# SWAEF Commentary: “How much are jousting sticks worth Dad?”

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Equity market valuations continue to swing wildly, tempting investors to treat price moves as information rather than focus on the underlying economic value creation that supports market value. Complex spreadsheets and ever more data encourage investors to believe valuation has become more accurate and reliable. “Tell him he’s dreamin’.” Avoiding overconfidence and acknowledging that valuations are only ‘best guesses’ is vital.

## Market Review

“$4.50 for jousting sticks!? Tell him he’s dreamin’. How much are jousting sticks worth, Dad? Couldn’t be more than $2.50, depending on the condition.” In addition to being one of my favourite movies, ‘The Castle’ and Darryl Kerrigan remind us that value can be somewhat arbitrary.

Complex spreadsheets convey a precision about the future that does not exist. For this reason, we try to keep our thinking about value and how it is created simple. Value creation requires economic rent, and significant value creation requires those rents to be durable. Privileged assets and market positions, pricing power and disciplined cost control are almost always among the keys to value creation. Yet they all too often give way to excitement about addressable market size and growth - factors that have little to do with value creation. The significant reassessments of value accompanying the sharp share price moves characteristic of casino-like equity markets, particularly during reporting season, should cause all fundamental investors to ask whether the numbers and data reported by companies are commensurate with the changes in value, given the prospects for durable economic rents. Without them, paper market value will eventually evaporate.

At a big-picture level, reporting season was perhaps overwhelmed by the ongoing macro tug-of-war between policymakers whose words attempt to assure investors of their commitment to controlling inflation and preserving the value of money, while their actions tend to promote the opposite. Despite his background in Stanley Druckenmiller’s hedge fund, which profited handsomely from betting against the success of intervention, Scott Bessent reached a different conclusion in his role as Treasury Secretary. His announced intention to buy back long-dated Treasury bonds followed intervention to support the yen, a course of action that did not elicit resounding support from his former hedge fund boss. As the purported risk-free benchmark on which most valuation methodologies rest, bond yields are, in our view, one of the greatest challenges to current equity valuations. Corporate profits, the financial economy and the asset values we count as wealth cannot be sustained and grow if the debt on the other side of the global balance sheet collapses or stops growing. As bond investors seek compensation for the risk of ballooning government debt and uncontrolled deficits - partly driven by escalating interest payments, which already contribute around half of the US deficit - the positioning of equity investors in gold and commodities is a wager they will be entirely unsuccessful. Equity investors ignore their bond market counterparts at their peril. Historic monetary growth and inflation are in the rear-view mirror. Should it slow, which is already the case in housing, inflation will follow, skewing the equation back in favour of bond investors and removing some of the inflation protection fuel which has supported earnings and equity markets. Given the size of the global balance sheet relative to the income statement, the potential threat to asset values is significant.

Gold investors roundly disagreed with this picture during August. Gold producers dominated the list of gains in the S&P/ASX 200 for the month. The only impostors among the top 20 performers were CSL and Electro Optic Systems. Despite gold prices not yet reaching the peaks seen earlier this year, gold equity valuations are generally close to all-time highs. In securing his future career plans, one would hope Scott Bessent was wise enough to whisper a few advance tips on his monetary plans to Mr Trump. Portfolio diversification is important, after all. Like jousting sticks, the value of gold is behavioural, driven by the extent to which new investors are persuaded to exchange fiat currency for glittering metal. While we have been enthusiastic for some time about the prospects for real assets and the inflation protection they provide, we have favoured those with value in use: producing food, minerals or energy, or being integral to essential services such as telecommunications or healthcare. At around 5% of Australian equity market value, gold bugs have been big winners over the past month and recent years. On the economic-rent yardstick, gold prices in the US$4,500 range are delivering significant excess returns to all gold producers, explaining why most are trading at their highest multiples of book value in many years. This can be translated as requiring gold prices and economic rents to remain high for many years. We are less certain.

Buoyant results across much of the materials sector, supported by booming copper prices and solid realised commodity prices across most other key commodities, saw share price strength across nearly all major commodity players. BHP, South32, Sandfire, Alcoa, Mineral Resources, PLS, IGO and Capstone all saw price gains of more than 10%. Rio Tinto wasn’t too far behind. Unsurprisingly, the return on capital picture of the industry looks remarkably healthy, as illustrated by the BHP slide below. Copper assets such as Escondida and Antamina, with high prices aided further by gold credits, are allowing BHP to claim more than half of its earnings are now generated from copper. The fact this is fully consolidated earnings while actual ownership of Escondida is 57.5% is not in such large print. Whilst taking nothing away from BHP’s performance, the share price increase in the past 12 months is more than $100bn. Given iron ore pricing and the share price performance of iron ore peers have barely moved, nor have market fundamentals improved, the vast majority represents a repricing of copper assets. And given BHP’s copper production outlook has not changed significantly, this value increment rests on expectations of durably higher copper prices. While we haven’t been hiding under a rock and have heard about data centres and electrification needs, we remain cautious that demand cannot be price insensitive and the cure for high commodity prices will always be high commodity prices.

AI infrastructure and Australian electricity

More tangentially, as we attempt to understand the implications of AI and which parts of the value chain have prospects for earning economic rent, some of the developments in the domestic electricity market were potentially important. Simplistically, sustainable economic rent on data centres in Australia should AI participation be restricted to energy supply and the infrastructure assets housing the compute assets, in which chip and memory suppliers earn the excess returns, looks like a struggle. Power and non-compute infrastructure command around 20 cents in the dollar of AI revenues. On the 10 cents or so in the dollar which flows to power generation, economic rent will rely simply on having abundant low-cost power, which Australia doesn’t have, or convincing buyers to pay elevated prices over long periods. The announcement of government support for the Tomago aluminium smelter achieves precisely the opposite. Rather than allowing demand that would otherwise fall away, either reducing generation requirements or making it available to sell at higher prices, the government is spending taxpayer dollars to hold up demand and subsidise price. As electricity generation is emerging as an obvious bottleneck in the race for AI compute capacity, this appears to be madness. Any cost advantage in power generation and distribution should be guarded zealously. Whilst it is intuitively appealing to observe Australia's plentiful access to sun, wind and land as an attractive starting position for power generation, real life is less persuasive. The excerpts from Origin and AGL reporting below show 64% and 80% of power sold into the NEM in the 2026 financial year (including their power purchase agreements) respectively, were coal-fired. The generation of AGL and Origin combined is about 30% of the 180 TWh consumed annually in the NEM. The exercise of replacing current coal-fired generation is incredibly expensive, challenging and behind schedule. The 8,000 GWh or so of power (about 10% of NSW power use) which AGL was previously supplying Tomago (more than half the Bayswater generation) will now purportedly be supplied by Snowy Hydro. Given Snowy 2.0 (2,200 MW of capacity) doesn't operate yet, in real life Snowy Hydro will be standing between the Tomago smelter and power generated by AGL at Bayswater and paying the difference between market price and the lower price promised to Tomago, funded by the taxpayer. Aluminium smelters are nicknamed 'solid electricity' for a reason. They rely on low-cost power for competitiveness and NSW doesn't have it. Given AGL had previously been supplying this power at low prices, they and other generators selling power into the NEM will benefit from the taxpayer now funding this price subsidy together with the improving supply/demand balance from a large demand source not falling away. The value of existing generation assets seems almost certainly augmented by the deal. Taxpayers, not so much.

While less certain, we are also interested in the longer-term implications for the value of fibre and undersea cable assets, particularly where significant redundancy can be offered. As investors unquestioningly swallow almost every chapter of the gospel according to Elon, including the assumption Starlink will displace vast swathes of communications infrastructure, we feel there may be opportunity in a more nuanced view. Australians currently benefit from mobile and fixed line infrastructure, which is high quality versus global peers, requires no taxpayer subsidy and without which compute capacity is useless. As construction costs escalate rapidly, the prospect of telecommunications infrastructure becoming a valuable bottleneck doesn't seem far-fetched. At a minimum, costs of new capacity addition will rise. While government remains happy to subsidise inefficient producers in other industries and lambast effective operators such as Telstra, we are happy to take the other side.

Of the more frustrating events during the month, the private equity approaches for RWC and Cleanaway rated highly. While ever more public market capital is directed to the useless elevation of gold prices/ equities and ever higher pricing of intangible assets on the expectation of enduring economic rents without tangible capital, we have found far more appeal in real assets and businesses. The question of how much labour and which businesses will be displaced by AI through time remains highly uncertain, however, when we listen to Xero CEO Sukhinder Singh Cassidy justify large subscription price increases on the basis of "we're adding more value to the product every year… and does some of that get expressed in price increases? Of course it does", we hear someone who's forgotten the definition of productivity gain. If AI is bringing down development costs, customers should expect improved product without paying more. Exercising pricing power is a valid way of extracting economic rent. If it results in increasing customer dissatisfaction and more oxygen for competitors to develop superior products at lower prices, it is eroding durability and economic value. It seems far too early to conclude AI isn't threatening technology businesses, and while many are accustomed to price gouging, capitalising this in perpetuity seems perilous. We have tended to focus on the counterfactual. The more we can invest in assets and businesses offering reasonable returns on current profits with limited prospect of being displaced by AI and pricing power which hasn't been unduly exercised, the greater our confidence in the durability of returns. Both RWC and Cleanaway fall into this camp. In the case of RWC, the US$170m in EBIT generated in the 2026 financial year was nearly 20% lower than the prior year. Tariffs, higher copper costs and generally challenging levels of dwelling commencement and renovation are reflected in earnings which are below the levels of recent years despite management efforts to both shift products towards stainless steel and away from copper, restructure production and mitigate challenging volume levels. The agreed acquisition price of $4.75 per share and current debt of US$240m (enterprise value of around US$2.8bn) might represent about 16 times current EBIT, however, it is around 14 times the US$200m+ EBIT of recent years. The current share price, reflecting an expectation that the acquisition will be blocked by shareholders, given Australian Super has moved its ownership to nearly 15% of the company, is around 12 times this US$200m of EBIT. Whilst we understand management and Board frustration with a share price which hasn't moved in some years and perhaps doesn't reward the hard work in dealing with challenging conditions, we see plenty of appeal in staying owners at current valuation. As other investors see greater attraction in paying A$18.5bn for Pro Medicus (around 90 times EBIT and 70x revenue) for a business making less money, it is clear perceptions of value diverge greatly for different pools of investors. "Tell him he's dreamin'" would be an understatement!

Cleanaway has both similarities and differences. While underlying earnings have grown, significant items and adjustments have been plentiful in recent years, acquisitions have played a significant role in driving earnings growth, capital expenditure has risen markedly and return on capital remains mediocre despite a privileged asset base. We remain unconvinced that management is optimising economic returns. Management and the Board have supported a non-binding proposal from EQT Infrastructure at $3.13 per share, implying an enterprise value of $9.2bn at the bid price, given net debt of $2.3bn. While headline multiples of more than 18 times EBIT seem appealing, the EBITDA multiple of around 10 times reflects depreciation and amortisation almost equal to operating earnings. Sustainable capital expenditure relative to depreciation has a very meaningful impact on value. US peers have driven economic rents significantly higher by exercising pricing power, reflecting the privileged nature of their assets. Cleanaway's economic returns raise significant concerns about whether the assets are being sold to private equity without recognising the economic rents that could be released.

Healthcare: cyclical pressure and operational improvement

Pleasingly, across a number of healthcare businesses, including CSL, Cochlear, Ramsay Healthcare and Resmed, our perceptions of good quality businesses becoming broadly undervalued in the face of anaemic short-term earnings growth were vindicated. Sally Warneford, our learned and experienced healthcare analyst, has spent many long hours determining whether businesses such as CSL and Cochlear have faced cyclical, rather than structural headwinds, driving a vastly different valuation outcome. CSL in particular, rose 39% during August through nothing more complex than providing confidence the Behring business was retaining market share and stabilising revenue and earnings. Given the market valuation had retraced to less than half of the multiple investors were paying for CBA, the earnings multiple remains far from elevated even after the share price rise. Very cheap jousting sticks in retrospect!

Tougher operating conditions have been beneficial across the sector, driving companies into addressing bloated cost structures and improving efficiency. The efforts of new management at Ramsay Healthcare in using a combination of technology, capex efficiency, capacity optimisation and improved customer/doctor satisfaction to drive improved performance, deserve much credit. Running hospitals is a crucial but difficult job using complex and expensive assets. Doing it well should give rise to economic rent but hasn't for some years. This is changing. While Sonic Healthcare is yet to see any such improvement, we often find appeal in businesses which are fundamentally strong, yet investors are focused disproportionately on what can get worse over what can improve. The leading diagnostic business described by Sonic below commands a market capitalisation of less than $10bn, is driven by medical excellence (which is why doctors like it), has great technology potential given an unrivalled test database and digital investments and has needed to deliver productivity gains for many years in the face of pressured government pricing. Markets such as the US, with more than $2bn of revenue and the UK with nearly $1bn are delivering very low margins. Low returns on capital driven by overpriced acquisition activity are creating pressures for change. Markets such as Australia are already implementing co-payments as government pricing pressure has suppressed profitability to unsustainable levels. Valuation is extrapolating these operating conditions continuing. While this may be right, they could also get better.

## Market Outlook

Benign conditions, but rising structural risks

To borrow from Dennis Denuto, the 'vibe' from a raft of post-reporting-season company meetings were positive. Although we remain frustrated by the extent to which significant items and adjustments encourage investors to focus on overstated earnings—though possibly not to the same extent as among US peers—operating conditions can only be described as benign. The other side of excessive government spending and deficits must appear as a surplus somewhere, and strong corporate profits are undoubtedly part of the equation. Even in housing, where negative gearing and capital gains tax changes are suppressing demand for credit and affecting housing prices and turnover, results from large players such as Mirvac and Stockland were solid. Nevertheless, we expect conditions to become tougher. Rising house prices over long periods have greatly damaged the health and sustainability of the Australian economy, causing asset price gains to be mistaken for household saving and vast amounts of credit to be deployed in propelling house and land prices rather than productive activity. Although understandably unpopular, a shift towards more productive uses of credit is essential for longer-term growth. Economic value and rent are also the drivers of a country's long-term wealth. While it is easy to see how Australians benefit from selling 62% iron ore to the rest of the world at exceptional margins and returns, the same cannot be said for stratospheric house prices. We remain cautious about the listed equity market's direct and tangential exposure to asset prices, and we continue to do our best to assemble a portfolio of companies with genuine economic diversity. Similarly, we believe it is more important than ever for companies to avoid excessive leverage, highlighting the need to focus on cash operating profitability as the driver of valuation rather than geared price-to-earnings ratios. Ungeared companies will provide much-needed diversification benefits should conditions prove more challenging than currently forecast.

AI spending, inflation and portfolio positioning

On the risks and benefits of AI, it would be disingenuous to profess much insight. Whether the extraordinary capital spending on computing power will generate a return remains impossible to determine. Most companies have plenty of interesting use cases; however, few have plans for step changes in their labour forces. It is fanciful to think there is sufficient incremental revenue opportunity for many companies to make massive payments to AI providers and not come out behind without substantial workforce changes, given that profit pools in most industries are not rising materially. In the interim, investors face the coincidence of massive private-sector capital spending on AI; the destruction and disruption of assets across oil, energy and associated logistics through wars; and government spending behaviour that has yet to normalise from the seemingly costless handouts during COVID, funded and partly induced by ridiculously accommodative central banks. It is easy to see why inflation fears remain paramount. This coincidence has laid the foundations for exceptionally buoyant equity market conditions and challenging bond-market conditions. This historically large divergence causes us much concern. Bond markets are vast and crucial. The more of a company's value that comprises cash flows not requiring heroic assumptions about the distant future, the happier we are. Jousting sticks: we would rather not pay more than two fifty, depending on the condition.

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