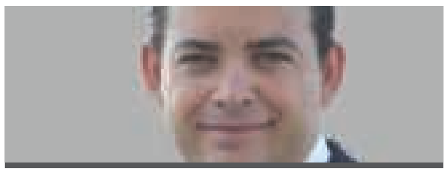
Stock Market Review

‘Either cheap shares or good news, but not both’



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Many international financial commentators commonly use this phrase to explain a widely held view that it would be very hard, if not impossible, to identify cheap shares when the newsflow on the company in question and the general economic environment are both positive.

In fact, it is questionable whether, in the minds of value investors, any cheap stocks were available during the international equity market booms in 1999/2000 and in 2007/08. At times of generally positive economic developments and high expectations, the mood among many investors is generally euphoric and prices overshoot on consistent strong demand irrespective of underlying company fundamentals.

Financial indicators such as price to earnings ratios normally climb to high multiples and likewise dividend yields decline to very low levels during stock-market booms. It is also generally true that in times of euphoria, most retail investors enter the market due to the ‘feel good factor’ and this leads to record activity on the market.

On the other hand, when the mood is generally pessimistic, activity declines and retail investors generally do not participate due to the ‘fear’ factor. However, it is precisely in times of overall pessimism when the best investments are made. In fact, many value-driven investors prefer having bad news and therefore cheap shares since this creates a market opportunity. It may be very difficult to convince investors to buy into a company at times of uncertainty however history shows that time and again, these are the most profitable entry points.

Over recent months, many international commentators invariably argued that the market is currently in such a situation where, as a result of the overall macro-economic gloom created by the eurozone debt crisis and the slowdown of the Chinese economy, investors have an opportunity to buy various blue-chip companies at very attractive levels. Some of the most commonly cited companies are Microsoft, Johnson & Johnson, other IT companies such as Oracle and Cisco as well as some other pharmaceutical companies such as Merck and Amgen. One commentator in particular stated that “I feel like a kid in a candy store... I don’t where to begin.... the best companies in the world are now some of the cheapest stocks”.

This situation came about from the global economic slowdown and fears of a eurozone break-up leading many investors to disregard shares and on the other hand focus on increasing allocations towards bonds. These same commentators feel that in view of the very low yields on investment grade sovereign debt (which are negative in some instances), the exact opposite should be happening and investors should be taking advantage of high bond prices.

However, the key message from such financial commentators is that investors should look at the longer-term picture. One cannot view an investment in such companies as a short-term trade with the intention of selling at a handsome profit in a very short period of time. Instead, an investor must look at the long-term perspective irrespective of the occasional volatility that one has to be prepared to live with. History suggests that over extended periods of time, shares are better investments than holding on to bonds or just retaining idle cash.

So, is the same also happening in the local market? Where do we currently lie in the cycle? The local equity market measured by the MSE Share Index experienced two bull markets in its 20-year history. The bull markets generally coincided with the peaks also evident across global equity markets. The first bull market in Malta was in 1999/2000 and after a sudden correction, the market rallied to unprecedented levels in 2006 although international equity markets peaked two years later. The timing difference was due to a number of localised affairs mainly related to the Government’s privatisation programme.

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What is interesting is that as international equity markets suffered a sharp decline in the aftermath of the bankruptcy of Lehman Brothers in September 2008, both the Malta Stock Exchange index and the main global equity benchmarks reached their lowest levels in March 2009 and began to recover despite the occasional wide periods of volatility. However, the MSE Share Index has generally lagged behind the strong recovery experienced internationally. The local equity market underperformed in 2009, 2011 and so far again in 2012. Moreover, only last week, US indices reached their highest levels since December 2007 with European markets climbing to their highest in 15 months. The strong upturn internationally was in response to the bond-buying plans by the ECB and the further quantitative easing programme by the Federal Reserve.

The MSE Share Index once again did not respond to the measures by the central banks to intervene in the markets and continued to underperform. The uncertainty created by the local political situation could be one determining factor. The local market is generally dependent on the high weightings of the two large local banks which account for 50 per cent of overall market capitalisation. These share price movements mainly influence the movement of the Index. As such, one must look at companies on the Malta Stock Exchange individually to measure the underperformance. While many companies are seeing their share prices trading at multi-year lows, other equities have held up relatively well despite the pessimistic news.

The title of this article ‘Either cheap shares or good news, but not both’, can be useful in the context of a number of local companies. Take MIA plc as an example. Earlier this year, the share price had dropped to €1.65 from the 2011 high of €1.85 as the airport operator had announced that it expected a slight decline from the record passenger numbers in 2011 and also as the market awaited the news on the restructuring exercise of Air Malta. As passenger numbers began to improve after the weak first quarter of 2012 and the European Commission approved the Government’s plans for Air Malta, the share price recovered quickly above the €1.75 level. As such, those investors looking at investing into MIA now compared to when the price was at €1.65 earlier this year have to take account of the recent newsflow by the airport operator.

The share price is now above €1.75 since Air Malta received approval for its restructuring exercise and passenger forecasts were revised up after the strong Q2 and in anticipation of a good summer season. The equity therefore reflected the good news that was released. In hindsight, the low price created by the ‘bad’ news was a good entry-point.

However, taking a longer-term view it would be worthwhile and interesting to analyse the current price of MIA to the historic all-time high of €1.876 in November 2005. Passenger numbers at the time were much lower than the record levels registered in 2011 and so far in 2012, and since then MIA was successful in increasing its non-aviation revenue from the air terminal extension, the management of the car park, other initiatives and now also from the Sky Parks Business Centre.

On the other hand, one can look at the companies such as Go plc as well as Lombard Bank Malta plc which are experiencing a somewhat different situation to MIA.

The share price of Go plc is trading below its net asset value per share which is something not normal for most companies with the exception of property companies. The sharp decline in Go’s share price over the years resulted from the steep losses taken on the Greek investment. However, the renewed uncertainty on the possible further capital injection into Greece was the main reason for the renewed downturn in the share price from a level of €1.10 to the current level.

The equity may be regarded as cheap in view of the discount to book value and investors considering an investment at this junction ought to take into consideration the uncertainty created by the most recent announcement by Go which led to the renewed downturn. This may have created the opportunity for investors to take a position ahead of the decision by the Go directors. Sentiment towards Go should improve if the board blocks any further investment in Greece and this could lead to a recovery in the share price.

Likewise, the share price of Lombard also dropped to below the net asset value and is at its lowest level in seven years as a result of the uncertainty regarding the bank’s largest shareholder as well as the sharp decline in the profits of the postal subsidiary.

Here again, contrarian investors may be looking at accumulating shares of Lombard ahead of an improved performance from Maltapost and also on news of the larger shareholder.

It is very rare to find cheap shares when there is positive company news and an equally encouraging economic outlook. As such, investors need to take advantage of uncertain times to accumulate company shares that may not be reflecting the true fundamental strength and the potential for higher profits and future dividends. This generally translates into a higher share price when newsflow is positive and investor sentiment is bullish.