

# thebigpicture

guideposts for the private investor

Week Commencing 15 December 2003

## **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.

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## COMPANY GROWTH EXPECTATIONS

Measured against the growth prospects of the Australian economy, overall growth rates expected for larger Australian companies are now more sustainable. The disparity among companies' growth prospects remains high with investors needing to make choices about management capacity to deliver.

Last week's edition of *thebigpicture* outlined how it was possible to estimate the growth rates investors are attributing to companies. This involved separating the current enterprise value of each company into three components:

- the value of the existing profit stream;
- a discount rate which is assumed to be the company's cost of capital; and,
- a growth rate.

Analysing the largest 30 industrial companies listed on the Australian stock exchange using this framework showed that the market was expecting an overall rate of growth for this group of 5.2% a year.

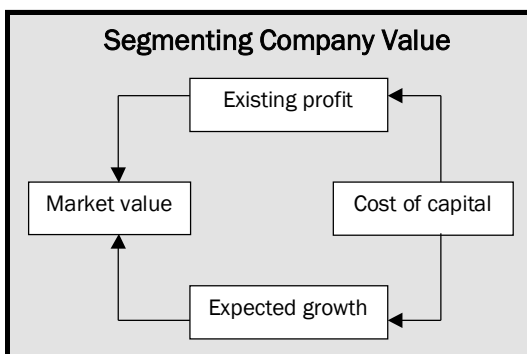
As markets become overpriced, growth expectations begin to outstrip what is possible in the longer term for the economy as a whole. This signals greater risk for investors buying at those prices.

From the perspective of the overall market, a 5.2% growth expectation was a positive sign insofar as it indicated that the anticipated growth rate was within the capacity of the Australian economy (and related industrial economies).

However, *thebigpicture* analysis threw up a wide range in growth expectations across the 30 companies analysed. There was a high of 13.2% a year for Mayne Group and, at the other end of the range, a 2.0% a year contraction expected for Telstra.

The arithmetic average growth rate was 6.7% implying that investors are tending to assume a lower rate of growth for the larger companies than they are for the smaller ones within the group.

*"By ranking companies according to their growth and return characteristics .... [investors] have access to another important guidepost in their investment decision-making."*



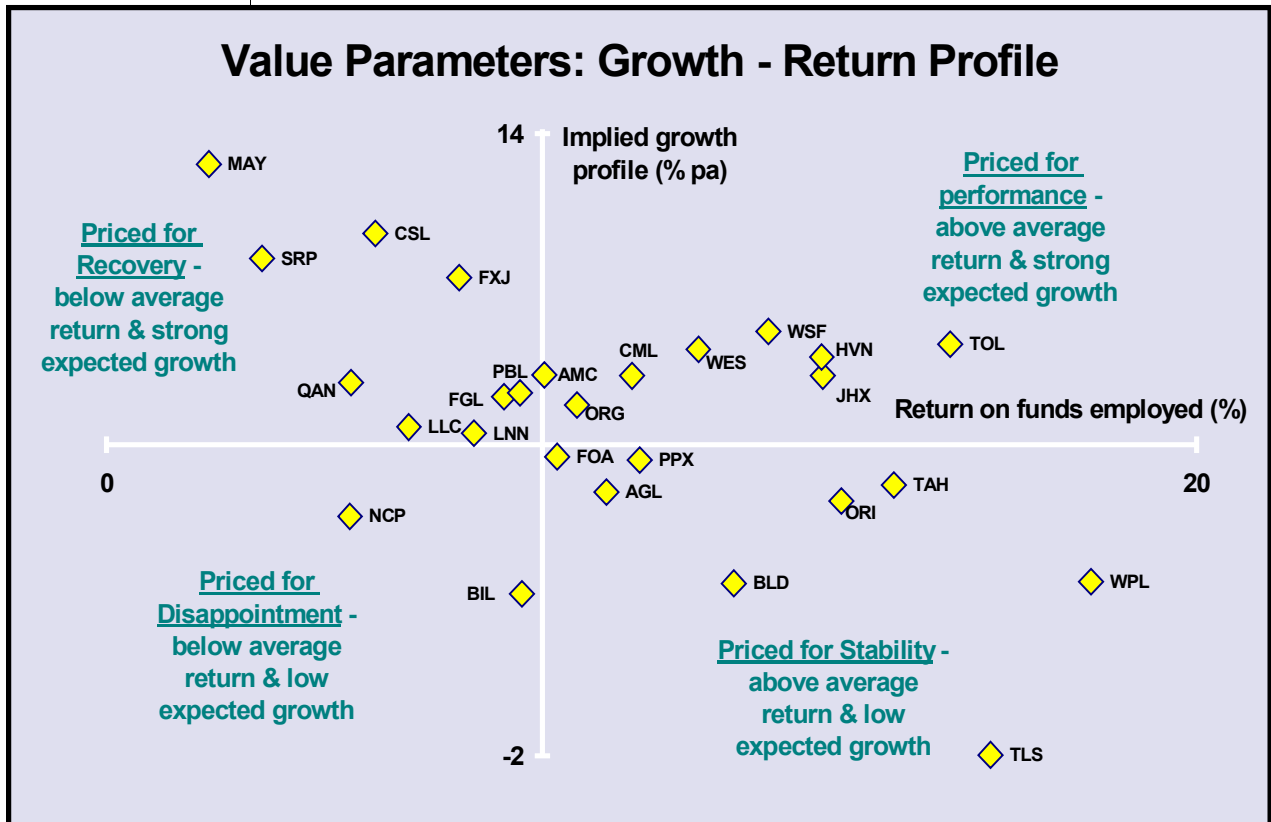
A company with better growth prospects will not always be the more attractive investment. Better growth prospects need to be traded-off against rates of return.

There is some tendency for investors to expect higher growth rates from companies with relatively low rates of return. These companies are often in the 'fallen angel' category with a recovery being factored into the market pricing.

The chart on page 2 suggests some guideposts for investors making stock selections. It shows the rate of return for each of the companies analysed using its last full year results and the implied growth rate in its market pricing calculated in the way described

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## COMPANY GROWTH EXPECTATIONS CONT'D



(Continued from page 1)

in *thebigpicture* last week.

The chart segments the companies into relatively high (and low) growth and relatively high (and low) return companies. Companies fall into one of four categories:

- stocks priced for recovery: low current return with high growth expectations
- stocks priced for performance: above average return with relatively high growth expectations
- stocks priced for maturity: above average returns with relatively low growth expectations
- stocks priced for disappointment: below average returns and relatively low growth prospects

This allocation is how the market sees the companies at a single point in time. The position of the companies will vary with movements in share prices. Relative positioning might not change with general market movements. Relative positions will shift, however, with changing perceptions about the growth characteristics of individual companies.

The market is currently putting a price on

Mayne Group, for example, which suggests that a strong business recovery is forthcoming. The market is saying, in its current pricing, that it will grow its way out of its current poor returns.

At the same time, the market seems to be saying, in the case of Telstra, that it is a very mature business. It faces a contraction in its income despite already having above average returns on the funds employed in its business.

Among the challenges for investors, as always, is to recognise divergences between the market's current view and the capacity of company managers to deliver something different.

For example, Telstra managers might be able to do better than the market is expecting. The people running Mayne might not be able to deliver the anticipated growth. Telstra could be the better investment and Mayne a disappointment despite Mayne investors currently expecting that it has the superior growth outlook.

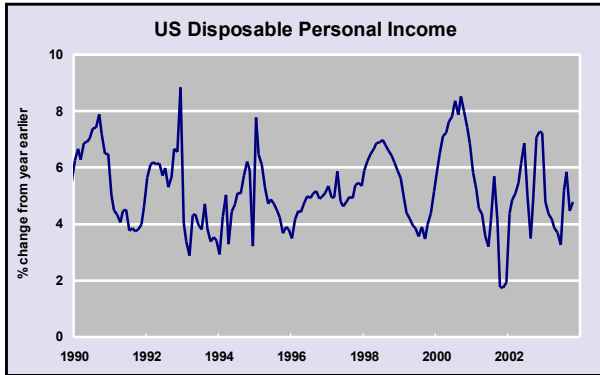
It is possible, too, that the Mayne managers will deliver a relatively strong growth profile in coming years but that this has already been incorporated into its market value. Delivering the growth might simply

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*“A company with better growth prospects will not always be the more attractive investment. Better growth prospects need to be traded-off against rates of return.”*

## THE US ECONOMY: HOW STRONG? CONT'D

(Continued from page 4)



2.1% in the third quarter of 2001.

However, attempts to rebuild low savings remain a drag on faster consumption growth. The 3.3% savings rate in October was much lower than the 9% that prevailed ten years ago. However, there has been some recovery from the sub-3% rates that had prevailed for most of the past three years.

Business sales, the fourth indicator, grew by 0.7% in October to be 5.1% higher than a year earlier. The growth rate has returned to where it had been just prior to the invasion of Iraq.

Despite this improvement, the growth rate is more consistent with an economy in the latter stages of expansion rather than one bouncing from underperformance into the early stages of an expansion.

So, the overall verdict is to be wary. In each of the four indicators there are positive signs. Conditions are better than they had been. However, none of the indicators is saying that there is a strong bounce underway or that the US economy has entered the early stages of a rapid expansion.

A more rapid expansion, with the help of supportive Federal Reserve policy, might still be ahead but the existing evidence is insufficient to draw that conclusion.



## COMPANY GROWTH EXPECTATIONS CONT'D

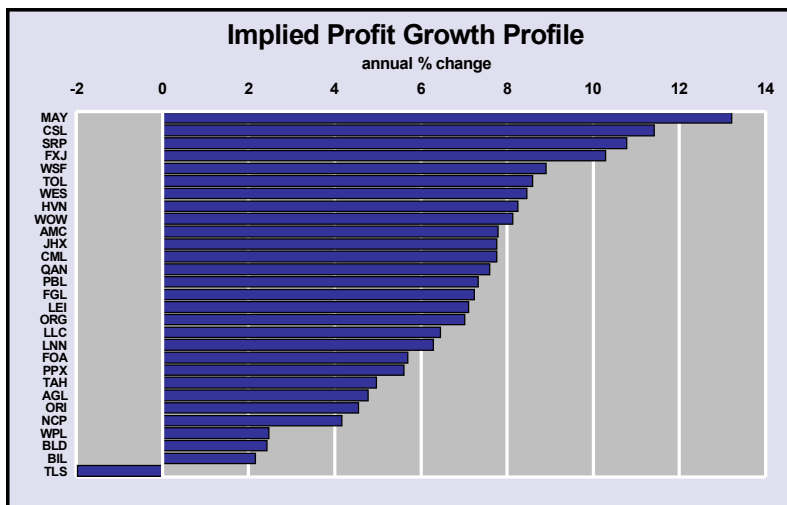
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confirm what the market had been expecting. For that reason, its subsequent share price performance might not be especially attractive.

The growth-return chart does not take away the need for further research or

judgements about company management. It does, however, help to identify the extent to which expectations have already been embedded in share prices so that investors have a fuller knowledge of what they might be buying when they begin to assess potential share market investments.

*“Among the challenges for investors, as always, is to recognise divergences between the market’s current view and the capacity of company managers to deliver something different.”*



Importantly, investors are able to judge relative positioning among selected stocks. By ranking companies according to their growth and return characteristics in this way, they have access to another important guidepost in their investment decision-making.

## THE US ECONOMY: HOW STRONG?

**There is a more positive tone to the US economy but care should be taken to avoid overstatement.**

Some recent reports have portrayed the US economy as booming. Other descriptions have been less dramatic but have conveyed the same sense of an unambiguous turn in conditions.

As usual, there is a risk of getting caught up in the sheer volume of statistics. *thebigpicture* has tried to avoid this risk by returning periodically to the same four statistical guideposts to check the vital signs for the US economy

The four performance guideposts are ones which are used by the National Bureau of Economic Research (NBER) in deciding whether the US economy is heading into recession or expanding. The NBER is the organization charged with defining US economic cycles and the timing of recessions and expansions.

Employment is the first indicator. It has stabilized in recent months. Data for November showed no change in the size of non-farm payrolls from the previous month. Employment in the three months

to be fully using its existing workforce before adding more people to the payroll. Nonetheless, the employment indicator is an important gauge for the well being of people generally, their income prospects and confidence about the future. It is, at best, in a neutral zone.



Industrial production, the second indicator, rose by 0.2% in October to be 0.6% higher than a year ago. Four consecutive months of expansion have followed a period of 12 months during which monthly output grew on only three occasions. To that extent, improvement is evident and the momentum of change is positive.

Other indicators, such as the Institute for Supply Management monthly survey, are suggesting that the manufacturing expansion is continuing in the short term. However, the change is better described as recovery from the relatively intense weakness of earlier in the year rather than a robust acceleration in growth.

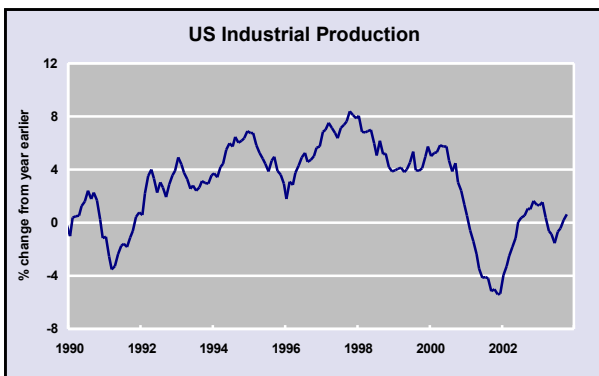
The availability of personal income is a critical ingredient in the spending decisions of consumers. Disposable personal income, the third of the indicators, was 4.8%

higher in October 2003 than it had been a year earlier. This growth rate falls within the range of income expansion rates that had prevailed though most of the 1990s.

Continued income growth is helping to underpin some recovery in personal consumption growth. Personal consumption growth had accelerated to 5.4% over the year to October having been as low as

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*“A more rapid expansion, with the help of supportive Federal Reserve policy, might still be ahead but the existing evidence is insufficient to draw that conclusion.”*



to November 2003 was 0.2% higher than in the three months to August 2003. However, non-farm payrolls are still 0.2% smaller than they were a year ago and 1.7% lower than their peak in December 2000.

Employment will tend to be slower than other indicators to show improvement because business usually wants to be assured of better conditions and will want to