Investing in the current stage of the cycle: It is what it is

BY BRAD MENDEL

"THE stock market is filled with individuals who know the price of everything, but the value of nothing." – Philip Fisher.

The above quote from historical investor, Philip Fisher, accurately captures the difficulty of investing in today's stock market where valuations, particularly in the US, and a number of local and offshore sectors, are looking expensive.

While corporate balance sheets and earnings growth look reasonably strong, supported by record low interest rates and US tax cuts, we sit here with the anticipation of higher interest rates, a dissipation of fiscal stimulus and yet higher inflation, none of which we believe are accurately priced by the market. That is, we believe investors are suffering from recency bias as valuations are ignored and momentum and price chasing take hold under the belief that future conditions will replicate the past.

Of the 500 companies which comprise the S&P500, just SIX companies have contributed to over half of this year's return, assisted by crowded ETF trades.

Inversely, 494 out of 500 companies have contributed to less than half of this year's return of the S&P500. The exclusion of Facebook, Amazon, Apple, Netflix, Google (now named Alphabet) and Microsoft (known collectively as FAANGM) from the S&P500's year-to-date return, would decrease this return to approximately 4.5 per cent from approximately 10.5 per cent.

We believe that prices have detached themselves from expected fundamentals on both the upside and downside in certain markets. While the US continues to achieve record highs, the UK FTSE 100 has only recently surpassed its high from 1999 with confidence (it briefly breached this record in 2015 only to retreat by almost -23 per cent). European, emerging market and Australian share markets are still significantly below their previous records, some deservedly so.

We have enjoyed the benefit of rising asset prices underpinned by the lowest interest rates on record. Consumers, companies and countries alike have continued to binge on debt with the belief that historically low interest rates will continue into perpetuity. Yet, beyond a threshold, a marginal dollar of debt borrowed produces a lower rate of return until it becomes a burden to the borrower.

We believe the $250 trillion of debt

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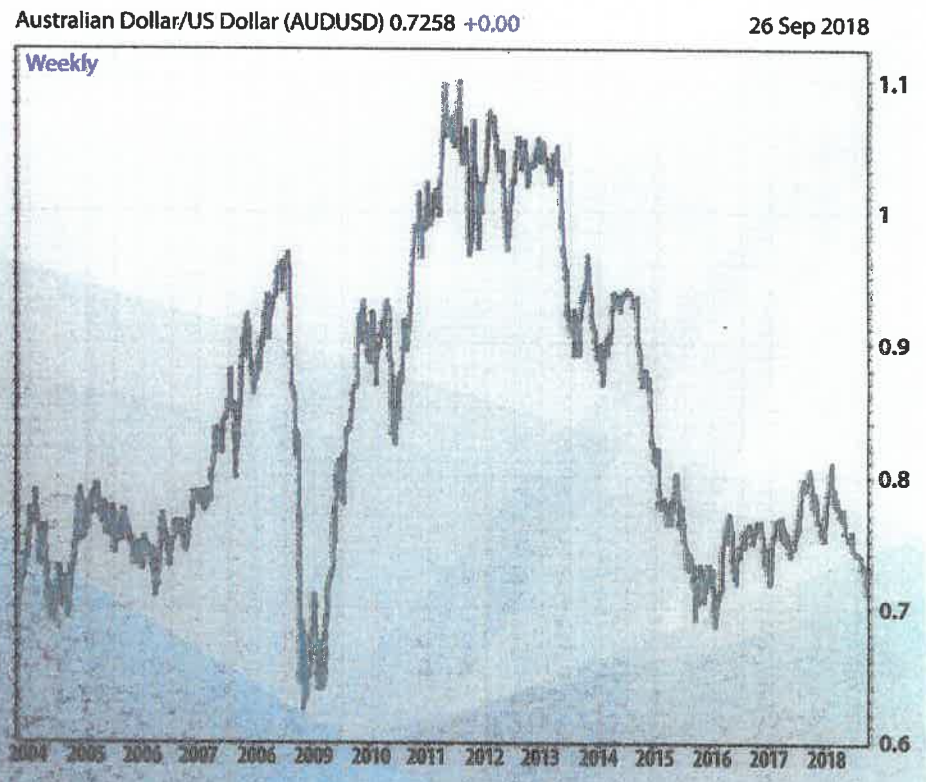
Australian Dollar versus the US Dollar over the past 15 years



Investing in the current stage of the cycle cont.

accumulated in the global economy has become a burden. Rising interest rates will impact economic activity and the valuation of assets globally.

As the effect of massive (and borrowed) US fiscal stimulus in the form of tax cuts is eventually fully absorbed by the economy and as global interest rates rise, we anticipate that we are heading toward an economic state of stagflation – low growth with high inflation.

To protect clients' assets from the abovementioned uncertainty of global markets and geopolitical posturing, our portfolios are diversified by asset class, geography and multiple custodians. With Australia representing two per cent of global equity markets, our clients have always accessed global investments to complement their Australian assets. In any event, we frankly see better opportunities outside of Australia and see ongoing weakness in the Australian dollar.

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We are also paying attention to global disruptive innovation from Israel to the United States. Technological and scientific innovation in business, such as Fintech and 3D printing, and healthcare, such as developments in genomics, are captivating and providing new areas of investing for the future.

Being able to differentiate ourselves from the crowd to find genuine value has been a successful strategy for us and for our preferred global fund managers, both in Australia and overseas, who have outperformed their respective benchmarks on three, five and 10-year track records.

Investments which are uncorrelated to global equity markets are important such as selective alternative and global property investments. Gold bullion and gold equities have typically acted as an essential insurance policy and as an inflation hedge and have long been held in our portfolios.

To us investing is a marathon, not a sprint. It is absolutely imperative to take a 5 to 7-year view in forming an investment strategy to dissipate volatility and ignore frenetic headlines.

Preservation of capital is paramount and discipline, due diligence and diversification ensures both a return of capital as well as a return on capital. We are fully aligned with our clients as every investment advised is owned by at least one BMF Wealth director.

Disclaimer: Any opinion included in this article is general in nature and does not take into account your objectives, financial situation or needs. Forecasts stated are not guaranteed to occur. We recommend consulting with a qualified financial adviser before making investment decisions.

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