

5 August 2011



## Investment briefing

### Making sense of a volatile world

Our investment philosophy is supported by what sounds like a simple notion that stock prices follow earnings which follow economic growth. However, what happens to economic growth, how that translates into company earnings, and the value the market places on those earnings are far from straightforward. Today there are real worries about the course of global economic growth and this creates uncertainty about future earnings streams. This results in the sort of share price volatility that we are seeing in markets.

We understand all this, but we have continued to emphasize the importance of an equities exposure to underpin adequate real returns for investors. While further short term volatility should be expected, we have a level of confidence about the underlying or medium term return potential that is somewhat at odds with the economic backdrop. While there are clearly difficult macro uncertainties, we have the fortunate position of there also being many companies with the fundamental strengths to perform well in spite of this.

Markets today are worried about disappointing economic performance and decidedly lack lustre growth potential for an extended period. Let's be clear the developed world faces a very prolonged period of adjustment in which debt levels must be brought down. This will constrain growth. During the adjustment process economic growth will be below potential levels unless and until capital expenditure provides an offset to public and household sectors deleveraging. The only other potential source of extra demand is foreigners, but since every export is also an import this is a zero sum game though it would be beneficial if surplus countries (China in particular) boosted consumption and imports.

There is of course long standing frustration with China's excess savings and inadequate consumption. Post GFC there has been a switch away from export led growth and to infrastructure spending. And their current account surplus has shrunk as a proportion of Chinese GDP, though it has not declined appreciably relative to global GDP. This means that China is not making the global adjustment process any easier and what we need is the planned switch to consumption led growth. The problem is that a significant boost to consumption will take some years. Meanwhile China massively boosted fixed asset investment post GFC but has more recently been slowing things down to control inflation pressure. This slowdown increases global fragility and most particularly the vulnerability of Australia to global weakness.

Not surprisingly the recent decline in equity markets has been accompanied by a drop in the Australian dollar. As we have been saying for some time, the Australian dollar is vulnerable in a range of scenarios and generally weakens in times of strong risk aversion. The currency has benefited from the robustness of Asia, developed market monetary policies which undermine their currencies, and from having some distance from the debt troubles of the developed world. However, Australia has its own debt vulnerability – household debt levels are at extremely elevated levels (personal borrowing is around 80% of GDP). While household savings have been increasing, in aggregate Australia still spends more than it saves. Net foreign debt is 50% of GDP<sup>1</sup> and growing given an ongoing current account deficit which was (-3% of GDP at the end of March 2011)<sup>1</sup>. This means that Australia relies on foreign savings and this creates a vulnerability in a savings short world and in particular for the currency. The bottom line is that in this challenging investment environment a foreign currency exposure is a very valuable source of portfolio diversification and risk control - which is why we are maintaining our overweight position in the Horizon funds as part of our strategic overlay process.

The strategic overlay adjustments we make to diversified portfolios are aimed at increasing the reliability of returns. This process is risk focused rather than return seeking. We continue to increase strategy flexibility and the tailoring of strategy to evolving market conditions to progressively increase the robustness of returns. However, in this complex and in many ways difficult market environment we are emphasizing the importance of investing in the right companies rather than adjusting asset allocation.

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In an increasingly bifurcated world of over-leveraged developed economies and cash-rich developing countries, global equities offer attractive opportunities. There are many companies, only some of which are based in developed markets, which will benefit from exposure to growth opportunities in markets and economies which are largely free from the public sector and consumer debt which hobble "western" economies. Not only are revenues growing strongly in these markets but increasingly profitability is expanding rapidly such that margins can equal or in some cases exceed those in traditional developed economies.

Whilst public balance sheets remain under pressure in many developed markets, corporate balance sheets and cash-flows are very robust. Efficiency improvements continue for many companies with productivity gains running at over 1.5% p.a. which is greater than the average of the last 8 years. This is showing in strong capital spending growth of 17% annualized as corporates use technology to enhance efficiency. This shows that cash-flows for many global companies should remain strong which bodes well for medium term returns from global equities. In the US alone corporates hold over \$1.5trillion dollars of cash.

At times of uncertainty in markets, valuations between high and low growth companies converge, and this has historically been an appealing time to access better quality opportunities to invest for strong medium term returns. Investors who are agnostic about the domicile of a business but who focus on where the longer term growth opportunities lie are likely to see strong returns in the coming years. The opportunity set is not limited to a narrow set of industries but is broad based from Japanese robot manufacturer, Fanuc equipping Korean car makers, to Nestle now which does 40% of its business in emerging markets. Additionally, even though developed market growth may be constrained there are still opportunities to grow earnings, for example the shedding of low margin businesses and more generally taking advantage of a rare generational opportunity (because of high unemployment) to increase efficiency and workplace flexibility. Further opportunities will come from regulatory drivers (there has for instance been a compliance obsession with measurement accuracy which is benefiting Swiss company SGS) and as a consequence of the sifting out of weak players in a challenging economic environment.

In this environment it is being in the right stocks that's important. We expect a growing divergence in valuations between winners and losers over time. We're aiming to position our strategy to increase robustness in difficult times. Stocks in MLC's Global Equity portfolio have an average gearing level of 26% versus a benchmark level of 45%. Since February 2009, when the current strategy was put in place, there have been 14 months in which global equity markets have produced negative returns. The MLC Global Equities portfolio has out-performed in all but one of those months, a hit rate of over 90%. Average out-performance during those negative months has been over 40bps per month which has helped produce annualised excess returns of 1.9% (gross) since February 2009. Earnings for stocks held in MLC's global equity portfolios have beaten earnings for the market as a whole by over 40%. With lower debt levels than the market and stronger cash-flow generation, these stocks should be well positioned to weather the short term volatility in equity markets and produce strong medium term returns for investors.

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