Investing with discipline: a closer look at risk, valuation and long-term returns

At U Ethical, our primary objective as managers of the Australian Equities Trust is to deliver competitive, risk-adjusted returns over rolling five-year periods. Central to this goal is how we understand and manage risk, particularly the permanent loss of capital and the risk of missing valuable opportunities. Unlike volatility, which is a natural part of equity markets and not inherently negative, our focus is on navigating deeper, long-term structural developments with resilience.

A useful illustration of our disciplined approach is our current underweight position in Commonwealth Bank of Australia (CBA), the largest company in the ASX 300 Index. While this position has posed short-term challenges, it reflects our long-term conviction and valuation discipline.

Risk beyond volatility

Deviation from the index does not necessarily increase risk, and we believe that thoughtful divergence is essential to outperformance. Our ethical investment mandate already excludes several sectors (such as nuclear, weapons, and tobacco), but we maintain an active awareness of index composition to balance risk and return effectively, important in a particularly concentrated market such as Australia.

Financial services and materials dominate almost half the index. While our exposure is lower, we selectively invest in the companies within these sectors that meet our standards for quality and ethical responsibility. Only a small number of companies contribute to returns and to a sustainable world and it is our task to identify and own the ones that do. Of the 42 financial companies and 60 materials companies represented in the index, we own eight financials and four miners, reflecting our selectivity and high-conviction approach.

Positioned for success

Our strategy includes guardrails to allow conviction in portfolio positions while managing where our view differs considerably from the market. For instance, we implement a limit on individual stocks of +/- 5% relative to the index. Missing out on winners can be equally detrimental to performance as losing money in a stock, and our guidelines ensure both caution and opportunity are reflected in our positioning.

In this context, we hold about 8% of the portfolio in CBA which constitutes 12% of the index. Despite the stock's continued price rise, our analysis indicates the market is overvaluing the company.

Valuation considerations

CBA trades at a valuation premium that exceeds what fundamentals alone would justify. It's price-to-earnings ratio is nearly double that of its domestic peers, yet its dividend yield is among the sector's lowest. CBA remains overvalued when compared to global banks; it's price-to-book value is twice as expensive as the next highest bank and three times the global sector average.

Some of this premium is warranted – CBA is a well-managed, tech forward bank with a leading share of customers and deposits. As a result, the bank delivers industry-leading returns on equity. However, this premium has continued to expand, and when valuation metrics stretch so far beyond reasonable historical ranges, experience shows us that mean reversion tends to follow. Recognising when short-term narratives are detached from long-term value creates opportunities disciplined investors.

The role of passive flows

CBA's recent rise in price appears to be driven by several short-term factors. Political uncertainty in the United States has prompted capital to shift into other developed markets, disproportionately benefitting Australian financials due to their significant weight in global indices like the EAFE. Australia comprises 7% of the EAFE index, and financials are 41% of EAFE Australia[1].

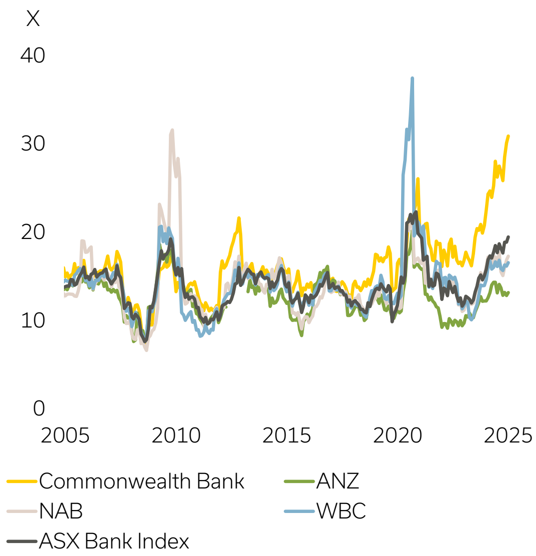
As the most heavily weighted Australian bank, CBA has received substantial flows from US-based index funds and ETFs. With passive investment strategies on the rise - US passive funds received $900bn in inflows during 2024, while $165bn flowed out of active funds[2] – CBA has benefitted from this trend creating a separation between it's share price and fundamentals.

Remaining patient and disciplined

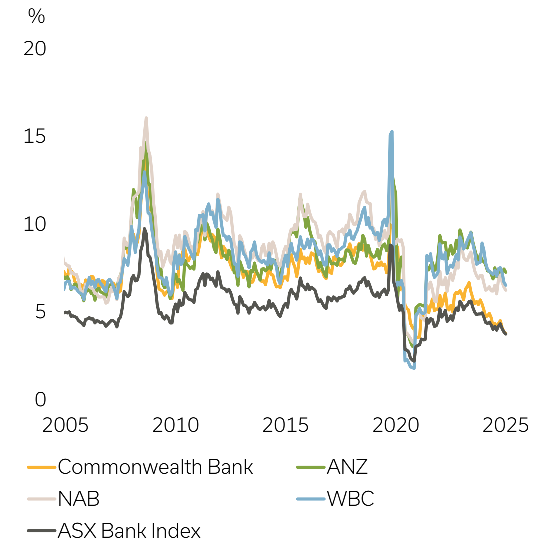
If this is indeed a flow-driven event, it may persist in the short term but is unlikely to continue indefinitely. Political environments change quickly, and global capital can shift just as rapidly. While we can't predict the timing, we maintain confidence that fundamentals will eventually reassert themselves. Our long-term view means that we have patience to look beyond transitional fluctuations and focus on enduring trends.

Several other Australian financials exhibit fundamental progress and present more attractive investment opportunities. QBE and Suncorp are benefitting from rising insurance premiums, and QBE is also making progress towards growing its profitability in North America. Macquarie Group offers diversified exposure to global themes such as digital infrastructure and the energy transition. These companies offer access to growth opportunities in the Australian financial market at more reasonable valuations.

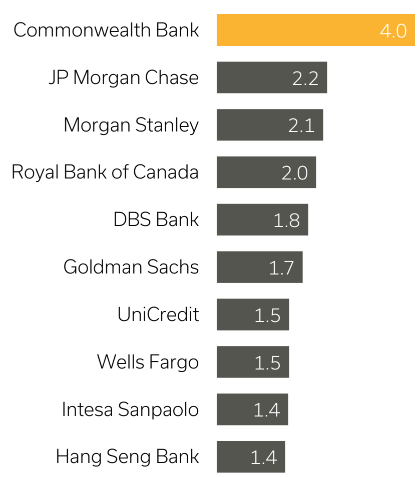
Price to earnings



Gross dividend yield



Price to book value



Source for chart data: Bloomberg. Data to June 2025.

Conclusion

Investment is more art than science, and while we don't claim to have a perfect formula, our underweight position in CBA reflects a considered conviction. We have strong faith that current valuation levels are unsustainable, but remain measured in our exposure, given the short-term unpredictability of market flows.

Our investment process - rooted in rigorous analysis, collaborative decision-making, and long-term thinking – is built to achieve consistent, ethical, and sustainable performance. We remain confident that our disciplined approach can resist short-term pressures and deliver long-term returns.

Sources:
[1] Bloomberg (2025).
[2] Morningstar Direct Asset Flows (2025).

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