The Case for Investing in Australia

Australia has been largely ignored by Western investors—despite a record-thriving economy. But it shouldn't be.

PHOTO: BIANCA DE MARCHI/EPA/SHUTTERSTOCK

Australian stocks, often overlooked, have some things going for them now. Even so, the case for Aussie exposure isn't clear-cut.

By Eric Uhlfelder
Sept. 8, 2019 10:05 pm ET

With the rally in U.S. stocks entering its second decade, investors looking to diversify abroad might consider Australia.

The Australian stock market represents just 2.2% of the S&P Global Market Index. But that small percent of global market capitalization belies one of the world's most impressive economies, closing in on its 28th year of growth. The country has large mineral deposits and commodities, a well-educated populace, well-established investment standards, and the economy has piggybacked on neighboring China's economic boom over the past two decades.

Lately the case for Aussie exposure has become muddled. The breakdown in U.S.-China trade negotiations threatens Chinese and Australian growth. A national housing boom—fueled by falling interest rates, population growth and dubious mortgage lending standards—has hit a wall, though the situation appears to be stabilizing for now.

Meanwhile, household indebtedness is high. And Australia's banks, long regarded as top-tier, especially when they sidestepped the 2008-09 global banking crisis, are licking their wounds in the aftermath of a government report issued earlier this year that criticized their conduct. The Australian Royal Commission's finding, issued in February, has led to tighter lending standards but avoided recommending more severe corrective measures so as not to cause a credit crunch.

Aussie dollars

Nevertheless, Australian banking shares—which represent well over a quarter of the market—have declined on average by 20% in U.S.-dollar terms over the past two years. More than half of that loss was associated with the weakening Australian dollar, which is down to around US$0.67. Five years ago, the Aussie dollar was trading above parity with the greenback.

While consensus 2019 economic growth estimates for the country are above 2%, Australia's central bank fears slowing domestic growth. The bank last month lowered its benchmark interest rate by a quarter-point to a record low of 1%, following a similar move just one month earlier. Markets are anticipating further cuts, which could push the Australian dollar even lower versus the U.S. dollar and euro.

Sobering as these events are, they are creating investing opportunities.

Said Haidar, whose Haidar Jupiter global macro hedge fund was up more than 30% through the first half of the year, has been profiting from these trends, shorting the country's currency and being long its sovereign debt (whose value moves inversely with interest rates) since 2018. After the Royal Commission's recommendations showed less bite than most had feared, Mr. Haidar went long Australian stocks. Local shares were up 20%, in Australian dollar terms, during the first half of 2019.

‘Global growth stories’

With a consensus that interest rates will remain low over the next several years, keeping the Australian dollar weak, BlackRock’s head of Australian Fundamental Equity, Charles Lanchester, figures there is an opportunity for investors outside Australia to invest on the cheap in “global growth stories” whose foreign profits will receive a further boost when repatriated into Aussie dollars.

A hedge fund that has been focused on Australian companies with international ambitions is the A$400 million (US$275 million) LHC Capital Australia High Conviction Fund. Co-managers of the fund Marcus Hughes and Stephen Aboud have realized 16.6% annualized returns since the fund’s launch in 2012 through June 2019, nearly doubling the returns of the Australian benchmark ASX 200 with less volatility.

LHC has achieved these results by targeting mostly small-cap Australian shares with growing world-wide businesses that are undervalued due to the lack of institutional interest and limited analyst coverage. The fund avoids long positions in the country’s more volatile banking and commodity shares, Mr. Hughes says.

Circuit boards

One example of LHC's recent plays includes Sydney-based Altium Ltd. ALU 2.51% , a provider of printed circuit boards relying on open-source design for its components and data-management software. For the past three years through early September, its local shares (trading in the U.S. as ALMFF) soared more than fourfold to nearly $25, becoming a A$4.5 billion market-cap stock.

UBS analyst Josh Kannourakis, who follows Altium, says shares of Altium look fully priced to him. But he says the company is "well positioned to deliver strong revenue and earnings growth driven by industry growth, partnerships, and increased market share."

Mr. Uhlfelder writes about global capital markets from New York. He can be reached at reports@wsj.com.