Investment insight

Australian shares in 2016 – a year of contrasting halves

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A reflective look at 2016 for many people might elicit memories of a string of events delivering surprising outcomes that ultimately played out as few would have predicted. Within the political landscape, we witnessed the outcome of the Brexit vote and the victory of Donald Trump in the US Presidential election, while on the sporting field we saw perennial 'battlers' Leicester City, the Chicago Cubs, the Cronulla Sharks and the Western Bulldogs take all before them to be crowned champions.

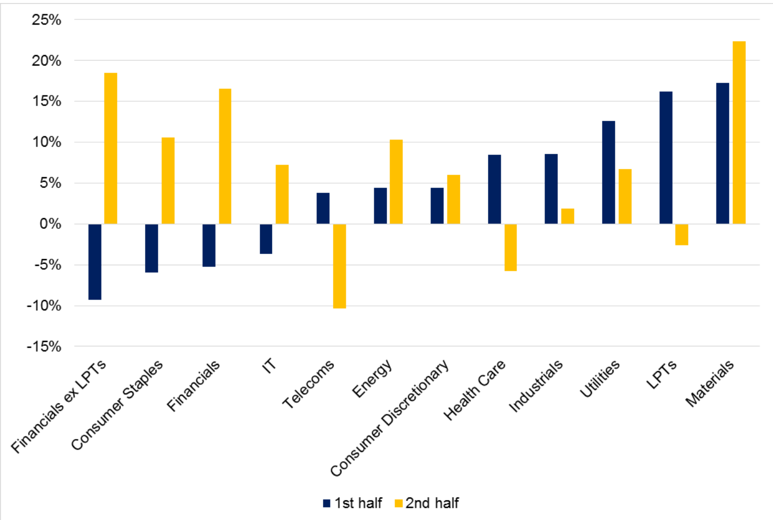
2016, the year of the underdog.

From an investment perspective, value investing was probably that underdog, entering 2016 having endured a prolonged period of relative underperformance which had delivered commensurately poor results for most active managers beholden to the style. However, history will show that there was a strong shift in market sentiment part way through the year, which has seen the value style come roaring back into vogue. This piece seeks to reflect on 'the year that was' for the Australian share market, a period which we think provides an interesting case study in the cyclicality of investment styles and the importance of constructing balanced portfolios.

2016 Australian shares recap – two contrasting halves

A quick recap of the performance of Australian shares over the course of 2016 is useful in providing context. The calendar year performance was strong, with the benchmark S&P/ASX 300 Accumulation Index returning 11.8% despite experiencing significant periods of volatility. While periods of heightened volatility are fairly common, less typical is the significant rotation within the market that began in the March quarter and gathered momentum through the second half of the year. Chart 1 compares the differences in sector performance in the first half of 2016 compared to the second half.

Chart 1: Comparison of Australian shares sector returns for the first and second halves of 2016



Note: S&P/ASX 300 Accumulation Index. **Source**: JANA Investment Advisers Pty Ltd/FactSet.

What is perhaps the most noteworthy observation from Chart 1 is the change of market leadership between the two half year periods – most of the significant sector laggards in the first half (eg Financials, Consumer Staples) were among the strongest performers in the second half, while some of the more defensive/yield sectors (eg LPTs, Health Care, Telecoms) were the reverse. The Materials sector is the clear outlier from the chart, delivering strong returns in both halves, with a large proportion of stocks in the sector experiencing a significant re-rate over the course of the year driven by a rise in underlying commodity prices.

From a style perspective, it was value that was the key beneficiary of the rotation in the market, driven by two main factors:

1. Investor selling of (relatively expensive) defensive companies and stocks considered to be ‘bond proxies’ in the environment of rising bond yields through the second half of the year; and

2. Investor rotation into exposures with greater valuation support and more leverage to economic growth, most notably across the Materials (resources) sector, but also in Financials (banks).

The prevailing market environment had driven most value managers to be positioned underweight the stocks in the first category, and overweight one or both of the sectors in the second group.

Although 2016 was ultimately a good year for value stocks, it should be noted that the favourable environment was largely a reversal of headwinds experienced over the previous few years, so the strong year for value meant recouping lost ground compared to the growth style. This is highlighted in Chart 2, which illustrates the relative performance of value and growth stocks since June 2014.

Chart 2: Relative performance of value and growth stocks since June 2014

Note: Cumulative outperformance versus the market. **Source**: JANA Investment Advisers Pty Ltd/MSCI.

Cyclicality of styles and importance of ‘holding the line’

Following on from Chart 2, it is noteworthy that as at 30 June 2016, a number of value managers within our Australian shares research coverage had experienced their largest ever underperformance over any 1 year period, as the drivers of the market continued to work against their style of investing. Understandably, these managers were under considerable pressure to turn things around, which is an aspect that most clients would be acutely aware of when thinking back to which managers were closely monitored from a performance perspective for much of 2016 – most that spring to mind in this regard would likely be value managers.

Many of these same managers populate the top quartile of the performance tables for 1 year results to 31 December 2016, just 6 months later. Things can turn so quickly!

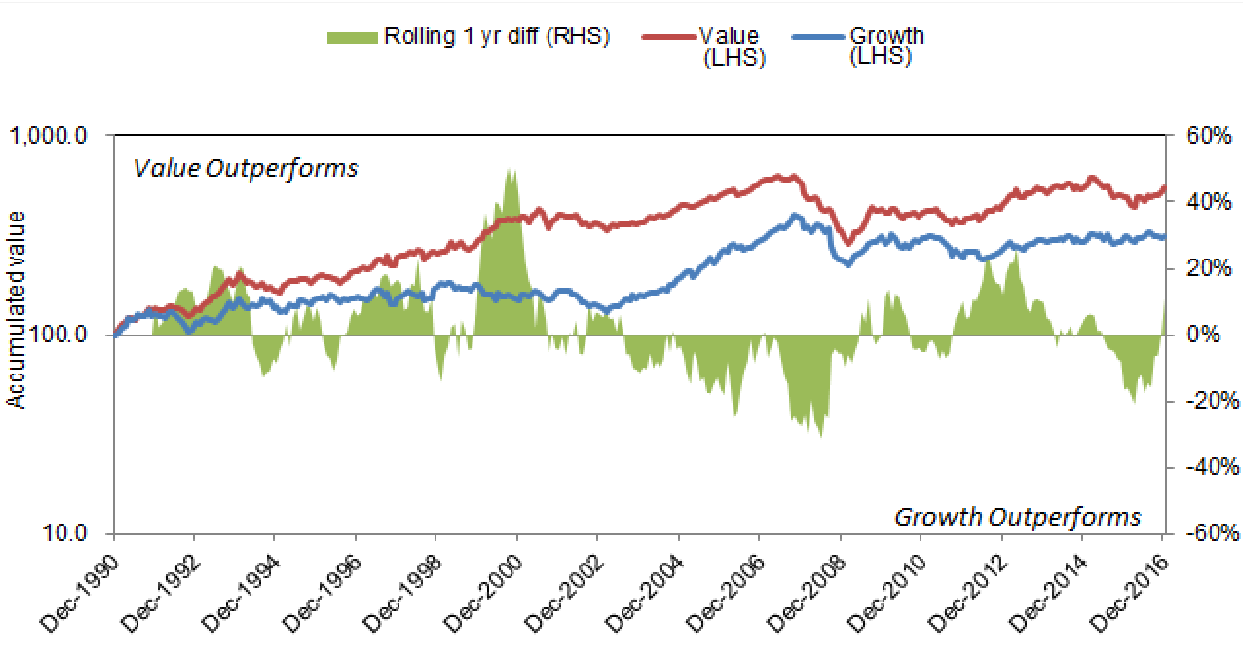
While underperformance of an investment manager for a prolonged period of time is difficult to tolerate, it is important to understand the cyclical nature of investment styles and understand the biases in manager investment processes that can drive results at certain points in the cycle. The relative performance of value and growth stocks is now roughly even over the 2 ½ year period (as shown in Chart 2). However, the result could have been much worse for your portfolio had your conviction waivered for your value manager mid-year and a decision implemented to terminate the allocation in favour of a manager who had delivered strong performance over 1 and 3 year periods – there is a high likelihood this would have been a growth manager.

Looking over a longer period adds to the picture for the cyclical nature of the two styles. Chart 3 shows the cumulative performance of both value and growth styles to 31 December 2016, as well as the relative performance on a rolling 1 year basis.

Chart 3 illustrates that since 1990, the value style has outperformed growth; however there have been periods where each style has underperformed for long periods of time before reverting.

The chart highlights that gravitating toward ‘yesterday’s winners’ is a strategy that is likely to deliver a disappointing outcome.

Chart 3: Performance of value and growth styles to 31 December 2016



Note: MSCI Australia – Value/Growth relative price performance. **Source**: JANA Investment Advisers Pty Ltd/MSCI.

Style balance in portfolios

JANA generally favours broadly style neutral portfolios with no significant biases when recommending a structure for a client’s Australian shares portfolio. Diverse and complementary approaches are important as different styles will be in and out of favour at various points in the cycle. While there may be certain points in time that it could be beneficial to tilt the portfolio depending on the perceived opportunity set, timing a move is typically challenging and can be complicated by other factors including cost and timing of transitions, and manager capacity. Building a balanced portfolio to start with helps to provide a robust outcome for the aggregate portfolio over the long term.

Prospects for the value style looking forward

While the current market environment provides a backdrop of uncertainty, particularly from a political perspective, the nearer term (at least) style prospects look likely to continue to favour value stocks at the margin. Within the Australian market, most value portfolios remain tilted toward overweight positions in Materials, Banks, and domestic cyclical names which appear well positioned on pure valuation grounds or earnings upside potential, while defensive and yield names (held underweight) are likely to remain under pressure in an environment of rising bond yields. Given the market appears reasonably fully priced at current levels, this may play out as a continuation of the rotation seen through the second half of 2016.

Conclusion

After a significant period of relative underperformance, the value style experienced a sharp reversal in sentiment, with investors refocusing on stocks with greater valuation support as bond yields and commodity prices rose through the second half of 2016. The rotation in the market was significant, and investors that maintained conviction with underperforming value style exposures that had faced style headwinds are likely to have recouped the relative differential to growth over the past few years.

Looking forward, the environment appears to favour the value style at the margin in the near term, however, with a longer term perspective we expect balanced portfolios to continue to provide the most robust outcomes for clients, as maintaining a complementary mix of styles should provide ‘winners’ at most points in the cycle.

The last year has been a reminder that you cannot wait for the market to turn to reposition your portfolio, as inflection points can often be sudden and notoriously difficult to predict.