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The Australian share market has moved through a wide range since March this year, initially falling 8% from a record high and then recovering by June. While the pessimism about stocks has obviously eased, it's worth looking at why this fluctuation occurred.

A key trigger for the slide in March was a steady stream of earnings downgrades. While many of the downgrades were from smaller companies, investors thought the problem could have implications for the broader market.

Many companies that lowered their earnings expectations cited a slower Australian economy, moderating sales growth and higher costs as the reasons behind their announcements. The companies most affected were those with the largest exposures to the Australian economy, such as building-material suppliers and retailers.

By June, many of these stocks had recovered because investors were buoyed by gains on world share markets and the possibility that the selling was overdone. But still, concerns linger about the economic outlook and the potential for cost pressures to undermine profitability.

It is Perennial's view that the share market is unlikely to repeat the gains over the past year or so - the S&P/ASX 300 Accumulation Index rose 23.5% in the 12 months ended 31 May 2005. More difficult conditions for investors, ironically, could suit growth investing over other styles.

It is during tougher times that true growth stocks usually prove to be quality investments. Perennial believe that this is because they tend to have a long-term competitive advantage. This advantage can be a superior product or service, a regulatory barrier to entry in an industry or simply that a company owns high-quality assets.

A competitive advantage usually translates into more sustainable revenue streams because these companies often have pricing power. The competitive advantage gives companies an ability to pass rising input costs onto their customers. Further, the demand for the company's products is usually resistant enough for it to at least hold onto its market share. These companies are typically the ones that pass Perennial Growth's Sustainable Growth Test.

Good prospects

Perennial Growth invests in companies with sustainable earnings growth that is attractively priced. Which stocks does it think fit this criterion today?

Toll Holdings Ltd., Australia's largest freight company, and Patrick Corp. Ltd., the country's biggest port operator, are held in the portfolio because their capable management and technological competitive advantages mean they can readily exploit the trend for companies to outsource their logistics.

James Hardie Industries NV has had a prominent public profile in the last 12 months on the issue of asbestos liabilities. However, its superior fibre-cement home siding (plasterboard) products give it a tight grip on the US market, delivering a sustainable growth outcome for the company.

ABC Learning Centres Ltd. has a sustainable competitive advantage as Australia's largest operator of childcare centres. ABC is focused on optimising its management systems to ensure its resources are fully used. Beyond a certain level of occupancy, the financial rewards for the company are significant given the company's largely fixed cost base.

Cochlear Ltd., the world's largest maker of inner-ear hearing devices, has patented technology as its competitive advantage. The company has recently expanded its growth opportunities by developing a capability to help the partially, as well as the profoundly, deaf. Cochlear realised that its growth among the profoundly deaf was limited to population growth. The acquisition of Entific, a Swedish company specialising in hearing loss, has broadened the company's product range, thereby extending the life of its sustainable growth profile.

The competitive advantage of mining companies is often the mines they own. BHP Billiton Ltd., for instance, has large and easy-to-access ore reserves in the Pilbara which lowers its average cost per tonne produced. Diversified mining groups such as BHP Billiton and Rio Tinto Ltd. have recently negotiated significant price increases for their bulk commodities thanks to China's

swelling demand. Both companies have plans to invest significantly in increased capacity, adding to the financial rewards over the medium to longer term.

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