



SHARES DOWN BUT NOT OUT

Most investors are familiar with Warren Buffett's advice to be fearful when others are greedy and greedy when others are fearful. But when share prices fall around the globe as they have in recent weeks, it's difficult to keep your wits about you when everyone else is at their wit's end.

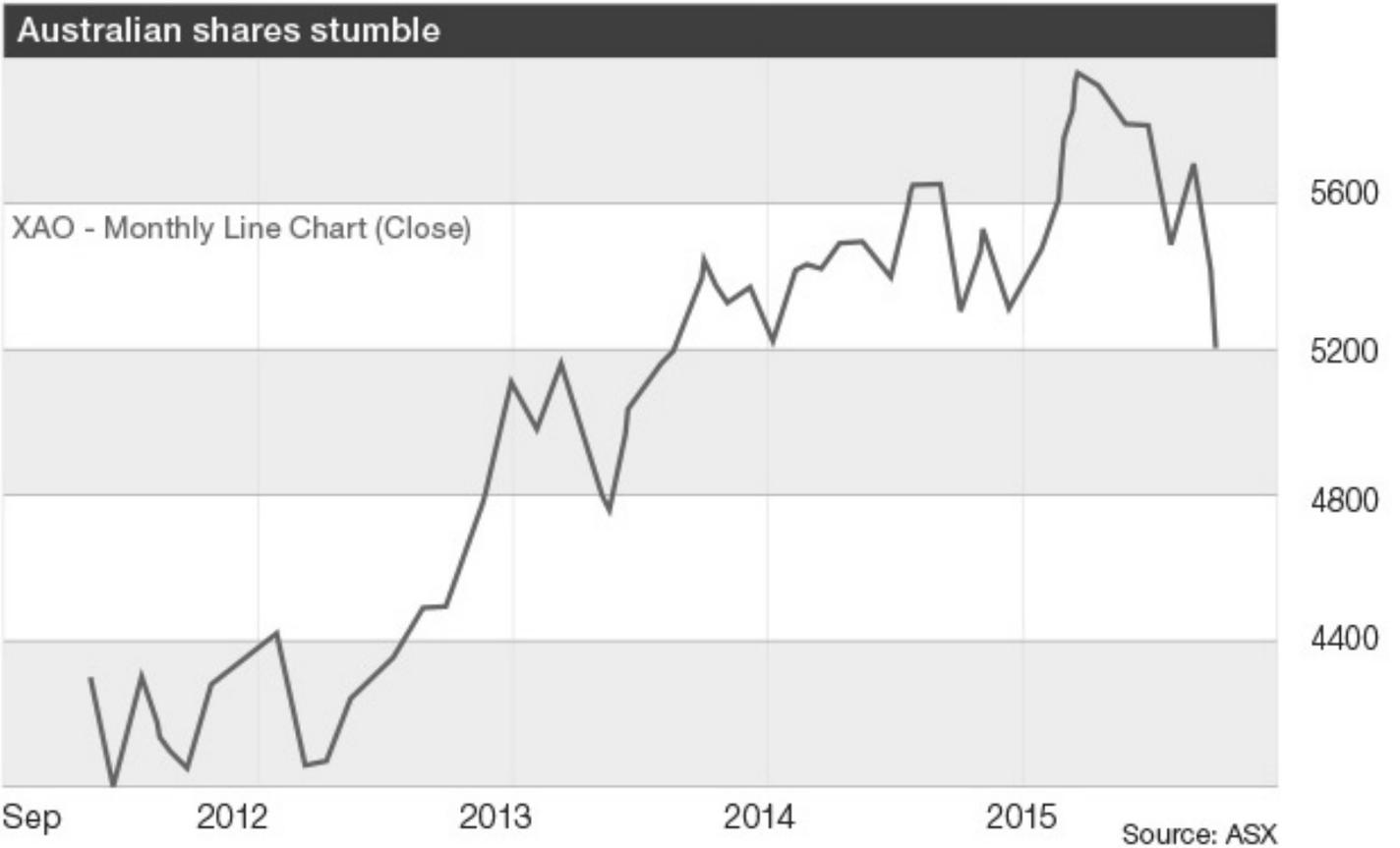
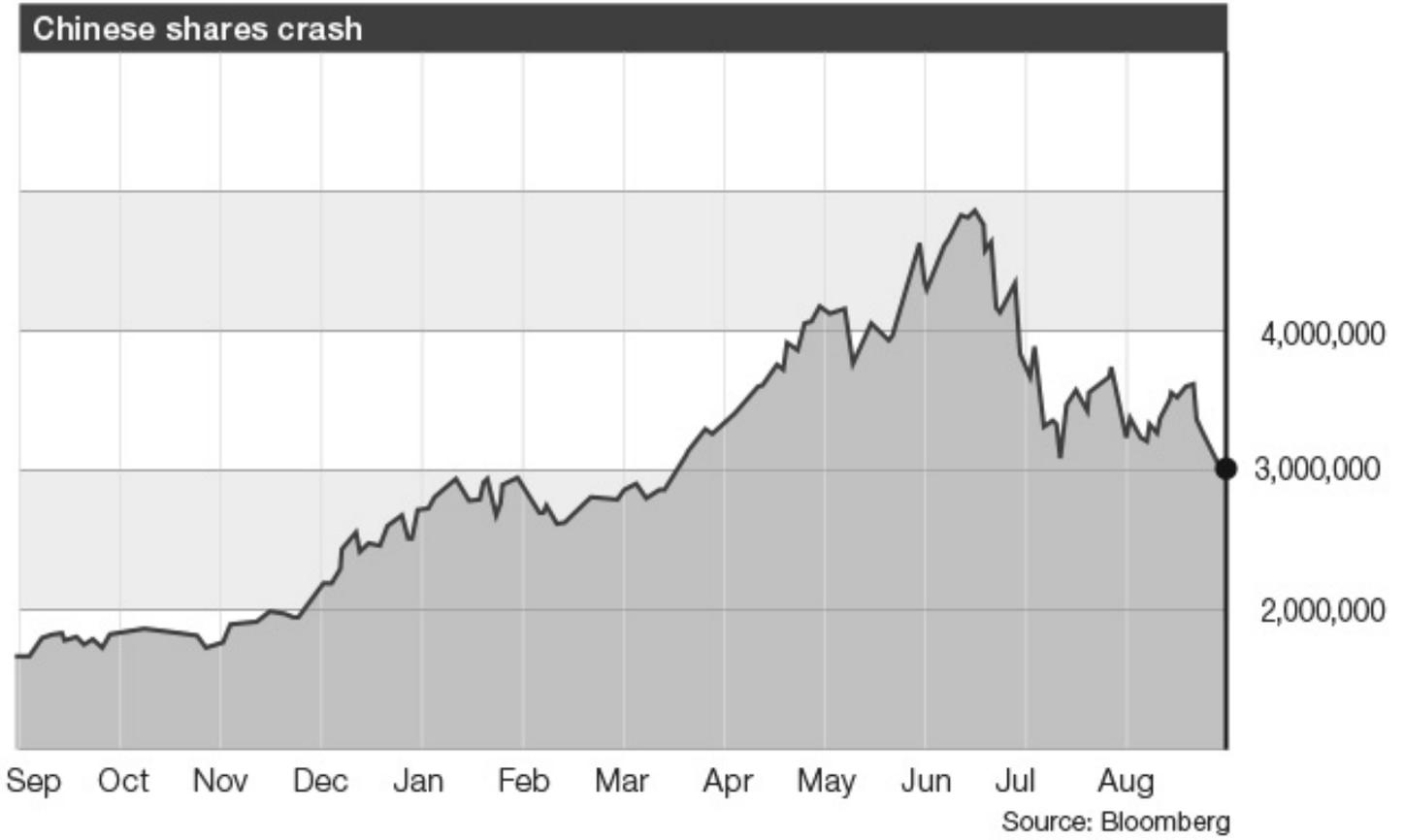
At a time when it's difficult to forecast what will happen to share prices from one week to the next, what is certain is that in the long run good quality investments will provide the best returns. So investors who focus on value rather than price will be the first to find disregarded gems among the debris.

Before jumping in though, it's important to understand the reasons behind the latest market volatility.

What just happened?

The trigger for the latest sell-off was the Chinese market's 8.5 per cent fall on Monday August 24. Shares on global markets from London and Tokyo to Wall Street and the ASX quickly followed suit. In the days that followed, waves of indiscriminate selling were punctuated by relief rallies. By mid-week, the local market was 16 per cent below its April high.ⁱ

Although there have been worse corrections since 2008, it was the sight of so many global markets toppling in unison that had many investors rattled.



Chinese slowdown

After climbing 150 per cent in the year to June 12, it was clear to many observers that Chinese shares were due for a reality check. When it came, reality was swift. The Shanghai market has fallen about 38 per cent from its June peak, but it's still about 35 per cent higher than a year ago.

The issue that pricked the Chinese share bubble was concern about a worse than feared slowdown in the nation's economic growth as it transitions from an investment boom to a consumer-driven economy. The International Monetary Fund forecasts growth of 6.8 per cent in 2015, a cracking pace compared with other leading economies, but well down from 7.4 per cent last year.ⁱ

As China transitions to a 'new normal', there are bound to be hiccups along the way. However, the Chinese authorities have shown a willingness to intervene in the market to manage the economic transition.

Global concerns

Events in China may have triggered the latest sharemarket volatility, but global investors have been worried on a number of fronts all year. Falling oil and commodity prices, the Greek debt crisis and uncertainty about when the US Federal Reserve will start lifting interest rates have made investors cautious.

Falling commodity prices, in particular, have created uncertainty for businesses and investors and taken a toll on the share prices of Australian producers. They have also raised concerns about global deflation, making it harder for the US to start lifting rates.

Sharemarkets hate uncertainty and are likely to over-react to news, good and bad, until the outlook is clearer. Investors who avoid a knee-jerk reactions in the heat of the moment will be the winners.

A correction, not a crash

The general consensus among economists and commentators is that local shares are experiencing a correction, not a crash. Our sharemarket is not over-valued and the outlook for the local economy is still fundamentally sound.

According to CommSec, the US and European markets were 18-20 per cent over-priced before the latest sell-off, based on the ratio of share prices to company earnings (PE). Using the same measure, the Shanghai market was 46 per cent over-valued at its peak while Australian shares were just 10 per cent above their long-term average PE of 15, where they sit now.ⁱⁱ

In other words, local shares are not cheap but not expensive either. And some stocks that have been heavily sold may already be in value territory, provided their earnings are underpinned by solid economic fundamentals.

Australia's economy is growing slowly but steadily. The Reserve Bank of Australia forecasts growth will rise from the current 2 per cent to 2.5-3.5 per cent by the end of 2016.^{iv} Consumers are spending and property prices are rising. Even falling commodity prices are not all bad; they keep inflation low and they are driving the fall in the Aussie dollar which helps our export and tourism sectors.

Back to basics

When share prices are fluctuating wildly, it's worth remembering that when you invest in shares you are investing in companies not abstract prices. As the annual profit reporting season draws to a close, there were few nasty surprises.

Despite the challenging conditions, companies lifted dividends by about 8 per cent on average. Even BHP Billiton, in the face of falling profits due to commodity price falls, kept its promise to increase dividends. BHP's dividend yield is currently around 7 per cent, higher than the big four banks.

Australian shares offer substantial rewards for investors in quality companies who stay the course.

If you would like to discuss any of the issues raised in this article in the context of your financial situation, don't hesitate to give us a call.

i ASX 200 Index as at August 26, 2015

ii China's transition to slower but better growth, IMF, 14 August 2015, <http://www.imf.org/external/pubs/ft/survey/so/2015/CAR081415B.htm>

iii 'The correction we had to have?', CommSec Economic Insights, 24 August 2015

iv 'Market drop defies economic reality' by Adam Carr, Eureka Report, 26 August 2015, http://www.eureka.com.au/article/2015/8/26/economy/market-drop-defies-economic-reality?utm_source=exact&utm_medium=email&utm_content=1445139&utm_campaign=Wednesday&modapt=

Astute Capital

16/11 Preston Street

Como

WA 6152

E lindsay@astutecapital.com.au (mailto:lindsay@astutecapital.com.au)

P 0407 388 023

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