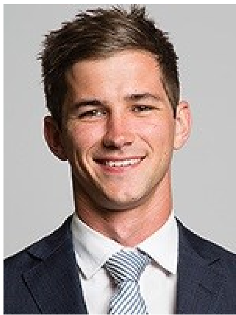
Perpetual

THE LONG AND SHORT OF INVESTING IN VOLATILE MARKETS



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A challenging macroeconomic backdrop of rising inflation and interest rates has tested investor patience over 2022 and global recession fears have done little to help. Perpetual Deputy Portfolio Manager Sean Roger discusses developments with the Pure Equity Alpha and SHARE-PLUS Long-Short Funds, a reassessment of the short book and his thoughts on the past reporting season.

The macroeconomic side of things has had a massive impact on global markets over the past 12 to 24 months. Most recently, investor attention has been fixated on the impact that a sharp rise in interest rates will have on economic conditions globally. The market seems convinced that we are heading into an economic slowdown with the key concern being the health of consumer and business activity as broad-based inflation and interest rates increase globally. It is hard to argue with this perspective.

Falling asset prices (particularly housing) will likely impact consumers perception of wealth. Consumer discretionary income will be hit by a rising cost of living due to the increasing cost of everyday items like food or petrol, higher energy costs and those with a mortgage will be paying materially more in monthly interest costs. Similarly, business profitability and investment will likely come under pressure as inflation, including wage growth puts pressure on margins.

Consumer resilience

Closer to home – and potentially further complicating the macro view – is that the results and trading updates provided in Australia's August reporting season were in aggregate better than both our and the market's expectations. To date, the consumer is proving resilient to these pressures as evidenced by demand for discretionary retail remaining materially above pre-Covid levels and credit quality for the banks remaining extremely strong.

In this volatile environment, we are keeping an open mind and focusing on our bottom up, fundamental research. We are not macro investors and thus are not making big macro calls in the portfolio. We do, however, consider the macro drivers for each position and run scenarios on the portfolios to understand how they will likely perform in different environments.

Short book changes

From a positioning perspective, the short books look very different to what they did six months ago. Heading into the start of this calendar year, we had a short book that was full of companies we felt were being materially overvalued by the market. This included a decent exposure to 'Covid winners', both in Australia and offshore, including companies like Zoom and Peloton. We also had good exposure to the e-commerce names in Australia and a number of profitless tech companies where we had real questions around the sustainability of the business model. As markets started to price in higher rates, we saw a dramatic shift away from momentum investing back towards fundamentals, which saw a number of these shorts fall materially, driving strong performance for the short books.

We used this volatility to cover a number of these positions. This was partly due to some of them reaching our target valuations, but also because we felt the market was becoming very confident on the 'short profitless tech' thesis. We are always wary of situations where market confidence in a short view is high and when share prices are at depressed levels. And while we have held onto a few of the tech names where we have materially differing views on earnings sustainability to the market, we currently see better shorting opportunities in other parts of the market.

Three opportunities for shorting

There are three areas where we currently see opportunities.

1. **Lack of pricing power.** This applies to companies that are exposed to significant inflation in their cost base, but which have minimal pricing power. A common message we heard during reporting season was that companies would offset cost pressures by passing on these increased costs to customers through pricing. While there were examples of companies being squeezed on margin due to lags in the timing that these costs could be passed on, at this stage it seems like most companies are successfully passing on at least some of the cost pressures. The risk we see is that, as consumer demand softens, it will become harder for those companies with low pricing power to pass these costs on.
2. **Expensive defensives.** In an environment of macro uncertainty, the market has flocked towards companies with perceived defensive earnings. We are finding shorting opportunities in some of these names where we believe the quality and defensiveness of earnings are lower than the market perceives.
3. **Earnings quality**. With interest rates at almost zero over the past two years, companies haven't needed to pull levers to try and make earnings look better. Profitability just hasn't been important to a market obsessed with revenue growth and total addressable markets. Now, with rates having gone up, companies need to start producing proper cash flows and proper earnings. As a result, we're starting to see the signs of companies getting a bit more desperate around how aggressively management earnings are presented. In particular, profitless companies need to prove that they can be profitable, and we think that they'll be actively trying to make that earnings line look better. But we think it'll go across the board, across all sectors.

The Perpetual view is that we go offshore sparingly and only when it's a company or a theme that we're experts in from our research in Australia or it's a trend we've seen before. The funds have built positions in Flutter Entertainment (FLTR) and La Française des Jeux (FDJ) and these two gaming companies remain key positions. To use FDJ as an example, we feel like we have an edge given the insights we have observed through our investment in and analysis of The Lottery Corp (TLC) business in Australia. We have seen the benefits that the shift in the distribution of lottery tickets away from retail, towards online has for margins and profitability. We feel that FDJ is following a very similar trajectory to TLC however is earlier in the journey with TLC digital penetration at ~38% and FDJ at 11%.