Airlie
Funds Management

STARTING POINTS MATTER

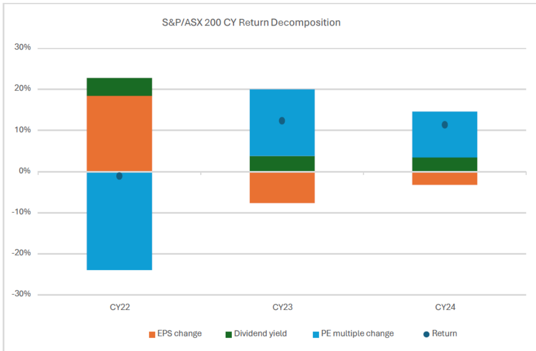
Understanding the three components of shareholder returns.

INVESTMENT INSIGHTS

I learned a valuable lesson in July 2022, the last year the S&P/ASX 200 index posted a negative return, that starting points matter. I had gone on leave to have my second child in December 2021 as markets were making all-time highs, the cash rate was on the floor (and the RBA was promising to keep it there for years) and a raft of IPOs were hitting the ASX.

When I returned six months later, it was like returning to a different planet: the S&P/ASX 200 had fallen 12%, the Fed and the RBA were aggressively raising rates, and what was most notable to me was the absolute consensus bearishness that had taken hold. Things were bad, and they were only going to get worse. This bearish view had become so dominant that we actually chose the title 'Beware the Dominant Narrative' for our national roadshow that year, suggesting the fundamentals facing most Australian companies weren't actually that terrible.

If we take that starting point of July 2022, the S&P/ASX 200 has gone on to return 38% inclusive of dividends, an impressive return over two-and-a-half years. What is interesting about this strong return is that, in my view, it was a function of the starting point. In any year, your total shareholder return as an investor is driven by three components: earnings growth (how much did earnings per share change by?), dividends, and the change in the price/ earnings (P/E) multiple. It is this last component I find the most interesting: how much are investors willing to pay, on average, for a particular earnings stream?



Source: Macquarie data, Airlie Research

If we look at these three components at an index level, as in the chart above, the P/E multiple is the best guide we have to the 'psychology' of the market: when market participants feel bearish, as they did in CY22, the market P/E contracts. Despite delivering 18% earnings growth, the S&P/ASX 200 return was flat because of this sizeable de-rate. When market participants feel things are improving, the P/E expands. As you can see in the chart above, the bulk of the 38% index return generated in the last two-and-a-half years has come from the P/E re-rating rather than earnings growth. In fact, over the last two years, earnings have declined 11%, while the P/E has re-rated by 27%.

Whether or not this is sustainable is anyone's guess, albeit I would speculate that actual earnings growth is going to be needed for further returns from here. If we do get a rate cut or two in 2025, such earnings growth should be achievable, although it is interesting that our market has rerated over 2024 in line with the US, which enjoyed 100bp of rate cuts over the year, despite the lack of falling interest rates in our own economy.

So now we have a new starting point, 1 January 2025, and it's a very different one. The average P/E multiple of the S&P/ASX 200 has re-rated from 12.7x in July 2022 to 17.7x today. In particular, the re-rating in the Big Four banks, which collectively drove almost 40% of the return of the ASX over the last two years, has rendered the 24% of the S&P/ASX 200 index, which they represent as overvalued, in our view, considering their anaemic profit growth outlook. Does this mean it's a bad time to invest? Not necessarily. We are big believers in the age-old saying, "It's time in the market, not timing the market" that drives long-term wealth creation in investing in equities. That said, we are tilting the portfolio towards businesses where the starting point reflects depressed, rather than elevated, expectations.

A number of these investments are positions we established in 2024: BlueScope, IDP Education, IGO, The Lottery Corporation – all businesses where expectations are muted. Others are positions we've added to as share prices have fallen: Ampol on weak refining margins and production issues, BHP as Chinese stimulus disappoints, CSL as the Vifor acquisition has fallen short

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