

# thebigpicture

guideposts for the private investor

Week Commencing 28 April 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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## *thebigpicture* INVESTMENT DECISION MODEL

Now that the Iraqi war is all but over, investors might be tempted back to equity markets. To avoid the risks of irrational exuberance they will need some valuation guideposts.

*thebigpicture* approach recognizes that every share price implies a growth rate and a target rate of return.

The target rate of return for a private investor should be about 11%. This is based on a 10-year government yield (the no risk investment alternative) of 5.4% and a 6% factor to take account of equity market risk. After tax for a superannuation fund, this would approximate 10.5% or, for an individual at the top personal tax rate, 9%.

The target return will determine how much an investor should pay for a company. For example, if a company was expected to deliver a \$1 million profit consistently, an individual requiring a 10% rate of return would be prepared to pay \$10 million for the business. The same principle should apply to the purchase of a single share as applies to the purchase of the entire company.

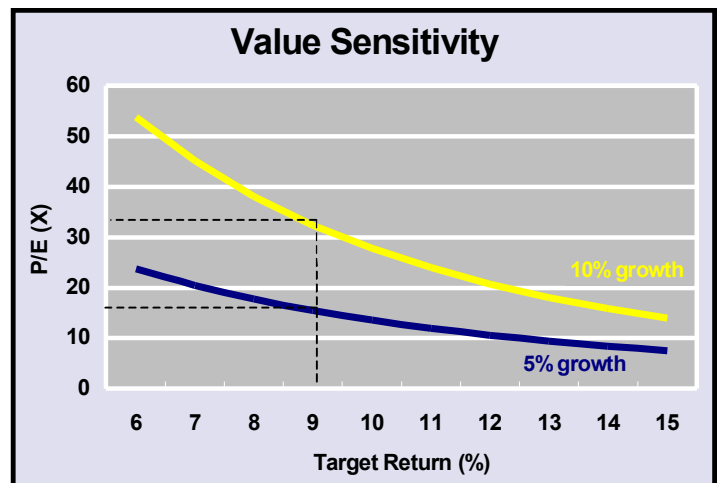
The chart based on profit levels in the Australian market illustrates the decision making approach an investor should adopt.

Each line shows the price/earnings ratio which matches any given target return. It shows how an investor with a low target return, for example, is prepared to pay a relatively high price. Each line is also defined by a given rate of growth. The higher the rate of growth, the higher the line moves up (and, therefore, the more the investor is prepared to pay).

An example. An investor has a target return of 9%. She believes that a company in which she is a potential investor can achieve a long-term rate of growth of 5% pa. The lower of the two lines indicates how much she is prepared to pay. In this case, the chart says that a p/e of 15.5 could be reasonable. So, if base sustainable earnings were 20 cents a share, this investor would be prepared to pay up to \$3.10 a share.

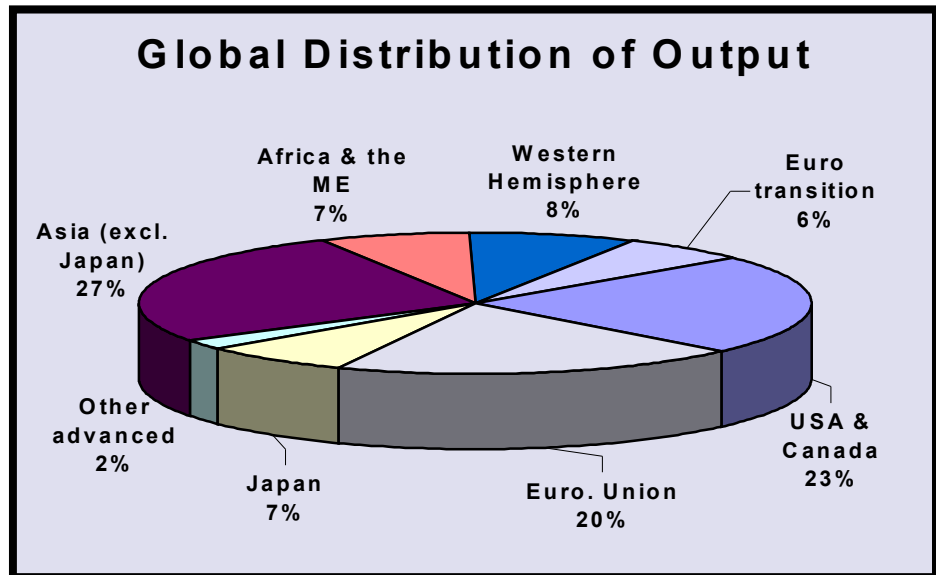
Another investor, with the same return target, believes that the growth potential for this company is actually being underestimated. Based on his research, he believes a 10% growth rate is sustainable because of lower costs, new products and overseas expansion. His decision making curve is the higher of the two. It says that he would be prepared to pay up to \$6.50 a share for the company.

The example shows that there can be large differences in value perceptions. The differences, however, boil down to the anticipated growth of the company. Irrational exuberance



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## THE WEEKLY CHART SPOT



Source: International Monetary Fund

The USA and Canada account for 23.1% of global GDP according to data compiled by the International Monetary Fund. Despite the emergence of the European Union, this north American grouping remains the largest regional market with any degree of political and economic cohesion.

The 15 member European Union accounts for 19.7% of global GDP. The additional ten members which are being drawn from elsewhere in Europe could add up to an additional 2.3 percentage points to the size of the grouping. In this sense, Europe could emerge on a par with the USA and Canada but there will be a significant disparity between this European group and north America (excluding Mexico) in terms of unified political institutions, language and stage of economic development.

The underlying dynamics of growth between the two will also differ. The European entity will be suffering a declining population base whereas population growth in the USA is expected to exceed 0.7% pa over the coming several decades according to projections by the UN's Population Division. Moreover, one of the key regions of the European Union – Germany – is suffering structural adjustment difficulties which seem likely to curtail its growth until action is taken to improve economic flexibility through more market oriented adjustment policies than Germany has been used to in the past.

Looked at as a regional entity, Asia including the developing economies (such as China and India) as well as the more advanced states (such as Korea, Taiwan and Singapore) is the largest discernible economic grouping. This group also retains its status as having the strongest growth prospects. This reflects their position in the development cycle, the benefits flowing from more vibrant political and economic institutions as well as underlying population growth.

Nonetheless, Asia is a series of fragmented national markets more so than any of the other regional groupings. That said, China and India account for 17.5 percentage points or two-thirds of the region's output.

While Japan remains a sizeable national economy in its own right, its own structural adjustment needs will prevent it from having the sort of influence on global regional growth performance in the foreseeable future that it has had in the past.

From an Australian business standpoint, exposure to the USA and Asia are the preferred options. Unless there is something special which a company can add in the European context, there is little compelling reason to seek out exposure in that part of the world either because of its size or underlying growth characteristics.

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## *thebigpicture* INVESTMENT DECISION MODEL CONT'D

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ance is actually an unrealistic belief in a company's growth potential.

A market p/e of 30 times current earnings implies a growth rate around 10% a year for an individual investor with a reasonable target return from his investments. Is such a growth rate reasonable? Using the available macro information can pro-

vide one sanity test. With developed market economies growing at around 3% and inflation running at a similar rate, assuming profit growth in excess of 6-7% will require special conditions. Investing at prices which imply 10% growth indefinitely might well be irrational unless an investor can identify explicitly how a company can outperform consistently and sustainably the economies in which it has to operate.

## THE ASIAN GROWTH OUTLOOK CONT'D

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Despite improved prospects, capital flows into the region have not resumed generally. However, foreign direct investment in China has risen strongly and reached US\$53 billion in 2002, according to the World Bank, some 20% ahead of the flow in 1997. Elsewhere among the main south east Asian economies foreign direct investment flows of US\$8 billion in 2002 were less than half the US\$21 billion attracted in 1997.

The picture is not entirely clear but there could be some rationing of capital and China's accession to World Trade Organization membership might well be a new factor in its relative appeal as a capital destination.

Most recently, the SARS outbreak has added to the woes of the region which is seen as the source of the disease and the area of greatest danger. Clearly, the services sectors and businesses where face-to-face contact is necessary are being detrimentally affected. So, too, will investment flows as the meetings which are necessary to consummate transactions are postponed.

The World Bank is currently estimating that SARS is likely to subtract about 0.3 percentage points from regional growth forecasts

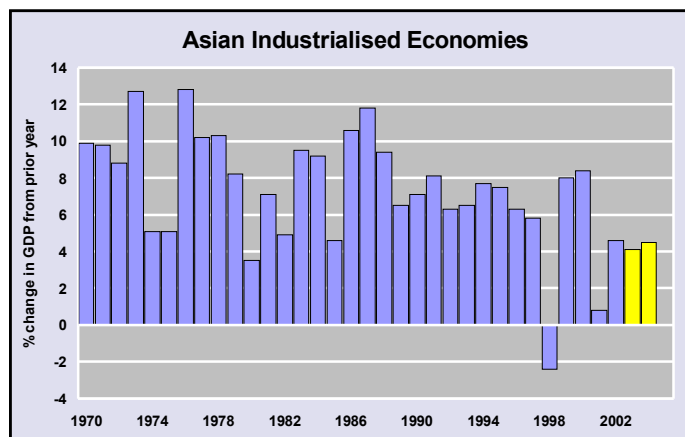
but that is without any clear understanding of the full extent of the impact of the disease.

One of the strengths of the region is its reduced reliance on the developed economies to drive its growth. Increasingly China is emerging as a hub around which the region is aligning itself.

Exports to China are in response to its own

strong domestic market as well as the growth of its export industries. Exports to China from among the east Asian countries accounted for 16% of their total exports in 2002 compared with 8% in 1990 making China a more important destination than Japan for the nations in the region and only slightly less important than the USA. With exports to other east Asian economies accounting for 21% of the region's exports, nearly 40% of exports are now intra-regional compared with 25% in 1990. As the World Bank has described the relationship: "China and other East Asian countries are becoming increasingly enmeshed with each other, through production and intra-industry trade networks which yield classical gains from specialization and trade for the participants."

This pattern of development implies a stronger and more sustainable economic



base for the region. However, from a business perspective it also implies that the region will be less reliant on outside participants than it was at the beginning of the 1990s. Companies seeking to do business within the region will have had to spend time building links within the network of emerging relationships if they are to successfully penetrate the business opportunities.

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## THE ASIAN GROWTH OUTLOOK

The Asian region is set to become an increasingly important source of global growth. The latest forecasts show that the Asian region economies have largely recovered from the shocks of the late 1990s and have emerged onto what appears to be a more sustainable, even if slightly slower, growth path.

The focus on Asia will depend in part on what is happening within the region but will also arise in an important relative sense: not only will its population be growing relatively quickly and becoming more affluent, Europe's population will actually be declining.

Arguably much of the promise which had been anticipated in the 1990s from Asia is still to be realized. However, there are some potholes in the path immediately ahead.

Most of the forecasters which review conditions in the region regularly are suggesting

that Asia has resumed a relatively strong growth track in the context of the world economy. The International Monetary Fund and the World Bank have both published shorter term forecasts for the Asian region in the past few days. The table summarises the current view of regional economic activity.

However, it is not likely that the same powerful but ultimately unsustainable forces which delivered growth in the 1990s will be duplicated in the foreseeable future. The Asian bubble burst when it dawned on investors that the anticipated growth upon which assets had been valued could not be sustained. Either structural changes had to occur to permit

relatively strong growth rates to persist or valuations had to be modified to reflect the real life constraints on what could be achieved. In fact, some of both were needed and the changes are still under-way.

Institutional change aimed at improving the business investment climate has loosened some of the constraints on growth and has helped raise the region's sustainable growth rate. Continued institutional change, including the development of more robust financial systems, is needed to ensure further improvement in the business investment climate to support growth.

A second pothole which could have upset the relatively sanguine outlook implied by

Asian Growth Forecasts							
% change from year earlier	Average		IMF			World Bank	
	1985-94	1995-01	2002	2003	2004	2003	2004
Developing Asia	7.7	6.6	6.5	6.3	6.5	6.0	6.3
China	10.2	8.4	8.0	7.5	7.5	7.2	7.2
India	5.4	6.0	4.9	5.1	5.9	na	na
Other Developing Asia	5.8	3.6	4.4	4.4	4.7	na	na
Japan	3.4	1.4	0.3	0.8	1.0	0.6	1.6
Korea	8.2	6.1	6.1	5.0	5.3	4.9	5.5
Taiwan	8.0	5.3	3.5	3.2	3.7	3.0	4.0
Hong Kong	6.2	3.6	2.3	3.0	3.3	2.0	4.0
Singapore	7.8	5.9	2.2	3.0	3.5	1.7	4.9

regional forecasts has been high oil prices which have threatened growth prospects. To the extent that these were driven by the war over Iraq and are likely to subside, this will diminish in importance.

The availability of foreign capital will be a constraint. To some extent, capital availability will depend on conditions in the advanced economies and the willingness of multinational companies to invest.

A vibrant Japanese economy was an important contributor of capital to support development in the 1980s and early 1990s. That source of support is no longer so evident.

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