Roundtables

Capturing transforming economies: The case for active equities

Matthew Smith November 26, 2019

Intermede's Barry Dargan (right) with Park Street Group's James Dakin

It was the Greek philosopher Heraclitus some time between 535BC and 475BC who said "change is the only constant in life".

Intermede's Barry Dargan; Park Street Group's James Dakin (left)

Intermede Investment Partners' London-based portfolio manager, whose job is to find and invest in high quality growth companies globally.

"I'd say it's relentless and one of the main challenges we have is staying on top of that; it's unrelenting and you just have to keep on top of this opportunity, accept that it's morphing and changing," Dargan said.

But just as Heraclitus's phrase has remained relevant and constant, so too have many of the fundamental drivers of change, the group of experts around the table concluded.

Human behaviour and reactions to change, disruptors disrupting the status quo, winners and losers emerging – these are all constants in equity markets today and are likely to remain constants in the future, the experts agreed.

How these constants impact and indeed define the as yet uncertain outcomes over the longer term need to be set against the backdrop of 'here and now' global macro factors such as low interest rates, the effect of unprecedented central bank policies, quantitative easing and monetary stimulus, the group decided.

"I remember a couple of years ago looking at a group of internet stocks and one thing that really hit me in the eye was the free cash flow yield on all these companies was four, five, even six per cent, growing at 25, 30, 40 per cent a year, which is astonishing when you think we're in an interest rate environment of one and a half or two per cent… this is astonishingly good value for our still very high-growth companies" Dargan continued.

"But if you believe we're going to go back to a normalised interest rate environment of five to six per cent, that doesn't look so great, it looks okay, but not that great. But if you're in an environment where for the foreseeable future interest rates are going to be one per cent or no more, then that is powerful stuff," he said.

Environmental factors such as interest rates and monetary policy settings are warping our understanding of fundamental factors that remain constant as investors, the group explored.

Within this setting Simon Elimelakh, head of MLC's investment portfolio analytics team, said he backs active management and also emphasises the importance of blending styles of managers to help smooth out the ride for investors.

"We believe in active management and these days that's a big statement to make because not necessarily everyone does," Elimelakh said.

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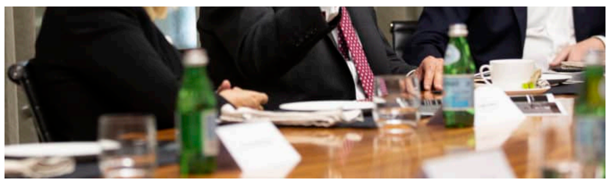
"Why blending managers makes sense is because there is more than one way to beat the market, and while value managers have been under pressure and growth has been doing well, if you look from a longer term perspective, mixing good quality managers with different styles is really important," he said.

"Active managers have an important role to play in this market, we fundamentally believe that. Managers need to stick to their guns; I don't think metrics are broken," Brook Sweeney, Lonsec's senior investment consultant, said in support of the principles of Elimelakh's point.

"At some point, a good business is a good business and a bad business is a bad business and if you have a process that helps you buy the good one and not own the bad one, then eventually that will play out," Sweeney said.



MLC's Simon Elimelakh (middle); Lonsec's Brook Sweeney (right)

James Dakin, co-founder and adviser of Sydney based wealth management business, Park Street Group, noted.

"Where the rubber's hitting the road for the average retail client, mum and dad, is the fact their term deposits are now paying less than two per cent, and you know one and a half per cent at best in some cases… that's actually what's caught a lot of people's attention and that's where the conversations have come up; they're not thinking about the industrial revolution and technological disruption and such, they're just thinking about "Oh, my goodness, I'm not earning any money in my term deposits."

Evergreen's Angela Ashton

"When talking about the investment side of things we always try and engage conversation from a longterm perspective. We do actually try to ignore the noise. Some clients will react to the noise. We always try and bring it back to long-term and valuation fundamentals," Dakin said.

"I think the fundamentals story will come back because it's sexier, every stock has a story. But I agree it is getting a bit lost at the moment," Angela Ashton, co-founder of investment consulting firm Evergreen Consultants, said.

"Whether you're talking about 5G, individualised healthcare, 3D printing, whatever the story is, what it's really about is this idea of compounding growth… whether it's EPS [earnings per share] or some other sort of measure," Ashton commented.

THE FIFTH REVOLUTION

The current economic and societal disruption stemming from the diffusion of digital technology – widely recognised by futurists and global economic think-tanks as "The Fifth Revolution", following the oil, automobiles, and mass production era – is posing unique challenges for equity managers; equities investors, funds researchers and market strategists, agreed.

Intermede's Dargan, MLC's Elimelakh, Park Street's Dakin, Lonsec's Sweeney and Evergreen's Ashton were joined by Aman Ramrakha, Morningstar Australia's director or manager research ratings, Michael McCarthy, CMC Markets Asia Pacific chief markets strategist, and Myooran Mahalingam, MLC's global equities and global listed property portfolio manager for the global equities markets discussion hosted by *Professional Planner*.

A discussion about navigating transforming economies as equities investors spanned industries, from healthcare, to automobiles, to telecommunications, construction and everything in between.

MEAN REVERSION DELAY

While the group brought up numerous examples of industries where the dynamics of the disrupted and disruptor will continue to play out for years to come, there was also a strong recognition that environmental factors such as central bank monetary policy.

"Human behaviour hasn't changed, markets are behaving differently because the influence on markets have changed," CMC Market's McCarthy, said.

"Because of QE, because there's so much money out there… the VIX [volatility index] doesn't behave like it used to. You used to get volatility and volatility would go in clusters. That doesn't happen anymore," McCarthy noted.

"What's different is how markets are reacting doesn't mean it's different from a human behavioural perspective. Because of low interest rates and these other factors markets are behaving differently so you're not getting a reversion to the mean, or certainly not as quickly as you once did," he said.

This delay of mean reversion to the fundamental valuation of stocks was related during the discussion to investment style, addressing the notion that some market watchers might believe this time is different and the perhaps growing belief from some quarters tha

CMC Market's Michael McCarthy; Morningstar's Aman Ramrakha (right)

"I've heard the argument that suggests value has no hope of ever coming back in light of central banks' distortion of the market, that it's broken and it won't come back," Morningstar's Ramrakha said.

"My observation on value is that when you talk to some of these managers, particularly the deep value ones, they're doing a lot more work on the 'zero dollar case' on a company than they would have done at any other time in their careers, because I think the ability for the market to take something to zero has been a bit more pronounced in more recent years than we've perhaps seen," he said.

With risk comes opportunity for investors, the group agreed.

"Irrespective of style I think there are opportunities for individuals and investors who have discipline and process to create wealth for themselves and their clients," Myooran noted.

QUALITY IS KEY

"I think the broad parameters of what we look for in a company haven't changed," Intermede's Dargan said.

Sustainable competitive advantage, great management, scalable business opportunity, and open-ended growth were all things Dargan still looks for in a company.

"It's just the opportunities kind of morphed, and also I think a lot depends on where you are in the economic cycle.

MLC's Myooran Mahalingham

"I think where you have an excess of liquidity arguably and zero rates you have more likelihood of unicorn-style businesses being accepted by the market and there's a lot more money-chasing and less opportunities," he said.

The participants in the discussion reflected on their observations of global equities markets throughout their careers and concluded that accelerating change is inevitable.

Dargan summed it up pointing out developments on our doorstep that could propel Heraclitus's idea of change into another stratosphere.

"Things like 5G could be really quite revolutionary – the ability to have every device talking to each other and [separately] the ability for Artificial Intelligence to be able to make the sort of decisions that are currently in the human realm."

"I think having lived through 30 years of tech progression I'd say it is a bit different today insofar as it's becoming more profound, happening faster, more on offer, but it's basically a continuation of everything I've seen really over the last 30 years," he said.

ACTIVE EQUITIES, AMAN RAMRAKHA, ANGELA ASHTON, BARRY DARGAN, BROOK SWEENEY, EQUITIES, GROWTH, INTERMEDE INVESTMENT, JAMES DAKIN, LOW INTEREST RATES, MICHAEL MCCARTHY, MLC, MYOORAN MAHALINGAM, QUANTITATIVE EASING, SIMON ELIMELAKH, TECHNOLOGY, TRANSFORMING ECONOMIES, VALUE

Smith is head of content and managing editor of Professional Planner and Investment Magazine.

Matthew's Profile

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