

Do fundamentals matter? (Part 2)

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Around 3 months ago, we wrote an article entitled "[*Is the sharemarket correctly pricing in fundamentals?*](#)" In that article, we compared the market capitalisation of **Afterpay**, a 'buy now pay later' company – with no track record of profitability – to the market capitalisations of some of Australia's most successful global companies, such as **Amtcor**, **Orica** and **Brambles**. Our conclusion was that while Afterpay may have some real opportunities for growth in the long term as it rolls out its business model, that this appeared to be more than fully factored in its then \$29.7 billion valuation.

In the last few months there has been no let-up in the momentum style of investing in conceptual stocks, and recently Afterpay's price touched A\$150 a share – which gave the company a market capitalisation of A\$43 billion. This rise in the share price in less than 3 months is an increase of A\$14 billion in value from when we wrote our article last November.

To give readers an idea of the magnitude of this move, \$14 billion is **more than** the **TOTAL** market value of **Metcash** (an Australia-wide wholesaler to the IGA Supermarket, Mitre 10 Hardware and Cellarbrations liquor chains, and forecast to make a net profit after tax (NPAT) of over \$270 million this year), **Aurizon** (which operates vital rail infrastructure assets in Queensland and which is forecast to earn well over \$450 million NPAT this year and next), and **Shopping Centres Australasia**, which owns 80 convenience shopping centres anchored by long-term attractive leases with Woolworths and Coles. These three companies are all very well-managed and have businesses which will be generating good cashflows for many, many years if not decades to come.

The extraordinary rise in Afterpay's market value is yet another symptom of the continuing euphoria present in some sections of sharemarkets all around the world. The electric carmaker **Tesla** – another company yet to build a record of sustainable earnings – is now the sixth-largest listed company by market-cap in the United States, trading on a price/earnings ratio of over 1500 times earnings, while earlier this month one unit of cryptocurrency Bitcoin hit over US\$40,000 in price. Another sign is the frenzy of launches in the US of 'special purpose acquisitions companies' (SPACs) – effectively listed 'cashboxes' – created to raise capital to acquire other companies, although no acquisitions are specified.

Encouraged by continuing loose monetary policy thanks to ultra-low interest rates and quantitative easing from Central Banks as well as continued lavish fiscal stimulus from many Governments around the world, many investors continue to throw their money at companies bereft of any major fundamental value, focusing instead on many companies' 'blue sky' potential – despite a continued fairly uncertain economic outlook. Many market participants appear to be expecting infinite share price appreciation from many of these companies, making no provision or 'margin of safety' for any commercial setbacks or regulatory changes, for instance. This phenomenon has driven the divergence between 'value' and 'growth' stocks to levels which have now surpassed the 'tech boom' which ended so suddenly 20 years ago and which destroyed so much wealth for investors chasing these stocks.

Meanwhile, many well-established, good quality Australian companies which have a long track record of making healthy profits and that pay income to their shareholders in the form of dividends – and which are forecast to do so for many, many years in the future – continue to languish unappreciated. (This includes, incidentally, many companies which are being highly innovative in their use of technology to drive their future earnings growth, but which are not at present seeing this translated into better share prices.)

The importance of staying true to label

So when will these market aberrations end? Picking the peak of a bubble is of course extremely difficult to do. Famed investor and chronicler of bubbles Jeremy Grantham reminded us recently that “[l]ong, slow-burning bull markets can spend many years above fair value and even two, three, or four years far above. These events can easily outlast the patience of most clients. And when price rises are very rapid, typically toward the end of a bull market, impatience is followed by anxiety and envy”.

This is why it remains so important to maintain perspective and to not get caught up in hype, and to not subscribe to theories about a so-called “new era” touted to justify outrageous increases in share prices and the many ridiculous valuations that we are witnessing today.

When the market is running hard – especially in some hot sectors – it can be increasingly difficult to maintain a proper perspective and to focus on the things that ultimately really matter, like understanding a company’s competitive advantage (in the shape of for example long-lasting assets or licenses).

Successful long-term investing has always been about and will always be about devoting the time and effort to fully understand a business by looking and thinking beyond the daily headlines, remembering that there is a difference between trading and investing, and often between a company’s share price and its true underlying value.

As a long-term investor focused on quality and value companies and not looking to take excessive risks with our clients’ monies, we continue to back proven well-established companies that own long duration assets that generate very sustainable and growing cashflows and which are run by very experienced and competent management teams, as is the case with companies such as **Amcor**, **Brambles**, **Orica**, **Metcash**, **Aurizon**, and **Shopping Centres Australasia**, rather than succumb to the current mania being seen in some sections of the sharemarket.

At some point the current market euphoria in the ‘hot’ sectors *will* end, and the share prices of companies will revert to being more based on their fundamental characteristics, rather than unrealistic blue sky forecasts. In the past, speculative frenzies have often ended suddenly and with little warning, as the market loses interest in previously popular companies and many investors try to sell down their holdings of nebulous value at the same time. When that time comes, investors will once again be reminded of the importance of investing on the basis of quality and value.

Because of this, Investors Mutual remains true to the promise that we have made to our investors for over 20 years – that we will use our best efforts to identify companies underestimated by the market, selecting what our research shows us are the right companies at the right prices, to deliver regular income and longer-term capital growth, and ultimately to help our investors achieve their long-term goals and aspirations.

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