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Stocks

Comeback stocks – unearthing value

Mark Story - July 10, 2008

Like boats on an incoming tide, all Australian stocks stand to benefit from an expectant correction on the S&P/ASX 200 index from current levels (5,300) to around 6,300 points by year's-end. Given the degree to which the entire index has been oversold (down 16.9% in financial year 2007/08), purists could argue that all stocks - in varying degrees - have the whiff of 'come-back' about them.

So all you need to do to find the best value-plays is look for stocks where the P:E has fallen the most, right? Well, not exactly the conflicting currents that have menaced our bipolar equity market have coughed-up some curious dynamics.

Despite suggestions that they're in the maturing stages of a bull market run, stocks within the resources index, up 25% (in FY 07/8) are most analysts top value-plays on the prevailing view that the commodity run cannot be derailed.

By comparison, some sectors were severely oversold for good reason, and LPTs or infrastructure stocks are a case in point. Only brazened contrarians would jump back here with a short-term view, especially given that many of these stocks still carry more debt than equity.

And given that the retail sector is bearing the brunt of our economic slowdown, the same could be said for consumer discretionary which on a drop of 42% fell at twice the rate of the broader market. The key to 'value-style' investing within the current market, says Matt Brooks from ABN Amro Morgans is sniffing out low P:E ratios relative to their projected earnings.

Notable standouts here were those stocks that had their earnings upgrades either buried within a morass of otherwise bad news or were severely doubted by the market, these include: Flight Centre, JB Hi Fi, MYOB, Nomad Building Services, Webjet, and to a lesser degree Telstra which still lost 7.6% for the year after lifting its earnings forecasts.

The current dilemma for investors, says David Cassidy UBS strategist is buying stocks - which analysts like on a one year-forward valuation - ahead of a wave of pending earnings downgrades.

But based largely on the magnitude of the recent correction in which the All Ord's experienced its biggest fall in nearly 30 years, Brooks says it's the big-caps that deserve front and centre stage in the value-play stakes. Due to their robust earnings profiles and yield, he expects resources giants, notably Rio Tinto and BHP, recently down by 8% and 7% respectively following a recent pull-back, to be the first to bounce.

Having lost 28% during the first half of 2008, and underperforming the S&P/ASX 200 by 21%, Brooks says financials are the second most deserving sector of the value-play moniker. With a single-digit 2009 P:E of 9.1X and growth of 8.1%, he says banking looks decidedly cheap relative to other sectors, and favours QBE Insurance, ANZ and CBA - down 28.2%, 35.4%, and 27.2% respectively at year's end.

Despite JP Morgan’s dim outlook for the sector, which dragged share prices even lower, Richard Wallace of Wallace Funds Management expects the S&P/ASX 200 Financial Index to recover half of its 30 percent 2007/08 losses over the next quarter. He especially likes Westpac (recently beaten-up over the St George takeover) and CBA on the strength of robust deposit in-flows.

Offering a gross yield of around 11%, Justin O’Brien of Citi Smith Barney says the top four Australian banks represent fantastic buying, as long as there isn’t a significant up-tick in default rates. “If inflation is pulled back, and consumer sentiment improves the best place to be is banks where 80% of lending is tied-up in the top four,” says O’Brien.

Banking and resources aside, Geoff Wilson of Wilson Asset Management says there are also pockets of value emerging, more notably from stocks within the industrials index, which shed 36.6% last year. “The great unknown at this stage is what impact the slowdown in the economy will have on the profitability within the industrial sector,” says Wilson. “While next reporting season will reveal much, we’ll get an even better insight in February next year.”

But Cassidy reminds investors that while the market is at its cheapest in five years, all values-plays should be approached with specific turnaround time-frames in mind. He says with smaller stocks being more leveraged to the economic cycle, it’s hard to be confident of earnings beyond the top 100 stocks.

While consumer stocks remain tricky, he likes Harvey Norman and David Jones on a three-to-five year outlook. But given their yield, value proposition and earnings growth outlook, he supports a one-year view on property stocks like, Mirvac and Boral.

And of the smaller-caps, he likes some of the mining service stocks that have been unfairly beaten-up, like NRW Holdings – due to its direct play on the iron-ore mining story. And as long as the US$ doesn’t power ahead, he sees value over the next year in Billabong, Resmed, and Aristocrat in which he’d like to see earnings downgrades of at least 5% during next month’s reporting season.