

# thebigpicture

guideposts for the private investor

Week Commencing 17 February 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.

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).

Newsletter subscribers may also subscribe to *thebigpicture* premium content which includes tailored analysis and seminars on economics, business and policy issues affecting investment decision-making. Further information can be seen at [www.thebigpicture.com.au](http://www.thebigpicture.com.au).

◆◆◆◆◆◆◆◆◆◆

**thebigpicture Economics**  
ABN 71 040 787 936  
PO Box 333, Malvern  
Vic 3144

## HIGH GROWTH STOCKS: THE RISK REVEALED

The beginning of the half-year reporting season has immediately highlighted the riskiness attaching to companies whose share prices imply high growth rates.

Wesfarmers, News Corporation and Aristocrat Leisure have all suffered to varying degrees through some reappraisal of their growth prospects. Foster's Group and commonwealth Bank also had some concerns expressed about their growth but, with lower expectations than the others, there was less adverse price impact arising from comments about how difficult the trading environment appeared to be.

As *thebigpicture* has previously outlined, the share price of a company can be divided into two components:

- the value of the existing profit stream (capitalised at a rate consistent with an investor's required rate of return); and
- the implied value of the growth (i.e. the difference between the first component and the market capitalisation).

### Equity Investment Guideposts

Required rate of return

Achievable growth

Sound governance

Investors would normally expect high growth to equate with superior share price performance. Whether it does depends on how much of the growth is already incorporated into the prevailing share price. The advantage of looking at the value of the implied growth in this way is that it highlights the additional risk which is being incurred and allows judgements about how achievable the growth (and a correspondingly higher share price) might be.

Following the last round of profit announcements, *thebigpicture* calculated that for 60 of the largest listed companies, the average rate of growth over 20 years implied by their prevailing share prices (when the All Ordinaries was 2900) was 6.7%.

This growth rate needs to be viewed against the perspective of:

- long term profit growth (i.e. since 1960) in Australia being about 10% a year; and,
- current macroeconomic expectations (ie sustainable GDP growth of 3½% and inflation of 2½%) implying that prospective profit growth will be lower than historical rates and more likely to be in the vicinity of 5½-6% pa.

While a lower market had made company growth prospects more achievable, they were still at the upper end (or exceeded) what appeared to be consistent with Australia's economic performance.

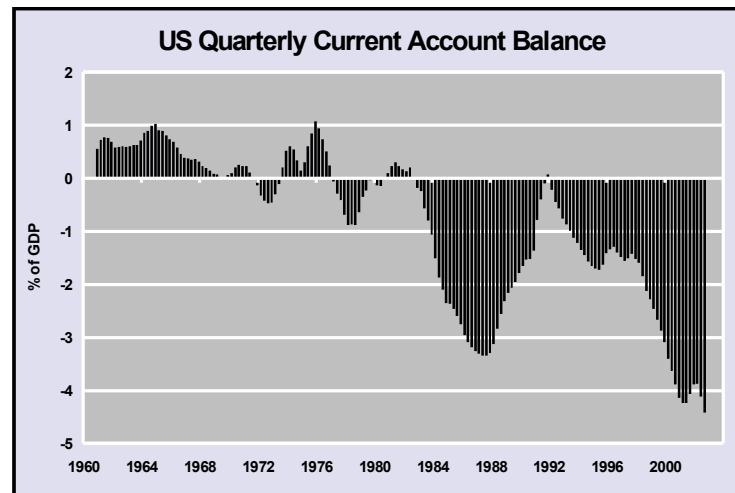
In the case of Wesfarmers, however, the expected growth averaged 11.7% and it was 12.7% for Aristocrat. The News Corporation had factored in a 13.5% growth rate.

Any company which expects to perform better than the Australian economy consistently over two decades will have to be doing something special. Certainly, Wesfarmers had acquired a reputation for superior choice of investments and unusual skill in integrating acquisitions into its existing organisation. Aristocrat's global orientation would have

*"An overnight reappraisal of a company's growth prospects can strip 10% from its value for each percentage point reduction in long term growth expectations."*

(Continued on page 3)

## THE WEEKLY CHART SPOT



Source: US Department of Commerce, Bureau of Economic Analysis.

*“While not yet evident, the current account balance is edging its way toward again becoming an important economic policy issue for the US.”*

The US balance of payments deficit has been around 4% of GDP since the second half of 2000. Throughout the 1990s there was a progressive deterioration in the balance on current account.

Whether a payments deficit represents a cause for concern depends on how easily it can be funded. To the extent that it cannot be funded through importation of capital, there will be a tendency for higher inflation and a depreciated exchange rate to force an adjustment which would eventually bring about a sustainable balance.

The US is in the relatively happy position of being able to run large deficits because the world wants the US dollars being exported for international commerce and as a store of value. It is not similarly enchanted with Australian dollars or, for that matter, any alternative currency.

During the 1990s, this was particularly evident with capital flows into US financial markets and direct investments being drawn by a period of unprecedented economic expansion.

Now, as the attractiveness of US markets is less evident, the funding pressure might become slightly more acute. The US currency remains the only meaningful alternative for international commerce (although the Europeans have reduced its need and aspire to supplant its role further through wider adoption of the euro as a medium of exchange) so that there is no crisis looming of the sort which might confront other countries if there had been a similar change in their circumstances.

Nonetheless, at the margin, there has been reduced demand for US financial and real assets leading to some weakening of the US dollar. While not yet evident, the current account balance is edging its way toward again becoming an important economic policy issue for the US.

## WHAT'S THE POINT OF ANALYSTS? CONT'D

*(Continued from page 4)*

skills to be able to take on the company view fearlessly and to expose its weaknesses. Notwithstanding the supposed break between research and corporate finance, for such analysts, it might be a challenge to find a willing employer.

Investors can, however, count on one thing. A company which has consistently applied good corporate governance by

having strong economic returns as the principal objective is not going to change rapidly. If a company has been able to achieve a return on its funds in excess of its cost of capital and it sees this as an important ongoing goal, small variations in profitability of the sort which analysts might uncover are unlikely to affect the decision to invest.

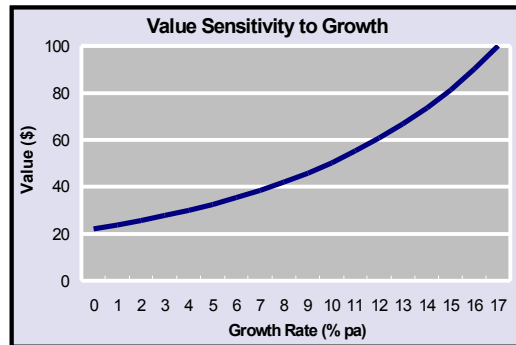
## HIGH GROWTH STOCKS: THE RISK REVEALED CONT'D

(Continued from page 1)

allowed it access to quickly growing markets so that its profit outcomes were not tied to the performance of the Australian economy. And, for News Corporation, the ambitions of the Chairman for a global media company might well be consistent with a high rate of growth.

In contrast, Foster's had an anticipated growth rate of 7.5% and with a share price which had already pushed lower would have required a 6.9% rate of growth immediately prior to the release of its profit report. Despite concerns, therefore, about apparent weakness in the wine market and long term constraints on the rate of beer consumption growth, the expected growth profile accorded much more with reasonable expectations than in the other cases.

The chart, based on a simple valuation model, helps illustrate the risks attached to growth. As a rule of thumb, at higher rates of growth, a single percentage point increment in the anticipated growth rate adds an additional 10% to valuations. Hence the emphasis by companies on seeking out those opportunities which will deliver the higher growth outcomes.



The leverage also works on the downside. An overnight reappraisal of a company's growth prospects can strip 10% from its value for each percentage point reduction in long term growth expectations. In the case of Aristocrat or News Corporation, for example, bringing their growth prospects

back to the average could strip off up to 50% of their value.

If the growth rate required to validate the existing share price is relatively high, investors should exercise caution. That is not to say that they should eschew such companies entirely.

They should, however, divorce themselves from market sentiment by seeking to reassure themselves that:

- the higher growth prospects are achievable within the confines of likely macroeconomic growth rates;
- the prospects for the particular industry are strategically sound; and,
- the company has the personnel to manage the growth.

Unless an investor can tick off on all these factors, longer-term investment returns might be improved by opting for lower growth investments which are priced accordingly.

*"...longer-term investment returns might be improved by opting for lower growth investments which are priced against a more realistic set of assumptions."*

## When Will The Shooting Start?

**The sooner shooting starts in the Middle East, the quicker markets will lose their excuse for inaction and governments will be able to avert a looming policy paralysis.**

According to the latest report to the United Nations Security Council, the Iraqi government is making enough concessions to permit a more extensive investigation of their weaponry potential.

The ploy of stringing out the concessions in this way is dividing those western countries which might normally be US allies against Iraq and creating tensions between the west and other Arab nations, forestalling US military action.

The delay is having a twofold effect on markets. It continues to provide an excuse

for inactivity. However, there are some fundamental reasons for slow rates of economic growth and market weakness. **the big picture** does not subscribe to the view that the potential of war is at the heart of the malaise.

The second effect is the opportunity cost. It is generally difficult for governments to have many serious issues on their agenda at once. For example, in Australia, national security matters have apparently delayed consideration of several policy issues including tourism, telecommunications, education and tax reform. This policy paralysis comes at a cost. Perhaps the only silver lining is that, in accommodating the US so conspicuously, the possibility of a free trade agreement between Australia and the USA might be speeded up.

## WHAT'S THE POINT OF ANALYSTS?

**Is there any point in looking to analysts any longer for earnings forecasts? Recent experience is indicating that, when it counts, they offer little value for investors.**

For investors seeking to manage their own equity market positions, the returns-growth-governance guideposts should remain the focus of their attention. It is increasingly unlikely for analysts to uncover information which is not encapsulated in **thebigpicture** three-step approach to equity investments.

The roles of analysts are changing greatly. At one point, they were highly valued for the insights into company performance which they could provide. Those able to become sufficiently close to companies could occasionally uncover information, either directly or by putting together parts of the mosaic which, once known, could affect the value of a company. Their clients could achieve a financial advantage when they were told.

To the extent he could do this repeatedly, an analyst's reputation, market power and bank balance would grow.

Nowadays, there are legal risks associated with finding such an edge. A company dare not confide information which is generally not available and, to the extent that an analyst is able to discover something new, there is a legal minefield associated with how the information is used and to whose advantage it might be deployed. There are obligations on a company to ensure that price sensitive information is quickly diffused and made generally available once executives become aware that something is to be published.

The redundancy of analysts is taken another step with the practice of companies offering earnings guidance to the market becoming more commonplace and, once given, there being an obligation to ensure that the guidance remains up to date.

Earnings estimates now mirror the guidance which companies offer the market. To the extent that companies are being misleading or inaccurate, analysts' reports will reflect this.

Moreover, the community of analysts has been unable to identify any of the most egregious examples of corporate failure. Individual analysts might have had an occasional contrary view but, as a group, they have failed to provide the sort of early warning which would make them valuable to the market in its decision-making.

There is also considerable evidence that analysts' forecasts are too closely tied to an extrapolation of recent performance. For example, no matter what the overall economic circumstances, analysts are prone to initially forecast a standard gain in earnings which, very frequently, is around 10%. Subsequently, in a down cycle, they are forced to drag the forecast back, usually after they have been told to do so by the company or after a result when it is too late to have added much investment value.

Very frequently, profits are highly leveraged to economic conditions and may fall with even a deceleration in growth. Analysts are rarely so brave as to extrapolate such a potential deterioration in economic conditions into company profits.

Today, to be useful, analysts need to second guess companies. Usually, this would require them to integrate more effectively a macroeconomic view into their company profit forecasts. If they did, they could say that their view of the business environment was different to that of the company and that it is likely that the particular company would be changing its guidance. Alternatively, and more mundanely, their view could validate that of the company.

They might also be useful when their intelligence on overall business conditions was sufficiently good that they could foresee, for example, an Aristocrat situation developing. Foreseeing it and aggressively marketing a view to that effect are, however, two very different things.

This means that the successful analysts will no longer be the ones which have the closest relationships with the companies they follow. Rather, they will be the ones with sufficient confidence in their own

*"...the successful analysts will no longer be the ones which have the closest relationships with the companies they follow. Rather, they will be the ones with sufficient confidence in their own skills to be able to take on the company view fearlessly and to expose its weaknesses."*

*(Continued on page 2)*