

Stock-picking – the lost art

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“Exit, pursued by a bear” – Shakespeare, The Winter’s Tale

Negative sentiment currently dominates the equity markets. Retail investors are exiting equity markets throughout Europe (and the world) as the credit crunch continues to destabilise the financial system. Such investors have seen a ferocious bear pursuing them, and their running is an instinctive and understandable response. However, for those with the means and mettle to stick around, a new (but promising) landscape is taking shape.

The ‘hedgies’ are hiding in the hedges, the prop desks are no longer being propped up, the teenage scribblers are going back to school and the momentum jockeys are struggling to find any steed they can. In the absence of a fundamental compass, finding your way can be very hard.

However, mass capitulation creates very real investment opportunities. Many of the investment greats made careers out of differentiating between superior and inferior assets. Their best returns came from buying quality stocks at bombed-out valuations, usually when fear and panic ruled. Lord Rothschild once counselled “buy on the sound of war-cannons, sell on the sound of victory trumpets”.

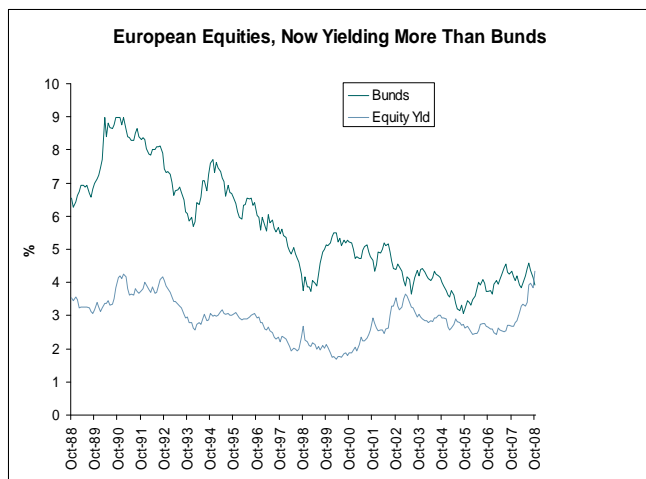
With European markets having fallen by over one third from their peak, they now yield over 4.4%. With German government bond yields having dropped below 4%, equity markets are scarcely wildly overvalued, and value is emerging in the aftermath of the bear rampage.

What of the credit crunch? More institutions will go bust or need bailing out and it will take another year or so of pain before the cleansing is complete. Banks’ balance sheets must shrink and credit will contract in the ‘real’ economy too. Companies in every sector will be evaluated and those found wanting will crumple and fold like, well, a ropey mortgage bank (remember those creatures?).

Therein lies the opportunity. In every sector there are companies which bought the hype about “optimising” the balance sheet and which leveraged up to pay out cash to myopic shareholders. That wasn’t such a bad idea while credit was cheap and plentiful, but a debt covenant that seemed comfortable just a year ago can now be fatal. With a modest shortfall in sales, a bigger miss on profits and an even bigger miss on cashflow, the company breaches its covenants and it is in liquidation.

However, in every sector, there are also companies that resisted the leverage fashion and they are the very companies that are now masters of all they survey. They are the ones buying their bankrupt rivals, taking market share and investing for growth. With sales, profits, cashflows and dividends growing, their stock prices should rise, the question becomes “when” rather than “if”.

A new paradigm is emerging. In every sector, there is greater scope than for many years to harness attractive returns. In recent years, a rising tide of debt and credit lifted all boats, and stock-picking was just about which boat would rise more than its neighbours. Now the tide is going out, avoiding the leaky boats will be crucial and proprietary fundamental research will be invaluable.



Source: Dresdner Kleinwort

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