



EVANS & PARTNERS

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Solihull Terrace

Portfolio Construction Strategies

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I will discuss...

- 1). Sector Analysis & Portfolio Construction
 - 2). "Buying" & "Selling"
 - 3). Market Outlook – A few observations
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If you wish to contact Evans & Partners...

Nigel Credlin

Investment Adviser

ncredlin@evansandpartners.com.au

Ph. 03 9631 9804

More detail on Evans and Partners can be found on our web site

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Good investment ideas are pointless unless accompanied by sound portfolio design

- Invest in a portfolio, not a collection of individual securities.
- Portfolios are built around a return objective, a given risk appetite and a time horizon.
- Portfolios need to be designed and managed to produce a bottom-line which is consistent with these criteria.
- For example, in designing an equity portfolio always seek to produce a bottom-line that promises to outpace the market with respect to...
 - earnings growth,
 - dividend growth
 - return on equity,...without compromising –
 - Valuation
 - Sector diversification (i.e. control thematic bias).



Good investment ideas are pointless unless accompanied by sound portfolio design

- Accordingly, when contemplating any change do so on the basis that it will enhance the bottom-line characteristics of the portfolio – increase the earnings growth, bolster the dividend yield, reduce the PE multiple, improve the industry diversification etc.
- If you are going to invest in equities you must hold at least 12 stocks and not be passive (because the bottom-line is always changing!).



1). Sector Analysis
Which sectors are primed for growth?

Where growth =

Increasing earnings per share and shareholder returns (ROE) – which should overtime warrant a higher valuation multiple.

This is achieved via -

Good management/capital allocation.

A good industry.

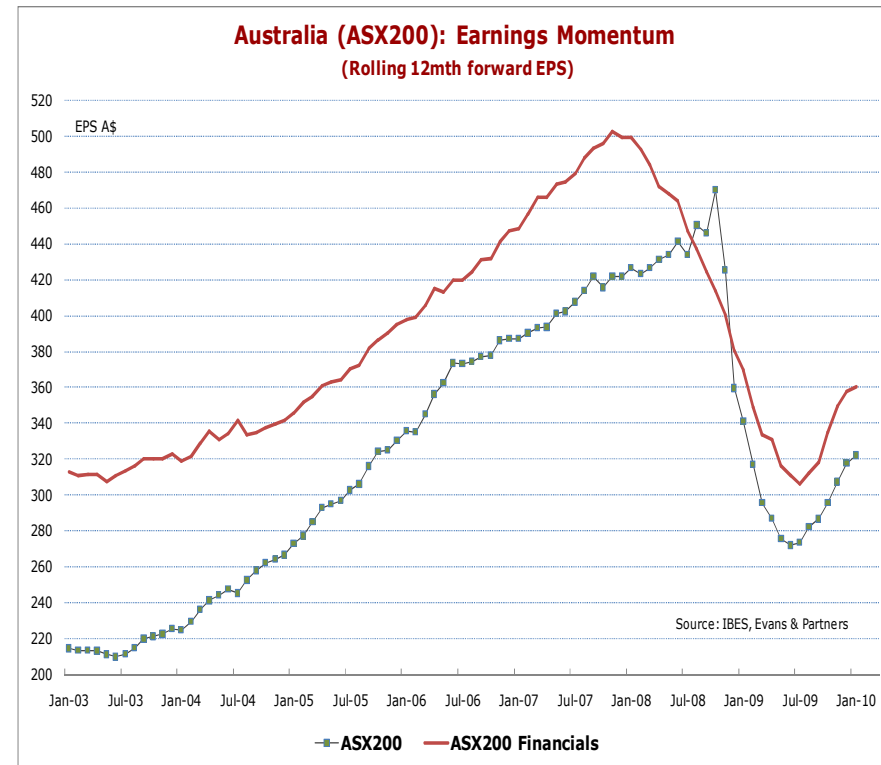
A good cycle (i.e. buying at the trough of an industry cycle).



When asking...
"Which sectors are primed for growth"
 ...you should be thinking about whether your portfolio is well-placed to outpace the market with respect to EPS growth through FY11 and FY12.

| ASX200 | FY09 | FY10 (f) | FY11 (f) | FY12 (f) |
|---------------------------|-------|----------|----------|----------|
| Earnings per Share Growth | -22% | 2% | 22% | 15% |
| Price/Earnings Multiple | 17.3x | 17.0x | 14.0x | 12.1x |

Source: IBES



Portfolios always need to be tilted in favour of the “earnings leaders”

- ***When business conditions are buoyant and interest rates are rising –***
 - focus on stocks which can protect their earnings thanks to a relatively defensive industry (e.g. healthcare, grocery retailing, utilities), the capacity to put up prices and/or the capacity to win market share from vulnerable competitors.
- ***When business conditions are depressed and interest rates are falling-***
 - focus on stocks which, having taken a hit with respect to profitability, are poised to benefit from a cyclical upturn in sales volumes. When applied to a lower cost base, increasing sales volumes can deliver a huge initial lift in margin and reported profits.

You also need to differentiate between stocks which provide market risk (beta) and stocks which are actually well-placed to deliver an improving earnings outlook. It is ideal if you can get both, but the first priority should be an improving operating outlook.



Industry cycles: Order of preference (Industrials)

1) Financial Transactions

- Functional financial markets + investor confidence + M&A pick-up through FY10.
- **Prefer: Computershare. Macquarie Group** (~\$45 per share).

2) Residential Construction

- Australia - 50% affordability improvement + undersupply. US Housing has found a base.
- **Prefer. Crane Group, Boral.**

3) Advertising

- Flows off business confidence & profits.
- **Prefer. Seek, News Corp.**

4) Commercial Construction/Infrastructure ramp-up 2011-16

- 2009 slump. Stability 2010. Renewed strength 2011. Strong outlook thereafter as infrastructure spend ramps-up.
- **Prefer. OneSteel, Downer EDI.**

5) Credit Quality

- Impairment charges peak Sept half 2009.
- Recovery profile depends on asset price stability/macro strength.

6) Consumer Discretionary

- Income boom in FY09 following by slump in FY10. Thereafter, higher interest rates a drag. Australia cannot have both a resources-led & a consumer-led economy.
- **Prefer. Fosters.**



2). Selecting the right time to “BUY” or “SELL”.
Techniques used by investors that help trigger a buying or selling decision.

Again,

Any decision to “buy” or “sell” should be on the basis of looking to enhance the bottom-line characteristics of your portfolio!

A collection of “*good ideas at the time*” is not a portfolio, nor is a collection of broker “*BUY recommendations*”.



Market Risk: Equity market performance is driven by the interaction of three factors.

1). Interest rates.

- Currently supportive (less-so Australia).
- Should remain supportive well into 2010.

2). Profit expectations.

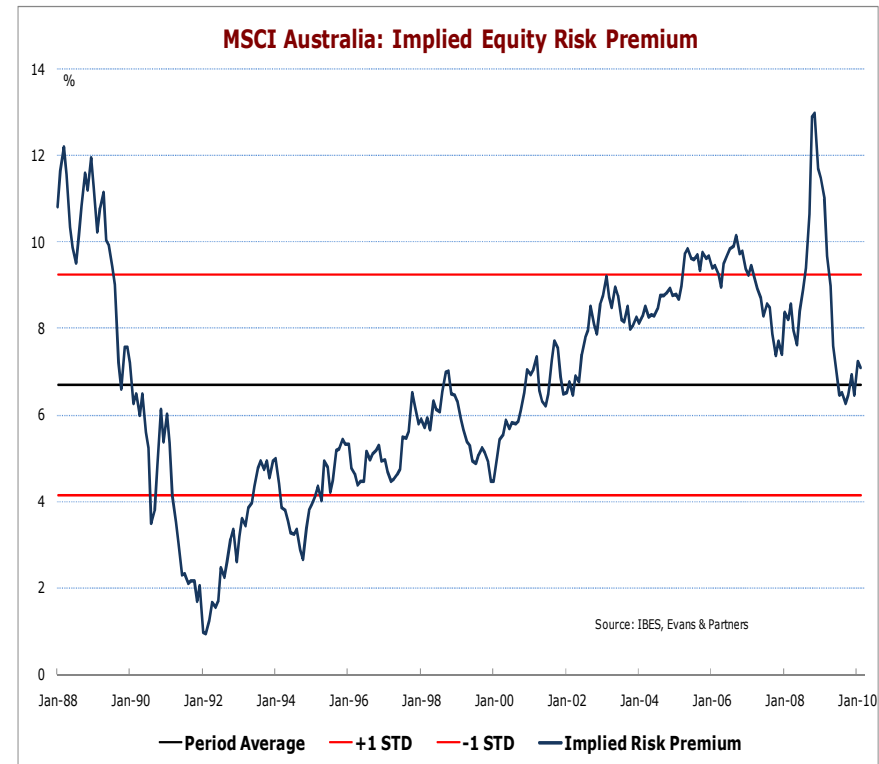
- Currently very supportive.
- Buoyant 2010 & 2011 expectations may be tested later in the year.

3). Risk tolerance (i.e. greed & fear).

- Extreme risk aversion was the major driver of the bear market. Pricing of risk needs to remain conservative.

Thus, the sweet spot for equity markets = low or falling interest rates, rising profit expectations and improving risk tolerance.

Sell into greed. Buy into fear.



Stock Risk: An investment decision needs to incorporate a view on...

1). The quality of the industry

- High barriers to entry; concentration; pricing power over customers; access to economies of scale; low regulatory risk etc.
- Cyclical or defensive? If cyclical, are margins/earnings at a cyclical high or are they depressed?
- Is the industry in a structural expansion phase (i.e. growing at a greater rate than GDP), mature or in decline?

2). The quality of the company

- The track record & experience of the Board & Management.
- The capital allocation history. Good decisions – including giving capital back to shareholders - will be reflected in improving shareholder returns.
- Strong free cash flow (Cash is real! Profit is an accounting concept).
- Balance sheet: Capacity to fund the business strategy, appropriate debt-servicing capacity etc.
- Market expectations for profit growth over coming years.
- The trend in earnings revision – *"the first downgrade is never the last"*



...and

3). Absolute valuation

- How much am I paying for this story?
- Be prepared to pay a bit more for “quality” and a market-plus earnings outlook.
- PE multiples useful but also consider –
 - PEG ratio (historic PE multiple/expected EPS growth).
 - EV/EBITDA (cash flow based metrics).
- If you are an income-seeking investor: yield, pay-out ratio, DPS growth.

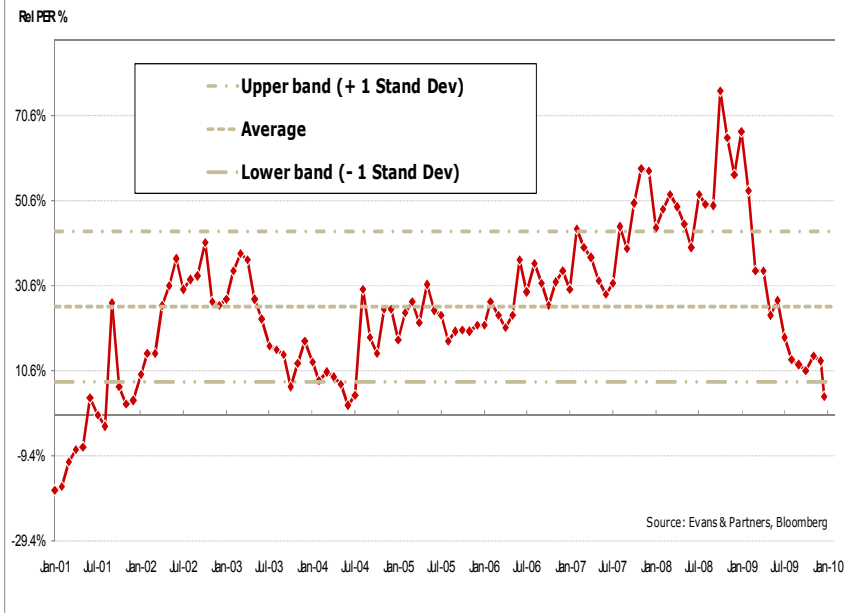
4). Valuation relative to the market & industry peers

- This is important!
- In general, if you are going to buy a stock that is trading on a significant premium to the market and/or peers you need to have comfort that it will continue to deliver better than market earnings/returns into the medium term. ***Any slippage, and the downside risk to the share price is significant (i.e. earnings downgrades + PE compression).***
- Ideally, look for opportunities to “buy” when good companies are out of favour (i.e. a depressed relative valuation).

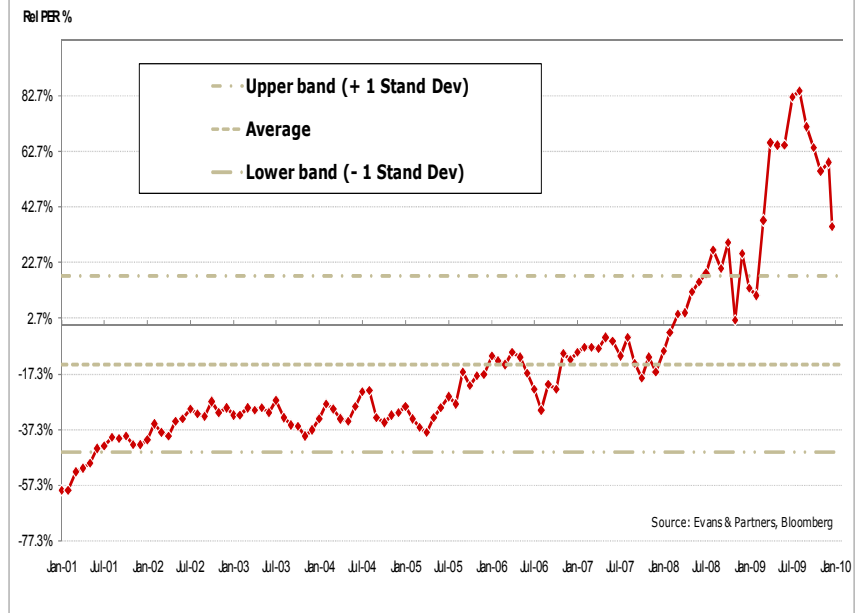


Relative Valuations: A few examples

WOW - Relative PER v Industrials (ex. REIT & Property)



BLD - Relative PER v Industrials (ex. REIT & Property)



“Alarm Bells”

- **Beware deteriorating shareholder returns** (ROCE, ROE etc) – even off a high base.
 - The marginal dollar being invested by management is diluting the quality of the business.
- **Beware negative earnings revision.** Tends to come in waves.
- **Quality of management**
 - A clear & consistent strategy.
 - Stated goals are being met.
 - An incentive system that encourages improving shareholder returns.
 - Beware high staff/management turnover.
- **Beware a “crowded trade”.** If every broker in the market has a “BUY” recommendation, best to look elsewhere.
- **Beware thematic risk:** Lehmann Brothers goes broke and every bank stock in the world collapses!
- Understand what the key macro sensitivities for the industry/company are. For example;
 - Financials = asset prices.
 - Retailers = household disposable income + confidence.
 - Resources = commodity prices.
 - Media = business confidence & profits.



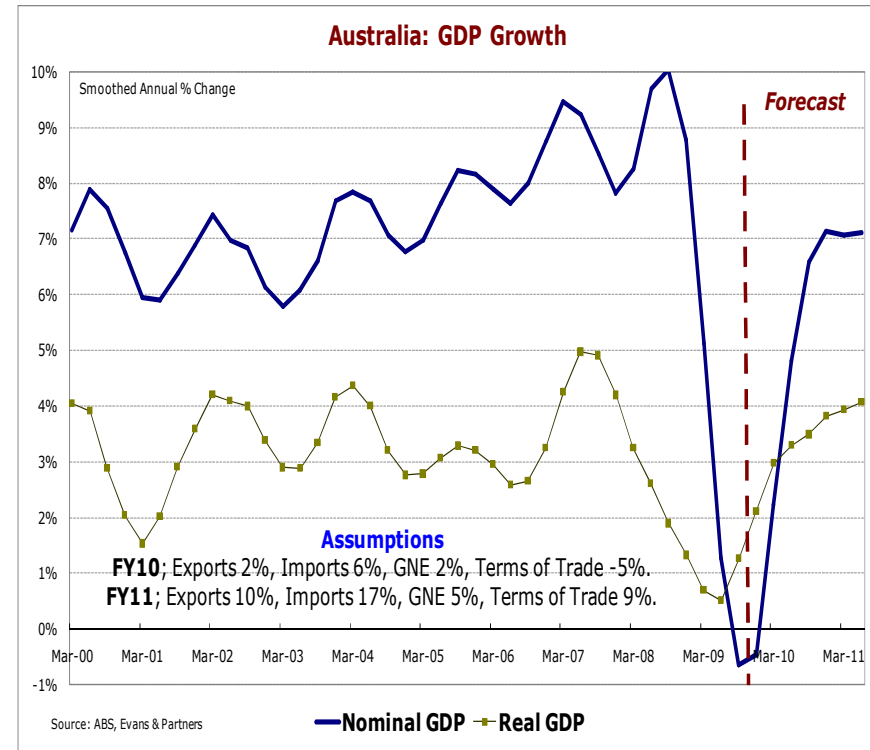
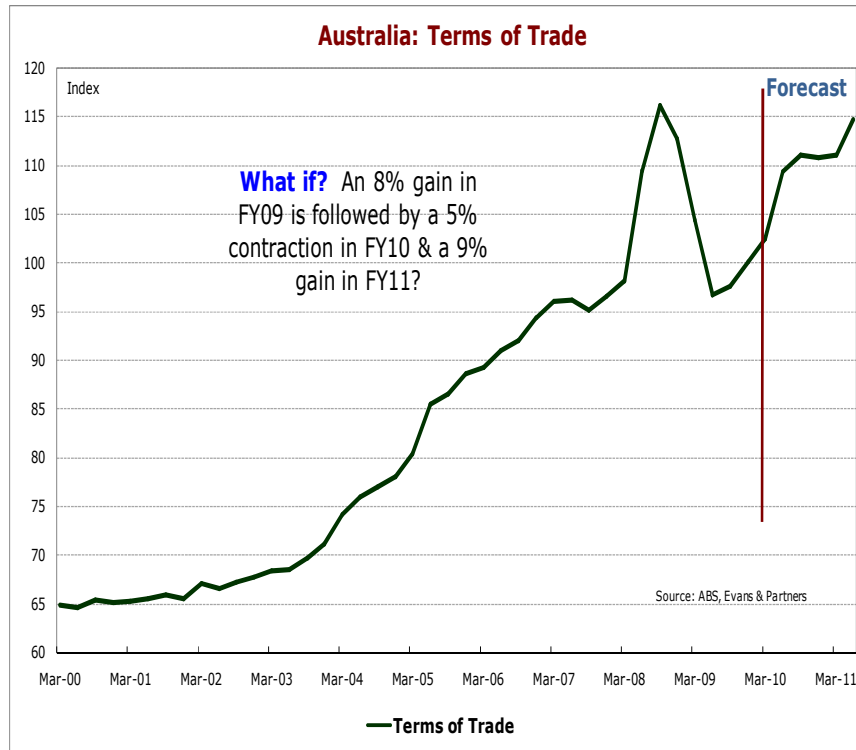
3). The fate of the global economy in the year ahead will be a function of...

- **A relatively typical, profit-led, cyclical recovery in the OECD; albeit off a very low base.**
 - Underway in the US; mixed in Europe; struggling in Japan.
- **The containment of various structural distortions which could yet overwhelm a fragile cyclical upswing.** That is,
 - banks that are unwilling to lend.
 - OECD households that are unwilling to consume.
 - massive budget deficits too big to ignore.
- **A resolution of the current dislocation in global currency markets.**
 - Ongoing US Dollar weakness would be a catalyst for rising political, economic & financial tension. If it was accompanied by ongoing Chinese intransigence with respect to Yuan appreciation, then the global investment environment would be all the more fragile.

To the extent that the business cycle recovery is not totally compromised by the structural distortions, it will only increase the need to reverse the emergency policy stance in the US, Europe, Japan & Australia (i.e. tighter liquidity, higher interest rates, tax increases etc). Thus, even a positive economic outcome will not be without its challenges. Equity markets have had their free lunch.

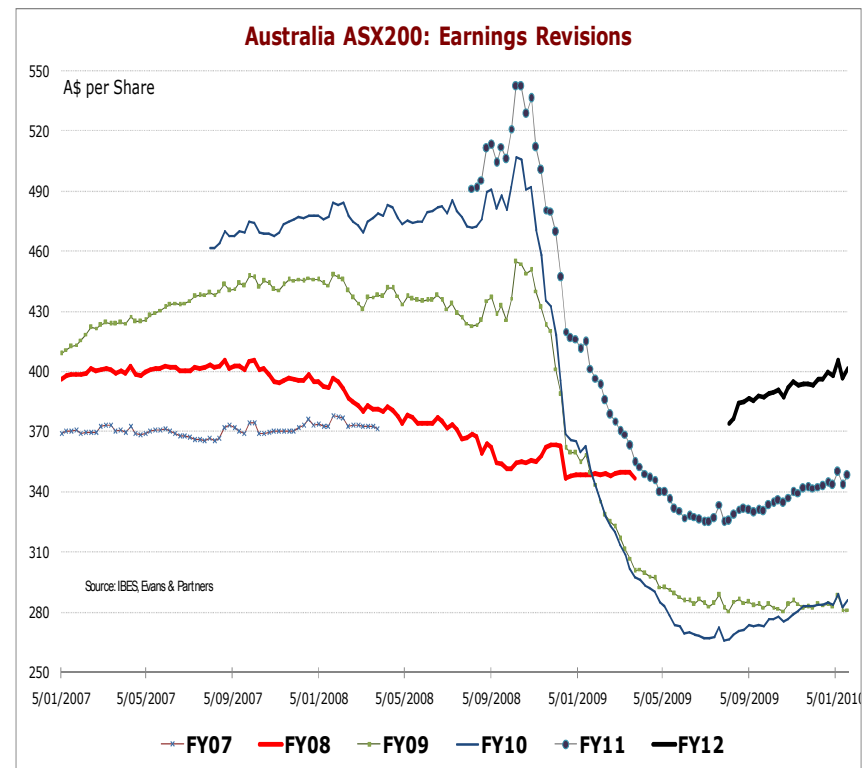
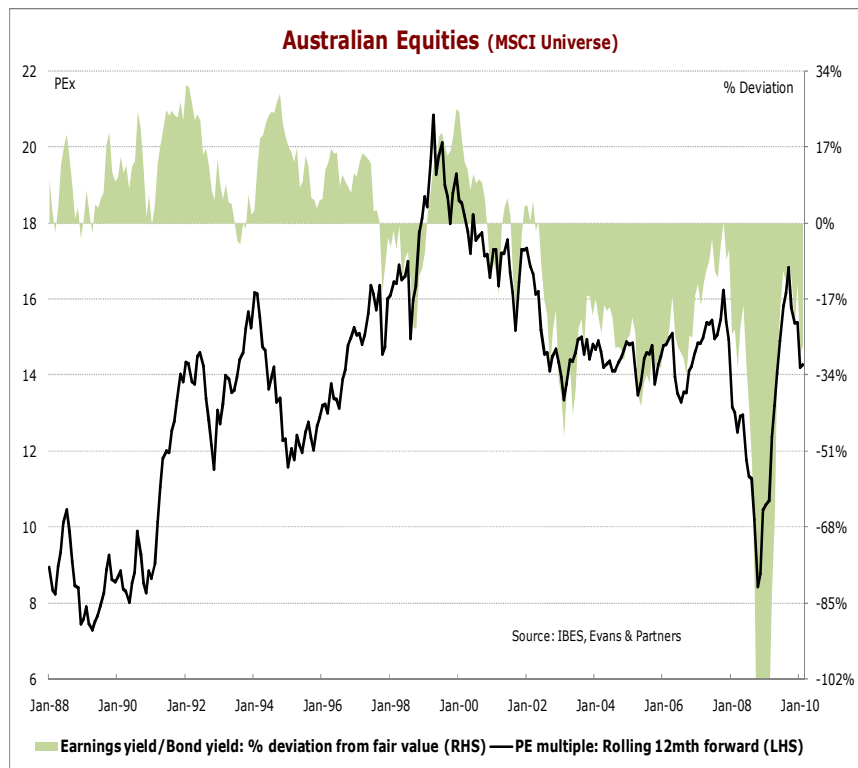


Australia: Nominal economic weakness a challenge for corporate profits in FY10. FY11/FY12 will be better.



Australian Equities: Waiting for the profit recovery

ASX200 Index Target February 2011 = 5150 - 5250



Australian Equities: Model Portfolio

| FINANCIALS | RESOURCES | GLOBAL INDUSTRIALS | DOMESTIC INDUSTRIALS |
|---|------------------|---|--|
| QBE Insurance Commonwealth Bank Westpac | BHP Billiton | The News Corporation CSL Orica Computershare Probiotec Fosters | Toll Holdings Origin Energy Seek Healthscope Crane Group Woolworths Spark Infrastructure Aust Infrastructure OneSteel Tox Free Solutions Asciano Downer EDI |

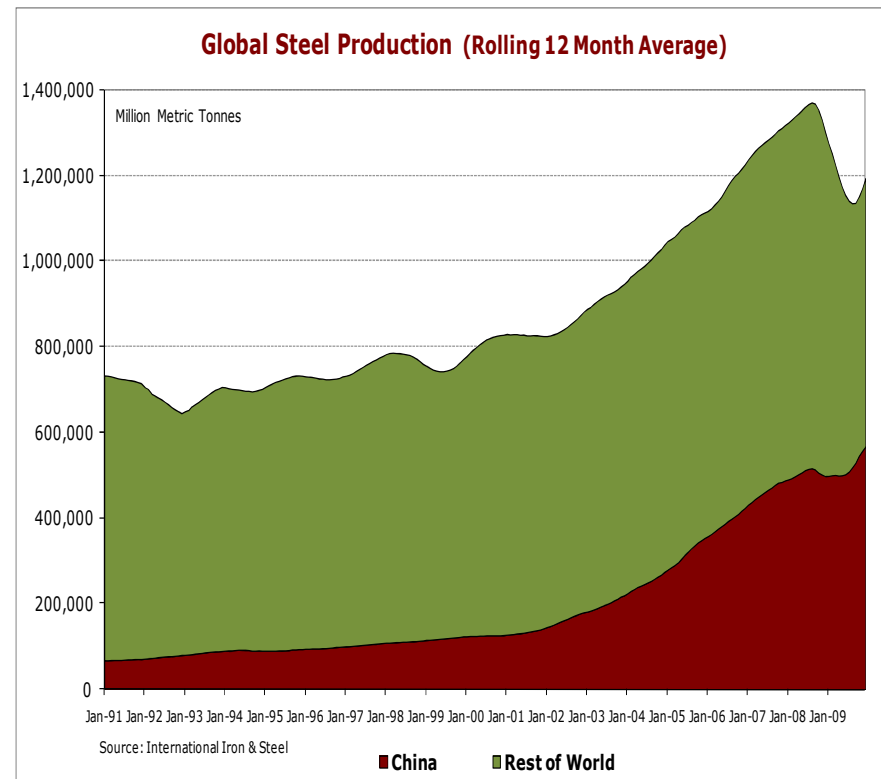


Financially engineered commodity markets - The next sub-prime mortgage?

•While difficult to quantify, investment and/or speculative flows are having an increasing impact on exchange-traded commodity markets. As such, commodity prices are not being set by supply/demand fundamentals in the real economy.

•**The commodity price dilemma.** There comes a point (e.g. early 2008) where rising commodity prices stymie global economic activity either directly via the impact on business costs & household spending power and/or indirectly via the policy response to higher inflation. In particular, rising energy & food prices come with a large economic & social cost.

•**The US\$ dilemma.** US\$ weakness has been a primary catalyst for speculative flows into exchange traded commodities. Ongoing US\$ weakness is not a viable scenario for the global economy. At some point, commodity markets will have to absorb a strong cyclical recovery in the US\$. (We think this recovery has started).



Key Messages

- At any point in time, there is always a long list of things for an equity investor to worry about. If the three basic drivers are supportive – interest rates, profit expectations & risk appetite - then it is best to contemplate these risks from a relatively fully invested position. It is only when the “risks” start to compromise these core drivers that a defensive response is warranted. This is not occurring at the moment.
- Moving into 2010, equity markets remain well-placed. With respect to earnings momentum, global markets are far better placed than the ASX200.
- Preferred cyclical exposures = *financial transactions, residential construction, new-age media.*
- **Don't be complacent.** The next 2-3 years will have numerous hurdles – fiscal repair across the OECD; a world no longer fuelled by leverage; rising interest rates in Australia; commodity price volatility; a global price for carbon; unemployment etc.
- Uncertainty is best managed via appropriate diversification and coherent portfolio design.

