CIO Monthly Note

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Market volatility a reminder to review portfolios

The recent market volatility is a timely reminder for investors to review their portfolios and expectations of future returns.

Key questions investors should ask themselves are: Is my portfolio performing how it is designed? Should I be targeting income or growth? Is the recent market correction a time to accumulate?

In the current market environment, we believe it is prudent to have a diversified and defensive portfolio that is generally designed to outperform more volatile markets. Also, a 10% total return is still very achievable on a one year view.

Coupled with this defensive tilt, in an environment of sluggish growth, the portfolio should also look to maximise income over growth. The law of averages suggests that targeting high growth companies when the broader economy is sluggish increases the risk of an earnings disappointment. Stock selection is critical. Investors should not simply 'set and forget' their portfolio. Following the latest market correction, equity valuations are great value with PE ratios a touch below long run averages (~14x forward earnings). Investors need to be nimble enough to react to opportunities when they arise like the recent correction while also avoiding over trading.

As with all markets, but especially the local ASX, sector and stock selection is very important. Given the relatively large weight of the resources sector in the local market, it is sometimes helpful to look through the latest headline figure to examine the return of the market ex-resources. Despite the headline ASX300 Index declining 6.5% over the quarter, key defensive sectors such as the Industrials, Utilities and Staples actually delivered positive returns. This just highlights how important it is to get your sector and stock selection right.

Looking forward, our portfolios are set to remain defensive with underweights to Metals, Mining and Energy. While an increase in corporate credit spreads is a concern, it is worth noting that corporate gearing is well below 2006 and 2007 levels. Of the defensive sectors, we remain cautious about the outlook for Consumer Staples given the significant structural challenges in that industry. For example, the once relatively safe duopoly of Coles and Woolworths is now not such a safe bet, as high margins have attracted new global entrants.

Following the latest correction, it appears the market has already downgraded the earnings outlook for FY16 as corporate Australia has failed to cyclically recover from the mining slowdown. This offers a buying opportunity but we would caution against expecting a sharp sustainable cyclical upswing any time soon.

On the month ahead, my tip is to keep an eye on the US quarterly reporting season that gets underway in early October. This will be a good litmus test for the health of the US corporate sector which will impact investor sentiment. On balance equity valuations are very compelling compared to long run averages and also in relative terms when compared to cash and bond yields.

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