EVANS & PARTNERS

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Getting sensible about returns

As we have been discussing in recent notes, it remains a challenging environment for investors. Valuations are stretched and there is a backdrop of heightened political, policy and macro risk that has not yet been factored into markets.

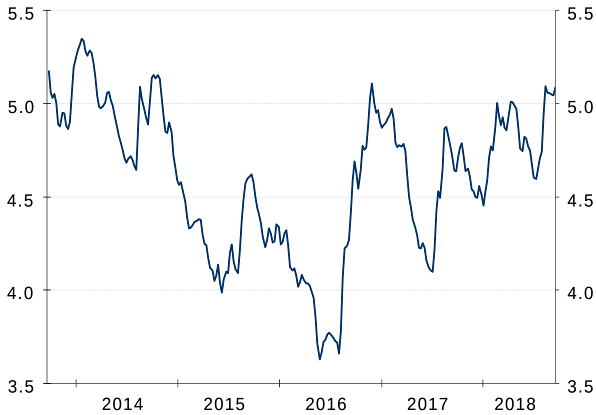
Given this macro environment our strong recommendations to clients are:

- Be realistic about your expectations for future returns and focus on a core set of stocks where there is a reasonable probability of moderate but acceptable levels of return.
- Be patient and wait for opportunities to arise from market volatility.
- Increase exposure to alternative assets.

One way to identify stocks with a reasonable probability of acceptable returns is through the GARY (Growth At a Reasonable Yield) framework. We re-run this screen and highlight the following stocks and sectors. Some points to note on this are:

- Infrastructure stands out as having the best balance of yield and growth.

Australian Infrastructure Yield



Source: Thomson Reuters Datastream, Evans & Partners

- Some Real Estate Investment Trusts (REITs) appear appealing, including Unibail-Rodamco-Westfield, Viva Energy REIT and Stockland.
- Non-bank financials increasingly appear attractive. Some have regulatory or operational issues (AMP, IOOF). However, for an industry with strong underlying growth, these concerns should prove to be temporary.
- Other industrial companies that appear attractive include MYOB, Navitas, Tabcorp, Super Retail and Amcor.
- Note that the banks are not as attractive on this basis, given meagre growth prospects in the industry going forward.

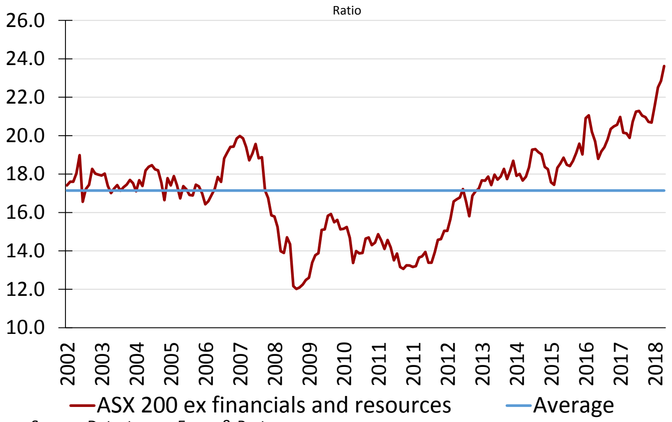
Getting sensible about returns

As we have been discussing in recent notes, it remains a challenging environment for investors. Valuations are stretched and there is a backdrop of heightened political, policy and macro risk that has not yet been factored into markets.

Some of the risks that we are focussed on include the trade war, weakness in China, tightening financial conditions in the US and increasing pressure on emerging markets. These issues could be particularly visible over the next few months given the recent escalation of the trade war and the imminent imposition of sanctions on Iran.

On the valuation front we have been highlighting that valuations are even more stretched than they appear. Growth stocks are trading at their most expensive level in 15 years, and price to earnings ratios (PEs) for the industrial sector are 27% above historical averages, as shown in the chart below.

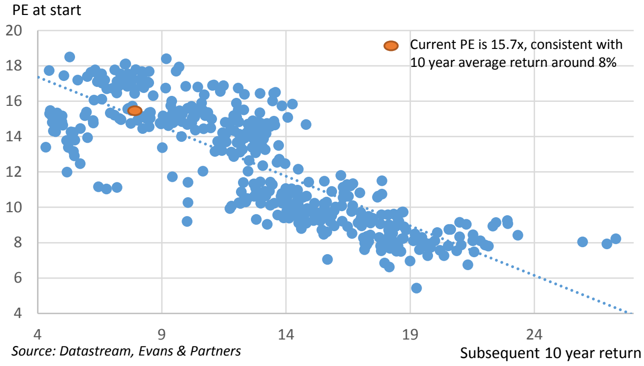
Australia Core Market Forward PE



Source: Datastream, Evans & Partners

Elevated valuations are important because there is a strong historical relationship between the current PE ratio and future returns. The chart below compares the PE at any point in time, with the subsequent 10-year annualised return. The current PE of the Australian market (around 15.7x on a forward basis) is consistent with future returns of around 8% per year.

ASX 200 valuation and future return %



Source: Datastream, Evans & Partners

Given this macro environment and valuations our recommendations are:

- Be realistic about expectations for future returns and focus on a core set of stocks where there is a reasonable probability of moderate, but acceptable, levels of return.
- Be patient and wait for opportunities to arise from market volatility.
- Increase exposure to alternative assets.

Enter GARY

In this note, we focus on the first of these recommendations by relooking at GARY stocks.

One way to identify stocks with a reasonable probability of acceptable returns is through the GARY (Growth At a Reasonable Yield) framework. The GARY score is a simple measure of expected return and is calculated as:

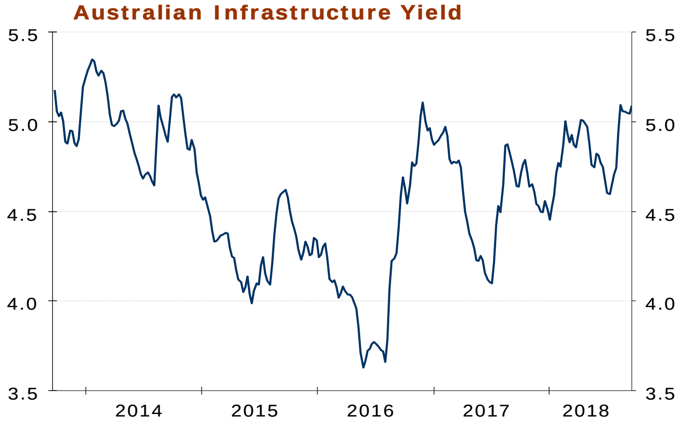
GARY score = Dividends plus Sustainable growth

Where sustainable growth is estimated from FY19-21 growth in dividends and revenue using Bloomberg consensus forecasts.

Any stock that can score 10% meets the criteria of acceptable potential returns. The table below calculates GARY scores for a number of stocks based on Bloomberg consensus earnings estimates.

Some point to note on this are:

- Infrastructure stands out as having the best balance of yield and growth. There has been little movement in the share prices of Transurban and Sydney Airport over the past two years which has resulted in a derating in valuations and a rise in the dividend yield on these stocks. Atlas Arteria also appears, although its yield is below the 4% threshold.



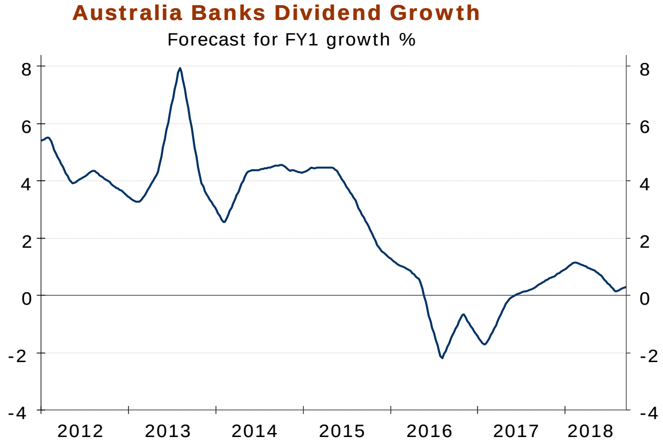
Source: Thomson Reuters Datastream, Evans & Partners

- Some REITs appear appealing, including Unibail-Rodamco-Westfield, Viva Energy REIT and Stockland.

GARY: Australian Stocks with Growth At a Reasonable Yield						
Name	Sector	EAP Rec	Div yield	Growth*	Gary Score	Franked Gary
Yld > 4%, GARY> 10%						
URW CDI	Real Estate	**Positive**	6.1	8.9	15.0	15.0
PENDAL GROUP LTD	Financials	**Positive**	5.5	8.6	14.1	14.4
MYOB GROUP LTD	Information Technology		4.0	9.7	13.7	13.7
PERPETUAL LTD	Financials		6.5	5.7	12.2	15.0
NAVITAS LTD	Consumer Discretionary		4.4	8.3	12.7	14.0
PLATINUM ASSET	Financials		5.9	6.2	12.1	14.7
TRANSURBAN GROUP	Industrials	**Positive**	4.9	6.4	11.3	11.4
TABCORP HLDGS	Consumer Discretionary		4.3	6.7	11.0	12.9
SYDNEY AIRPORT	Industrials	**Positive**	5.2	5.8	11.0	11.0
VIVA ENERGY REIT	Real Estate		6.3	4.4	10.7	10.7
STOCKLAND	Real Estate	**Positive**	6.3	4.1	10.4	10.4
SUPER RETAIL GRO	Consumer Discretionary		5.2	4.8	10.1	12.3
Facing challenges						
IOOF HOLDINGS LT	Financials		6.7	10.8	17.5	20.4
AMP LTD	Financials	**Neutral**	7.0	5.8	12.9	14.4
Others of note						
ATLAS ARTERIA	Industrials		3.5	12.5	16.0	16.0
QBE INSURANCE	Financials		3.6	9.5	13.1	13.6
CHALLENGER LTD	Financials	**Positive**	3.4	7.7	11.1	12.6
AMCOR LTD	Materials	**Positive**	3.3	7.2	10.5	10.5
JANUS HENDER CDI	Financials	**Neutral**	3.7	6.8	10.5	10.5
MAGELLAN FIN GRP	Financials		3.8	6.5	10.4	12.0

Source: Bloomberg, Evans and Partners

- There are increasing numbers of non-bank financials on this list, reflecting weak share price performance over the course of the year. For some there are stock-specific issues (AMP with regulatory issues and IOOF with integration issues), while for others such as Pendal, Platinum Asset Management, Janus Henderson and Challenger it is more to do with industry re-rating. But for an industry underwritten by strong underlying growth in inflows due to an ageing population, these concerns should prove to be temporary.
- Other industrial companies on the list include MYOB, Navitas, Tabcorp, Super Retail and Amcor.
- Note that none of the banks make the list due to the meagre growth prospects in the industry going forward. The adjacent chart shows the downgrading of dividend growth prospects for the sector over the past 5 years – analysts' expectations have been lowered from around 4% to zero over this time.



Source: Thomson Reuters Datastream, Evans & Partners

GARY: Australian Stocks with Growth At a Reasonable Yield

Name	Sector	EAP Rec	Div yield	Growth*	Gary Score	Franked Gary
Major Banks						
AUST AND NZ BANK	Financials	**Neutral**	5.7	1.2	6.9	9.3
NATL AUST BANK	Financials	**Positive**	7.2	0.8	7.9	11.0
COMMONW BK AUSTR	Financials	**Positive**	6.0	0.3	6.3	8.9
WESTPAC BANKING	Financials	**Neutral**	6.8	1.0	7.8	10.8

Source: Bloomberg, Evans & Partners

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