cloud offering, and ongoing significant long-term growth opportunity.

ResMed ((RMD))

Remember when Ozempic was wiping out ResMed's business because the world had finally discovered an easy solution to obesity?

I do. And boy, am I glad I stuck to my faith and even purchased additional exposure when fear and conspiracies (including hedge funds) were weighing down on the share price.

Similar as with Cochlear, ResMed remains the global leader in a segment that remains well-supported for many more years to come. Given long-lasting problems for key competitor Philips, it is likely ResMed can look forward to permanent market share increase, even if a dip is likely upon Philips' US market return.

Whenever someone posts a table of the best long-term performers on Wall Street, ResMed's US stock features on it. From the depth of the Ozempic-driven sell-offs mid last year, the shares have now rallied 66%.

Part of market enthusiasm is linked to management's promise margins will continue to increase. Wilsons believes management is able to outperform market expectations, and has thus set a market-beating price target of $40.25, implying that 66% can still rise to above 80% in the months ahead.

How's that for a turn of events?

TechnologyOne ((TNE))

When management promises 15%-16% growth on average per annum, this implies the company doubles in size every five years. TechnologyOne has done better than that since 2004.

2024 in particular has been spectacular for loyal shareholders. The shares entered the calendar year around $16 and are nine months later trading around $24. That's 50% for those not that proficient with numbers!

Past performances have proved exceptionally resilient and predictable, but never spectacular and this is why TechOne is constantly under-appreciated by analysts and investors. This is the tortoise of the local technology sector.

TechOne did not report financials in August, but UBS saw enough evidence elsewhere to predict the upcoming FY24 release, and the years beyond, will yet again offer robust growth numbers on expanded margins, as promised by management at the helm.

UBS's price target of $26.20 implies there's plenty of good news still in store, even after such a stellar share price rally.

Xero ((XRO))

We like to include Xero in our local basket of technology winners that are conquering the world by stealth, and the accountancy software provider in the cloud is part of that small selection, but we have to remain honest: Xero was born across the ditch, in New Zealand.

Now operating from a number one position on both sides of the Tasman, Xero has positioned itself as the number two in the UK and is working on achieving similar success in the USA, where market dynamics are a whole lot different, and thus more challenging.

But new management at the firm is confident and analysts have been convinced, also noting early signs of on-the-ground progress.

Goldman Sachs sees an additional opportunity opening up in Canada and has lifted its price target to $201, more than 34% above today's share price.

Numbers nine and ten (and more) are inside the local collection of major Gen.Ai beneficiaries on the ASX, including Goodman Group, NextDC and Macquarie Technology, for which not one, but most price targets suggest a lot more upside should remain on offer because of strong demand for, and investments in, data centres globally.

Readers familiar with my personal research into All-Weather Performers know all of the companies mentioned are part of my curated lists and/or currently owned by the FNArena-Vested Equities All-Weather Model Portfolio.

My personal research revolves around identifying the highest quality companies on the ASX, which is not a pure growth strategy, but it leans a lot closer towards it, far, far away from your typical 'value' oriented strategies.

Paying subscribers have 24/7 access to my curated lists via a dedicated section on the website: https://fnarena.com/index.php/analysis-data/all-weather-stocks/

Interview With Michael Howell, CrossBorder Capital

Oct 03 2024

Michael Howell, founder and managing director of CrossBorder Capital, chatted with FNArena from London about global liquidity, its impact on asset markets including equities, gold, bonds and commodities.

Michael also expanded where liquidity is in the cycle versus the longer-term trend.

Below is a transcript of the interview which is available at

https://fnarena.com/index.php/fnarena-talks/2024/09/27/fnarena-talks-with-crossborder-capitals-michael-howe-about-global-liquidity-driving-gold-and-financial-assets/

and/or

https://www.youtube.com/watch?v=KsCf0E0m8OU

The interview was conducted on 25 September 2024 and the video was released two days later.

Danielle Ecuyer: Michael, could you provide some background for listeners?

Michael Howell: My history goes back to when I worked for Salomon Brothers, the US investment bank, in the second half of the 1980s. Salomon Brothers, for those that don't remember, was probably the pre-eminent trading firm in bond markets worldwide. It traded government bonds around the world and was big in forex with an understanding of what was going on.

Salomon's devoted a lot of time to research, including researching ideas that we probably take for granted now in financial markets; many often emanated out of the Salomon Brothers research team. One of the big things they used to focus on through the office of Henry Kaufman, the head of research, was flow of funds analysis for the US economy.

In other words, trying to understand the flows of money going into financial markets, and how that was reflected in terms of rising or falling asset prices, changing interest rates, moving currencies, etc. At the time it was very much a US centric view.

By the late 1980s, the world was becoming more and more global, so I just extended the analysis to the international arena, and started to look more and more at cross border flows, what international central banks were doing and how that affected global financial markets. And I suppose, hence our name CrossBorder Capital was formed.

Danielle: Can you flesh out a little bit more what your parameters are for global liquidity? What sort of things do you include in your measures?

Michael: Let me go further and say that if you look at the global picture, the total amount of liquidity winging its way around the world is about US$175trn, which is about one- and three-quarter times, or one and two thirds' times bigger than world GDP.

So, it's certainly a big pool of cash and it's very important to understand in terms of what we mean by liquidity. I think you've got generally two definitions out there. One is what traders or investors tend to think of as market liquidity, in other words, the market depth they've got when they're trading or investing. Can I buy 100,000 shares in BHP, around the current price spread and in market size? That is one definition of liquidity, that's market liquidity.

That's not what we mean, although it tends to be a derivative, and it follows from the concept we monitor, which is funding liquidity. And what that is really saying is: is there the credit or savings in the system that will allow this transaction to take place?

Funding liquidity is really measuring all the credit and all the cash savings that exist in a particular market. We aggregate it, because liquidity moves around, it's fungible. It moves from country to country, particularly in a world of floating exchange rates. And therefore, global liquidity is the key concept to understand.

This is all the credit and cash savings worldwide, the amount that is passing through world financial markets. We can look at that through the lens of what central banks are doing; we can look at it through the lens of what private banks are doing, both shadow banks and a high number of high street banks, and we can look at it in terms of cross border flows, all those factors. All those dimensions we include in our measure of global liquidity.

Danielle: Can you comment on the concept of financial abundance?

Michael: Okay, very good point. Danielle, I think the first thing to say is liquidity is cyclical, and the bottom of the last cycle was around October of 2022, and we've been seeing rising liquidity in the global economy, or at least rising liquidity in financial markets passing through financial markets, ever since.

That's why world asset prices are going up. For those that have noticed, we've had a two-year bull market pretty much in risk assets. And the reason for that is not necessarily because the global real economy is generating huge amounts of profits and not really because interest rates have been coming down.

It's much more because the flow of liquidity has been going up. If you want to understand financial markets and how financial markets move, you've got to look at this concept, embrace this concept of global liquidity, because it's key. This explains why

Wall Street is soaring. This explains why gold is at an all-time high. All these asset prices are getting a bid because of rising liquidity.

Now, as I said, global liquidity is cyclical, and we've got to try and remember that it's not always abundant. There will be times where there will be a scarcity of liquidity, and that's really important. The way to sort of understand the whole process is to think, first, in terms of debt. We've got massive amounts of debt in the world economy, something like US$350trn of debt.

The point about debt is that debt doesn't really go away. You know, spoiler alert, debt is never repaid. But debt under a contract of issuing debt, that debt should be repaid. And if I borrow, let's say, US$100m for a five-year term, I've got to repay that US$100m in five years. And that may be a burden.

If you start to think about this US$350trn debt worldwide, which has an average life of about five years, that means, by simple math, every year, on average, the world financial system must refinance something like US$70trn of debt on top of what they're getting in new finance as well.

The reason for making that point is this is often lost on a lot of commentators, simply because economic textbooks tell you the financial sector is all about raising new capital for investment. Equally, that investment drives the business cycle, and that's often why economists tend to refer to nine-to-10-year cycles, because that's really the cycle, or the period of capital investment, the depreciation and reinvestment of capital.

Unfortunately, that world was left behind many, many, many decades ago. The world doesn't work like that anymore. If it did work like that, interest rates may well be important. They're not in the current world, and there's this great dance we go through every time the Federal Reserve coughs about interest rates, but it's largely irrelevant.

What really matters is the amount of liquidity that central banks create and inject in their systems. The reason for that comes back to the whole ethos of understanding refinancing in markets. If you've got US$70trn to refinance, you need balance sheet capacity to do that, and balance sheet capacity in the financial sector is all about liquidity. If there is insufficient balance sheet capacity, and insufficient global liquidity in the system, you cannot refinance your debt.

If you can't refinance your debt, you get a debt refinancing crisis. Every financial crisis you can think of over the last few decades has been a debt refinancing crisis going back to 2008, going back prior to the Asian financial crisis, thinking back to the US repo crisis in 2019; they've all been about debt refinancing problems, and therefore you need to keep a level of liquidity up to avoid those crises.

That's the job of central banks. Largely, if the private sector fails, such as the shadow banks in 2008, then what we've got to get is central banks coming in. Will there be a financial crisis in the future? Absolutely there will be. Because basically, debt grows exponentially and liquidity is cyclical, and sometimes those two lines don't match, and when they don't match, you get a financial crisis. And that's something we can think about, not immediately, but maybe a couple of years hence.

Danielle: Are central banks more efficient at pre-empting financial crises?

Michael: I think the answer is, they are, until they're not. And the great problem is the financial sector innovates, and the private sector always wants to create more and more credit, more and more liquidity, if you like, at least when left to its own devices, and central banks and policymakers always like to rein in the expansion of private sector credit vehicles.

They're always sort of increasing regulation or trying to stop it, unfortunately or fortunately, depending which way you look at it, the private sector is obviously a lot more alert than the policymakers, the regulators, and they tend to be a couple of steps ahead.

In other words, the financial system, in terms of liquidity provision, tends to be quite elastic, but then as regulations start to impinge and as central bank policy starts to tighten, you then see the private sector lagging seriously behind what levels of liquidity are necessary to refinance debt.

That's why you tend to get a financial crisis, and that comes back to the sort of understanding why liquidity is generally cyclical.

Another thing one might throw into that: if you get a very strong real economy, money can't be in two places at once. If it's in the real economy, financing economic growth, it's not in financial markets helping debt refinancing, and that's another reason that you can get a crisis. All these things matter in the long run, but central banks certainly have improved their game enormously since 2007, that is without question.

Danielle: Where are we currently in the cycle?

Michael: I think it's important this time to actually start to think not just of the cycle in global liquidity, but also try and envision a trend that's going on as well. Because one of the things that has happened, certainly in the wake of the 2008 financial crisis, and more particularly following the covid crisis, is the governments worldwide have started to increase their outlays and their spending dramatically.

For example, the US government's outlays are four times bigger today than they were ahead of covid. There's an enormous increase in outlays, whereas tax rates are not really going up at the same pace. What you've got is very, very large primary deficits before interest payments in most of the western world.

The scale of that is unprecedented. Once you start to add in interest costs as well on the debt they've got, you start to see government deficits growing at six to eight percent per annum. We were used to, historically, seeing maybe one or two percent occasionally over the years, but nothing like a sustained or embedded six to eight percent. The question is: how do they fund that?

Increasingly, they're turning to financial markets to fund that, and they can't keep using the long end of the market. Selling bonds to institutions pushes up long term interest rates, and that compounds the whole interest bill. What they must do is to go to the front end, the short end of the market, and effectively to use another expression, print money. And that is what is increasingly happening. If you look at the US, the US currently is funding the deficit 75% with monetisation.

They're basically monetising the US deficit. Milton Friedman, long departed this earth, would be turning in his grave if he started to see what was going on right now. That's the reason that you've got gold at all-time highs. There is monetising going on. The US is not the only party doing this, everyone else is beginning to turn in that direction.

That's why I think it's important to think about the trend. Because if you start to look at extrapolations of government spending and government deficits by the IMF in every country, you start to see rising debt to GDP ratios to eye-watering, really large levels.

The US debt to GDP is about 100% or so and likely to test 200% by 2050. These are astronomical demands on financial markets. That's why the gold price is going up. That is why the gold price is going to go up even more.

If you're compounding at a growth rate between eight and ten percent, you are doubling the stock of debt within 10 years. That means not only the stock of debt is going up, but also the value of gold is going up, or the value of the amount of liquidity in the system is going up, all these things are moving *pari passu*.

It's not just the cycle, even though I emphasise the cycle, you've got this time around to think about the trend as well. Therefore, start to think of money, inflation hedges in portfolios, and start to think gold or Bitcoin, or starting to diversify into commodity markets,

<u>Danielle</u>: Can you explain how central banks are monetising the debt?

<u>Michael</u>: At the risk of getting caught in the weeds, if a long-term institution or a private individual buys a government bond that is just coming out of existing savings. So, there's nothing untoward about that. That's normal funding. If the government issues too much debt to that body of investors, then interest rates are likely to go up, and that's a risk. If they start to issue to banks, and banks buy the debt, the banks' balance sheets will expand.

As banks balance sheets expand, that is increasing money supply. For example, if a government employee gets a pay increase and they deposit the increased wages in their bank account, the bank has to find an asset that will broadly match that deposit, so they will go for a government bond, and particularly a short, dated government bond, because that's pretty much matching the type of duration or the type of risk they're taking over the deposit.

So, the balance sheet, both liabilities and assets rise, and as bank deposits increase, and it's funded by raising government bonds, that is an increase in money supply, and it's a monetisation, and that's exactly what the US is doing.

If you look at what Janet Yellen at the Treasury has overseen in the last two years, there's been something like a one and a quarter year drop in the average maturity of bonds that are being offered in US auctions. That may not sound like a lot, but in fixed income speak that's an enormous change. They're basically skewing the calendar towards very short-dated bonds, and they're encouraging by doing that, for banks to buy the stuff.

If you think of treasury bills, that's not an instrument that you know is sold on the high street. It's not something that household investors tend to hold. It's what institutions, and particularly credit providers like banks, hold. So, what you're looking at is a significant increase. Almost a quarter of all US government debt is now in treasury bills with very short term, less than a year, in maturity.

Are governments going to reverse track and start to fund at the long end? They will find it difficult to do that without raising interest rates, and that would compound the interest bill, so they don't. They basically kick the can down the road, and they fund at the short end.

<u>Danielle</u>: Would the US default on its debt?

<u>Michael:</u> The idea of the US defaulting is fanciful. I mean, that's just nonsense. It's incapable of doing that because we all use dollars. The whole international financial system uses dollars. America can always pay its debts by printing money.

The issue is not so much a binary will it default or not? It is much more about what is the faith or the ultimate value of the US Dollar as a store of value. The fact is if they're printing so many dollars, although they may force us to hold those dollars and therefore avoid default, the value of the dollar goes down. That's not against other paper units. That's a fake narrative as well.

If I'm looking at the USD versus the Yen, or looking at the USD versus the Aussie dollar, you don't really see the movement that much. These things are basically depreciating together. It's gold that you really ought to look at, which is an independent benchmark, or even Bitcoin; dare I say that seems to be moving a little bit like digital gold. What you've got to look at is alternative benchmarks to try and gauge the devaluation of paper money.

The US may well be the cleanest shirt in the laundry here compared to other countries, The Eurozone, where you're looking at is a very ugly situation. When it comes to demographics, it's the wealth, the cost of welfare states, that is really driving these governments towards bankruptcy, and that's the problem we've got. The tax base is not increasing. Outlays are zooming higher. Europe, as an example, must take on more and more defence spending, and it just can't afford to do it.

How do they square the circle? They're going to have to monetise in some form. The US has already got that bug. You know the Bank of Japan owns most of its government debt market. This is why the gold market is going up. Other countries outside of the Western orbit, China, Russia, Iran, etc, are basically using gold now as as one of their main reserves.

It's not the question of whether the US is going to default on its debt, or the US dollar is suddenly going to worthless. That won't happen. The fact is the US still has the biggest financial markets in the world. If you've got a country like China that is earning an enormous trade surplus, there's only really one place for them to put their surplus, and that's in US financial assets. There's no other game in town.

At the margin, they're starting to shift more of their reserves into hard assets like gold, and that is pushing the gold price higher.

<u>Danielle:</u> What asset classes do you like and what are your thoughts on the latest China stimulus?

<u>Michael:</u> I think everyone's right to look at China and to see China as one of the major problems out there for the world economy or policymakers to tackle. Having looked at several of the comments in the media in the last 24 hours, a lot of what I can see is just rubbish. People are focusing on ridiculous things, like there's a 20-basis point cut in rates, or whatever it may be, or they're giving support to the housing market, or putting a few extra dollars into the stock market.

What we've got is a situation where, structurally, the model of what you may call red capitalism, which is China's recipe for success, is no longer working. The reason it's no longer working is it really needed the West to accommodate it. And the West is now saying, hang on, we're not going to do this anymore. We don't want to open our markets to cheap Chinese products and destroy jobs.

You can see that emanating worldwide, but particularly coming from the US, and certainly coming out of the lips of the mouth of Trump, who really started all this.

But I think it's a general movement. People are very concerned about China dumping goods, and that won't happen in the future. So, China's got to rethink its whole economic system. It needs to enfranchise the consumer; it needs to get consumer spending higher. It needs to find other avenues of growth.

Ultimately, what this is really telling us is that China is over-producing products, just look at the market for electric cars or solar panels or whatever. They're producing every year more than the world can ever consume. The only way China can square this circle is by letting its real exchange rate collapse. Think of it as the nominal Yuan multiplied by some price index put through high street prices or asset prices.

What China is doing right now is not letting its real exchange rate collapse. It's holding the nominal Yuan up at high levels. The yuan is now almost at a year to date high as we speak, and they're taking all the punishment on the chin of lower prices. Consequently, the real exchange rates are adjusting lower by prices falling, particularly asset prices, and that simply cannot go on.

Ultimately, China's either got to stop production and print lots and lots of money, and hope it gets the exchange rate down a tad and starts to get asset prices and high street prices up. If China is serious, we've got to look over the next few months and see whether there is a big monetary expansion. You simply cannot judge that on one day or 24 hours news. You've got to look at what the People's Bank is doing over a sustained period, and that's what we intend to do.

We suspect the Chinese, not being foolish, are going to start stimulating their economy. Therefore, you've got to look for more, much, much bigger liquidity stimulus, maybe over a three-to-six-month period. That will involve not CNY1trn, but several trillions of money dumped into their financial markets.

If that is the case, and we suspect it could be, you're going to see commodity prices worldwide lifting off very substantially again. You'll also see the price of gold rocketing and making even higher all-time highs. So that's the recipe, and China is key to understanding it.

<u>Danielle:</u> Does monetisation feed into high street inflation?

<u>Michael:</u> Absolutely, it is a dominant risk. I would disagree with the fact US inflation is currently 2% which is what the Federal Reserve tells us. It's considerably higher than that. It's more likely in the three to four percent range, underlying US inflation. But the figures are being distorted by what the Treasury and the Federal Reserve are doing.

We tend to think of high street inflation as being a cocktail, or a hybrid of different inputs. Monetary devaluation, or devaluation of paper money, which we've been speaking about, is one of those ingredients. Another could be things like oil prices. Another could be technology. Another could be cheap Chinese goods. All these factors tend to be inputs into high street prices.

I'm sure people around the world will attest or back me up, but if you look at my personal inflation rate it certainly isn't two percent; it's a lot higher than that. So high street inflation is probably wrongly quoted. It's a higher level than the two percent that is sort of appreciated worldwide.

Among the factors that have held inflation down are things like increased technology, AI, cheap Chinese goods, the fact oil prices are still significantly below their 2008 high. Monetary inflation may well have been substantial in the last 20 years, vis-a-vis gold, asset prices, but it hasn't fed through to the High Street, because you've had these offsetting factors.

If you roll forward for the next decade or two, you've likely got liquidity expanding by an eight to ten percent annual rate and you may not get these offsets in the High Street, so quite likely you're going to see monetary inflation, in other words, devaluation of paper money spilling over to a much greater degree in terms of consumer prices. Therefore, I would say the starting point has got to be not two to three percent, but more likely three to four percent, and possibly a bit higher.

Danielle: What assets do you like?

Michael: It comes back to looking at the cycle and differentiating that from the trend. I think, in terms of the trend, we're in a world of much greater monetary inflation. And that's insane. Monetary inflation is here.

It's going to get a lot worse. You need protection against monetary inflation in investment portfolios. The 60:40 mix of equities, 60% in equities and 40% in bonds, which is traditional among advisors, you can throw that out of the window because it doesn't work anymore. In a monetary inflation you need more diversification into dedicated monetary inflation hedges. Take that 40%, which is traditionally in fixed income, and start to dice it up into other areas.

You could put 10% into cash, 10% into other real assets, maybe like commodities or more dedicated inflation hedges. You probably want to put some in fixed income, but I would say you want to be in TIPS. In other words: inflation protected securities. Even holding money in cash at the short end of the market, you can still get decent returns.

Start to look at prime residential real estate, because that tends to do well in monetary inflation. I think all these dimensions are better and will give you better returns than conventional bonds.

Bond markets are yielding a return of something in the order of 4% to 5% worldwide, whereas we're looking at monetary inflation rates of near eight to 10%. That's telling you bonds are not really keeping pace.

Equities will keep pace, certainly high-quality equities, and certainly, equities in things like the technology space or maybe commodity related; those are the sort of things that should keep pace in this environment. But you've got to move away from a 60:40 portfolio and start thinking more about diversifying or chopping out that 40%.

In terms of the cycle, the liquidity cycle bottomed in October of 2022, and we've been saying pretty much ever since that point it's likely to peak out in late 2025. So you're looking at something like a three-year bull market.

We're probably two years through that already, so we've got some way to go, but a lot of the gains have already been taken. You will make money by investing in risk assets over the next 12 months, likely, but a lot of the gains are behind us.

The adage still applies: bull markets always climb a wall of worry. How many advisors have been telling you the last two years not to invest in these markets? I should think an awful lot.

It pays to be a contrarian: buy at the bottom, right at the bottom of the global liquidity cycle, and sell towards the top. We're not at the top yet, but we will be in 12 months.

Danielle: Australian premium quality residential property has been in high demand, is this a sign of monetary hedging?

Michael: 100%. These are dedicated monetary inflation hedges. They tend to historically match rates of monetary inflation. This is evidence this is happening, as is the gold market.

If you look at this politically or geopolitically, we're not creating what the socialists call industrial proletariat. We're creating a financial proletariat, because those people that don't have assets are really screwed in this world.

You've got to have assets to try and protect yourself against monetary inflation. And if the world, as we characterise it, is going to feature higher High Street inflation as well, then the poorer elements of society who must spend most of their remuneration on food or goods, are going to get absolutely squeezed in the next decade or so, and so you're going to get this huge rift in society. We've already seeing it, but you ain't seen nothing yet.

Danielle: Michael how can people access your research?

Michael: There are basically three channels that we publish through. One is a substack called Capital Wars, where we provide data and narrative about what's going on. We do the occasional tweets on Twitter (X) with the handle @crossbordercap.

There's a book I wrote about five years ago which is called Capital Wars, which details all this stuff about global liquidity and why it's relevant and how we measure etc, published by Palgrave Macmillan.

The fourth area is looking at our institutional research service, which is providing a lot of data to quant funds or providing analysis for traditional institution investors. That's available on www crossbordercapital.com.

You can find Michael Howell on X
@crossbordercap: https://x.com/crossbordercap Substack at Capital
Wars: https://capitalwars.substack.com/
Website: https://crossbordercapital.com/

Australian Banks: When The End Of The Trend?

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Australian banks have run up to historically high valuations, well above expectation. But the tide is beginning to turn, and brokers warn of several factors conspiring to affect a period of bank underperformance.

-Bank valuations reached historical highs
-Super inflows a prime driver
-Competition intensifying
-Signs of housing boom easing
-Rotation into resources

By Greg Peel

Six brokers monitored daily by FNArena cover the four major banks. Between them, they currently have fifteen Sell or equivalent ratings across the four, with seven Holds, and all but two Buys; one each for ANZ Bank ((ANZ)) and National Australia Bank ((NAB)).

Elsewhere, the two regionals Bendigo & Adelaide Bank ((BEN)) and Bank of Queensland ((BOQ)) attract nil Buy ratings, two Holds and nine Sells.

In contrast, Macquarie Group ((MQG)) and Judo Capital ((JDO)) enjoy more Buy ratings than Sell ratings, as does Suncorp Group ((SUN)), which has no Sell ratings, but is in the process of divesting of its banking division to ANZ Bank to become a pure insurance company.

The Australian bank index has risen 38% over the past twelve months, led by the majors. The largest bank, Commonwealth Bank ((CBA)), has risen 33% despite attracting only Sell ratings from brokers, and having done so for some time. The sector has generated an extraordinary total return of 50% over the last twelve months, Wilsons notes, despite a tepid earnings growth outlook and increasingly extreme valuations.

Major offshore banks have also posted strong gains over the last twelve months, Wilsons points out, which have been supported by the Fed's pivot towards an easing bias in late 2023, and expectations that lower interest rates would support "soft landings" across developed economies.

This dynamic has been quickly priced into bank valuations, both on the ASX and globally. In an absolute sense, the ASX200 bank sector's forward PE multiple has never been higher, led by index heavyweight CBA.

Perplexingly to Wilsons, CBA trades on double the PE multiple of JP Morgan which is arguably the highest quality bank in the world, while having a lower return on equity and offering a similar level of earnings growth.

So why have the banks just kept on rising? Clearly no one's paying any attention to bank analysts. In the face of broker warnings, who just keeps buying?

You

...is the simple answer to that question.

New data which has been analysed by Macquarie shows domestic superannuation funds were the standout major buyers of bank shares in the twelve months to June. The data offer a breakdown between super funds and domestic investment funds (ie non-super investments) as well as households, offshore buyers and other sectors.

Super funds increased their ownership of the sector by 1.6% over the period to 29%. This equates to $6.4bn of investment over twelve months and $2.1bn in the June quarter alone. As the banks have not been issuing new capital, someone has to be on the sell-side. Macquarie notes selling has largely come from investment funds (who might be paying more attention to bank analysts) and offshore investors (who may be looking through a more global lens).

So why have super fund managers ignored said bank analysts and just kept on buying? The data, Macquarie notes, indicate super funds have not been increasing their allocations to the banks and indeed remain largely neutral on a mere 0.4% overweight. The reality is super funds have increased holdings to domestic equities overall by 18% over the year, whereas the market overall has increased holdings by 9%.

This implies it is fund inflows, not fund manager strategy, that is driving increased bank buying. The banks are such a significant lump of the ASX200 market cap that super funds, most of which are passive, have no choice but to increase their bank holdings as more funds flow in.

And there is no end in sight. In July this year, the government-mandated super guarantee increased by 0.5% to 11.5% of income and will increase again to 12% in July next year.

Rates Don't Matter

When the RBA started hiking rates in 2022 it was assumed demand for credit would suffer, offsetting the benefit banks enjoy in margin improvement from higher interest rates. Mortgage stress in particular would lead to a collapse in house prices of some -10-20%, depending on whom you asked.

It hasn't happened. The RBA made its last rate hike last October to 4.35%. In the year to August, private sector credit rose 5.7%. Within that, business credit rose 7.7% and housing rose 5.0%. Overall, credit growth remains resilient and is actually picking up modestly. This is likely to continue, Morgan Stanley believes, particularly if expectations of the first RBA rate cut grow stronger.

The twist in the tale is ongoing strength in housing could actually be an impediment to near-term rate cuts, Citi warns.

Despite the impediment of higher for longer rates, anything housing related continues to "hum," Citi notes. House prices continue to rise, and credit growth continues to be resilient. The broker has oft been questioned recently as to how long this can be sustained, given an already considerable household debt burden and mortgage rates in excess of 6%?

The debt burden is ultimately a reflection of the income supporting it and Citi sees a considerable shift towards higher income earners being active in the housing market, which likely reflects inflation working through incomes in a tight labour market. The recent cohort of borrowers is of a higher quality than that of the previous housing peak in 2022, Citi finds, largely reflecting improved household incomes.

With an inability to meaningfully lift housing supply, Citi suggests it is likely housing credit will remain resilient along with house prices. The broker is nonetheless Sell-rated on the banks and, in a relative comparison, prefers the retail-exposed banks. CBA and Westpac ((WBC)) are the biggest mortgage lenders.

Will house prices just keep on rising?

Other than a slight early wobble, Australian average house prices have only continued to rise in the face of effectively seventeen RBA rate increases (each of 0.25%) since May 2022. Sydney and Melbourne initially led the charge, but more recently have lagged, allowing the smaller capital cities to pick up the ball and run.

This reflects an affordability shift Australians looking outside the two big cities for more affordable prices. As to when affordability or the lack thereof reaches a nationwide red line is unclear.

National prices increased again in September, to 6.7% year on year growth. That did represent a slight annual slowdown, Morgan Stanley notes. Auction clearance rates remain in the low 60%s, which is consistent with slight positive growth, but have been falling since the beginning of 2024.

The rental market also looks to be softening, from extremely tight levels. Listings have increased with the vacancy rate rising in the past three months, to 1.3% nationally. Morgan Stanley notes this has resulted in an easing of "asking rent" growth, which has flattened out in the past few months, with annual growth slowing to 6.8% year on year.

These weaker conditions imply some headwinds for the broader housing market, Morgan Stanley suggests, but will take some time to flow through to CPI inflation given lags – asking rents are still up 40% versus pre-covid but CPI rents are only up 15%.

The above would imply a peak has been seen. but the issue is supply. You may have heard this is a bit of an issue in parliament of late.

Weakness in construction continued in August as building approvals declined by -6.1% month on month, reversing July's improvement and falling below expectations, driven by apartments. Approvals looked to have troughed (up 4% from a year ago) but at very low levels, Morgan Stanley notes, and with limited upward momentum.

The broker expects sustained improvement in building activity from here will be challenging prior to rate cuts being delivered.

Morgan Stanley suggests current housing conditions are likely to persist through the rest of this year. While an expected slowing in migration rates should reduce some of the housing under-build, the broker does not expect enough of a decline to completely offset this, which should see prices somewhat supported. Affordability remains a key overhang to activity and construction, and this is unlikely to meaningfully improve until rate cuts come through, something Morgan Stanley does not forecast until May next year.

Other forecasters are anticipating the first RBA cut in February. A few are toying with the idea the monetary loosening could start before Christmas this year.

What could derail the banks?

Rising house prices even in the face of higher for longer interest rates are a gift for the banks. But only if they behave themselves.

Deposit competition among the banks is not intensifying as Macquarie had expected, and may even be easing. Instead, it appears banks are competing on the lending side again. While lending competition generally favours banks versus non-banks, it still comes at the expense of returns, the broker notes.

Macquarie's Lendi Mortgage Pricing Index appears broadly stable, but anecdotal evidence suggests banks are beginning to offer cashbacks again for select refinance deals. Also, some banks are competing more aggressively for larger mortgages.

With mortgage growth again diverging between the majors (ANZ and CBA continue to grow above system while NAB and WBC's growth is weak), Macquarie suspects banks will need to pull the price lever again to avoid market share losses. Furthermore, based on feedback, similar pricing dynamics also occur for SME loans.

In Macquarie's view, this potentially creates downside risk to broadly flat consensus net interest margins in FY25, which do not appear to incorporate lending competition pressures and the impact of potential rate cuts in 2025.

To pick up on noted bank divergence, Australian mortgage system growth was 5.5% in August, broadly in line with recent months, Morgan Stanley notes. But Macquarie Group

(+19%), Bendelaide (+9.5%), ANZ (+7.0%) and CBA (+6.5%) grew mortgages above a bank average of 4.5%, NAB only managed 1.0% growth while Westpac (-0.5%) and Bank of Queensland (-5.5%) went backwards.

While competition among banks remains ever present, the breakout of mortgage wars for the sake of market share is a tide that sinks all boats, in terms of net interest margins.

That's one issue that could derail the banks.

Earlier, Macquarie pointed out recent bank buying in the face of advice to the contrary has been driven simply by increased flows into super.

While super fund contributions and flow are likely to continue, Macquarie doesn't see this driving ongoing outperformance of banks relative to the market as they are already broadly neutral. The broker sees the next potential flow catalyst being offshore selling, likely on macro sentiment, which would result in bank sector underperformance.

<u>The China Syndrome</u>

It has already been happening. In the last week of September, the banks underperformed the ASX200 by -6.5%.

Morgan Stanley's earlier assumption had been that bank outperformance this year was partly due to a "safe have"' status within the Australian market, and that it's been better to sell mortgages and deposits rather than iron ore or oil and gas. At the same time, the broker's Macro team noted a firmer consensus of a soft landing and potential improvement in commodity signals could be catalysts for rotation out of banks.

When China's economy got itself into trouble, largely due to a collapse in the Chinese property market, Beijing responded with little more than tweaks around the edges in terms of providing economic stimulus, even as experts cried out for more. The issue was China's extensive debt burden.

Things have only gotten worse, so finally Beijing has bitten the bullet. The government has announced more significant stimulus measures, resulting to a turnaround in what were weakening commodity prices.

Banks and resources are the two biggest chunks of Australia's market cap (some 60% between them), hence any step-up in investment in one typically leads to selling in the other. The money has to come from somewhere. Hence over history, the banks and resource sectors have tended to rise and fall in opposition to each other.

Add in the recent -50 basis point rate cut by the Fed, with the expectation of more to come and swiftly, and offshore factors are conspiring to lead to a switch to bank underperformance.

The average major bank PE multiple has recently fallen from a peak of 18.5x to 17.5x, Morgan Stanley notes, but is still above the ten-year average, the three-year post-covid average, and pre-2022 rate hike levels. The outperformance of banks versus resources has been significant.

Indeed, as at end September the banks were trading individually at 20-45% premiums above the ten-year historical relative PE despite having a poor earnings outlook, Macquarie notes.

When Things Go Bad

A key trend from August results, trading updates and disclosures from the banks is the extraordinarily low levels of credit impairment charges the banks are currently taking, this despite worsening underlying asset quality trends. Credit impairment charges at some 8bps in UBS' view are low, with consensus expecting around 13bps and 14bps in FY25/FY26.

The debate continues about the sustainability of low impairment charges, with consensus increasingly accepting a structural change of lower impairments. While losses will likely stay low for longer, Macquarie believes it is too early to write off the possibility of higher bad and doubtful debts (BDD) charges.

Macquarie believes the flow-on impacts of covid continue to impact banks' impairments. For example, the broker estimates impairment charges would have been up to $270m higher per half than reported if banks didn't unwind the overlays they built during the covid period.

Macquarie finds it difficult to reconcile that just in a few years, banks' risk assessment has changed, and adverse scenarios that banks presented (which underpinned their substantial loan losses in FY20) are no longer relevant. While banks still have more provisions than they can utilise, there has been a sizable drawdown over the last twelve months despite the economic outlook slowing.

If macro conditions deteriorate, banks will potentially need to retain their provisions and possibly rebuild them. This will adversely impact expected BDD charges, which are currently extrapolating a very benign period of credit losses for the foreseeable future.

Macquarie believes as the economy slows, impairments will rise, and risk-weighted assets will increase. In past cycles, banks started to build their provisions earlier in the cycle, but this time provisions are already in place, and write-offs tend to come when the economy begins to show signs of stress.

On the other hand, if wrong, the broker believes lending spreads will decline more than expected over the medium term and sees risk to pre-provision estimates in FY26 and beyond, coupled with the likely de-rating from current multiples that are more than three standard deviations away from their long-term average.

Relief from credit stress will no doubt come when the RBA begins to cut rates. However, rate cuts will put pressure on bank net interest margins. Macquarie estimates -5-9bps of margin impact from -100bps of rate cuts.

Banks trade at a steep premium to their historical averages, which differs from cycles, Macquarie notes, and could impact their performance.

Consensus

In Macquarie's view, valuations and fundamentals are not conducive to continued outperformance in the banks, and the broker sees material downside risk to share prices from current levels, particularly as the economy slows and rates decline, supporting an Underweight sector stance.

Citi is Sell-rated on the banks but does prefer the retail-exposed banks.

Major banks' operating trends have been better than expected in 2024, and investors have paid much higher multiples for their strong balance sheets and "safe haven" status. Morgan Stanley has lifted its price targets, but retains a negative stance given share prices imply nothing goes wrong in 2025.

With bank earnings multiples at all-time highs and the outlook for earnings growth still tepid at the best, Wilsons remains comfortable retaining a significant Underweight to the Big Four banks within its Focus Portfolio.

FNArena Major Bank Data					FY1 Forecasts				FY2 Forecasts			
Bank	B/H/S Ratio	Previous Close $	Average Target $	**% Upside to Target**	% EPS Growth	% DPS Growth	% Payout Ratio	**% Div Yield**	% EPS Growth	% DPS Growth	% Payout Ratio	**% Div Yield**
SUN	4/2/0	17.93	18.72	**4.41**	13.2	13.7	83.0	**4.9**	7.7	- 8.3	70.7	**4.5**
MQG	2/2/1	224.91	209.62	**- 6.80**	18.2	8.2	63.9	**3.1**	10.5	8.1	62.5	**3.3**
JDO	3/1/1	1.64	1.64	**- 0.12**	16.5	N/A	0.0	**0.0**	63.6	N/A	0.0	**0.0**
BEN	0/1/4	11.42	10.45	**- 8.49**	- 13.0	2.1	76.7	**5.6**	- 1.1	2.6	79.6	**5.8**
BOQ	0/1/5	6.12	5.41	**- 11.68**	100.0	- 15.9	79.0	**5.6**	0.0	2.0	80.5	**5.7**
ANZ	1/2/3	29.64	27.37	**- 7.65**	- 5.4	- 5.8	73.6	**5.6**	- 1.8	1.2	75.9	**5.6**
NAB	1/1/4	36.43	32.94	**- 9.59**	- 5.2	0.4	74.8	**4.6**	2.5	1.7	74.2	**4.7**
WBC	0/4/2	30.14	27.76	**- 7.90**	- 7.1	16.7	86.9	**5.5**	1.6	- 5.3	81.0	**5.2**
CBA	0/0/6	132.74	101.23	**- 23.74**	4.7	2.2	80.0	**3.6**	3.0	2.8	79.9	**3.7**

Rudi's View: Australia's Most Highly Recommended Stocks

Oct 23 2024

By Rudi Filapek-Vandyck, Editor

Risk comes in multiple shapes and forms.

A lot is being written about top notch valuations for global share markets, but the risk that is showing itself yet again this month in Australia is the risk for disappointing operational performance. On Monday, Nick Scali ((NCK)) shares are trading down -4.7% following a subdued AGM trading update.

Nick Scali's disappointment follows in the footsteps of ARB Corp ((ARB)) and EVT Ltd ((EVT)), as well as the travel sector representatives Flight Centre ((FLT)) and Web Travel Group ((WEB)) last week. For good measure, not all market updates are of a negative nature as can also be seen through the share price responses post market updates by the likes of Amotiv ((AOV)) and Bellevue Gold ((BGL)).

Maybe the safest conclusion to draw is that operational challenges remain a tangible headwind for many an ASX-listed company, smaller cap companies in particular.

For local investors, the art of successful investing hasn't changed since the August results season: it's about identifying which companies remain a great investment despite short-term weakness, plus separating out those unlikely to disappoint when communicating their latest insights.

Maybe FNArena can help with this mission?

After all, we do have access to research, opinions and views from analysts and strategists whose job it is to analyse, project and predict when it comes to share markets and individual ASX-listed stocks.

The Super Stock Report Top Twelve

The most straightforward methodology is through simply adding up all Buy/Hold/Sell ratings inside the FNArena universe, with our monthly **Australian Super Stock Report** providing exactly such an overview.

The October update, freshly published on the website last week, revealed a rather unique phenomenon. I say unique because in the more than two decades of compiling this Report, I cannot remember one single precedent.

The Top 40 of highest recommended stocks all have the maximum score on the FNArena Sentiment Indicator which ranks between positive 1 and negative -1. A positive 1 indicates all ratings are Buy or equivalent. A negative -1 implies all ratings are negative.

To compile our monthly Top 40 we require at least three (out of eight) brokers covering. Yet, all in the current Top 40 currently have no other ratings than Buy.

The local index is near an all-time record high, but this observation is as much a reminder to all of us the share market remains widely dispersed and polarised, with smaller cap companies representing both opportunity and risk.

Setting the minimum of analysts to five (5) generates the following **twelve most highly recommended stocks on the ASX** (as per last week's update of the Australian Super Stock Report):

-Universal Store ((UNI))
-Whitehaven Coal ((WHC))
-Patriot Battery Materials ((PMT))
-Accent Group ((AX1))
-GQG Partners ((GQG))
-Paladin Energy (PDN))
-Nickel Industries ((NIC))
-Worley ((WOR))
-SiteMinder ((SDR))
-Seek ((SEK))
-Flight Centre Travel ((FLT))

The first observation to make is both Seek and Flight Centre have had their share of negative news announcements this year, but sector analysts clearly do not think this removes the fact both share price are undervalued and much better times should announce themselves on the horizon.

Also, the aforementioned Amotiv and Nick Scali are equally on the long list of maximum Buy ratings, as are Superloop ((SLC)), Lindsay Australia ((LAU)), SRG Global ((SRG)), Kelsian Group ((KLS)), Beacon Lighting ((BLX)) and Zip Co ((ZIP)), among many others.

For more details, FNArena subscribers can download the monthly Report via the website, or simply use the link near the bottom of today's story.

FNArena's R-Factor

Another way of looking at individual stocks is through analysts' forecasts and establish where share price multiples are at in relative comparison. We have now entered the territory of **FNArena's R-Factor**.

Starting with EPS forecasts for the current and next financial year, and also taking into account dividend yields for both years, provides us with the following Top 12:

-Beach Energy ((BPT))
-Atlas Arteria ((ALX))
-IPH Ltd ((IPH))
-Challenger ((CGF))
-Perpetual ((PPT))
-Nickel Industries ((NIC))
-Charter Hall Retail REIT ((CQR))
-Downer EDI ((DOW))
-Spark New Zealand ((SPK))
-Kelsian Group ((KLS))
-HomeCo Daily Needs REIT ((HDN))
-Nine Entertainment ((NEC))

Here, the obvious comment to make is that in all cases there is a reason for why the shares look 'cheap' and 'undervalued' when measured against analysts' forecasts. In most cases the reason is a series of bad news announcements which have made investors rather reticent to jump on board.

Bear in mind, for example, Citi analysts on Monday repeated their view that Beach Energy is simply 'too hard' to assess at the moment, due to too many unpredictable negatives.

Toll road operator Atlas Arteria is facing multiple risks and headwinds in both France and the USA. IPH Ltd shares are being weighed down by negative filing volumes in Australia. Challenger has just released its Q1 trading update, described by Ord Minnett as its worst performance in more than a decade.

And so forth, and so forth.

While FNArena's R-Factor can be a great starting point to find companies that seem grossly undervalued, the real challenge is to decipher why this is the case, and whether it's temporary or longer-lasting.

The presence of HomeCo Daily Needs REIT might be directly related to the high yields on offer, alongside the prospect of a robust recovery in earnings per share. This REIT, like so many others, would benefit from RBA rate cuts and lower bond yields, although investors shouldn't bet on it for the months ahead, according to market consensus.

Best Buys, Conviction Calls & Model Portfolios

A third method is a lot more labour intensive, but we've done the *hard yakka* over the weekend by combining all the various Conviction Lists, Model Portfolios and sector favourites from the brokers FNArena monitors regularly.

This effort has generated a **list of 15 companies** that might well be described as **Australia's most favoured equities** as markets prepare for a different twelve months ahead. Given the input, this selection is much more focused on larger cap companies, which in light of the disappointments that are coming out of the smaller cap segment, might well be the better risk-adjusted option, still.

The following might surprise a few, including myself, but **ResMed ((RMD))** is the most favoured among professional strategists and portfolio stock-pickers. We counted ten nominations, plus a 0.6 reading on the FNArena Sentiment Indicator, plus two Buy ratings from brokers not monitored daily.

The shares have recovered more than 70% since the depths of the GLP-1s scare this time last year and, clearly, the expert opinion is this growth story has a lot more to offer, still. ResMed is scheduled to report Q1 financials on Friday morning, Sydney time. A lot of attention will be paid to the gross margin, alongside the underlying composition of what should prove yet another robust performance.

Equally (if not more) important: irrespective of what happens in response to Friday's result release, analysts generally remain confident to see ResMed grow earnings at double-digit percentages for many more years ahead.

The second most highly rated company is **James Hardie ((JHX))** whose short-term outlook is currently in question because of devastating hurricanes raging through the south of America. James Hardie is oft referred to as possibly the highest quality cyclical on the ASX and experts' confidence in continuation of this longer-term growth story seldom wavers.

James Hardie does occasionally update the market with unexpected misfortunes and its key markets are highly cyclical, but all tends to end well, as also shown by the fact the share price hit an all-time record high earlier this year. James Hardie too will release quarterly financials shortly, on November 13.

James Hardie has been nominated nine times, rates 0.7 on the FNArena Sentiment Indicator, with two extra Buy ratings from brokers not monitored daily.

The four following nominations are **Xero ((XRO))**, **Aristocrat Leisure ((ALL))**, **CSL ((CSL))** and **Santos ((STO))**. All have eight nominations with otherwise minimal added differences.

Xero has successfully convinced analysts and investors it can adhere to the *Rule of 40*, which has pretty much become the golden standard for fast-growing technology companies, and make successful inroads into the US market. Don't just take my word for it, look at the share price over the past twelve months.

Most share price targets set by analysts are still above today's share price. Xero will report FY24 financials on November 7.

Gaming multinational Aristocrat Leisure remains off limits for selectors with a strict ESG focus, but fact remains Aristocrat has been one of the prime outperformers among larger caps on the ASX, also beating most smaller caps along the way, and it'll be a brave forecaster to predict this feat shall not be repeated in the years ahead.

The company is looking to divest of its non-core Social Casino operation, while continuing to invest heavily elsewhere and put the squeeze on competitors who cannot replicate. One of the new competitors, Light & Wonder ((LNW)) recently lost a court case with as yet unknown full ramifications.

As more US states are opening up for online 'gaming', the years ahead could offer additional avenues for growth. Aristocrat is yet another company that reports financials out of the normal cycle in Australia. Its release of FY24 financials is scheduled for November 13.

CSL reports in August and February and the case for owning Australia's number three index weight was yet again neatly summarised by Bell Potter on Monday, with the broker initiating coverage with a Buy rating and $345 price target.

The core business, which is Behring (plasma), represents circa 72% of CSL's annual revenues and, assisted by ongoing margin increase, this part of the business should continue to grow at double-digit percentages for many more years ahead. Says not only Bell Potter.

The two other main parts, Vifor (relatively new acquisition) and Seqirus (vaccines), have been struggling of late and Bell Potter's forecasts assume nil growth from both. Regardless, the broker remains confident management will deliver on its promise to grow the total business at double-digit earnings per annum over the mid-term.

CSL will update analysts at its R&D investor day on October 22, though no major new revelations are expected.

The inclusion of Santos very much reflects the falling out of favour by Woodside Energy ((WDS)) whose capital allocation decisions in recent times do not receive widespread approval. Loyal shareholders with appetite for tasty dividends should prepare for much reduced payouts in the years ahead, says virtually everyone.

Santos is now the most preferred energy sector exposure locally. As for the outlook for energy prices generally, let's just say expert opinion and projections remain divided.

Next in the ranking is **Brambles ((BXB)**), the world's number one pallet logistics company whose fortune has made a turn for the better, after a long period of disappointing shareholder experiences. The release of FY24 financials in August is a case in point with the share price quickly rallying from below $16 to above $19.

Brambles is now seen as on a more sustainable growth path, with plenty of management's in-house initiatives (including technology) seen as further cementing the company's new growth profile.

The following three companies' high ranking stands in contrast with sector analysts' ratings, as shown by rather subdued readings on the FNArena Sentiment Indicator. Those companies are **Rio Tinto ((RIO))**, **Westpac Bank ((WBC))** and **ARB Corp ((ARB))**.

This might be explained, particularly in the case of Rio Tinto and Westpac, through relative preferences. For institutional investors, the question is never shall we own Large Cap diversified resources or banks, but how much must we own. Call it the tyranny of large index weights.

Hence, given just about everyone views Australian banks as grossly overvalued, but definitely not 'cheap', the best way of interpreting Westpac's high ranking is probably: if you must own at least one bank, Westpac is most preferred.

Rio Tinto has been criticised for paying a high price to acquire Arcadium Lithium, but most sector analysts have targets above today's share price. More stimulus forthcoming from China feeds into sector optimism as well, as does the general view the global economy is poised for a recovery next year, not economic recession.

ARB Corp recently issued a disappointing market update, but most expert voices are clearly not too worried. The large US market, and the company's investments and alliances, should bode well for many years to follow.

ARB Corp has five nominations, as do **BHP Group ((BHP))**, **Car Group ((CAR))**, **South32 ((S32))**, **Suncorp Group ((SUN))**, and **Telstra ((TLS))**. The latter five all enjoy a positive reading on the FNArena Sentiment Indicator (equally backed-up by brokers not monitored daily).

The big surprise here, I assume, is the inclusion of Telstra. This long vilified large cap has long provided shareholders with an elongated erosion in the share price as dividends went backwards, then stagnated. That trend is now reversing and expectations are for ongoing increases in dividend payouts in the years following.

I think Telstra is now Australia's most favoured dividend stock, also helped by the fact banks are seen as pricey and Suncorp will pay out a big dividend this year (sale of bank), but it'll fall quite heavily in the year thereafter. On current consensus forecasts, Westpac's dividend is set for small declines in both FY24 and FY25.

Those forecasts will be put to the test when three of the local Big Four report financials in November, including Westpac.

A Golden Era For Engineering Services?

Oct 30 2024

Defence, energy, digitalisation industries collide with sustainability to provide a very positive investment spending backdrop for Australia's engineering services companies.

-Major infrastructure spending is back
-Defence budgets on the rise due to geopolitics
-Net zero targets equal more investment
-The future is digital
-Which companies are set to benefit?
-Worley chasing the sustainability dollar

By Danielle Ecuyer

Ramping up investment in Australia's future

The rather un-glamorous sector of engineering services might be entering a golden era of major infrastructure spending across what can only be considered as "critical" industries for Australia's well-being and future.

A big topic with even bigger financial carrots is hanging in the offing.

In the latest deep dive sector research conducted by RBC Capital, focusing on "disruptive forces", the broker explores opportunities for engineering services in the defence, energy and digitalisation industries.

The report offers a cursory observation of the shifting sands of geopolitics, explains the need for energy systems to be decarbonised and climate event resilient, as well as the ongoing rise of digital demand across industries, including the burgeoning growth in data centres.

These factors underpin sizable tailwinds for companies exposed.

RBC takes a top-down approach to set the scene for why its analysts have initiated coverage on **Ventia Services Group** ((VNT)), **Downer EDI** ((DOW)) and **Service Stream** ((SSM)); each in possession of downstream exposure to the industries mentioned.

Goldman Sachs shines an ESG light on **Worley** ((WOR)) investigating whether the company is an "underappreciated solutions provider" to the global greening agenda.

Industry-by-industry outlook

Defence budgets are rising in Australia.

Around 18-months ago I sat with a renowned stockbroker for a coffee at Sydney's Australia Square who explained to me just why Darwin was the hot new investment capital of Australia.

His observations were prescient.

RBC highlights rising geopolitical tensions, think China/Taiwan as one example in the Indo-Pacific region, which are leading to substantial investments in infrastructure. Australia has consistently spent between 1.8% to 2% of GDP on defence over the last 20 years, compared to the US at 3.5% and Russia at 4.1% of GDP in 2022.

The latest estimates from the 2024 National Defence Strategy and 2024 Integrated Investment Program explain a $5.7bn rise in defence spending over the next four years and an increase of $50.3bn over the next decade.

This equates to a rise in spending to 2.4% of GDP by 2033.

RBC explains the opportunities for Ventia, Downer and Service Stream that exist through the $14bn-$18bn spend for the infrastructure and adjacent facilities for the Northern Territory Bases; the $17bn-$18bn on what the broker refers to as enabling facilities such as training, and $15bn-$20bn in Theatre Logistics.

At the midpoint of $53.5bn, this implies only 14% of a total $375bn has thus far been allocated.

Notably, Darwin is rated highly as a significant strategic location and contractors with existing Defence relationships tend to have more "sticky" contracts given the high barriers to entry.

RBC points to the top five defence reportable contract providers as BAE Systems, Boeing, **Ventia**, RTZ (formerly Raytheon) and Thales.

Tackling decabonisation

When it comes to the carbon challenges for Australia's energy infrastructure, multiple factors come into play in meeting the country's legislated greenhouse gas emission targets for a -43% reduction versus 2005 levels by 2030, and net zero emissions by 2050.

The government is targeting 82% renewable energy in the Australian electricity grid by 2030 with RBC explaining renewable energy produced reached 31.4% in 2Q24 based on National Electricity Market data. In 4Q23 it was as high as 42.7%.

Coal fired power stations are reaching the end of their "useful life" and up to 90% of them are forecast to retire before 2035, and the entire fleet before 2040.

Replacing coal fired power stations requires new utility scale generation and storage because of the intermittent renewable energy generation. This decade the grid has added 12.5GW of new generation and 1.3GW of storage with 490km of newly constructed transmission lines.

Current coal fired power stations have 21GWs of capacity, so a mind boggling 20GW of generation and storage with 2090km of transmission lines need to be built.

RBC details the added complexity of the changing demand forecasts. Residential consumption from the gird is anticipated to be basically flat in 2050 because of rooftop solar.

Business, industry, the switch to electrification and emerging hydrogen production are forecast to add additional demand of 45Twh, 65Twh and 55Twh, respectively.

Nuclear energy was placed on the agenda in June by the Liberal Party. This is not viewed a realistic opportunity for Ventia, Downer or Service Stream.

Going digital is a journey

In the latest iteration of the National Broadband Network, the Commonwealth Government announced an additional optic fibre to 1.5m premises or a $2.4bn investment to transition to fibre-to-the-premise from fibre-to-the-node.

Currently 6,000 homes/businesses are upgrading each week, including yours truly a few months ago. In June 2024, 2.3m premises had the new connection with an additional 3.5m premises anticipated by June 2025.

While your mind is probably debating how good or bad the NBN is, ultimately the future lays in the fastest connectivity for devices and use of generative artificial intelligence.

Enter one of the biggest investment spends this decade: data centre build outs. FNArena has written extensively on the topic, see also the dedicated Gen.Ai section on the website: https://fnarena.com/index.php/tag/gen-ai/

Suffice to say energy supply is integral to the build out, as are defence and cyber security.

RBC points to the 2023-30 **Australian Cyber Security Strategy** which highlighted during the 18-months to December 2023 one cybercrime was reported every six minutes. Ransomware causes -$3bn in damages to the Australian economy every year.

The estimated cost to businesses is advancing at circa 14% per annum.

The broker believes part of the solution is improvements and/or construction of digital infrastructure. Since June 2019, aggregate data consumption has increased at 1.20% compound average growth rate and is only expected to rise.

Just think how many streaming services are in your house.

In the Defence sector digital infrastructure is used via defence data centres, the cloud such as AWS or Microsoft Azure, and hybrids of data centres and the cloud.

Ventia: the all-rounder with quality tilt

Ventia Services Group was created from a merger in 2015 between Leighton Contractors Services, Thiess Services and Visionstream. In June 2020, in what was a reverse takeover, Ventia acquired Broadspectrum (formerly Transfield) from Ferrovial for $465m. The company IPO'ed on November 18, 2021.

Current market capitalisation stands slightly below $4bn with 35,000 people in action across 400 sites in A&NZ. The suggestion made is Ventia occupies a sweet spot for investors with favourable exposure across the three major infrastructure sectors.

Highlighting the strength of the group's defence exposure, Canaccord Genuity detailed a six-year, $564m contract with the Department of Defence for firefighting services. It is a continuation of an existing contract, starting in 2004 with options to go past 2030.

The new contract at around $94m p.a. marks an increase of $35m-$40m p.a. and represents one of five contracts the group is seeking to renew with the Department of Defence, valued at around $550m annually in defence property and asset management services.

RBC explains Ventia is the largest engineering services company to Defence currently, managing 60k plus social housing units in NSW, and with the largest private firefighting unit domestically. The company services all four of the defence departments including Digital Group, Joint Logistics Command, Security & Estate and Capability Acquisition and Sustainment Group.

Looking at the company's first half results, Canaccord stated strong growth in Defence & Social Infrastructure and Telecommunications boosted 11% growth in revenues and a 9% increase in EBITDA. Macquarie observed the results met expectations with an upgrade to 2024 guidance to 10-12% from 7-10%, although consensus was already positioned for 11% growth pre the result.

Morgans noted the results were slightly below expectations and consensus but with $17bn work-in-hand the outlook is for earnings growth across all sectors the group operates in.

Ventia is highlighted by RBC as being the provider for Transpower NZ's Transmission Grid Services (the high-voltage transmission network) for around 25-plus years. The contract was renewed in May 2022 for another five years with an additional five-year option.

RBC envisages the group can make inroads into the Australian market. With a relatively smaller share, it will benefit from growth in the overall market, as outlined in the expansion for the domestic transmission line network.

Regarding the digital exposure, Ventia has designed, installed and commissioned over 50,000kms of fibre across Australia and connected around 6m premises to the network.

With “vast” wireless capabilities and skills in fixed network technology and energy infrastructure, RBC believes Ventia is “well positioned” to service both energy needs and service digital infrastructure.

FNArena daily monitored brokers are all Buy-equivalent rated, except Ord Minnett with a Hold rating.

RBC Capital initiated coverage with an Overweight rating and a $5.25 target price. The analyst explains a track record of stable earnings, shareholder returns and a position to benefit from structural tailwinds offset a perceived negative by some, as well as a lack of time in the public market.

The FNArena consensus target price is $4.56 with Canaccord at $4.75 and Buy rated. At current price levels ($4.56) the stock is trading on 2025 prospective price-to-earnings ratio of 16.4x and 4.5% dividend yield.

Downer EDI: Can what’s old be new again?

RBC details the transition Downer EDI has been conducting with new CEO Peter Thompkins, including exiting the Rail Freight and Mining businesses, the divestment of -70% of its commercial laundry business and addressing ICAC investigations and accounting anomalies. The company is now concentrating on Transport, good for around 52% of FY24 revenue, Utilities at 20% of FY24 revenue and Facilities at 28% of FY24 revenues.

Management is also implementing a -$175m cost out program in FY25 with a target EBITDA margin over 4.5% for FY25/26.

The share price has been responding from a low around $4 in January to current levels around $5.75 which equates to a $3.7bn market capitalisation.

Drawing a comparison with Ventia and Service Stream, RBC’s analyst emphasises Downer has a more “capital-intensive approach” to its business model, leaving it open to greater construction risks while the road services business needs more fixed assets.

FNArena daily monitored brokers, Ord Minnett, Macquarie and UBS, acknowledged management’s profitability enhancement targets at the FY24 results, which Macquarie viewed as better than consensus expectations.

UBS pointed to depletion of low-cost contracts in water and Vic gas as benefiting the company alongside its cost out program. While Ord Minnett pointed to the priorities in the energy transition and utilities segment.

All are Hold-equivalent rated with an average target price of $5.623. At current price levels, the stock is trading on a FY25 prospective price-to-earnings ratio of 14.3x and a 4.1% dividend yield.

RBC initiated coverage with an Hold-equivalent rating and $6 target price.

Service Stream slides into other sectors

With a long-established exposure in telecommunications where NBN represented 74% of FY24 telecommunications revenues and wireless the balance, Service Stream's strategy as detailed by RBC is to expand into other industries such as utilities including water, industrial and electricity, roads transport and more defence, recently.

Add-on acquisitions are part of the strategic thrust with Comdain Infrastructure in 2018 ($160m) and Lendlease Services in 2021 ($310m). As the company diversifies its earnings stream, RBC believes a re-rating is possible.

Macquarie observed at the FY24 results Service Stream secured over $2.2bn in contract works over the period and earnings rose 13.2% on a year earlier, some 2.85% above the broker's forecast due to strength in telco and utilities. Going into FY25, the work-in-hand pipeline reached $5.2bn across all major markets.

Citi was equally upbeat, highlighting no shortage of positives from FY24 results, notably robust cash conversion, better utilities margin and an improved 2H24 telco performance.

Ord Minnett highlighted a strengthening balance sheet with an increasing share of revenue generated from less-capital intensive operations and maintenance works at 70%. This allows for improved transparency of earnings and cash flow.

The FNArena consensus target price stands at $1.593 with two buys; Citi ($1.70 target price) and Ord Minnett ($1.67 target price). Macquarie has a Hold-equivalent rating ($1.41 target price).

Service Stream has around a $960m market capitalisation and trades on FY25 prospective price-to-earnings ratio of 16.1x and 3.6% dividend yield.

Sustainability funds hold a US$2trn key for companies

Goldman Sachs estimates the Sustainable Fund universe is worth US$2trn with a wider ranging classification of Sustainable assets under management across asset classes under different mandates and strategies from PWC and GASIA at US$18trn and US$30trn, respectively.

For Worley ((WOR)), the classification of "sustainability" has implications for the stock's re-rating potential, the broker explains. The company is currently **"36% underweight by global sustainability funds"** against its benchmark weighting.

Worley is highlighted for the FY26 goal to generate 75% of revenues from sustainability-related projects compared to 52% in FY25.

Due to investor feedback at the FY24 August earnings presentations, Worley has broken down sustainability-related categories into "transitional", essentially natural gas, and "sustainable".

Goldman Sachs explains the company's category of "sustainable" ex "transitional" represents 34% of aggregated revenues in FY24. The broker also views the role of natural gas as a significant transition fuel to firm renewables as energy supplies transition from coal-fired power generation.

Under the EU's Corporate Sustainability Reporting Directive Regulation from FY26, the new Worley classification has the potential to attract increased Sustainable Fund ownership, the analyst argues.

Addressing concerns over a slowdown in near-term green capex projects, Worley's sales pipeline is viewed as "solid" with a slant towards sustainability-related works at 41% as at June end and 44% transitional, or 85% in total.

Equally, the broker estimates $4.2trn of annual incremental green capex is required this decade to achieve global net zero, water and infrastructure goals.

Worley's exclusion from Sustainable Funds relates to a view the company is still oil services based, despite the shift to more sustainable projects and a legacy Ecuador business.

On balance, the broker believes Worley is a green enabler for higher emitting industries, Energy, Resources and Chemical, with potential to build low carbon businesses and/or reduce the environmental footprint, by employing its low carbon expertise.

At the latest 3Q2024 update, Worley revealed a decline in 2H24 backlog and lowered FY25 expectations. Goldmans Sachs observes it's a "cyclically challenged" macro environment. The CP2 LNG terminal project by Venture Group LNG could generate over $6bn to the company's backlog as the project edges towards a final investment decision.

Macquarie believes Worley will reiterate FY25 guidance at the upcoming Nov 21 AGM for a split of net profit of 45:55 between 1H25 and 2H.

The broker expects 5% revenue growth over the current fiscal year versus double-digit growth in FY23/FY24.

FNArena daily monitored brokers all have a Buy-equivalent rating with an average target price of $18.26. Goldman Sachs is also Buy rated with an $18 target.

Investing In The Era Of Hyper Change

Nov 06 2024

Nilesh Jasani, founder of the Geninnov Fund chatted with FNArena from Singapore about generative artificial intelligence, change and investing in innovation.

The discussion includes the size and scope of generative artificial intelligence; how technology and innovation are changing the world; what Geninnov invests in and why Jasani still prefers public markets to private markets.

Below is a curated transcript of the interview which is available via the **FNArena Talks** section of the website:

https://fnarena.com/index.php/fnarena-talks/2024/10/17/interview-with-nilesh-jasani-founder-of-geninnov-global-innovation-fund/

As well as via YouTube:

https://www.youtube.com/watch?v=0mVrFMA2CUY&t=1054s

This interview was conducted on October 9, 2024.

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Danielle Ecuyer: How has your career to date brought you to the place of starting Geninnov, a generative innovation fund?

Nilesh Jasani: It appears like my entire career was always trending towards this point. I was an engineer, and I was fortunate enough to attend a college which had a semiconductor fabrication unit at that time. I was one of the few guys in India who manufactured something on a silicon wafer during my education. I was introduced to neural networks. So, two fields diametrically opposite, are the fields which are of critical importance today and were part of my education.

I started my career at IBM, and things that are important today, when you try to really compare x86 architecture with ARM, those kind of things were, again, part of my career. I also got to manage a team based in Seoul in Korea in the late 1990s. I got to manage a team based in Taipei in the middle of 2000 when companies like Samsung Electronics and TSMC were coming out.

I have been following these fields and areas all these decades, even when I was managing Jefferies and doing all sort of other things. These things were somehow always important to me, for no other reason than they were simply interesting.

Something happened in 2022. I said to myself I want one more inning of the career. The way I see it, 2022 is when humanity learned how to manufacture intelligence without two people having s-x. And that is ushering us into a completely new era. Almost everything that was happening in the name of AI and technology until 2022 meant we could not create machines that had ‘intentionality’.

Intelligence is something that is very easy to see but very difficult to define. It’s like you have an infant. You’re barely teaching her/him how to poop and how to cry, and one day, he/she knows how to manipulate your feelings by crying in a particular way to get picked up. This is something the baby is doing that our machines could not do.

Development of ‘intentionality’, a narrow neural network method in 2022, completely upstaged that, and that is the reason why the world is in a completely new stage for technology, and a completely new stage for humanity. We have machines that can address every problem out there at a different level of complexity compared to our human brains, and that is ushering us into this era of innovation.

I want to have a front row seat to possibly the biggest theatre of our lifetime. That’s why I am starting on the journey of this generative Innovation Fund, because I want to bring together various experiences and interests I’ve had in life.

I’ve been fortunate to start new companies and new divisions and worked in so many different markets. I’ve seen different aspects of technology, from IBM to software, to Palo Alto where my all my friends are, and so on and so forth, bringing all these together appears like something that will allow me to incorporate various things I’ve learned and that have interested me.

Question: Could you explain how you view the size of the generative AI market?

Jasani: Look. It’s going to be all-pervasive.

Transformers started as a narrow neural network method to roughly guess the next word in say, English. That’s how the guru math was initially designed in Google Labs about five years ago; and humanity stumbled upon something that is most amazing, one of the greatest discoveries of all time, and we are unable to fathom where its applications are going to end.

What started as a narrow neural network method to understand one language, somehow, the same formula figured out all human languages. The same formula, in no time, figured out all computer languages that we have. It not only did that at the next level of scaling, by 2023 it figured out human vision at the next level of scaling, which is ongoing. It is figuring out inter-relationships and things in our DNA data, or earthquake tremors, or crystal structures; that nothing in our mathematical or statistical toolkit could do until now.

Where this is headed and where it is going? All of us are shocked by the applicability of this method, and machines have started working on themselves, so the implications are not in chat boxes and Copilots. Those are narrow day one use cases, like the way email was for Internet. In the same way the Internet did not remain about computers to computers, communication through emails, but turned out to be much, much more.

This is far bigger.

While popular imagination is still fascinated by what chat boxes can do or cannot do, and the various issues over there, the implications are for driver-less cars. Also, the implications are for robotics, in molecular sciences, drug discovery, renewable energy and whatnot.

It's impossible to even forecast the fields of applicability, let alone the amount of business one can do. I am more in the camp that this is going to be as pervasive as internet or mobile telephony, and with far more applicability over time.

Question: Is the evolution dependent on the build out of infrastructure, like data centres?

Jasani: The simple reality, the way I see it, is that nobody knows exactly where this technology is going and how it is going to evolve. In Chapter One of this era, we are in this concept of data centres and the global brain concept that if Danielle wants to know what is two plus two, that thing will possibly go to some data centre somewhere where 20,000 Nvidia chips are interconnected, and somebody will do a trillion-by-trillion matrix multiplication, and come back saying 'four'.

Do you really need to do that? Are there other ways to do it? Should you not have an agent that says this is a solved problem that can easily get solved on your calculator, rather than go to a data centre?

The reality is that over time, the AI compute, which is 95% in cloud today, will possibly go to 70% in your pockets; 70% in the gadgets or instruments that you have. Your compute will have to be decentralised. Things will have to move to the edge.

Many other things will have to happen. We may stop thinking more in terms of our queries and chat boxes, and we may start thinking in terms of how we use the new technologies and the ones that come thereafter, to really change the driving, to really change the way we work at home, and in all sorts of devices and infrastructure.

So rather than waiting for something to emerge, I think all of us need to start participating. The sooner we get started, the sooner, we ourselves will come up with new innovations and new solutions.

Question: How do you look across the universe of stocks that you are afforded, because you're looking across multiple countries, you're looking across multiple industries. Is it a case of trying to isolate down those companies that have large R&D spends that, as you alluded to, are already first movers?

Jasani: The way we arrive at our conclusions and our starting point is always through material, scientific and technological innovation. We are in a new era. We strongly believe that internet era business models are shifting. The Internet era gave rise to a particular way of businesses, a particular kind of businesses succeeding. Most of the gains were captured in the application layer.

It gave rise to a different way of investing, venture capital investing. That's when innovation moved to garages.

I think in the generative AI era all these business models are shifting. Ideation is getting commoditised. Computers are no longer speaking specialised languages. One can deal with machines in human languages. It is giving rise to completely different kinds of forces.

It is giving rise to this era where anyone can come up with products and features, but making money out of ideas alone or products and features alone is becoming more and more difficult. So, the business posts are shifting, more and more value is captured in hardware or near hardware layers, rather than in the application layer, and that's the material shift for all of us.

Currently, there's a lot of debate on this topic. We have our views, which are somewhat extreme, but there's a lot to think about. The second thing we do is we try to understand not only innovations, but the companies and trends by being close to the sources. We try to spend far more time reading MIT journals and Nature magazine than say, reports that come out of investment banks.

We are trying to understand innovations at the root by talking to the right people, rather than talking to CFOs and CEOs. We are trying to really then focus far more on monetisation rather than simply products or features.

You see what's happening with Microsoft, or what's happening with Salesforce, or what's happening at SAP; suddenly the numbers of products and features are going through the roof.

You can say that some of these companies have introduced more features in the last one-and-a-half-years than over the previous 15 years, but the ability to monetise is in question when the value capture is happening somewhere else.

We try to really focus on those things. We are also at the application end. We realise that lots of these things will spur innovation, like mobility. There are some amazing things happening in terms of level three and level four autonomous driving.

The field had somewhat stagnated over the last 10 years, but suddenly, as machines learned how to really train themselves through observation, level three and level four mobility have become feasible. We also invest in mobility.

We look for where robotics could be going from here. If people like Tesla or Apple are indirectly telling us they are new businesses, there's something else going on. We try to look at demographic forces, why automation could be resisted in certain spaces, say in countries like the United States, while in similar spaces, the automation would be more than welcome in places like China or Korea, because demographic forces are very different.

Our entire thing is we don't care about how many companies are listed out there, and we don't care, obviously, about learning all of them for their quarterly results or for their valuations and so on and so forth.

Our processes are the other way around; we focus on innovations we believe in, and we look for the right expressions. At various points, we add angles like monetisation, macro factors, regulations, valuations et cetera. **In a way, it's a process that's been successfully adopted by people like Warren Buffet that does not worry too much about what we don't know, but try to really do what we know reasonably well.**

Question: You hold Novo Nordisk, could you just possibly run through some of the details of the thesis for this so people can understand a real-life example?

Jasani: You possibly captured one of the three examples in our portfolio that has very little to do with generative AI. This exception is possibly the best way to explain the real nature of the portfolio, or rather our fund; we are an Innovation Fund.

We are not a hardware fund; we are not an AI fund.

Innovations can happen without any machine efforts, and that's fine. The way we see it, is that we are in the era of hyper change. We were in the era of change between 1992 and 2007, when innovation was one of the biggest drivers of businesses and investments globally; when our consumption baskets were changing, when our languages were changing, when we added hundreds of new words to our dictionary, like web, internet, laptops, Palm Pilots, Blackberries and whatnot.

A lot of things had to go away from our basket, like video VCRs and fax machines, to make way for the new things.

Now we are in the era of hyper change. In between, there was a bit of a stagnation. But once again, our languages are changing. Agents are no longer chain spots, and our consumption baskets are changing.

We are replacing our potato chips with GLP-1s. I think GLP-1s is one of the most amazing innovations of all time. Hopefully there are no side effects that we come to know 20 years later.

Somebody I read last week even claimed it's a bigger innovation than generative AI. Here is a molecule which is a gift that keeps on giving. It was supposed to be for your appetite, a suppressing molecule and not only after it became a solution for diabetes. What we are witnessing, almost on a quarterly basis now, is that it’s a molecule that could be a solution to certain kinds of heart diseases, kidney diseases, liver diseases, depression. GLP-1 is currently going to less than 2% of the people who need it.

It is such an amazing new molecule, and its potential is so huge. While prices will have to keep coming down over time for it to reach more and more parts of the population, there will be further innovations in the same space.

I think everyone has realised there’s a lot of potential in surrounding this space, the GLP-1 inhibitors. So absolutely, a lot more things will have to happen. But in companies like Novo, companies like Eli Lilly, you have completely different types of innovation that is sweeping the world. And they are attractive to us. They’re part of the kind of things that we look at; it’s fascinating and it’s interesting.

<u>Question</u>: Can you explain to people how autonomous driver-less vehicles are being created?

Jasani: Human vision was a problem. We could not make machines learn through observation in the way our kids do. Instruction-based programming is always something that doesn’t work in real life. It could not work in translation.

You may remember there was a time when Google Translate completely went away from instruction-based ways of translating from one language to another and went to learning based method. That happened a few years ago. Now, somehow, we could not do that with vision until transformers came in. With vision transformers coming in, roughly about a year, year-and-a-half-ago, it’s become possible for us to use vision data and let machines figure out whatever lessons they need to learn.

They’re spurring them suddenly in a new direction. Both robotics and autonomous driving are taking off because we can use visual data and let machines figure out what they need to do, rather than provide line by line instruction on 10s of 1000s of 10s of millions of things that happen in real time and how to deal with them.

This is effectively the reason why people like Elon Musk, companies like Tesla want to be in China versus, say, rely on the vision data only in the West; because the laws are very different.

The way you can possibly use camera data from cars moving on the street in China versus the US and the way you can use those data train your models. There are a lot more restrictions in privacy-conscious countries like the United States, while there are far less restrictions in China, where your models can improve very rapidly, because you can use a lot more data.

The entire driver-less mobility is going in different directions, even in terms of model developments. In many countries in the world people will be far happier overall if they can pay the cost for, say, getting a cab ride in a driver-less vehicle compared to a driver vehicle, and that may become the primary factor in an election.

In some other countries the attention could be more on the employ-ability of all the people who are involved in that industry, and producer utility versus consumer utility. All of us are producers and all of us are consumers. Which one dominates is different in societies at different times, and that is what will give rise to completely different innovation directions, not just in robotics or mobility, but across the board.

We're also witnessing how currently chat boxes, consumer applications, and corporate efficiencies are far more important in countries like the United States compared to China. So different countries are moving in different directions with all these technologies, and that's something that one should keep in mind by evaluating them

Question: How do you look at or do you look at rationalising valuations versus those companies that are at the forefront of innovation, with or without the use of generative AI? What interplay does macroeconomics have, if at all in your decision making?

Jasani: Investing is very difficult in public markets. As you know, you always end up having to look at too many factors that don't have much to do with businesses, whether they are interest rates or some election or some geopolitical factors and so on and so forth. One must be somewhat mindful.

For the fund, the reason why we are in public markets and not in private markets, is because we think that a lot of material innovation out here will have to happen with large companies that offer innovation monetisation.

Innovation is more and more moving away from garages and small companies and into the domain of giants. That's our belief and that's the reason why we must be in public markets.

We also want to keep an exit window open. Too many things are changing. We don't know where we are headed. I don't think anyone knows where the world is going to be next year, same time, let alone 2030, or 2025, and investing with your exit window closed in some multi-year vehicle has become risky when the world is innovating.

The world is moving so rapidly.

I think the most important thing to do is understanding the business investment. Try and tune out as much to other macro news as possible, if you are doing genuine business investment. Tuning out is difficult, but that's something we have to do.

Valuations are important, but equally, if we are thinking about investing in companies that are going to be growing at, let's say, 15% or more over a long period, and are accumulating IPs, accumulating leaderships in space and riding ahead of competitors like, say, Nvidia, creating the competitive distance.

Then you must think about valuations very differently. It is not value investing. It is growth investing, and as a result, yes, absolutely, you must look at valuation, but not in the traditional sense. You can't look at a five-year price to earnings chart; you have to compare to growth prospects.

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More information on Nilesh Jasani and the Geninnov Fund can be found at https://www.geninnov.ai/

Rudi's View: Confidence In Quality Rewarded

Nov 27 2024

By Rudi Filapek-Vandyck, Editor

Many years ago, I read a story by Marcus Padley praising the virtues of a one-stock investment portfolio.

The philosophy behind the idea is that when all your money sits in one stock, you will make sure you know every in and out about this company and you'll know when to take some money off the table and when to buy additional exposure.

The concept also makes sure you concentrate all your efforts in the right place. There's only one company to follow, query, research and analyse. Anyone can do this.

It's an appealing concept, assuming you choose the right company, which is always straightforward when we allow Harry Hindsight to have his say.

In my personal case, I might have chosen TechnologyOne ((TNE)) whose growth trajectory since 2004 is nothing short of 'stunning'.

Consider the share price back then was less than $1 and this week the price has exceeded $30. I am not even going to put a mathematical appreciation on this.

Year-to-date the shares have rallied more than 100%.

You wonder why I would ever buy an index ETF or try my hardest trading in and out of stocks whose momentum comes and goes.

But, of course, I could also have chosen CSL ((CSL)) which until the early covid-panic of 2020 had been an equally stunning investment for many years, but a whole lot less so since.

I would have built-up a lot of frustration had I put all my money into CSL, there's no denying it.

The underlying philosophy behind the one-stock portfolio does appeal though and the longer I analyse and comment on financial markets, and run my own Portfolio, the more I gravitate towards the core philosophy as expressed by investment legend Peter Lynch: **Know what you own, and why you own it.**

Truly achieving that, to be frank about it, is a whole lot easier to do when you concentrate your efforts around a selected basket of companies you get to know intimately as you own a large part of the targeted selection over a prolonged period of time.

This is essentially the framework I have created for myself and for those investors who pay attention to my specific research into All-Weather Stocks.

I like the idea of getting on board the TechOne shareholder register when only a few others are paying attention and still praising the company's quality and achievements many years later when just about everyone is starting to pay attention because the return has been absolutely phenomenal.

I am still not in a mood to sell and that confidence is built upon the multiple experiences and insights accumulated over that long period of ownership.

Having said so, one should never fall for hubris and fail to understand the importance of pure plain investor's luck. I might have been confidently singing the praises of TechOne for many years now, there's a big difference between being confident and knowing exactly how the future will play out.

I never knew the share price would double this year. I did not know TechOne's new product would be such a big hit so soon or that the UK expansion would beat all expectations. I also still remember 2016-2017 and 2020 when nobody seemed much interested and the share price didn't move much a la CSL today.

But I remained confident I should remain on board TechOne's register, regardless of what the market mood was during those times.

Combine all of the above and the logical improvement upon the one-stock investment thesis is to build a concentrated portfolio of selected companies you get to know really, really well.

In my case, I seek to identify the highest quality sustainable growers, the kind of companies like TechOne and CSL that are most likely to generate lots of shareholder value, over time, not necessarily right here, right now or all the time.

The market's mood swings are not necessarily straightforward or even "important", plus bad things can and do happen to great companies, occasionally, but that only sets them back temporarily.

The investment thesis for CSL is continued margin improvement on the back of strong growth in plasma collection and related products, which forms the basis and the bulk of the company. Vaccines and Vifor should start contributing positively again.

In TechOne's case it is the qualitative transformation of a business that is now truly blossoming and readying itself for an acceleration in the pace of growth on top of cash flows arriving in spades.

The board has just amended its dividend policy in line with the improving outlook, while additional shares for employees will no longer dilute shareholders.

Two decades ago, TechOne shares were valued on PE multiples in the mid-teens. Today, the PE multiple on next year's forecast EPS is a meaty 72x (60x on FY26 forecast). And yet, plenty of expert voices will tell us this does not by default prevent the share price from climbing further in 2025.

To understand the importance of last week's financial result, investors should know market consensus was positioned for the company to outperform on its own FY24 guidance.

As it turned out, financial forecasts were beaten on just about every single metric that counts for this type of business, even including temporary headwinds that make the underlying performance and operational momentum even more magnificent.

In simple parlance, this company that promised for years it would grow between 10%-15% per annum, and delivered on it, had upgraded itself for growth between 12%-16%, but is now likely to grow by around 20%, with ongoing upside surprise potential, including from acquisitions.

That, in a nutshell, is the valuation transformation that has taken place this month and which places TechOne in contention for the coveted title of **Highest Quality Growth Company on the ASX**, alongside the likes of Pro Medicus ((PME)), REA Group ((REA)), Aristocrat Leisure ((ALL)), Goodman Group ((GMG)), and WiseTech Global ((WTC)) — the founder's behaviour excluded.

All these outstanding ASX-listed achievers share some basic similarities, including consistent spending on R&D from a market leadership position.

These companies also make a mockery out of investors' obsession with trying to find ten-baggers among cheaply priced alternatives.

The share market's seldom highlighted *secret* is the highest and most consistent, sustainable returns have come from these highly priced, High Quality achievers — for the past 15 years.

Given the AI Megatrend will transform businesses and economies in the years forthcoming, the number one task ahead for investors might well be to figure out how this separates Winners from Losers, and how not to be deterred by the higher valuations for the first group and not to be suckered in by the lagging share prices for the latter.

One of the added advantages of running a multi-stock portfolio is you can allow some inclusions to lag and underperform. It's quite unnatural for all stocks to rally at the same time and in the same magnitude. Plus all of today's Winners have been out-of-fashion at some stage over the past 15 years.

Among this year's underperformers we also find Dicker Data ((DDR)), IDP Education ((IEL)) and Woolworths Group ((WOW)). While the reasons for IDP Education and

Woolworths have been well-documented, we look forward to better times ahead. As far as Dicker Data is concerned, we honestly have no idea.

Does the market know something we yet have to find out about? Let's hope not, but we are willing to take that risk.

In some cases, the risks don't add up or are too high to bear. The FNArena-Vested Equities All Weather Model Portfolio sold out of Audinate Group ((AD8)) and Steadfast Group ((SDF)) earlier this year. In both cases, the risk profile had deteriorated.

One of the added bonuses of running a multi-stock portfolio is that mistakes made or unexpected disappointments don't necessarily destroy the year's performance.

Ask FNArena: High Multiples About To Collapse?

Dec 17 2024

Earlier this month we asked investors to send in their questions. Today, we answer another question received.

Question: Are outperformers including Pro Medicus ((PME)) and WiseTech Global ((WTC)) at risk of collapsing? Some 'experts' have been warning these share prices could fall by as much as -50% due to elevated multiples?

By Rudi Filapek-Vandyck, Editor

Years and years of market observations on top of my own research and analysis have taught me one very important lesson: there's no one size fits all when it comes to investing and putting a valuation on companies and their equities.

The second important lesson I'd like to add is that rules and principles change over time, and most people don't like change.

From the moment I started to research the highest quality and better performing stocks on the ASX, I ran into the everyday dilemma investors face: according to the commonly quoted general rules we should all be looking for lowly valued stocks and ignore the ones on high multiples, because buying "cheaply" is the ideal starting point for long-term returns.

Except this isn't the case.

What actually happens in share markets is more reliable, better quality businesses are rewarded with a premium valuation and they still outperform their lower priced peers who might enjoy their moment every now and then, but overall offer a much shakier track record because they don't have a moat, are much more dependent on the economic cycle, or rather pay out a meaty dividend instead of investing in future growth avenues.

You don't have to take my words for it, but I invite you to compare the long-term track records of the likes of TechnologyOne ((TNE)), Hub24 ((HUB)), Aristocrat Leisure ((ALL)), Xero ((XRO)), REA Group ((REA)), Car Group ((CAR)), et cetera with companies that are trading on much cheaper valuations such as Aurizon Holdings ((AZJ)), Helius ((HLS)), Lendlease ((LLC)), Ramsay Health Care ((RHC)), and many, many others.

Do those 'cheaper' alternatives catch a favourable wind every now and then? They most certainly do. But they're not fit for a marathon, which, in my view, is what investing is all about.

The key hurdle for any investor who considers venturing into the higher quality segment of the Australian share market is almost without exception the higher valuations on display; either vis a vis peers in the same sector, or in comparison to peers offshore, or simply because of a sizable premium versus the rest of the market.

Unless you simply decide to close your eyes and follow market momentum during the good times, you're never going to overcome this hurdle, except when you accept that markets have profoundly changed post GFC, including on how to value businesses that grow irrespective of the economic cycle, with capital-light requirements, recurring revenues, extremely high margins and cornucopias overflowing with cash.

To your average dyed-in-the-wool value investor it is nothing short of heresy to suggest a company trading on PEs as high as 100x can be a much better investment than their preferred hostage to the cycle trading on a single-digit multiple, but that's exactly the experience from the past decade and a half.

One of the success stories from that period, WiseTech Global, listed on 11 April 2016 and has seen its share price multiply by more than 30x times tor a total return of 3275%. Very important detail: the average PE multiple this stock has traded on is circa 75x.

Note: not seven, not five, but SEVENTY-FIVE! Current multiples are 108x on FY25 consensus forecasts and 75x on FY26 forecasts.

This is also the key reason as to why so many have been calling out 'the greatest bubble of all time' and the 'everything bubble'. I think those alarmist calls are misguided and wrong. For starters, modern day businesses are a far cry from their predecessors from the old economy past; they are a far superior breed, as also expressed through various key financial metrics.

Hanging on to old-fashioned valuation methods is most likely not the best way to deal with the changing environment, especially when a megatrend like Gen.Ai comes along. We could all study the teachings from Aswath Damodaran, here's a link (https://pages.stern.nyu.edu/~adamodar/), but I find the analysts covered as part of the service FNArena provides equally represent most valuable input.

At the very least, their assessments and valuation inputs have been much more practical and useful than those bubble-critics on the sidelines who liked to challenge investor's sanity for owning shares when the WiseTech Global share price was around $90 (it has been above $140 since) or when TechnologyOne shares were trading around $12 (above $30 today).

Having said all of the above, as investors we also must acknowledge this year's outperformers including Goodman Group ((GMG)), Pro Medicus, TechnologyOne, and others have enjoyed an exceptionally favourable environment in which not only the US market supported continuous investor interest, but frequent positive operational surprises have provided ongoing fuel for additional share price rallies.

At some point, one must assume, things will become less straightforward and those share prices might yet again become more volatile. One observation to add is that higher PE multiples certainly attract more volatility, as has happened to all the companies mentioned at some stage in the past.

How to deal with this ‘risk’ is largely a personal choice. If you’re confident in the longer-term uptrend that is supporting the outlook for the companies you own, you may elect to simply let volatility run its process. Yes, at times it can be stomach-churning, and those bubble-critics on the sideline will make you feel extra-bad about it, but such is life in the share market, no?

For what it’s worth, the FNArena-Vested Equities All-Weather Model Portfolio, which owns most of the names mentioned, tends to keep exposure to single stocks between 2.5%-7.5%. Small adjustments are made to prevent that misfortune in one or two holdings torpedoes the overall performance of the Portfolio.

One of the most valuable lessons I learned from the decade past is that it’s seldom a great idea to sell out completely of these great businesses, unless valuations have gone genuinely wacky, or the outlook has dramatically deteriorated. Even then, how many times has everyone among us thought Pro Medicus is now really flying too close to the sun, only to be proven wrong, yet again?

Morgan Stanley has just initiated coverage with a market-beating price target of $300. Not that that is a 100% watertight guarantee, far from, but I tend to give it more credence than those forecasting a fall of -50% imminently.

By all means, take some profits every now and then, if that makes you sleep better at night and stay comfortable and relaxed with what you own. But also keep in mind that share price weakness, on occasion, is simply par for the course. If we’d demand 100% sunshine every day or else, we’d never leave home for a holiday.

I have a long-standing view that every expert who is interviewed on TV should wear a badge stating ‘value-investor’, or ‘daytrader’, or ‘Quality-Growth’, et cetera.

That way investors would have a much easier task with assessing the views and opinions expressed. Most value investors have a specific talent. Forecasting the direction of markets or appreciating the valuation of growth stocks are not included.

Make sure you listen to the voices that make you a better investor, or at least those that are genuinely trying to. There’s so much noise flying around and only so much our human brain and emotions can deal with. And don’t be afraid of change. Life *is* change.

Keep learning and educating yourself.

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