

Stock Market Review



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Taking advantage of volatility

During the summer months, international equity markets registered their sharpest quarterly declines since the final three months of 2008. Most major equity markets posted double digit declines with the worst performances coming from Germany, France and Italy all with declines of more than 25 per cent each. In the UK, the FTSE100, with a decline of 13.7 per cent registered its worst quarterly performance since 2002 with £212 billion wiped off the overall value of the companies forming part of the index.

In early August 2011, most markets briefly entered bear market territory and the following weeks were characterised by great volatility with further steep declines registered in the final days of September and early October. On October 4, the FTSE100 closed below the 5,000 points level for the first time in 15 months while the S&P 500 index in the US approached the end of the trading day in official bear market territory (more than 20 per cent below the April high).

During the final hour of the day, however, the US market staged a remarkable rally climbing by four per cent to close at 1,123 points. As global markets were haunted by the prospect of a European bank collapse or the break-up of the euro with contagion of the sovereign debt crisis spreading from the periphery countries to the larger economies of Italy and Spain, negative sentiment dominated the markets leading to indiscriminate selling in company shares, gold, other commodities as well as certain currencies.

However, it is in times when markets become inefficient and are gripped by widespread fear that value-based investors seeking fundamentally cheap companies make the best investments. In a recent statistic published on a leading international website, it was revealed that during the last three bear markets in the US, the largest gains were made within a short period of the market entering bear territory. Equity indices in the US have on average surged by 15 per cent during the first month after the bear market; by 25 per cent within three months and by 35 per cent within the first six months. In fact, since the October 4 low of last week, the S&P 500 Index climbed more than 10 per cent in only four trading sessions.

The legendary investor Warren Buffett was once again at the forefront of taking advantage of the recent volatile markets. Similar to the large cash injections provided to General Electric and Goldman Sachs in 2008, this time Warren Buffett's investment vehicle Berk-

shire Hathaway announced plans on August 25 to invest \$5 billion in Bank of America. The shares of Bank of America had dropped by 30 per cent in the previous three weeks amid fears that the bank lacks sufficient capital. More recently, Warren Buffett surprised the market and announced that Berkshire Hathaway approved a share buyback since they view that their businesses within the portfolio of Berkshire are worth considerably more and the market is not pricing them correctly.

Many international analysts and fund managers are using conventional indicators to point out that the sharp sell-off in recent weeks and months has presented some potentially rewarding buying opportunities. In the US, the price to earnings multiple of the companies forming the S&P500 at 11.5 times is the cheapest in many years. Likewise, the FTSE All Share Index in the UK is trading on a p/e ratio of only nine times compared to a long-term average of 12 times.

Various large cap companies with strong cash flows are paying regular attractive dividends to shareholders and following the drop in share prices, the dividend yields of such companies have become even more attractive. A useful indicator is a comparison between the dividend yield on company shares with the yield on government bonds. The estimated dividend income of the shares within the FTSE100 produces a yield of 4.3 per cent compared to 2.3 per cent for 10-year UK gilts.

Some companies in the UK such as Vodafone plc, National Grid and Glaxosmithkline are offering yields in excess of five per cent and international analysts believe that there are strong possibilities for these companies to maintain strong cash flows and sustainable dividends to shareholders going forward. In Malta, the 10-year Malta Government Stock is giving a yield of 4.2 per cent per annum. On the other hand, most publicly traded companies paying sustainable high dividends such as Malta International Airport plc and Maltapost plc offer a greater yield than this especially following the decline of their share prices over recent months.

Although it is impossible to call the bottom of the market, the sharp sell-off in recent weeks has provided an opportunity to acquire high quality multinational companies whose share prices are lower than they were during the 2008 crisis while their profits are higher than they were three years ago!

The opportunities that arise from indiscriminate selling were also evident in the local market in 2008/9 at the time of the previous sell-off across equities and also



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earlier this year. In 2008/9, the share prices of the two major local banks had dropped to multi-year lows and although the equities of both Bank of Valletta plc and HSBC Bank Malta plc have dropped by close to 20 per cent during the first nine months of 2011, share prices of both banks are still substantially above their 2009 lows. HSBC's share price is 27 per cent above the previous low of €2.08 in April 2009 and that of BOV is 83.5 per cent above the adjusted low of €1.335 registered in March 2009.

Likewise, in November 2009, Maltapost's share price had plunged to a low of €0.60 but the equity had then rallied to a high of €1.10 earlier this year as the company maintained a high level of profitability and more importantly also high dividends to shareholders.

Similarly, the share price of Malta International Airport plc is still 64 per cent above its adjusted low of €1.00 on May 6, 2009 as the airport operator announced record profits and also improved its dividend to shareholders in respect of the 2010 financial year.

More recently, the share price of RS2 Software plc had declined to a low of €0.30 on March 18 but the equity staged a remarkable turnaround and doubled in the past seven months as the company registered an improved performance and shareholders were rewarded accordingly through a 45.5 per cent increase in dividends.

Similar opportunities also became available in the bond market. In 2008 and 2009, the bonds of some major global companies had plunged in the aftermath of the Lehman bankruptcy but recovered within a few months as these companies proved their ability to honour their obligations. In similar fashion, on the local bond market, the prices of the bonds issued by

Corinthia Finance plc, International Hotel Investments plc and Mediterranean Investment Holdings plc all plunged towards the 80 per cent level and below in reaction to the political uprising in Libya.

However, as they announced plans to protect their cash flows during the trying times they were enduring and the dramatic situation in Libya began to improve, their bond prices rallied by as much as 35 per cent from their lows giving equity-like returns to those opportunistic investors who were prepared to increase their exposure to these bonds at the time of widespread concern.

During the coming weeks, more economic data will be published in the US which could shed some clarification over the uncertainty about growth prospects in the US. Meanwhile, investors will also closely analyse the third quarter reporting season which starts in the coming days.

Locally, Bank of Valletta plc will be issuing its September 30 full-year results by the end of this month. The financial statements will reflect the extent of the investment write-downs taken on the overseas bond portfolio and its impact on overall profitability which could impinge on the final dividend to be recommended at the next annual general meeting.

Any positive news from the economic front as well as from the release of company financial results, both locally and abroad, could help improve sentiment and reward investors who bought in the midst of greatest uncertainty. Investors seeking to benefit from the opportunities that arise at times of extreme volatility should look at such times with great enthusiasm and be guided by Warren Buffett's philosophy to "be fearful when others are greedy, and greedy when others are fearful".

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