Investment environment teaches new lessons

By Anet Ahern

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Every year the investment environment affirms some of the lessons of the past, and teaches us a few new ones - and 2015 was no different.

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Managing investments successfully involves a careful balance. On the one hand there is the requirement for consistency in process and philosophy. The dark side of that custom is potential dogmatism, which is why this needs to be balanced with open-mindedness and flexibility - and a candour which involves reconsideration of the evidence and admission of mistakes.

Over time, the potential for future long-term earnings growth is a main driver in the valuation of a share. This link seems perfectly sensible. However, when the expectation of growth in a company or indeed the economy changes, a disconnect develops between companies that are likely to continue growing at the pace investors became used to and those with lower expectations.

Opportunity for mispricing

Companies that are more closely linked to the economy are often subject to earnings downgrades when overall growth expectations are lowered. The faster growers are more in demand and the slower growers are sold down. This creates a great opportunity for mispricing, which can yield excellent long-term returns, with one caveat: investors can pay unreasonable prices for more certainty of growth for a long, long time.

This means that what appears cheap even when pricing in a lower earnings outlook, can stay cheap for a while. What appears to be an obvious overpayment for growth can persist for months, or even years. The lesson learnt here is not to underestimate the momentum of the desire for growth in a low growth environment, and to be circumspect around shares that look cheap. Take into account a wider range of future outcomes and tread carefully when buying "cheap".

When the current six year bull market started, quantitative easing was just starting. US interest rates had begun dropping from a high of over 5% and stimulation packages were in high gear. At the start of this year, there was an expectation in the market that we were on the cusp of another bout of growth - a view that was soon dispelled with developments in China and a sharp reduction in growth forecasts. The playbook turned out to have a few twists. No cycle fits a perfect pattern, and every aspect needs to be carefully considered, every time.

Intervention tools

The cupboard of the US Fed and government is not nearly as well stocked with intervention tools as it was in 2008. And intervention had more than a little to do with prolonging the existence of excess capacity in certain areas which a normal cycle would have worked out of the system a long time ago.

The absence of further stimulation via e.g. lower interest rates, combined with persistent oversupply, is not a shareholder-friendly recipe. Even if you are a confirmed bottom-up investor, the impact of the cycle needs to feature, at the very least, in your robust debates and scenario forecasting. It is always worth asking, "What if I'm wrong?"

The spreadsheet appeal of a leveraged business going into a growth phase can cause heady excitement. When the environment turns, the share prices of potentially needy companies can plummet, exacerbating the problem as their equity becomes worth even less. Their options for regaining robustness narrow. The key is to always view a company as a credit investment as well.

The resilience of the balance sheet, the health of the cash flow and the avenues open to them for shoring up their financial soundness always matter, but more so when leverage can become an issue. It is worth remembering that even if you are buying an equity investment, you always need to view it as a credit investment.

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