Investor Series: Just Another Day in the Post-COVID Sharemarket...

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Two mid-cap companies made announcements on 26 August – grocery wholesaler **Metcash** held its annual general meeting, while financial technology company **Zip** announced its full year results, which included news of a deal with eBay Australia. Despite reporting very upbeat results, Metcash's share price barely moved, while Zip was rewarded on the announcement of its new deal with Zip's share price soaring 27%. What was going on?

Metcash – Positive Result, Little Reaction

In recent months we have significantly increased our holding in **Metcash**, a wholesaler to retail brands such as IGA, Cellarbrations, and Mitre 10. Our confidence in Metcash's prospects strengthened after significant research including 'channel checks' and talking to many independent retailers. The IGA network has made significant progress reinvesting in its stores and reducing prices to be more competitive with Woolworths and Coles. Metcash has been growing sales, helped by the increase in grocery and hardware sales during the COVID-19 pandemic. IGA has also picked up substantial market share from the major supermarkets, benefitting from new localised shopping trends. We also estimate that Metcash should report a net **PROFIT** after tax of slightly over A$200 million next financial year, while the company has also been trading on a price/earnings ratio of around 14 times earnings, and has a 4% dividend yield.

So when Metcash announced at its AGM on 26 August that food sales were up 15%, liquor sales up 11%, and hardware sales up 19%, we felt vindicated by our positioning. These sales numbers were well above our estimates and market expectations. However, Metcash's 2% share price rise on the day underwhelmed us, as investors appeared more interested in 'exciting' sectors of the market, rather than companies with real earnings.

Zip – Poster Boy for Momentum Frenzy

On the same day, financial technology company Zip announced its results – a before-tax **LOSS** of A$45 million, and a deal with eBay Australia to offer credit options to small- and medium-sized businesses. Zip's share price hit a record high of A$9.95 on the announcement and finished the day 27.58% higher, adding close to A$1 billion in value to close the day valued at A$3.7 billion. (This compares to Metcash's valuation of about A$3 billion.)

Does it really make sense when a loss-making company's minor deal can justify a A$1 billion market-cap increase, while a well-established profitable company's double-digit sales increase barely makes any impact on its share price?

Such is the frenzy in the 'buy now pay later' (BNPL) sector – or should that be 'buy now, *profit* later'? – that **FlexiGroup** opportunistically announced a name change to 'humm', a substantial capital raising, and that it is moving its business model to being another fully-fledged BNPL company.

The market is currently a combination of exuberance and extreme valuations in a number of sectors. This is particularly the case in technology, where stocks like **Afterpay** are up 10-fold in five months. There is muted disinterest in many other sectors – mainly the ones made up of companies that actually make profits and pay dividends! Many market participants are seizing on short-term announcements, extrapolating these well out into the future, making no provision for economic or regulatory changes, and driving up the prices for some of the most speculative stocks on the sharemarket to enormous valuations.

Meanwhile, good-quality companies like Metcash, with proven solid earnings, a healthy 4% dividend yield, a reliable history of paying good dividends, and trading on a reasonable 14 times earnings, languish virtually unnoticed. The market is not currently rewarding companies which are going in the right direction as we head into an economic downturn and which are proving that they are able to maintain their earnings, profits and dividends.

This point in the cycle is reminiscent of other speculative cycles through which IML has invested over its 22-year history. The most emotional – and therefore least rational – decision-making body is the crowd. Successful long-term investment therefore requires rigorous analysis, disciplined behaviour and a steely determination to persevere with a tried and tested investing process, irrespective of bubble-like activity and headline-grabbing noise from some other sectors.

Conclusion

We know that when the sharemarket exhibits such extreme traits, that change is in the offing. Given the more challenging broader economic and business environment, at some point the market will begin to recognise and reward companies with robust business models and genuine earnings. The market will also lose interest in companies which may, possibly, become profitable at some stage a long, long way down the track. At that point, the market will return to recognising the value of companies with a competitive advantage, which are the number one or two player in their industry, which are run by high quality management teams, and which have recurring revenues underpinned by a strong balance sheet. The share prices of these companies will benefit greatly as a result.

Central banks are talking about keeping interest rates low for the foreseeable future, and economic growth prospects moving forward are far from clear. Because of this, at Investors Mutual, we are keeping your investments skewed heavily towards well-established companies like **Amcor**, **Aurizon**, **Coles**, **Metcash**, **Orica**, and **Telstra**.

These are companies which on the basis of our research, we believe are run by very capable, experienced and proven management teams, and which will be able to continue to generate good cashflows and dividends for shareholders in the years ahead. We also continue to keep faith with companies currently affected by the COVID-19 shutdowns, such as **Crown** and **SkyCity Entertainment**. These firms have strong, long-dated licences which will help them generate significant returns for shareholders in coming years as restrictions ease.

There is no doubt that certain sectors and stocks have entered bubble territory, driven by a wave of liquidity and momentum investing. What causes all this to end and when is anyone's guess, but in the past, such speculative frenzies have ended without warning, and in a very dramatic fashion as many investors look to exit many of these positions at the same time.

Our investment process has delivered successfully to our investors' expectations since our inception in 1998. We continue to stay disciplined, looking to pick the right stocks at attractive prices so that we can consistently deliver you positive long-term outcomes.