Reporting season wrap up

With the February 2015 reporting season wrapped up, Alphinity Investment Management's Lead Portfolio Manager and Principal, Johan Carlberg answers the big questions from the period and provides some insights to what lies ahead for the Australian economy.

1. What were some of your observations from the February 2015 reporting season?

The Australian sharemarket has had a very strong start to 2015 but this looks to have been attributed to the low interest rate environment and the lack of investment alternatives rather than a particularly upbeat reporting season. Overall earnings changed only slightly and the market appears to be on track for low, if any earnings growth in FY15. Having said that, if we look a bit deeper there were some positives that we can take away from February. Resources companies have been under pressure for most of the last 12 months due to the collapse in commodity prices and are largely responsible for the lack of overall earnings growth in the market. Excluding Resources however, earnings per share growth for the market has held at around 9%. If achieved, that would be a solid outcome and the best we have seen for some time. It is a bit concerning though that there is still little sales growth being reported and most companies are still relying on cost savings to achieve earnings growth.

2. Which were the best and worst performing sectors?

Perhaps somewhat ironically, some of the best result surprises were actually reported by the large diversified mining companies BHP Billiton and Rio Tinto. Analysts were well aware of the impact of lower commodity prices but had not anticipated the full extent of the miners' ability to reduce costs. The stocks reacted accordingly and performed strongly during the month. However, it appears that the respite for Resources stocks may have been short lived with the sector coming under renewed selling pressure since the end of the month. The reality is that the earnings leverage to the price of iron ore and other materials is much greater than any cost saving program. Some would even argue that the more the miners reduce costs, the more prices will fall as they chase volumes. The Healthcare sector had another solid reporting season, aided by underlying demographics and the weaker AUD, although sector heavyweight CSL moderated its full year outlook. Another interesting development was the downgrade by Woolworths to its FY15 earnings. Management pointed to weakening sales momentum and a need to adjust prices to fight off competition from Coles and price discounter Aldi. The announcement dragged down Wesfarmers (owner of Coles) too as increased price competition is good only for the consumer.

3. Were there any positive or negative expected themes that emerged?

At Alphinity we have for some time talked about the boost to corporate earnings from the weaker AUD and that started to come through in the December half. A diverse group of companies (Brambles, James Hardie, Amcor, Resmed, Cochlear and Macquarie Group) benefited from the translation of overseas earnings into AUD. This theme should only strengthen in the second half of the FY. Boards also continued the trend of recent years to return an increasing share of profits to shareholders.

While this trend may still have some more to go we are likely to be closer to the end than the beginning of it. For example, the banks are unlikely to lift their payout ratios any further as they need to preserve capital to meet future regulatory requirements.

4. How did Alphinity fare this reporting season? Will you be positioning the portfolios differently as a result?

The Alphinity portfolios delivered strong absolute returns in February but slightly lagged the benchmark for the month. While we always aim to better the market performance this shouldn’t come as complete surprise to followers of Alphinity. When the market is this strong it often doesn't worry too much about quality and in these conditions our process sometimes struggles to outperform. The outperformance of the Resource sector hurt our relative performance in February as did the market’s willingness to pay, in our view, excessive earnings multiples for companies that delivered solid but in many cases unspectacular earnings growth. While investors’ attraction to earnings certainty is understandable, in a low growth environment history shows that owning expensive companies can be very costly if earnings disappoint. There are always some new investment ideas that are generated during a reporting season and also some stocks that perhaps are looking less attractive, either after a strong performance or a disappointing result, but we don’t see any need to make significant changes to the portfolios. We remain well diversified and stand to benefit from, in addition to individual company factors, the weaker AUD and lower interest rates as it looks likely that the RBA will cut again.

5. What should investors expect going forward?

With the exceptionally strong start to CY15 equity returns, the market has now rerated to around 16.0x 1 year forward earnings and a 4.3% dividend yield, by no means at record levels but well ahead of the trading range of the last couple of years. Record low interest rates could well support markets at current levels. However, risks have increased in our view and not only because of increased valuation metrics. Earnings risk still remain in Resources (both Metals & Mining and Energy) and while cost reductions have been impressive across the market, sales growth remains elusive in most sectors which puts the sustainability of current growth rates into question. Low interest rates have clearly taken a lead year to date in the equity tug of war against the lack of earnings growth but a pullback would not surprise us in the next few months.

For more information please contact our Investor Services team on 13 51 53 or visit alphinity.com.au