

# thebigpicture

guideposts for the private investor

Week Commencing 14 October 2002

## Publishing and Subscription Information

*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.

To subscribe to the newsletter, go to [www.thebigpicture.com.au](http://www.thebigpicture.com.au) or send an e-mail to: [admin@thebigpicture.com.au](mailto:admin@thebigpicture.com.au).

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## REQUIRED RETURNS: INVESTMENT v SPECULATION

*Investors need to have a clear view of their required rate of return to be able to make effective investment decisions. Having a target or required rate of return differentiates investment from speculation.*

A target rate of return is one of the three *thebigpicture* investment decision making guideposts. Each of these guideposts will be reviewed in upcoming newsletters. Together, they form the basis for the investment decision-making model used in *thebigpicture* premium level service.

Investors, by definition, have a sense of value. In a business context, they know how much a company is worth to them and, therefore, the maximum amount they are willing to pay. A speculator, on the other hand, might not have any sense of underlying value. He or she will simply buy (or sell)

on the expectation that a price might rise (or fall) perhaps without ever knowing why.

The advantage of investing over speculation is the ability to analyze performance: to be able to reproduce winning strategies or identify why something did not work and, if necessary, to readjust the approach.

Put in simple terms, if an investor has a required return of 10% and a business is generating a profit of \$8,000 a year, he or she would be prepared to pay up to \$80,000 for the business. Applying this approach should be no different whether one is buying an entire business or buying a part of a business through an individual share.

What should determine the required rate of return? There are three components for an equity market investor:

- the rate of inflation which needs to be covered simply to maintain the purchasing power of the funds to be invested;
- a component which represents the real increase in value being sought from an investment; and,
- an amount to cover the inherent riskiness of putting funds into equity investments rather than maintaining them in safety (in, for example, government bonds).

The table on page 4 shows, for each of these components, suggested values at the present time and some comments as to the rationale for the choice of those values. *thebigpicture* suggests that the required rate of return ought to be in the vicinity of 13% for an Australian equity investor.

Having set the target, how can it be achieved? It is not possible in any meaningful sense to predict how share prices might fluctuate over any given period. All one can say is that, over the longer term, share prices ought to reflect underlying increases in value.

Thus an investor should follow a three-step process.

### Equity Investment Guideposts

Required rate of return

Company return

Sustainable growth trajectory

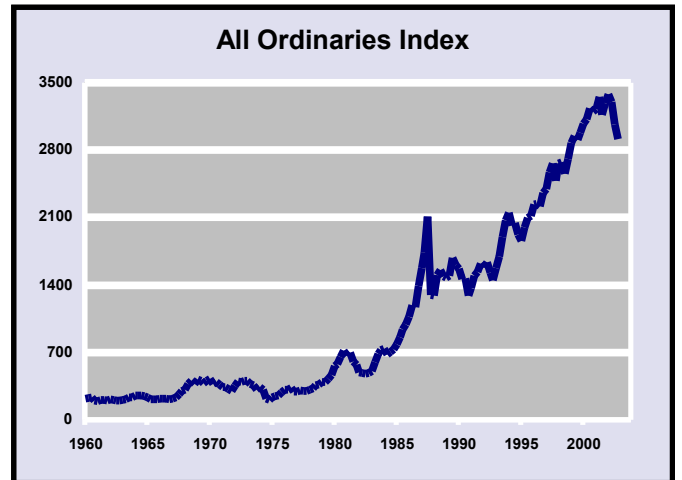
*“There are three components to the required rate of return for an equity market investor....”*

(Continued on page 4)

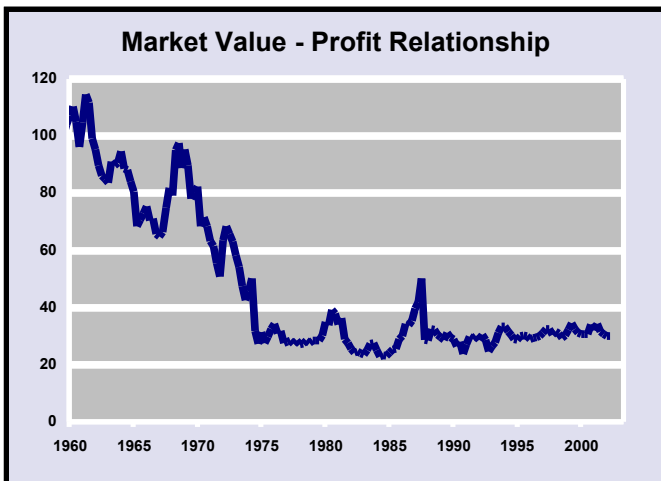
## Australian Equity Market Valuation Guideposts



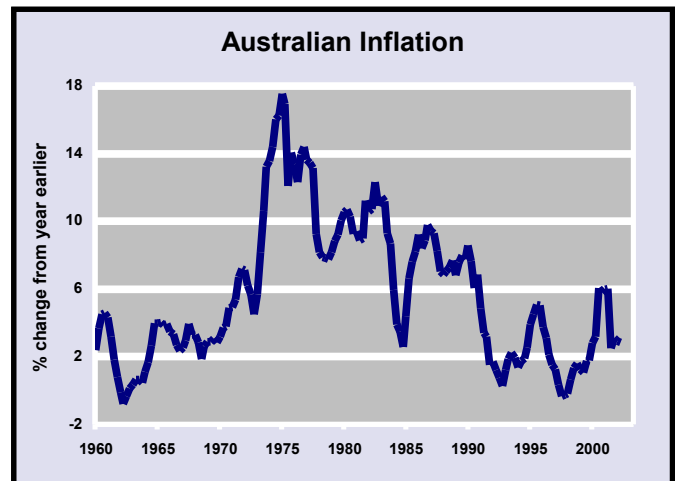
**Chart 1:** Corporate gross operating surplus as reported by the Australian Bureau of Statistics in the quarterly national accounts. It approximates earnings before interest, tax, depreciation and amortization.



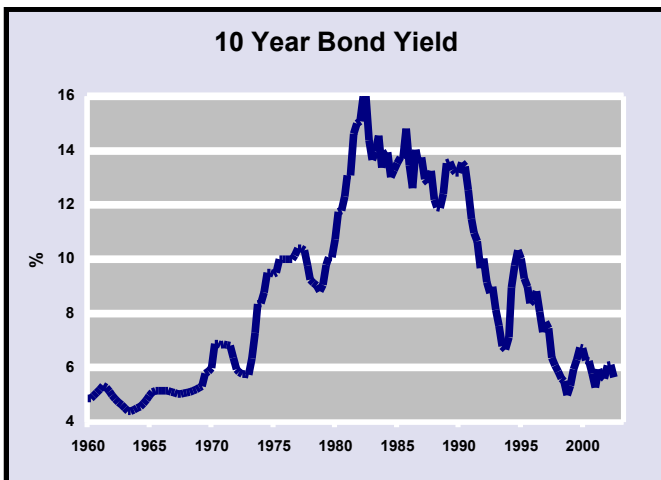
**Chart 2:** The All Ordinaries Index for the Australian market as reported by the Australian Stock Exchange and sourced from various publications including the Reserve Bank of Australia and the International Monetary Fund.



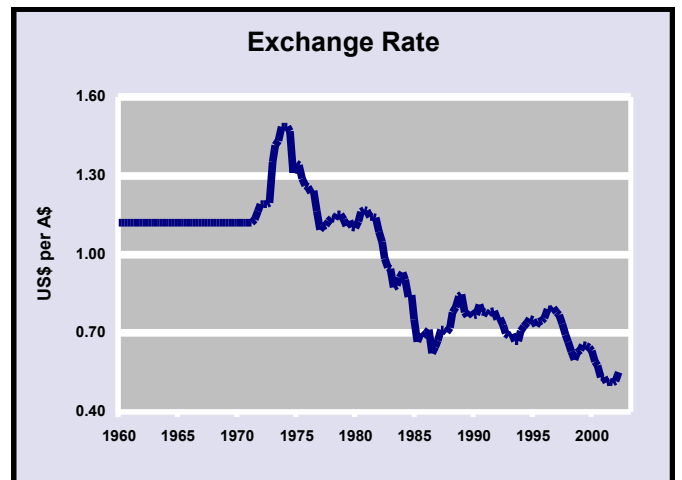
**Chart 3:** An index of the ratio of the All Ordinaries index and the corporate gross operating surplus. A downward move in the line implies that profits are growing faster than the increase in the market.



**Chart 4:** Inflation is measured by the consumer price index published by the Australian Bureau of Statistics with the data sourced from the Reserve Bank of Australia and the International Monetary Fund.



**Chart 5:** The yield on ten year government bonds as published by the Reserve Bank of Australia.



**Chart 6:** The average value of the Australian dollar in terms of the US dollar as published by the International Monetary Fund and the Reserve Bank of Australia.

## EQUITY VALUATION GUIDEPPOSTS

*“...a stable or appreciating Australian dollar could persuade overseas investors that the risks from investing in the Australian market have diminished....the prospect of the Australian market rising at a faster rate than the underlying growth in profitability might become a realistic expectation.”*

**Chart 1:** Underlying Australian corporate profitability has grown at a long term average annual rate just on 10%. In the year to June 2002, the corporate gross operating surplus increased by an above average 12.3%.

**Chart 2:** The All Ordinaries Index has increased at a long term annual rate of 6.5% after taking account of the most recent decline.

**Chart 3:** Although the rate of profit growth has, on average, exceeded the growth in market values, the outperformance was predominantly a feature of the 1969-74 period. Since 1974, the market has moved more closely in line with underlying corporate profitability although there have also been periods such as in 1985-87 when there was a sharp separation in performance. It is likely that data for the September quarter will show that the market has fallen while business profitability has shown relative strength.

**Chart 4:** The relatively poor market performance in the early 1970s coincided with Australia's worsening inflation performance which peaked at nearly 18% in the mid-1970s.

**Chart 5:** Rising inflation contributed to 10 year bond yields rising from around 6% to 16% and damaging market values. Since 1990, bond yields have reverted to levels more closely approximating the levels which prevailed in the 1960s. At face value, this should have had a significant positive impact on equity market values but market ratings have appeared to change little (see Chart 4).

*thebigpicture* bond guideposts highlight the risk of yields moving higher taking away some support for the market.

**Chart 6:** One explanation for the relatively poor Australian market performance has been the currency weakness. Overseas investors play a pivotal role setting values in the Australian market. Unfortunately, the 30% decline in the value of the Australian dollar (against the US dollar) has substantially eroded the returns available for foreign investors from the Australian market.

Looked at from the perspective of an overseas investor (that is, in US dollar terms), the rise in Australian corporate profitability since the middle of 1996 (6.3% pa) has been cancelled out entirely by the decline in the currency so that US dollar denominated profits have risen by only 0.1% pa. The 5.1% pa appreciation in the Australian dollar value of the All Ordinaries Index converts to a 0.8% pa loss in US dollar terms.

Looking ahead, a stable or appreciating Australian dollar could persuade overseas investors that the risks associated with investing in the Australian market have diminished.

If that was to happen, the prospect of the Australian market rising at a faster rate than the underlying growth in profitability might become a realistic expectation.

Thus, continuing profit growth combined with currency stability could offset a potential cyclical rise in interest rates to help support a rise in the Australian market.

## INFLATION STATISTICS: WHAT TO WORRY ABOUT

The calculation of the required rate of return illustrates for an investor the relevance of the inflation rate. Month-to-month inflation performances and expectations are reported extensively in the financial press. How much of this should be followed and how much ignored?

There are two aspects of the inflation numbers of which investors should be aware.

- There is the speculative element. This is driven by short term traders in currency, debt and equity markets (both futures and cash) looking to take advantage of the announced inflation number being inconsistent with what had been expected. This can generally be ignored by the serious investor who

can be quietly amused at their behaviour.

- There is the fundamental element. Here, the question for investors is whether there is any new information which indicates that the 3% assumed in the required return calculation is no longer applicable.

If inflation is going to be sustainably higher or lower than 3%, the investor's target return needs to be adjusted and the choice of investments reappraised accordingly. Such a change, however, would only become apparent over a lengthy period and a single period's inflation outcome should not have any noticeable impact on judgements about this.

## REQUIRED RETURNS: INVESTMENT V SPECULATION CONT'D

(Continued from page 1)

**Step 1:** measure the existing level of profitability of a target investment.

**Step 2:** calculate the maximum price which would be consistent with a 13%

not have to report their rates of return and not all companies manages businesses to maximize rates of return in mind.

In the newsletter for the week commencing

### Required Return Components

Inflation	3%	This is the upper end of the inflation range which has been targeted by the Reserve Bank and is consistent with acceptable inflation performance within the main western economies. This is higher than recent inflation rates which are cyclically low. A higher rate of inflation in the longer term is, therefore, more appropriate in setting longer term investment targets.
Real return	4%	This is a rate which is generally regarded as the risk free rate of return which is implied in government bonds and which investors need to cover as a minimum requirement.
Risk premium	6%	This is a generally accepted value for the relative risk (over that inherent in government bonds) assumed in investing in equities. It is compensation for the greater risk being assumed when investing in equities.
Required return	13%	

rate of return (as if you were buying the entire company).

**Step 3:** compare the existing market capitalisation with the target value calculated in Step 2.

If the market capitalisation is approximately equal to or less than the fundamental value, the investment would meet the return objectives and may be purchased.

If the market capitalisation exceeds the fundamental value, by this first guidepost, it is too expensive.

The investment might be acceptable depending on the prospective sustainable growth trajectory. This is the third guidepost to be discussed in more detail in coming weeks.

There is evidence that the market performance of higher returning companies is superior. Unfortunately, companies do

ing 26 August 2002, **thebigpicture** showed rates of return for the larger companies listed on the Australian Stock Exchange. That listing showed that, of the 58 companies covered, only 43% had rates of return on funds employed which exceeded the 13% required rate calculated above.

**thebigpicture** newsletter for the week commencing 9 September 2002 illustrated the extent to which the highest returning companies were also the ones which showed the greatest price appreciation. The combined price appreciation of the seven highest returning companies over the past five years was seven times greater than the combined price appreciation of the seven lowest returning companies.

See the details of this analysis at: [www.thebigpicture.com.au](http://www.thebigpicture.com.au).

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