M&CO *Newsflash*

It takes courage to plunge into a stock market that is fluctuating wildly, with as yet no firm direction...

Few pundits are prepared to call a bottom to the current period of volatility or forecast when and how strongly a recovery will proceed. But a general feeling prevails that the Australian economy - and hence the local stock market - will suffer less than counterparts in the US or parts of Europe. This results from the more conservative policies followed by our banks, as well as our exposure to China.

It can be like trying to catch a falling knife, yet at some point the rebound will begin and investors already positioned in the market can reap the rewards. As a consequence, those brave investors prepared to weather the bear market and buy now could achieve some impressive returns in the next few years.

Stock selection is critical. Even if Australia avoids recession, economic slowdown and continuing credit worries mean some companies will struggle. So the first investment rule is to give preference to companies with strong balance sheets. Along with this, investors need to ensure companies are able to maintain solid earnings. "Our long-term view is there is plenty of opportunity but investors have to be prepared to contend with significant near-term volatility," says Colin Whitehead, an analyst with Fat Prophets. "Good businesses that are leading their sector will emerge more dominant because their competitors are likely to be weakened or fall by the wayside."

The head of research at E&C Baillieu, Ivor Ries, says: "The next 12 months is going to be a lot about dividends and about how able companies are to maintain their dividends. With interest rates dropping, investors are going to have to stick to the income stocks." Stocks he recommends include **QBE, CSR, Boral, Telstra, APA Group, Leighton Holdings and Crane Group.** "They are all companies that have very little probability of a big earnings downgrade and a very high ability to maintain dividends," he says. "Some of them have tended to be very expensive over the years and now they are trading on normal price-earnings ratios."

Commenting specifically on CSR and Boral, which are heavily geared to the building and construction industries, he says: "A lot of analysts are saying there are going to be more downgrades in housing. If there are, we think it will only be short term because you have rapidly declining interest rates and a Government that is determined to pump money into housing. So if you do not get a win out of those in three to six months, you will get one in 12 months or two years.

"One of the primary tools for pumping up an economy is infrastructure spending and that means concrete and framing timber and all this other stuff that these guys produce."

For many investors, an important question is whether they should buy our leading banks, which have been hugely sold down and have recently been trading on relatively low price-earnings ratios and high dividend yields.

The research manager at FW Holst, David Spry, says the banks are going to be under pressure for a while. "Sentiment is shocking. But I think at the end of the day, for long-term investors who are prepared to ride severe volatility - which is what you are going to get - the leading banks, such as the Commonwealth Bank and Westpac, on days of severe weakness are probably not a bad way to go."

Spry also likes pharmaceutical stocks. "They will probably go OK in this environment because their products are not necessarily reliant on the economy - if you need them you need them, it is as simple as that."

Spry advises investors to shun the resources sector. "It's too early and it's a bit doubtful as to where commodity prices are headed. I know they are headed down but it is a question of how far."

It's a view not shared by Whitehead. "Among the resources, there is plenty of value out there. **BHP Billiton and Rio Tinto, at current valuations, are probably the safer opportunities.** There is still reasonable certainty around their future earnings. Yes, they are going to have some form of contraction, based on commodities prices coming down. But they have the contracts running at present. China is going to maintain reasonably high single-digit growth and of course their commodity demand is driven by the industrialisation process, not by their export sector so much, and that has significant internal momentum."

Mining engineering company **WorleyParsons** is another they have looked at. "They have come off pretty heavily. They are a dominant player within their sector and a well-run quality business."

Whitehead advises investors to "nibble away" at stocks rather than make aggressive moves. "Volatility is so high," he says. "That has to be smoothed out through taking positions in stages. But having said that, with a genuine three to five-year view, this coming 12-month period is going to present some great opportunities for investors who are averaging into the quality businesses and will really sow the seeds of strong future performance."

For independent analyst's research to assist you making a more informed decision on those companies, please call or email Crystal or Aris at our office today.

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