2016: Risks and Opportunities in the Stock Market

Introduction

When John Upton invited me to speak today he was looking for something forward looking and suggested taking about the outlook for sectors and stocks in 2016. I have chosen to talk about risks and opportunities, which I think meets his request. However, instead of looking directly at opportunities, I have put risks first in my topic *2016: Risks and Opportunities in the Stock Market*.

This is important for a number of reasons.

First, I am most often asked to speak to associations who are composed of members who are hoping I will answer the implied question: what will the stock market do this year? I have two responses to this: I don't believe that I can, nor can anyone else, consistently predict the stock market. More importantly, this is asking the wrong question. The correct question that they need to know the answer to is this: what are all the things that may happen? If any one of them happens, what action should you take? This insight is one of the most valuable that I have learned over 50 years of investing: imagine all the possibilities and have a strategy to deal with each of them when one of them occurs.

Second, putting risks first is fundamental to investing. If there were no risk in an investment, then everyone would have piled into it and arbitraged away any possible profit. Think purchase of a short term treasury bond: the return is certain, but it is also likely to be very low. When we come to the stock market, returns are made by accepting risk. The way to succeed is clear: it is to correctly assess those risks, assume those risks that are reasonable relative to the potential reward and then manage those risks. In other words, we should avoid unreasonable risk and try to focus on assuming risks that have a higher possibility of strong rewards.

Third, managing risk is critical to investing from another angle. Let me remind you of the most important insight into the process of investing: let your winning investments run, but cut your losing investments quickly while the loss is small. This is very close to Warren Buffett's dictum: *The first rule of investing is: don't lose money*. It is also close to Charles Ellis' famous article *The Loser's Game*, in which he explained that in a loser's game like investing, the winner tends to be someone who makes the fewest mistakes.

Of course, we will all make many poor judgements, which is why we cut the losers quickly. However, many investors take on risks they do not understand, which biases the game against them from the start and is compounded by their inability take the inevitable losses while they are still small.

So, if I cannot predict the market for you, and if you asking me to do that is the wrong question anyway, how can I help you in your investing for 2016 and beyond? I think the most valuable things I can talk about today are the risks that I think are out there. That way maybe you can avoid the worst of them and manage the rest.

Some Important Risks

Major Bear Markets

There is a general fear among private investors that another major bear market is just around the corner. This is an irrational fear that is held by those investors who have neither observed history as it happened to them nor have studied the history of markets.

I began investing in Australian stocks 51 years ago. In that 51 years there have been four major bear markets:

- The big one in 1974,
- A slightly smaller, but still significant one in 1981
- The one with the biggest one-day fall ever in 1987
- The one called the Global Financial Crisis in 2008

That is four in 51 years or on average we might expect no more than three to five in an investment lifetime. I have seen these four and if I live long enough, I might see my fifth one!

What is most important about the big bear markets is that you can learn to see them coming. This is one of the most important things I teach about investing. Big bear markets come out of periods of rampant speculation. Right now, there are no signs of rampant speculation in the Australian stock market. Rampant speculation builds up over several years, so it is unlikely to happen tomorrow or any time soon.

That is my prediction, but as I said earlier, nobody is good a predicting the future, so I could be wrong. Asking for my prediction is the wrong question anyway. What you need to know is how to see it coming and have a strategy to deal with it. There are two basic strategies:

1. Market timing – sell as it approaches
2. Buy-and-hold – ride through it holding only first class non-cyclical companies likely to hold their dividends

Which is best is arguable and is a far bigger subject than we have time for today.

Global Influences

We live in an increasingly uncertain world. There are always things that happen in the world that impact on our market to a greater or lesser extent. It is possible to worry so much about them that we are worried out of acting or we panic and make bad decisions. To some extent this is the nature of bull markets: they are said to climb a wall of worry.

I do not watch television and radio. I absent myself from social media. I do not look at internet news or chat sites. I read The Australian Financial Review every day, but very selectively for information and the detailed views of writers that I have come to respect. I can look up on the internet what I want to know, very selectively.

This filters out all the noise and the important news reaches me anyway. I can be out of the country for a couple of months, as I will be this year, and when I return I find I have not missed much that was of any lasting importance.

So, what do I do when I pick up a global influence that I assess is a threat for our market? I ask whether it is likely to affect any local industries. If the answer is yes, I ask which stocks and I avoid them. If on the other hand I discern that it will not affect stocks that the nervous nellies have sold off. I look harder to see if it is a buying opportunity.

My advice here is to try very hard to see where there may be an opportunity hiding somewhere in a threat. If we can see it before the crowd and have the courage to back our analysis, then we can make money from being threatened.

Slow Growth

There is slow growth all around us in Australia and overseas. In Australia there are multiple reasons for slow growth:

1. A reduction in immigration. Immigration has powered the growth of Australia. Government has turned down the tap.
2. The high household savings ratio and steady reduction in household debt. This all means lower spending and lower corporate profits.
3. Unemployment, which is low by world standards, but higher than it was in the boom times at 5.8% last week. This also means lower spending and plays back into the savings ratio and debt reduction.
4. Political gridlock and lack of skill. We vote for them, so we are all to blame here. This is not a solely Australian trend.

So, slow growth is a local phenomenon and is also imported from overseas through customers for our resources, manufactures and services.

It is more of a problem in some sectors than others – think iron ore, oil, gas and coal. So we should stay away until we have seen blood in the streets. There will be a time to buy, but most investors will have stopped watching. I am watching some of these sectors like mining services. It is a bloodbath, but a few strong survivors will emerge in time. It will also pay to watch gas and iron ore. It will be ugly, but look for the phoenix in the ashes.

The Chase for Yield

With the fall in interest rates, bank deposits and bonds have become less attractive. Private investors have turned to the stock market and began buying:

- Telstra for its high yield
- Banks for their high yield
- Other high-yielding stocks
- Hybrids, REITS and other securities with a high yield

The problem with this is that high yield invariably means one or both of:

- Low growth
- High risk

The biggest problem here is that many of these securities have a high yield because they have low growth prospects and/or they carry high risk. Remember that in general terms there is no free lunch in the stock market and risk tends to be inverse to yield, meaning that, all other things being equal, high yield is a reward held out for taking on higher risk.

So, they all rushed into the big four banks which created a mini boom and guess what happened; their prices fell sharply. This was not investing, it was momentum trading, also known as the greater fool theory and the result is always tears.

Initial Public Offerings and Backdoor Listings (Reverse Takeovers)

The rate of Initial Public Offerings is picking up, but more slowly than in previous bull markets. The private investor loves them almost as much as the promoters who are flogging off both the bad and the good at high prices.

In particular, be very wary of government privatisations and private equity floats. A few turn out to be good, but many have been way over-priced and some have been shockers. I never, ever buy an IPO or a privatisation. However, I have very selectively bought into ones that had apparently gone badly wrong, fallen in price and been a bargain. A recent example is Collins Foods. However, these are like specs of gold in the prospector's dish. Finding them is very hard work and requires great discipline to quickly sell the mistakes we make.

Currently there is a rash of backdoor listings or reverse takeovers as they are also known. These are generally start-up businesses and the vast majority are of little merit. There is a cycle here where mining explorers were backdoor listed into the shells of failed internet developers. Then more lately technology disruptors with no established business are being backdoor listed into the shells of the failed mining explorers. Each round raises more capital from the punters and blows it searching for something or trying to make a business idea work. Every now and then one is very successful, but here think lottery tickets.

Property Boom

Australian property prices are unusually high for several reasons:

1. Low interest rates
2. Taxation advantages including negative gearing and capital gains exemption or discount
3. A period of low construction in the main cites and the resources boom in Western Australia and Queensland

The result has been a boom in residential development, both houses and apartments.

This always ends in tears and we will again see holes in the ground and uncompleted buildings as developers hit the wall. There may be scandals around off-the-plan purchases.

Banks will be hit, as they were in all previous busts. Some may fail as two did last time and governments may need to bail out those too big to fail.

Lenders to banks including hybrids may be bailed in.

Property developers and banks are always high risk, but will be especially so in the inevitable property bust. If you must play, don't be left holding the parcel when the music stops.

Bonds

Government bonds are a secure loan asset that pays a low rate of interest which may just exceed the rate of inflation and so hold purchasing power. Corporate bonds and bond-like hybrids pay a higher rate, but the risk of default or loss is far greater.

Bond prices move inversely to the interest rate. So, as interest rates have fallen to levels last seen in the 1950s, bond prices have soared. It is inevitable that interest rates will rise again sooner or later. When this happens, bond prices will fall dramatically. Large capital losses can only be avoided by holding to maturity, but for many that may not be possible.

Hybrids pose additional risks from their complexity which most private investors struggle to properly understand. Each one is different, so don't go near them if you do not understand the Product Disclosure Statement.

Derivatives

A derivative is any financial security that trades at prices derived from some other primary financial security or index or even another derivative. Derivatives include Contracts for Difference, hybrids and Exchange Traded Funds.

Warren Buffett describes derivatives as time bombs or financial weapons of mass destruction. They can bite the investor in multiple ways. I never invest in derivatives.

Crowd Funding

When I have mentioned crowd funding to people recently, I have been surprised how few even knew what it was. Yet it has grown significantly overseas and will soon be legal here within limitations.

Basically crowd funding is the practice of funding a project or venture by raising relatively small monetary contributions from a large number of people, today often performed via internet-mediated registries.

It sounds harmless enough – you give the new start-up business a thousand dollars or so and if enough is raised you become a part owner.

Up until now any business raising money from more than a handful of unsophisticated investors requires a prospectus. A prospectus is costly, so crowd funding is a way around the existing regulatory protections where it is legal, as is proposed soon in Australia. The rationale for allowing crowd funding is the relatively small amounts invested, so the risk is seen as small. Really? If you invest $1,000 and the business fails you lose $1,000. I make that a 100% loss.

If you get caught up in the enthusiasm for an idea that is crowd funded, make sure you recognise the risk. Almost all booms involve the creation by clever people of such instruments to get around regulations put in place after the last scandal. They sow the seeds for the next financial scandal.

Peer-to-Peer Lending

This is a close cousin to crowd funding. It involves disruptor firms creating a mechanism for connecting lenders looking to earn a solid return with creditworthy borrowers looking for a competitive personal loan that is unsecured.

This is another example of clever people finding a way around the regulations that make bank lending expensive. I fear that this is another of those cases that will likely be the next financial crisis as greedy unsophisticated investors get caught up in the latest new thing and get burned because they did not understand the risks they were taking. Whenever credit expands rapidly like this outside of the regulatory framework it usually finishes in a crisis.

How to Find Opportunities in the Stock Market

For now that is enough about the risks. To round out this presentation I want to talk briefly about how to find opportunities.

We are in one of those times in the bull-bear market cycle when private investors are busy deleveraging after the last boom and licking their wounds from the last bear market. This is very much a market that is making a difficult passage gradually upward, but with significant periods of choppy price movements. This is a market for experienced stock pickers rather than trend followers. Investing for income and steady growth is the order of the day. We cannot just throw money at anything that moves. Successful investing must be far more selective.

There are two basic ways to play the stock market:

- Momentum trading and
- Investing

Although most private investors, including many of you in this room today think they are investors, they are really momentum traders.

Investors have a quite different mindset to momentum traders. At a recent conference I spoke about this and afterwards a participant came up to speak to me about my talk. He thanked me for talking about investing and professed that he too was an investor.

I asked him to tell me one stock he owned. After some reflection he gave me a stock that was in his current portfolio. I asked how long he had owned it and he said 11 months. I asked him how the business was performing. He told me that he had bought it at $8.10 and it was now selling for $9.80.

I gently advised him he was not an investor, he was a momentum trader. Remember I asked him about the business – sales, profits, rates of return, profit margins, gearing and so on - the kind of thing that an investor who had the mindset of a part owner in the business would have.

He mentioned none of these things, just the stock price. This is the mindset of a momentum trader who makes a profit from changes in the price of the stock.

Now, what I have just said is not intended to be a value judgement about momentum trading. It is simply a good way to distinguish between investors and momentum traders. It is important to know which you are. This is because if you are a momentum trader and you think you are investing, it can really screw up your decision making.

I will not say anything more about momentum trading today. Instead I want to talk to those of you who are, or would be, investors – part owners of businesses.

Where do investors find opportunities even in today's market which is most amenable to stock picking?

First, we want to find stocks that are safe and show growing earnings. In very general terms, this means:

- They have been operating successfully for a number of years
- They make a profit each year and pay a dividend. Ideally there will be growth in both
- They are in non-cyclical industries, or at least not overly cyclical industries
- They have relatively low debt ratios – if they are in cyclical industries, very low debt ratios
- They have a competitive advantage in a market that is not overly likely to be disrupted by new competitors
- Gross and net profit margins are high and/or increasing
- The return on shareholders' funds is greater than your required rate of return
- They are well-managed

Second, and probably most important of all, they can be purchased now at a low price relative to their intrinsic value, however you define that. Intrinsic value is not a single number. It is not even a range. It is total assessment than comes from a thorough analysis of the industry and the stock. When you find one you should know it instinctively.

Are they easy to find? No. It requires skill, experience and plain hard work. However, it is the only way to buy part ownership of businesses for a growing income stream, capital growth and safety.

Finally, diversify your portfolio by stock, by industry and especially over time. Diversification protects against chance, unknowable events and errors in analysis or judgement. It follows that your level of diversification should be the inverse of your level of investment skills. In other words, the less your skills the more you should be diversified and the greater your skills the more concentrated your portfolio might be. However, diversification has two dimensions – greater safety also tends to mean lower returns. As in all investing, a balance must be struck.

Remember, though that around half will be poor investments. Their business may not be as good as you thought. Weed them out quickly, but build and let run the good investments that you make.

Thank you for listening to me today.