LightHouse
Investment Services

"You make most of your money in a bear market. You just don't realise it at the time."

Shelby Davis

"Last Monday [when US markets plummeted 5.6%] we spent more money in the stock market, buying, than any day this year."

Warren Buffett, 15 August 2011

On the face of it there is plenty going on in the world today for investors to be nervous about. Whilst anecdotal evidence suggests that the US is taking steps (albeit baby ones) towards economic growth, Europe stumbles from one sovereign debt crisis to another. If Greece is unable to repay its loans (as seems almost certain) the balance sheets of the banks (predominantly German and French) that have invested in Greek government bonds will be seriously eroded. As we saw at the time of the Lehman Brothers collapse, the financial system is nothing if not endlessly interconnected.

As if this wasn't daunting enough, there is increasing unease about the sustainability of China's investment driven economic boom, as evidenced by the prices of commodities and the Australian dollar falling 10% to 20% off their highs over recent months.

Whilst the market responded wildly on a daily basis to events in Europe in particular, some exceptionally attractive opportunities emerged. Last quarter we talked about how having cash available when markets become excessively despondent can help deliver outsize returns for portfolios. The volatility of this current quarter provided an immediate example of how that cash can be put to use to good effect.

Without wishing to discount the effect of events in Europe on our local economy (particularly on the financial sector through the effect on its cost of funding), the prices of local equities fell to levels that were disproportionate with the likely effect of these events on their future earnings. The key long term drivers of a business' value are its level of earnings and its ability to consistently grow those earnings.

Whilst price to earnings ratios and yield can never provide more than a shorthand valuation of a security, Westpac ended the quarter trading at 9.5 times after-tax earnings and a pre-tax yield of 11.5%, Commonwealth Bank at 10.4 times and 10% and QBE at 9.9 times and 10.6%. These businesses have grown their per-share earnings by 6.5%, 9.4% and 11.1% per annum over the past 10 years.

If we can take any lessons out of the market's behaviour over the past year or so they are that we should not to be afraid of letting the cash balance in our portfolios build up, and that we should not be afraid of deploying that cash when good opportunities present themselves. By having a clear and rational view of the value of a security and by maintaining a healthy balance of cash and a "shopping list" of shares that you are prepared to buy at target prices, it is possible to resist the pull of the crowd, to have the patience to wait for attractive opportunities to appear and to have the preparedness to act when they do.

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