

thebigpicture

guideposts for the private investor

Week Commencing 4 November 2002

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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BEATING THE EXPECTATIONS

How should an investor react if a company reports earnings 'better than expectations' or 'worse than expectations'?

Each quarter in the USA and half yearly in Australia, there are media commentaries reporting on whether profits are better or worse than what had been expected. Should this be the basis for an investment decision?

How companies work to manage expectations was described in *thebigpicture* newsletter for the week commencing 26 August 2002. Company management will normally seek to ensure that forecasts converge around a narrow band of outcomes consistent with what it sees as being likely.

Equity Investment Guideposts

Required rate of return

Company return

Sustainable growth trajectory

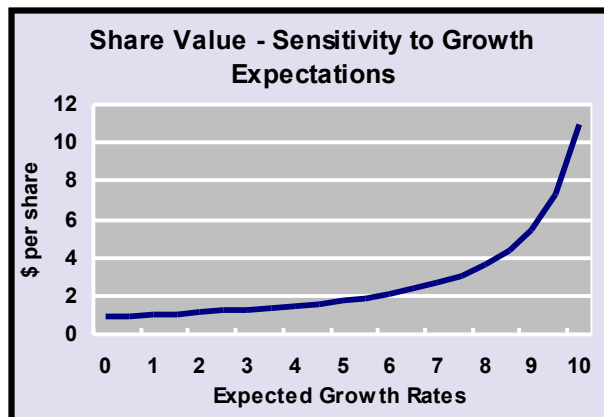
Since analysts are reluctant to promote numbers which stand conspicuously away from the level endorsed by the company, forecasts are usually nudged toward the consensus.

Thus we see for the well followed, higher profile companies that the range of forecasts is surprisingly narrow. For National Australia Bank the highest profit forecast by a recognized broking analyst for the year to September 2003 is apparently within 2% of the median and the high forecast for Wesfarmers for the year to June 2004 is within 5% of the median. This is a remarkable degree of convergence. These are companies subject to uncertain economic conditions with exposures spread over several continents. There are also divergent views among broking houses as to the macroeconomic conditions which are likely to prevail and influence the eventual outcomes.

In other words, these are not forecasts. Analysts are converging on profits to which they are being guided. Given the complicity of analysts and companies, actual results will be very close to what was expected with the deviations usually not being statistically significant. After results are reported, references to them being above or below expected outcomes, therefore, convey little information which is helpful for investment decision-making.

In this environment, real adjustments to expectations are occurring outside the results release and this is where investors need to be attentive because the effect on investment values can be great. Using a simple growth model might help to illustrate the potential impacts.

Let's say that there is a company with net operating profit after tax equivalent to 10 cents per share in the last reporting period, an expected growth rate of 8% pa with in-



(Continued on page 4)

Australian Bond Yield Guideposts

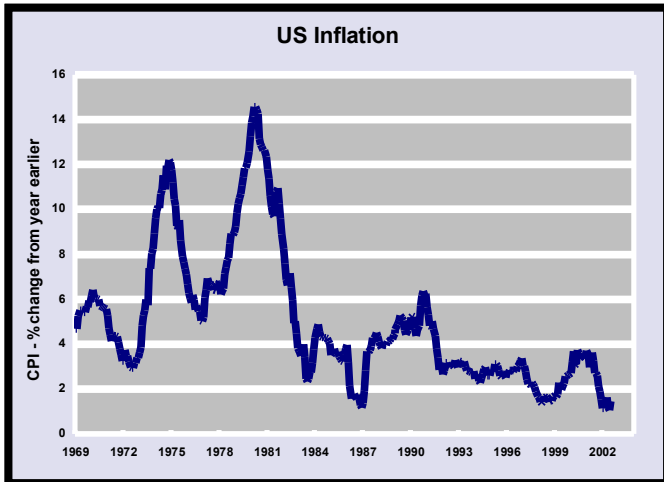


Chart 1: US inflation is measured by changes from a year earlier in the US consumer price index published by the US Bureau of Labor Statistics.

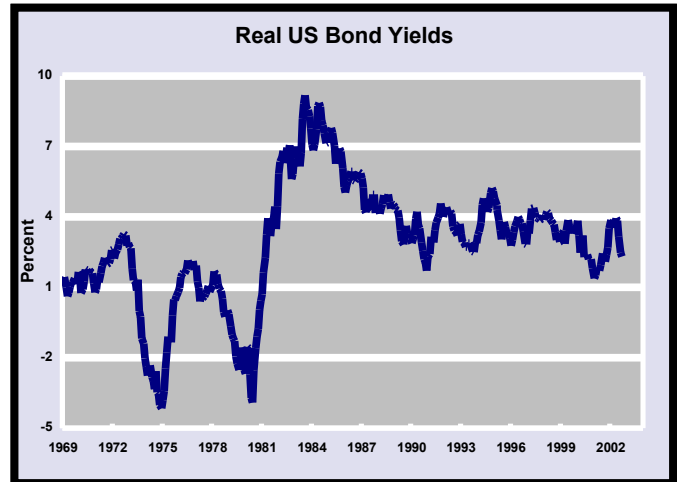


Chart 2: The real US bond yield measures the extent to which US 10 year bond yields exceed the rate of consumer price inflation as measured in Chart 1.

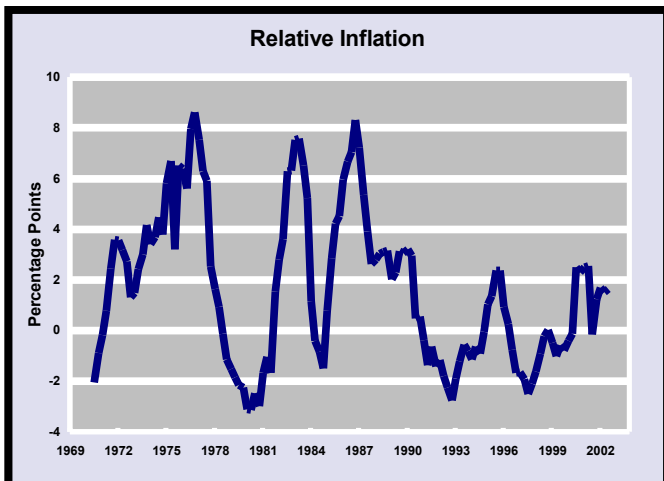


Chart 3: The relative inflation chart shows the extent to which Australian inflation, measured by movements in the consumer price index published by the Australian Bureau of Statistics, exceeds US consumer price inflation.

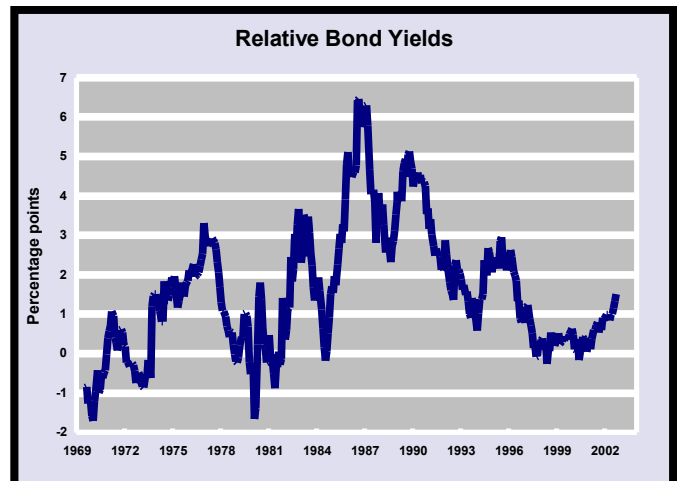


Chart 4: The chart shows the extent to which Australian 10 year bond yields exceed US 10 year bond yields.

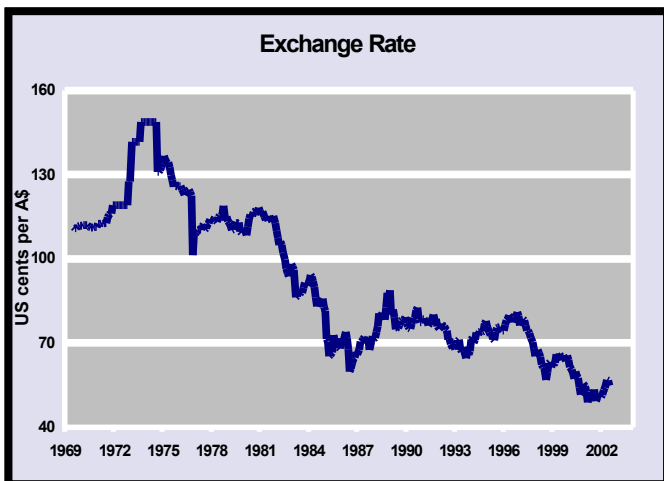


Chart 5: This is a chart of the average monthly value of the Australian dollar measured in terms of US cents as published by the Reserve Bank of Australia.

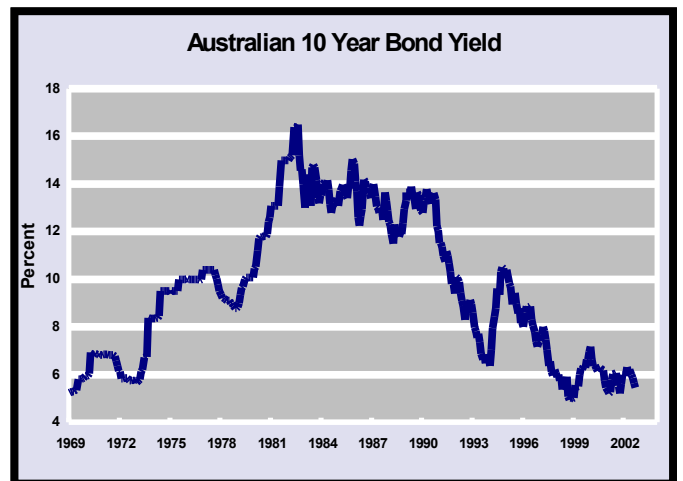


Chart 6: The chart shows average monthly 10 year bond yields as published by the Reserve Bank of Australia.

BOND YIELD GUIDEPOSTS

The bond yield guideposts are a set of indicators of the primary influences on rates to help investors to understand more clearly the pressures and direction of future movements.

Chart 1: US inflation has persisted below 2% since November 2001 in part due to the weakness in the economy and the associated deterioration in consumer confidence. Cyclically low inflation is placing downward pressure on bond yields but, with more buoyant growth rates, inflation is likely to return to 2-3% where the US Fed will attempt to hold it.

Chart 2: Real yields have been falling most recently implying that nominal yields have fallen by more than the decline in inflation. A partial explanation has been the weakness in US equity markets and the movement of funds into bonds as investors seek a safer haven. However, despite this, real yields are within the range which has prevailed through the past 12 years.

Chart 3: Australia's inflation performance has been satisfactory in the context of a relatively strong economy insofar as it has been maintained within the 2-3% target range set by the Reserve Bank. However, Australia's inflation outcomes have been higher than those in the USA. This relative performance would be placing some upward pressure on Australian bond yields relative to US bond yields. With a convergence in cycles, the relative inflation differential, and with it upward pressure on yields, should be eroded.

Chart 4: Australian yields have risen to a recent record premium against US yields of 1.5 percentage points. The yield differen-

tial reflects the relative inflation performance and a factor reflecting the relative riskiness of investing in Australia.

Chart 5: The value of the Australian dollar is still in a long term downtrend but has been relatively steady for the last 18 months. Currency weakness would nor-

| AUSTRALIAN BOND YIELDS | | | | |
|------------------------|----------------|-------------|------|---------|
| | Expected Range | | | |
| <i>percent</i> | Low | Most Likely | High | Current |
| 1. US inflation | 1½ | 2½ | 3 | 1.5 |
| 2. Real rate premium | 2½ | 3½ | 4 | 2.5 |
| = US yield benchmark | 4 | 6 | 7 | 4.0 |
| 3. Relative inflation | ¾ | 0 | 0 | 1.6 |
| 4. Risk premium | 0 | ¼ | ½ | -0.1* |
| = Australian yield | 4¾ | 6¼ | 7½ | 5.5 |

* Differential implied by level of Australian yield

mally put upward pressure on Australian yields relative to those in the USA as it would heighten the risk for overseas funds being invested in Australia. Market expectations that the Australian dollar might strengthen will help support the bond market which would show up in a tendency to lower yields and a contraction in the bond yield premium with the US market.

Chart 6: The yield outcomes arising from the guideposts are summarized in the table. It indicates that current yields of around 5.5% are below the medium term most likely outcome.

While *thebigpicture* is assuming that there will be some increase in yields largely driven by the US economic cycle, the assumed rise is not great by the standards of other cycles. Cyclically higher inflation in the USA which would tend to drive rates higher would be offset by a decline in the Australian yield premium as the relative inflation performance converges.

BEATING THE EXPECTATIONS CONT'D

(Continued from page 4)

The Billabong story is a relatively mild example from among many which highlight the important role of growth expectations in framing share prices. Every stock price embodies an implicit ongoing growth rate. Once information comes to hand which changes views about this implied growth rate, the higher the previous growth expectation the more dramatic will be the price

effect. This being the case, an investor needs to act speedily to prevent large losses.

Using a constant growth model to draw these conclusions is obviously a simplification in that growth rates will vary from year to year but the approach, for all its simplicity, provides an important guidepost without having to field a large and expensive research department.

“Cyclically higher inflation in the USA which would tend to drive rates higher would be offset by a decline in the Australian yield premium as the relative inflation performance converges.”

BEATING THE EXPECTATIONS CONT'D

(Continued from page 1)

vestors requiring an annual return of 11% after tax. Assume that the growth rate can persist indefinitely and that a standard growth model can approximate the underlying value of the business. That is, in this case, the value of the company would be $10 \times (1 + 8\%)/(11\% - 8\%)$ or \$3.60 a share.

If, however, something happens to change the expected growth rate on an ongoing basis from 8% to, say, 5%, the value ascribed to the company would be \$1.67 a share, a reduction of 54%.

Valuation is leveraged strongly to the anticipated profit growth rate. The chart on page 1 illustrates, using the example, the potential for share price revision if there is a change to the expected growth rate. It also shows how the sensitivity increases dramatically the higher is the expected growth rate.

The chart clarifies the riskiness of assuming that high growth rates can persist indefinitely. Persistence of high profit growth is usually dependent on a favourable confluence of circumstances including:

- strong management;
- favourable macroeconomic conditions; and,
- significant pricing power or maintenance of some form of competitive advantage.

If anything happens to upset this delicate balance or if there is a suggestion that these favourable circumstances are likely to be disrupted, the implied growth would be reduced and the share price impact, as the chart shows, could be dramatic.

This provides at least a partial explanation for what has happened to some of the so-called high p/e companies. Recent examples of companies to have their risk profiles highlighted in this way have been CSL, Cochlear and Computershare. In the past, another classic example which illustrates the same point was Coca-Cola Amatil. (Readers, at this point, should not conclude that there is actually a different explanation involving a con-

nection with stocks whose names begin with the letter 'C'!)

Once the growth rates which had been attributed previously to each of these companies were called into question, the share price impact was very significant and management appeared at a loss to explain why. In truth, few understood how the share values of their companies were being formed. Nor had financial advisers generally counseled clients adequately about the riskiness of any change in expectations so that, for many, it seemed almost incomprehensible that such a swift re-rating could have occurred.

Billabong International, the Queensland based manufacturer of surf wear and lifestyle products which are sold around the world, is in the midst of a similar adjustment to expectations. This has been a very successful company having achieved a tenfold increase in profit before interest and tax since 1996/97 and, for 2001/02, an operating return of just over 12% pa, a highly creditable performance.

However, the price had reflected the very best of circumstances which investors had been prepared to assume until Matthew Perrin, the chief executive, sold some of his stock. The sale appeared to conflict with several important principles of public company corporate governance and investors began to question whether there might be something in the business performance which had not been fully understood. Since the end of August, the market value has been cut by a quarter from \$1.8 billion to \$1.3 billion.

Assuming a required rate of return of 11% implies that the market downgraded the growth prospects from a very strong 15% a year to a still outstanding 11¾% a year for the next 20 years. Arguably, even the latter assumption might be too high and, to that degree, the market has not been especially harsh on Billabong despite the fall in share price which has already occurred. If anything, the Perrin actions might have simply been the catalyst for a necessary but minor growth re-rating.

“Once information comes to hand which changes views about the sustainable potential growth rate, the higher the previous growth expectation the more dramatic will be the price effect.”