ClearBridge
A Franklin Templeton Company

The Emperor's New Clothes

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Key Takeaways

- Index-driven momentum is inflating valuations and creating an illusion of strength in crowded Australian stocks, despite earnings fundamentals no longer justifying current prices.
- Valuation spreads in the S&P/ASX 200 have reached extremes seen only after major dislocations—signalling a compelling setup for value outperformance as sentiment shifts and fundamentals reassert themselves.
- Australia now presents a uniquely attractive value opportunity versus global markets, with passive flows amplifying mispricing and leaving high-quality, cash-generative companies overlooked at a time when liquidity is tightening and discipline matters most.

Seeing the Value Beyond Momentum in Australian Equities

For those who remember the fable The Emperor's New Clothes, the story is as relevant to markets today as it was to human nature centuries ago. An emperor, so enamoured with his own splendour, parades through the streets in "magnificent" garments, visible, supposedly, only to those who are worthy of their station. The crowd applauds what they can't see, afraid to speak the obvious truth: the emperor is wearing nothing at all.

In the Australian equity market today, a similar scene is playing out. Momentum and index-driven investing have created an illusion of strength, with many investors applauding the performance of popular, overvalued stocks while ignoring the uncomfortable truth that earnings fundamentals for these crowded stocks no longer support the prices.

At some point, as in the fable, markets participants will recognise what should be clear to see, and those without genuine value exposures in Australia could find themselves standing bare. And with cracks appearing in the momentum story, we might be starting to see this happen right now.

The Last Two Years: The 'Reign' of Momentum

The past 12 to 24 months have been a choppy period for equities, both globally and here in Australia. Despite being a bank/resources dominated market that has little leverage to the tech/AI driven momentum of the Magnificent 7, Australian market returns have been dominated by risk-on sentiment, index flows, and momentum-chasing behaviour. This has definitely made it a challenging environment for fundamental, valuation-focused active managers such as us to generate alpha.

It's natural to question whether maintaining style allocations, particularly to active, value-oriented approaches, still makes sense in Australia but history reminds us that markets are cyclical: momentum, themes, euphoria and pessimism all take their turns at the throne, and every such streak in the past has eventually unwound.

As Benjamin Graham wrote in The Intelligent Investor in 1949, "speculators often prosper through ignorance; it is a cliché that in a roaring bull market, knowledge is superfluous and experience is a handicap". But the typical experience of the speculator is one of temporary profit and ultimate loss.

The Valuation Illusion

The S&P/ASX 200 surely hasn't felt much like a value market of late. The index is trading at a price-to-earnings multiple nearly two standard deviations above its long-term average. That makes strong expected returns from a passive investment in the index increasingly hard to justify. However, finding value in today's equity market isn't hard, but we believe that one must look past the momentum-driven parts of the Australian equity market and towards value style stocks to find the alpha opportunities.

Our 20-plus years of fundamental company valuations give us a clear view of how far prices for Australian stocks have drifted from underlying worth. We do this by tracking the spread between our proprietary analyst valuations for our Australian Value Equity portfolio holdings (those undervalued stock ideas selected by our investment team) and those of the broader S&P/ASX 200.

The data is striking: our valuation spread measure surpassed 40 per cent in November 2024 and has remained elevated ever since. This is a level that has been reached only three times in the past two decades. History tells us that such extremes don't last. When liquidity tightens and sentiment shifts, the market's illusion fades, and investors rediscover the appeal of real value. Each of those over 40 per cent spread periods (post-Tech Bubble, during the GFC, and following the Covid-19 pandemic market crash) was followed by extraordinary outperformance for value investors.

Are Valuations Too Stretched or are Real Stories Being Ignored?

One of the key reasons we feel that prices have become detached from their earnings potential is that passive investors are focused on buying to match an index rather than assess a business. The high index concentration stocks in Australia are the market equivalents of the emperor's imaginary finery — impressive only as long as no one questions them.

The Commonwealth Bank of Australia is a case in point. Despite limited earnings growth over the past decade, its P/E ratio has expanded to levels difficult to justify, making it the poster child for index-led exuberance. Wesfarmers tells a similar story, with its re-rating also driven more by index flows than by fundamental growth.

In contrast, we believe that many high-quality companies are being overlooked amid the passive buy spectacle. Not all cheap stocks are genuine value opportunities, but disciplined analysis reveals many businesses with solid balance sheets, strong cash flows, and stable earnings that the market is currently discounting. Our bottom-up research allows us to distinguish true value from "value traps". We've deliberately positioned away from crowded, high-multiple names and toward attractively valued, quality stocks such as ANZ Banking Group, BHP Group, Aurizon, AGL Energy and Amcor. These are the businesses quietly building substance while others chase appearance. When the crowd finally sees through the illusion, we think they'll be the ones still clothed in the fundamentals.

Guidance for Asset Allocators

Yes, we are in a momentum-driven market. No, we don't know exactly what will end it, but we do know how it ends. Every cycle of exuberance gives way to a reckoning, and those with portfolios tied too tightly to the momentum trade risk being caught unprepared.

We are starting to see signs that we may be close to end of the momentum story given recent returns of typical growth names, Commonwealth Bank, and bitcoin etc. Once value spreads start tightening, they'll keep on going.

For asset allocators, we see a clear path:

- Use global allocations to capture thematic or AI-related exposures, where earnings justify optimism.
- Use Australian equities to access the value dispersion and mean-reversion opportunity, where the disconnect between prices and fundamentals is starkest.

When the Illusion Breaks

True value investing demands patience and discipline. It requires a willingness to see what others ignore and to act accordingly.

Just as the emperor’s parade eventually met its truth-teller, markets too will confront reality. When momentum fades and fundamentals reassert themselves, those with fundamental valuation-driven exposures will not only preserve capital but stand ready to lead the next phase of performance.

The illusion may dazzle for now, but history, and the data, tell us what comes next. In the end, fundamentals are the only fabric that truly endures.

About the Author

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- 33 years of investment industry experience
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