Spotting the gaps and value traps

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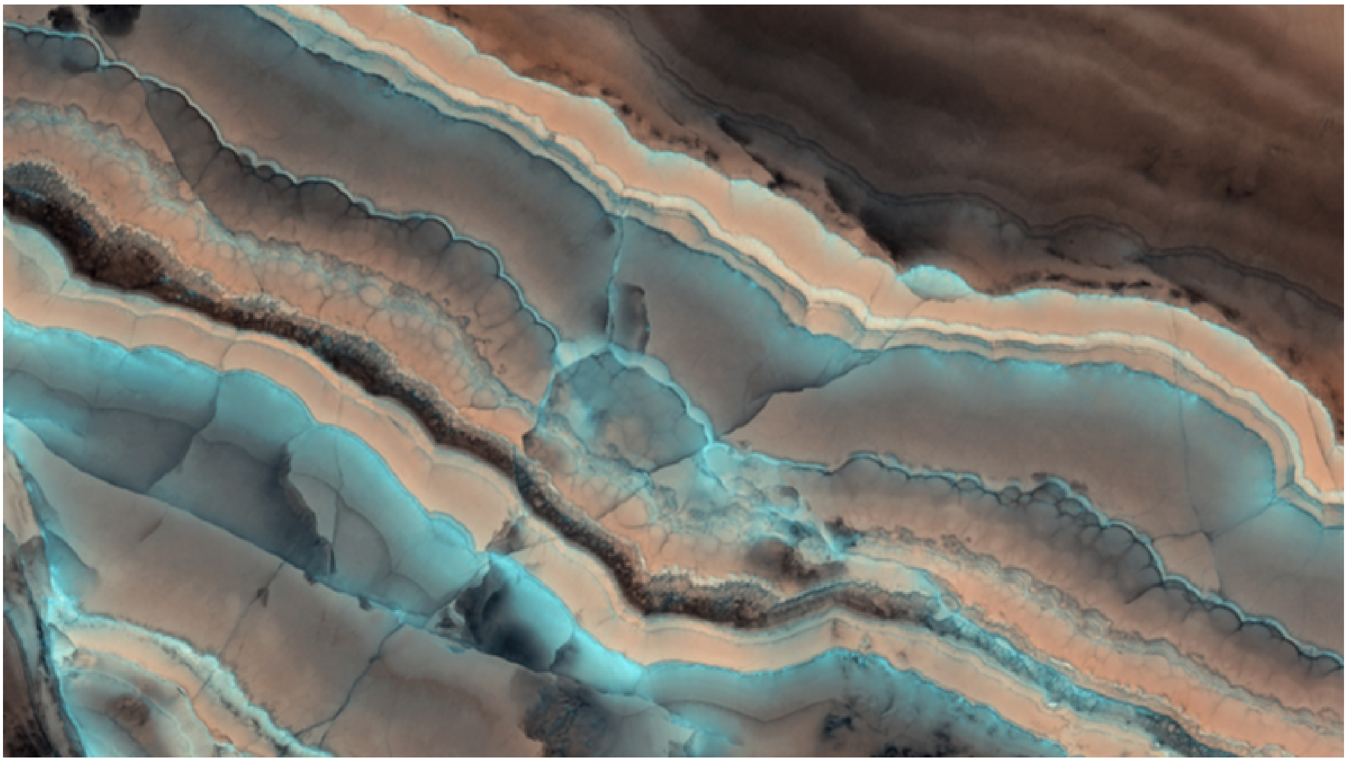

As a fundamental value manager, one way we can add value is avoiding stocks which look cosmetically cheap but are in fact value traps. A few value-style companies raised red flags in FY21 and, as a result, we were short or did not own them.

As a value manager, generating alpha from being maximum underweight in a company like CSL Limited (ASX: CSL) when it underperforms should be a given. No value manager can look at you with a straight face and tell you that buying a specialist pharmaceutical company at 40x + P/E (double its overseas equivalent companies) is a value investment. We have been maximum underweight CSL as we are value managers and no matter what way we look at the valuation, we have been of the view and continue to believe that CSL is overvalued.

Generating alpha from not owning CSL when it underperforms is pleasing given the alpha which it has detracted on the way up, however, this should be a given and hence we don't take credit for that.

As a fundamental value manager where we think we can add value is avoiding some stocks which cosmetically look cheap but are in fact value traps. The fund was short or did not own AGL, AMP, Aurizon, Coles, Lend Lease, Cimic, Amcor, IAG and QBE for most of this year. These are all traditional value-style companies, and all underperformed the market materially. We spent a lot of time analysing these companies and, for one reason or another, felt that while cosmetically cheap, a lot of them were value traps. Take AGL: in our heads the red flag came when they revealed they were looking to buy Vocus and then quickly back peddled when shareholders revolted. This revealed two things. First, that the company could see a weak operating environment in its core business and a need to diversify. Secondly, given the speed of the back pedal, it also showed a weak management team and board. For us, it was hard to be anything but negative wholesale electricity prices given the amount of renewable energy under construction.

On top of this, there is consistent regulatory risk as governments want to keep retail electricity prices low and phase in renewable energy as quickly as possible. AGL is the meat in this regulatory sandwich. Until the government works out that they need reliable base load generation and if the market price is forcing generator closures, the government will need to motivate the coal and gas fired generators to stay open. Until this happens, there will continue to be regulatory headwinds for AGL.

As we head into the new financial year, we feel really excited by the stocks and exposures we have in both the long and short book and believe we can generate significant alpha on both sides of the book. Picking the macro trends from here is incredibly difficult and if FY21 has taught us anything it is to keep an open mind. We consistently stress test the portfolio against various macro scenarios to understand where our exposures may be and discuss if we are happy with these exposures. While we will continue to do this, the core of our investment decisions will remain our fundamental bottom-up stock picking.

Read the full newsletter.

Find out more about Perpetual's SHARE-PLUS Long - Short Fund.