Think like an investor

Look beyond the media
2012

Time to think like an investor in 2012!

The media tends to focus on major geo-political events but the issues that affect our investments can be, and usually are, vastly different. In this paper, Perennial's investment boutique heads provide insights into some of the issues and trends that they as professional investors focus on when constructing and managing investment portfolios.

John Murray, Managing Director of Perennial Value Management, looks at the way the Australian equities market factors risks and bad news into the share price of companies. While there is no denying that there are serious risks that all investors need to consider, particularly if we look at Europe and the pressures of the sovereign debt issues there, John suggests that the market's recent reaction to Macquarie Group's profit downgrade may be a signal that investors are moving beyond the 'short termism' that has dominated the market.

Clay Carter, Head of Perennial International Equities, looks at the loose connection between economic growth and the performance of listed companies. In the US for example, for some time now headlines lamenting the dire state of the US economy have negatively impacted investor sentiment. History, however, shows that there is a very loose relationship between growth and equity market returns. High growth economies do not translate to sure fire returns in the stock market and vice versa. Some US based companies are doing very well in the low interest rate environment, with exporters also reaping the benefits of a very low US dollar.

Our professional investors in **Perennial Growth Management** go well beyond the media headlines when determining the long term growth prospects and opportunities of the companies and sectors they invest in. **Lee Mickelburough** uses the example of disruptive technologies to highlight how trends can impact market sectors, opportunity sets and stock prices. As investors, if we take a disciplined and holistic view of potential structural changes and weigh up the opportunities and risks, we can make some realistic assumptions about future earnings and share prices.

There is no doubt that the GFC thrust defensive investing into the limelight. Many investors now favour lower risk, fixed interest products that typically reward them when times are tough. The big question for fixed interest investors is where are we in the investment cycle? Will 2012 be the year that bond rates continue to fall (and therefore a great time to be in fixed interest – like the GFC or Euro crisis)? Or, are we at the bottom of the fixed interest cycle, and if so, is it wise to avoid longer term bonds in favour of cash and floating rate (not fixed) securities? **Glenn Feben, the Head of Perennial Fixed Interest,** makes the point that perhaps we are near an infliction point in interest markets.

Our final article is from our newly appointed **Head of Perennial Real Estate Investment, David Kivell.** With many column inches dominated by pessimism about the impact of China's slowing economic growth and global listed property in general, the regional property outlook seems pretty grim. David argues that while the region has not been immune to the impact of the issues in Europe, strong fundamentals for the Asia Pacific property sector should provide investors with good opportunities in 2012 and beyond. Perennial Real Estate is increasing its weighting to some of these opportunities.

So, read on and stop letting the media think for you. It's time to think like an investor!

Brian Thomas
Head of Retail Funds Management

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John Murray
Managing Director of Perennial Value Management

Aussie shares: It's all in the price

For sharemarket investors, the week commencing 6 February 2012 was potentially very significant. On Tuesday 7 February, Macquarie Group had an operational briefing, at which Nicholas Moore, the Macquarie Chief Executive Officer, announced that group profit for the year to March 2012 would be 25% less than the 2011 profit.

This announcement effectively represented a profit downgrade of some 15% and no doubt further confirmed all the negative views held by the Macquarie bears in the market. Such news over the course of 2011 would most likely have lead to yet another torching of the share price. However, a very strange thing happened to the share price in subsequent days – it went up.

What happened was that the market was willing to 'look through' the 2012 profit outcome in the belief that better times lay ahead for Macquarie beyond 2012. This is a view which Perennial Value ascribes to and which is reflected in the Perennial Value Australian Shares Trust's (the Trust) investment in this business.

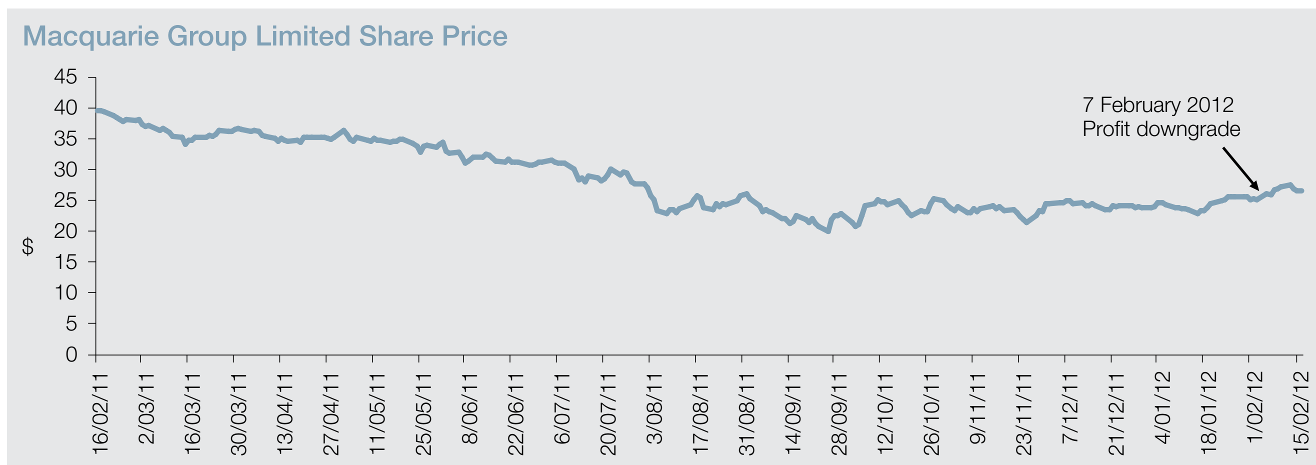
For the greater part of an investment cycle, we know that share market investors tend to look forward in pricing stocks. That is, they try to anticipate how profits will look into the future, typically over the next year or so and ascribe a valuation to the company accordingly. With confidence having been shot to pieces in recent years, this has absolutely not been the case. Investors' time horizons have basically been reduced to the 'here and now' and this has manifested itself in very high levels of cash holdings and an almost total reluctance to venture back into the stock market.

The key point from the Macquarie experience is that we have seen an early sign that investors are starting to lift their heads and are willing to look ahead again in terms of pricing stocks. Indeed, from a macroeconomic perspective, notwithstanding the daily dose of disastrous newsflow constantly emanating out of Europe, our stock market has been gradually rising since last September (up some 9% from then to the time of writing).

Again, this is telling us that investors are willing to 'look through' this Eurozone crisis and that all the bad news is in the price.

Taking the recent Macquarie share price experience, again investors have effectively said that all the bad news is in the share price. It also most likely means that there are no more sellers, the bears have no shares, in Macquarie at least!

Perennial Value's view is that the Trust possesses significant, yet to be realised, latent value in many of its stock holdings. These stocks are unloved in the extreme and always encourage debate when we discuss them in portfolio reviews. Macquarie is but one of these holdings and others include Simsmetal, Harvey Norman, Toll Holdings and Stockland. These stocks are complemented by a core of solid defensives, including Telstra, Tattersalls and Amcor, albeit the latter is somewhat less defensive. However, bear markets don't last forever, and as confidence inevitably returns to the market, it will be the very cheap, unloved, yet still good quality stocks which will lead the charge. Defensive stocks will most likely significantly lag in that environment. We are seeing early signs, as discussed above, that this is beginning to occur.



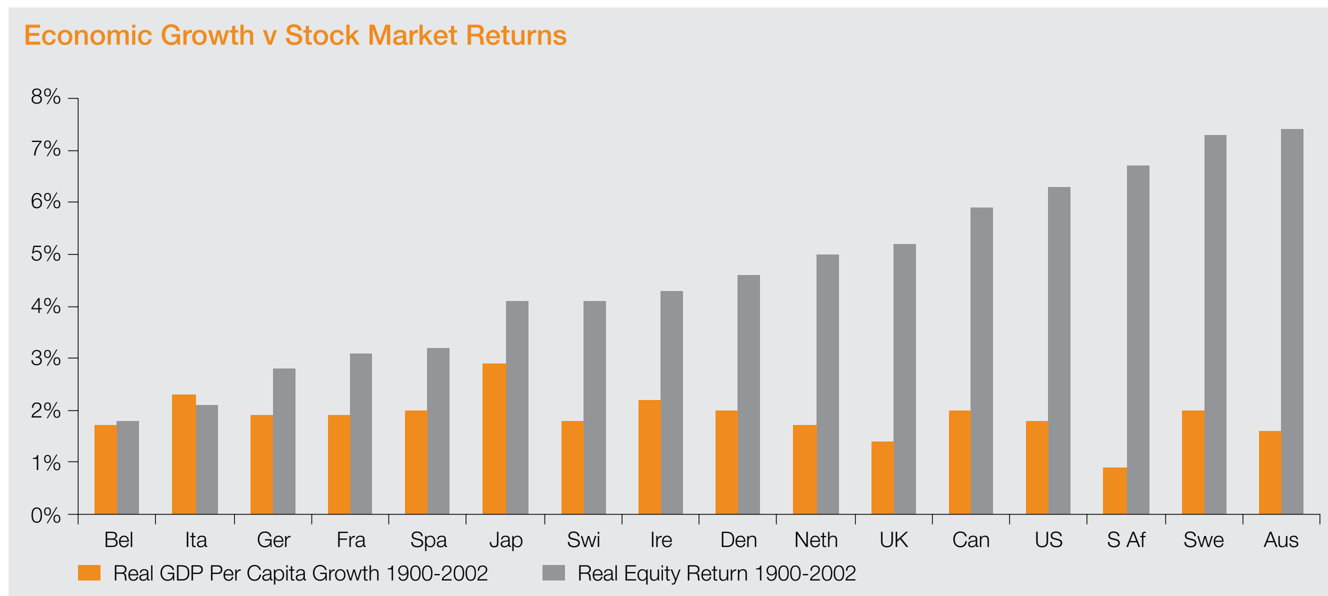
Source: Perennial Investment Partners Limited

Clay Carter
Head of Perennial International

Global Equities…
It's not the economy stupid!

The cataclysmic headlines of the past year have at times been hard for professional investment managers to ignore, let alone the general investing public. Yet an examination of the historic evidence should serve to remind investors of how weak the relationship is between real GDP growth and real returns in the stock market in any given year.

Academic studies suggest that even armed with perfect foresight regarding economic growth rates, this offers very little assistance in gauging the direction of stock market returns. The chart below for instance shows the disparity between economic growth and stock market returns over long periods of time across different countries.



Source: Ritter, J, 2005; 'Economic Growth and Equity Returns', Pacific Basin Finance Journal 13.

Although somewhat dated, this study covers in excess of 100 years of data across 16 different countries and indicates a very loose relationship between growth and equity market returns. High growth economies do not translate to sure fire returns in the stock market. For example, the Shanghai Composite Index has returned only 6% since the end of 2000 to the end of January 2012, in contrast to an economy that in real terms, has almost doubled in size over the same period.

A cursory glance at 2011 equity market returns and GDP growth offers a great example of this non-effect in action:

	2011 Real GDP	2011 Equity Return
USA	+1.7%	0.0%
Germany	+3.0%	-15.0%
UK	+0.9%	-6.0%
France	+1.5%	-17.0%
Brazil	+2.9%	-18.0%
India	+7.1%	-25.0%
China	+9.2%	-22.0%
Japan	-0.7%	-19.0%
Indonesia	+6.5%	+3.0%

Source: Perennial Investment Partners Limited

While we are by no means bulls on the global macroeconomic environment, as stock pickers we observe a great level of anxiety that has developed over this issue and the resulting compression in valuations for otherwise healthy businesses. While there has been gravitation towards yield assets in recent years, in our view the market appears to be underpaying for the growth on offer today compared with history.

Although widely held and far from contrarian, we believe shares in Apple Inc. (Apple) provide a good illustration of this effect:

Apple Inc (year end figures)	**2006**	**2011**
Sales	$19.3 bn	$108.2 bn
Net Income	$1.9 bn	$29.9 bn
Cash at Bank	$10 bn	$97 bn
Earnings Per Share	$2.36	$28.05
Year End Price	$85	$405
Price[1]/Earnings	28x	11x

Source: Perennial Investment Partners Limited

Another of our holdings, LKQ Corp, the leading supplier of recycled and refurbished automotive parts for the collision repair industry, demonstrates a similar effect:

LKQ Corp (year end figures)	**2006**	**2011**
Sales	$789 mn	$3,254 mn
Net Income	$44 mn	$213 mn
Earnings Per Share	$0.40	$1.45
Year End Price	$11.50	$30.08
Price/Earnings	28x	20x

Source: Perennial Investment Partners Limited

Much of our time is spent on determining the sustainability of growth and making the distinction between the structural and cyclical elements that drive it. Our general observation though as we enter 2012, is that the premium associated with 'structural' versus 'cyclical' growth is narrow. We expect that over the medium term this premium will expand as the virtues of such businesses make themselves apparent in this low growth world.

More than a decade on from the peak in market valuations when prospects for the world seemed irreproachable, we find ourselves with low levels of market valuations in a world with seemingly no end of troubles. As it did a decade ago, markets will likely again defy conventional wisdom, if not in the aggregate then via carefully selected companies capable of delivering structural growth with management that act in the best interest of their shareholders.

1. Price here excludes the net cash on Apple's balance sheet.

Lee Mickelburough
Head of Perennial Growth Management

There's no 'i' in cloud but there is in disruptive

We value companies for the long term and are particularly interested in when, and if, a competitive fad or trend will kick in and its expected longevity – is it passing or will it stick? As part of our research process, we talk to market participants such as suppliers, retailers and manufacturers to help us identify big future trends and validate our views on what we think is on the horizon. Technology, or more particularly, what many call 'disruptive technology' plays a big part in this. These are trends that are going to create big winners and big losers in terms of future company revenues.

In some ways it's hard to believe that iPhones have only been on the market since the middle of 2007. In just five years, the technology in this small hand held device as well as the rise and rise of smart phone technology in general and all things 'i' from Apple Inc. (Apple), have fundamentally, and permanently, changed the way many people engage with each other, source information, do business and even shop. For example, the RedLaser app or any of the bar code readers gives retail customers full price transparency at their fingertips; live sporting events can now be accessed on your smart phone; hard copy business presentations are becoming increasingly rare replaced by tablets; and, the boarding pass for your next flight is only as far away as your smart phone.

If you need to be convinced that smart phone and tablet technology has completely changed the playing field, look no further than your own mobile telephone or tablet or Apple's record profit result for the last quarter of 2011.

With sales of smart, portable devices expected to continue to climb significantly, the stakes are high for product producers and retailers and their future earnings. While the patent suit between Apple and Samsung gives us an insight into the battle for global market share, we expect the rapacious appetite of local consumers for the latest and greatest products, and the trend to buy them online, to put further pressure on traditional domestic retailers. Those sticking steadfastly to traditional retail models are set to be the big losers.

Traditional retailers will also need to keep pace with the march of new technology in what has traditionally been a boon sector – televisions. The humble and ever changing physical device we currently call a television is set to change yet again in the near future. As the rumours about Apple's work on the next generation television, with the same functionality as your computer and more, gain momentum, the clock is ticking for retailers and Apple's competitors. Retailers will need to evolve product offerings for televisions and carefully manage inventory levels, in order to stay relevant, avoid being caught with an oversupply of redundant stock and to maintain profitability. Needless to say, Apple's App Store will be a prominent feature on what we are calling 'a TV'. Equally, the development of smart device 'apps' will no doubt go into overdrive as suppliers across every sector of the market with existing apps, from financial services groups such as AMP to supermarkets such as Woolworths, continue to battle for customer attention in a bid to maintain and grow market share and profitability.

While the development, adoption and evolution of hand held and portable devices has been facilitated by cloud technology data storage and disrupted the traditional retail sales model, cloud technology is also disrupting the expenditure and business models of companies with large investments and ongoing spends in IT infrastructure and storage. However, in this instance, the disruption is set to deliver significant bottom line benefits and enhance the capacity of organisation's to increase productivity through the redirection of traditional IT spend. We have just one word for companies with this type of IT spend – winners.

Initially developed in 2000, cloud technology uses the internet as the service delivery mechanism for data storage, software applications and information technology services. Its flexibility, scalability and low cost structure completely change the traditional IT paradigm for businesses. Notwithstanding the opportunity, the business take up rate was low until 2010. However, the advent of dedicated cloud specific hardware from companies such as Cisco, Hewlett Packard and IBM, has seen the take up rate accelerate significantly over the last two years.

In our view, the successful adoption of this technology provides a lot of opportunities, as businesses are able to significantly increase efficiency and reduce the costs of supporting software, upgrading software and storing data. For example, virtual server technology means that ‘in-house’ storage is now an option for those companies with large, outsourced data storage models where capacity constraints previously made the investment in hardware and floor space requirements prohibitive. The reduction in the amount of hardware required also has the knock on benefit of minimising both the ancillary costs and the environmental footprint associated with running large data banks.

We believe that financial service companies with large data storage footprints, in particular, who get this right have a terrific and winning opportunity here. On the flip side, with data storage becoming an increasingly digital game, we see physical document storage as a business in decline. In this regard, we are very keen to see Brambles sell its document storage business.

Technology will continue to evolve and change. The successful companies and the beneficiaries of this change will be the ones who identify the opportunities and successfully embrace them to enhance growth, build sustainable business models and ultimately increase the long term value of the company. In the wealth management space for instance, IT systems need to be simplified and improved to contend with the increased pressure on fees and the competition for market share. We will be watching companies, such as Super IQ, who develop cost competitive and scalable technology offerings that go to the heart of what investors want.

As a growth investor, our investment process allows us to take a holistic view of markets and trends, such as disruptive technologies, in determining the long term growth prospects and opportunities of the companies and sectors we ultimately invest in. We evaluate each stock in our universe and pay special attention to trends and structural changes in our assessment of future earnings. We then compare our stock price to the current market price. In this way, our investment process highlights situations where enthusiasm for a new technology for example, can lead to unrealistic assumptions about earnings and share prices that are too high compared to our rational valuation.

Glenn Feben
Head of Perennial Fixed Interest

The pre-emptive nature of bonds

No one really knows how far the Reserve Bank of Australia (RBA) will ultimately need to reduce the official cash rate in the current cycle. It will ultimately be determined by the medium term performance of the Australian economy global issues, and, most importantly, where inflation heads over the next one to two years.

Late in 2011, the RBA commenced the process of monetary easing and financial markets are widely expecting that it will continue to do so during 2012. However, expectations as to how far rates might fall have fluctuated wildly over recent months. At the height of the sovereign debt crisis in Europe, financial markets were pricing in a cash rate of around 2.75%. Markets have tempered these expectations recently, as fears of a double-dip recession in the US recede and the risk of a meltdown in Europe appears to have fallen significantly following the liquidity measures introduced by the European Central Bank.

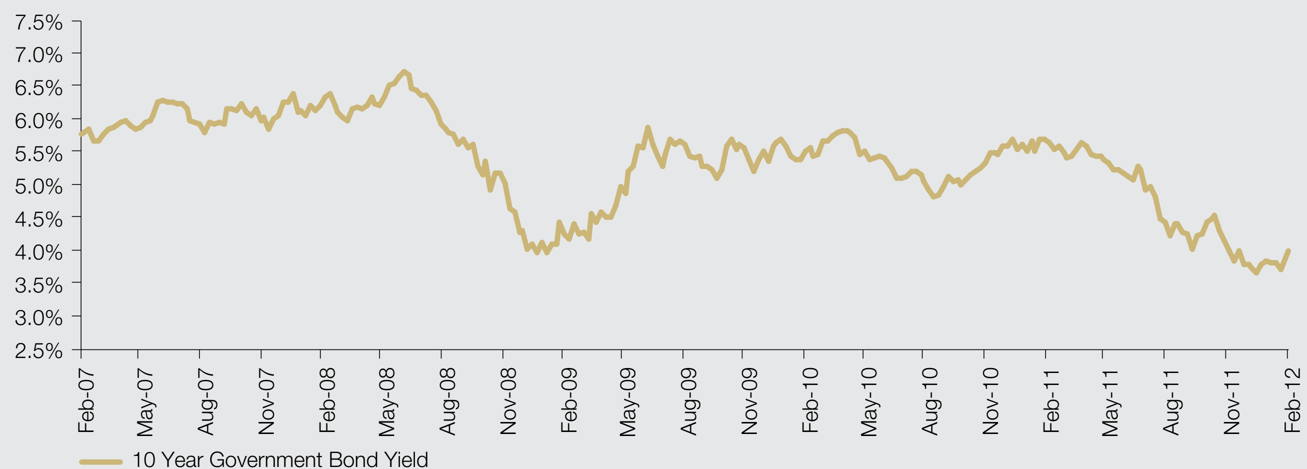
Certainly 2012 has begun on a brighter note and if this continues it will have important implications for the way investors position the defensive part of their investment portfolios. One thing we learnt from the GFC was the fickle nature of investor sentiment and when it changes direction, valuations in fixed income markets can move very quickly.

In this context, we think that investors would be well advised to consider how their defensive assets are likely to perform if the market starts to believe that the RBA has reached the end of the monetary easing cycle. In our view, this is more likely than not to happen during 2012.

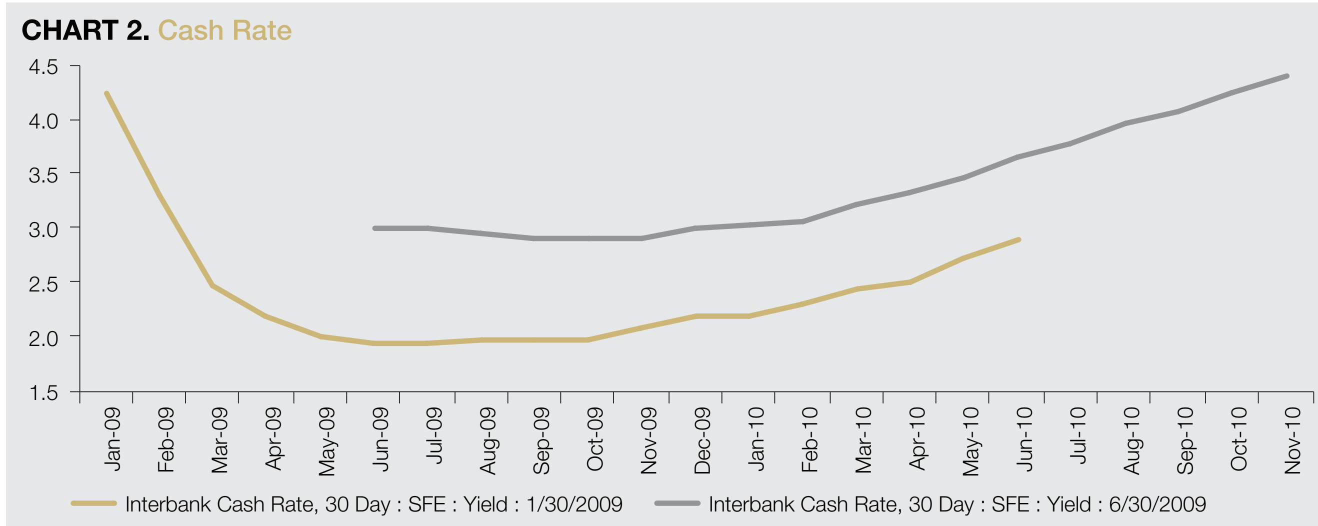
To get a sense of the impact this might have on longer term bond rates, and therefore fixed interest returns, it is perhaps instructive to take a look at what happened as we emerged from the GFC in 2009. In some ways this was similar to the current experience, with the cash rate reaching a historically low level of 3.0%, and the market, at one stage, expecting it to fall as low as 2.0%.

As can be seen in Chart 1 bond yields bottomed out in early 2009, with ten year Government rates falling to a low of 3.86%. This coincided with the point when cash rate expectations reached their most extreme level. As shown in Chart 2, in early 2009 the market was anticipating that the RBA would drop the cash rate to a little below 2%. By mid 2009, expectations had begun to shift dramatically. Investors had become far more optimistic about the prospects for the global economy, while the earnings of financial institutions, which had been at the epicentre of the GFC, were recovering strongly. As this shift in expectations unfolded, bond yields began to rise sharply (refer Chart 1) with the ten year yield eventually peaking at close to 6.0%.

CHART 1. 10 Year Government Bond Yields



Source: Perennial Investment Partners Limited



Source: Perennial Investment Partners Limited

So let's now take a look at how these developments affected the performance of fixed interest over this period. For the one year ending 31 January 2009, the domestic bond market (measured by the UBS Composite Index 0+ years) delivered an annual return of 15.16%, with more than half of this the result of the large decline in yields that took place over this period.

Bond returns of this magnitude are rarely repeated in the subsequent year, primarily because of the cyclical nature of interest rates. Indeed, this was certainly the case in the one year period to 31 January 2010, where the bond market return fell to a miserly 1.67%. If nothing else this should prompt investors to consider how their strategies would be impacted should we enter an environment where interest rates start to normalise.

In the year to 31 December 2011, the bond market returned an impressive 11.37%, again driven by a sharp fall in yields. As discussed earlier, should the market begin to think that the RBA has done enough, as we expect will be the case at some stage during this year, then bond rates will likely start to rise, possibly sharply given their low starting point, and in doing so materially depress fixed interest returns. Bear in mind this will happen well in advance of when the RBA actually commences the process of monetary tightening.

During this phase of the investment cycle, investor appetite for risk should be on the mend and their focus will increasingly shift away from the safety of government bonds to higher yielding opportunities elsewhere. This was certainly the case during 2009/2010, as the world emerged from the GFC and resulted in this sector of the fixed interest market strongly outperforming during this period. We feel there is a strong chance this will again be the case again during 2012/2013.

When thinking about how you should structure your defensive assets over the period ahead, we feel the best returns will come from shorter duration assets which stand to benefit from a narrowing in credit margins. We are emphasising these themes in the construction of the Perennial Tactical Income Trust. In our view, this approach will stand the Trust in good stead to comfortably outperform more traditional bond funds over the next few years.

David Kivell
Head of Perennial Real Estate Investments

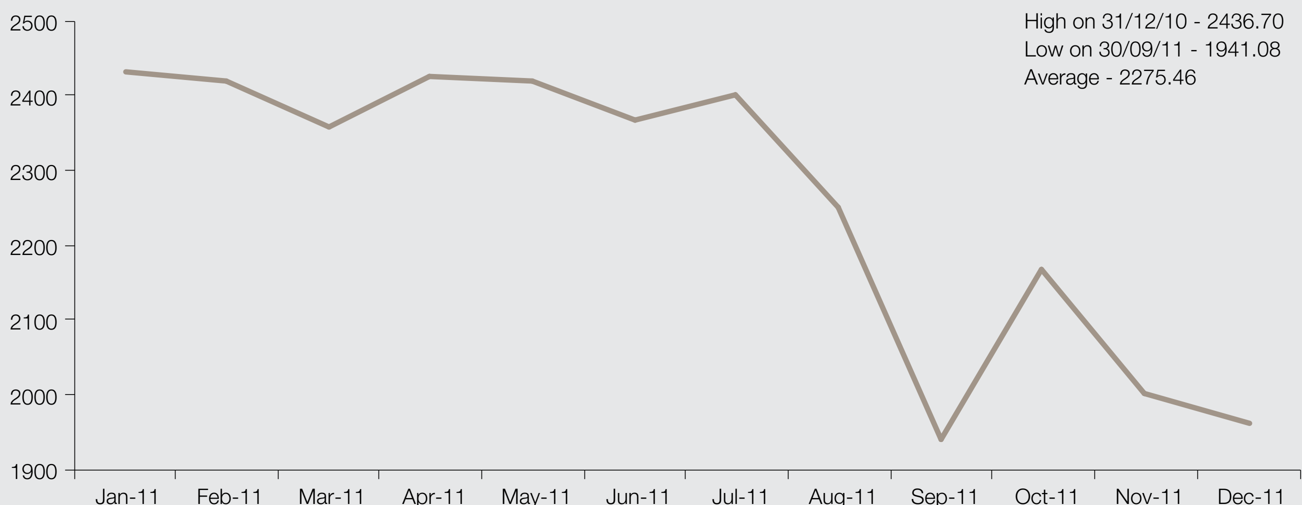
Forget Europe, the Asian property sector is open for business!

In 2010 Hong Kong, Japan and Singapore were the best performers in the Asia Pacific REIT market, each outperforming the broader market, with Hong Kong and Japan well ahead at 32% and 28%, respectively.

While 2011 started out with a great deal of promise the natural disaster in Japan, sovereign debt issues in both Europe and the US together with global macroeconomic concerns, weighed on global markets and investor sentiment. Unlike Europe, which struggled through the year and continues to do so, and the US, which is set for a long period of recovery, the Asian Pacific property sector is showing signs of a strong recovery in the near term.

Given the European backdrop, the sector had a tough year in 2011 amid the broader sell off and finished down 19.6%, as can be seen in the chart below, the best performers in the region posted returns of over 20%. The two Malaysian stocks, namely, Sunway REIT and IGB Corp, were up 29.1% and 23.8%, respectively. They each outperformed the broader market by 45% and 40%, respectively.

CHART 1.



Source: Bloomberg, Perennial Investment Partners Limited.

With Europe on hold for most investors and the US market expensive struggling with their recession and the Euro/Greek issues, the Asian property market is still open for business. The region, while not immune from global issues, continues to offer compelling value for investors. Indeed the sell off at the end of 2011 was largely driven by European sovereign debt concerns, poor market sentiment and poor liquidity. As a result of the sell off, the Asian property sector now has quality stocks that are trading at a deep discount to their fair value. The majority of these names are listed in Hong Kong, with strong management franchises, low leverage balance sheets. As these quality names are sitting on a growth platform in Asia, with improving fundamentals, we continue to add them to the portfolio.

We are cautious on the residential sector in Hong Kong and China and forecast a mild correction in residential prices. The sector continues to be driven by capital market liquidity and is heavily controlled by the government's tough policy measures. These include more land supply, stamp duty, restrictions on purchasers, tightening mortgage approval quotas. We do not expect the policy measures to be eased any time soon. That said, we do not see a hard landing such as one in 2008 either in China or Hong Kong as end user demand remains robust. In fact, we expect the year ahead will be a time of consolidation, where the strong players will outperform and the expense of smaller players.

Credit in China was in tightening mode for some time in 2011. We expect the government will lean toward economic growth bias which should lead to an overall easing bias. Given this scenario, we expect to see companies with strong balance sheets and strong purchasing power move into acquisition mode. The commercial sector is expected to perform well with positive rental reversion. Tight supply of prime CBD office space in first tiered cities in China, low vacancy rates, coupled with stable domestic and international demand for prime space will put upward pressure on rent. The retail sector will remain resilient in the current environment, supported by strong traffic and double digit retail sales growth. In our view, companies with large development pipelines in China's commercial sector and a stable defensive and diversified portfolio in Hong Kong, should perform well in 2012. We currently hold Sun Hung Kai, Henderson Land, Wharf and Hong Kong Land, and will look to add to these positions as we put the Euro issues behind us and investor focus moves to looking at regions that offer cheap stocks, with solid fundamentals.

Phone 1300 730 032 **Email** invest@perennial.net.au **Visit** www.perennial.net.au

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