

thebigpicture

guideposts for the private investor

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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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THE ANGELS KEEP FALLING

One of the most perplexing challenges for an Australian equity investor is dealing with the propensity for self inflicted wounds among Australian companies. The frequent conversion of market icons to fallen angels damages the standing of the Australian equity market and complicates investment decision making.

Pacific Dunlop (aka Ansell), Southcorp, AMP and Elders IXL (aka Foster's) are just a very few examples of prominent Australian companies whose managements have overestimated their own potential and put the company at risk. Shareholders suffered directly from a value decline and indirectly as companies missed out on opportunities as they regrouped after often near-death experiences.

The tribulations of National Australia Bank in the past few weeks over inadequate controls on risk (added to prior costly misadventures in the USA through its Homeside subsidiary) have again highlighted the exposure of the Australian investor to the fallen angel.

True, the National Australia Bank share price was not greatly affected by the forced resignation of its chief executive officer in the past week. Indeed, the share price rose on the news of his replacement.

The great unknown for Australian investors, however, is how much wealthier they would all be if Australian companies were safer. If one by one they did not have to spend several years rejuvenating themselves after a strategic misadventure and forego several years of growth in doing so, they would be worth more today. Returns from the Australian market would have been higher and its ability to attract offshore funds correspondingly greater.

It is tempting to blame management failure. However, there are environmental factors at work. A frequently recurring theme is strategic overstretch as companies make one acquisition too many often in an overseas country where their management skills have been largely untested.

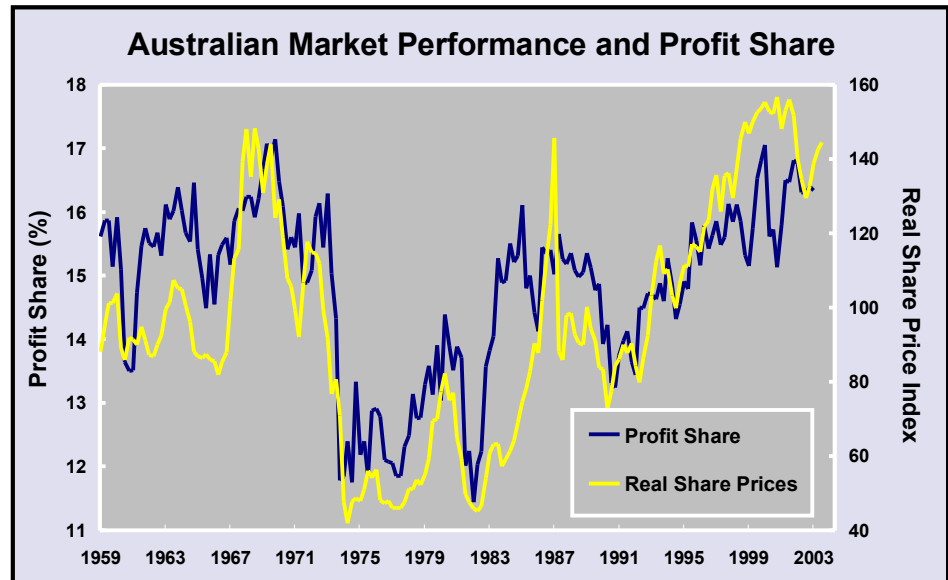
This has elements of a national problem. The small Australian market partly dictates behaviour. Contrast Australian managers with those in the USA. A US chief executive can come to the job without having traveled overseas. US managers can make their fortunes and reputations in their domestic market. This would be hard in Australia even

(Continued on page 3)

The Australian Fallen Angels

Amcor	Computershare	News Corporation
AMP	CSL	Orica
Ansell/Pacific Dunlop	CSR	Publishing & Broad'g**
ANZ Banking Group	Fosters Group	QBE Insurance Group
AXA Asia Pacific	Goodman Fielder	Rio Tinto
BHP Billiton	James Hardie	Santos
Billabong	John Fairfax	Seven Network
Boral	Lend Lease	Southcorp
Brambles Industries	Lion Nathan*	Telstra
Burns Philp	Mayne Group	Western Mining
Coal & Allied	MIM Holdings	Westpac
Coca-Cola Amatil	National Australia Bank	Woolworths
Coles Myer	Newcrest Mining	
* ex Bond Brewing		
** ex Bond Media and Crown Casino		

THE WEEKLY CHART SPOT



Source: Australian Bureau of Statistics and Standard & Poors

“From this position, history implies little scope for profit to grow faster than the rate at which the overall economy is growing.”

Private corporate gross operating surplus grew 3.5% over the year to the September quarter of 2003 according to statistics released by the ABS at the beginning of December. The gross operating surplus approximates after tax earnings before interest and depreciation and is indicative of the overall profitability of corporate Australia.

The 6.6% annual rate of growth in the September quarter was lower than the 10% long-term rate of growth in operating surplus but consistent with the slower rate of domestic price increase which is now a feature of the Australian economy.

The corporate profit share, as shown in the chart, is near the upper end of a range which has prevailed for the past 45 years. When profitability has been so strong in the past, countervailing forces have constrained its growth. Chief among these have been demands for higher wages.

From this position, history implies little scope for profit to grow faster than the rate at which the overall economy is growing, probably around 6% pa. History also implies stock market values are constrained by what the economy can deliver. Sharp stock market movements, such as occurred through the 1990s, have usually been associated with similarly sharp changes in the direction of the profit share.

Stock market indicators are not directly comparable to the make-up of the national accounts measures. However, recent stock price movements are implying that corporate profitability will now push beyond record levels.

US GOVERNMENT DEFICITS: GOING UP CONT'D

(Continued from page 4)

of line with the 7.3% annual rate of increase between 1940 and 2003. To that extent, it could be accommodated.

The chart on page 4 showing the historical accumulation of government debt levels does help to emphasise, however, that the renewed resort to debt funding is a change in the economic environment that prevailed in the past seven years.

Low interest rates became a feature of the 1990s not just because of low inflation. Stalled growth in government funding needs also helped. As growth in the fund-

ing requirement is resumed, higher interest rates are also likely since there is little or no scope for lower inflation to act as a counterweight.

For any given level of corporate profitability, higher long term interest rates will usually mean lower equity values. If interest rates were not changing, business profitability would be reflected in higher market values. One can expect higher interest rates to offset some of the impact of the higher profits. Consequently, the impact of the deficit change is likely to be more subtle than calamitous.

THE ANGELS KEEP FALLING CONT'D

(Continued from page 1)

among the smallest of public companies.

In October 2002, an entire issue of *the bigpicture* was devoted to discussing the fallen angel phenomenon. At that time, of the top 100 listed companies, there were 15 property or investment groups and 16 companies whose primary stock exchange listing was overseas.

Of the remaining 69 stocks of potential interest to Australian investors as locally based businesses, 39 had been forced to make a strategic detour or had been substantially downgraded by the market after having its financial potential re-estimated by markets.

The table on page one lists those companies. Even this is optimistic. The plight of many fallen angels – remember Pasmenco and HIH - has been so severe that they have disappeared from the top 100 rankings or, in some cases, any other rankings too. Others like David Jones have not recovered enough to make the size cut-off.

That left just 30. Of those, 17 were newcomers which had arrived on the market relatively recently after being privatized (eg Commonwealth Bank or Qantas) or spun off from larger public companies which had gone through their own strategic reappraisals (e.g. BHP Steel or Paperlinx).

There were only another 13 companies which had established a favourable reputation through their own operational and strategic decision making and had not traversed the full Australian corporate life cycle.... as yet. Flight Centre, Toll Holdings and Wesfarmers were examples of companies in this category.

But not all of these 30 companies are still with us. Aristocrat Leisure, one of the latter 13, has fallen from grace spectacularly to help sustain the national reputation. BRL Hardy has been taken from us by an offshore corporate buyer as has Bank of WA.

The value of Cochlear has been reappraised perhaps less so for its management shortcomings than other stocks. In its case, the fault lay with vastly over inflated expectations about performance and misplaced optimism about the riskiness of the industry in which it was operating.

All said, that leaves an ominous record for investors wanting to buy and sleep comfortably at night.

Is there any lesson here for investors? History says that the risk of strategic overstretch is an inherent feature of the Australian market. Three guideposts might be worthwhile.

- Assume that all companies will eventually succumb to the self inflicted crisis. This might appear a harsh judgement but it is valid statistically.
- Remain diversified so you are not disproportionately dependent on the one (or more) company going bad this year.
- Retain a high degree of scepticism: be ready to sell a well performing company.

A common factor among companies suffering from overstretch is that they become overly preoccupied with growth, market share, overseas exposure, strategic positioning and similar sentiments which reflect executive ego more than concern about building measurable value.

Unfortunately, the Australian market is a small community and there is typically considerable pressure on Australian executives to be seen to be active. Those that are not acquiring or divesting businesses are frequently identified as not up to the task. Straightforward operational success is little appreciated.

With so few companies and individuals upon which to focus attention, the daily media can become very personal and obtrusive. In few other countries would an executive's home renovation be an item of interest for the national press as it is so often in Australia.

Acquisitions have a role. When they happen, however, there should be conclusive evidence that they are capable of generating the necessary rates of return without there having to be too many assumptions about growth or synergies to justify the transaction.

Here is another suggested guidepost. No matter how well performed a company might have been in the past, as soon as one sees that it is departing from a disciplined investment approach, the company should be sold! History says that the risk of waiting is too great.

“The great unknown for Australian investors is how much wealthier they would all be if Australian companies were safer....History says that the risk of strategic overstretch is an inherent feature of the Australian market.”

US GOVERNMENT DEFICITS: GOING UP

The US government has foreshadowed that it will spend US\$520.7 billion more than it raises in revenue in the 2004 fiscal year. The \$757.2 billion adverse swing in its spending deficit from as recently as 2000 would be devastating for other economies but the US has a special position.

Although startling as an absolute number, the anticipated spending deficit for the year ending September 2004 is around the level which prevailed for much of the 1980s relative to the size of the US economy.

The 2004 deficit is likely to approximate 4.5% of US GDP according to the Office of Management and Budget (OMB) numbers released on 2 February.

Over the decade and a half between 1980 and 1995, the deficit ranged between 2.2% and 6.0% of GDP and averaged 3.8%. During the 1990s, however, strong and sustained economic growth drove revenues higher so quickly that what had once been regarded as a chronic imbalance was eliminated and a surplus equivalent to 2.4% of GDP was posted in 2000. Not since 1948 had this outcome been bettered.

Higher business productivity supported growth. At the same time, reduced defence spending following the conclusion of the cold war seemed to mean less need for standing armies. Surplus financing seemed sustainable indefinitely.

However, even as predictions of endless surpluses were being made, the economy had begun to slow. With government revenues growing less strongly and with newly emerging foreign policy considerations pushing defence spending higher, the fiscal outlook again changed swiftly.

With a one percentage point leap in the size of the deficit between 2003 and 2004, the notion of continuing budget surpluses has been consigned to the past. The prospect now is for continuing deficits averaging some 2.5 % of GDP until 2009, according to the OMB.

Whether a US government deficit is 'good' or 'bad' depends very much on how easily it can be financed. That, in turn, depends on the appetite of the rest of the world for US dollars or US dollar investments.

The USA is the only country able to borrow from the rest of the world in its domestic currency. It is able to force others to bear the risk of a fall in the value of the dollar.

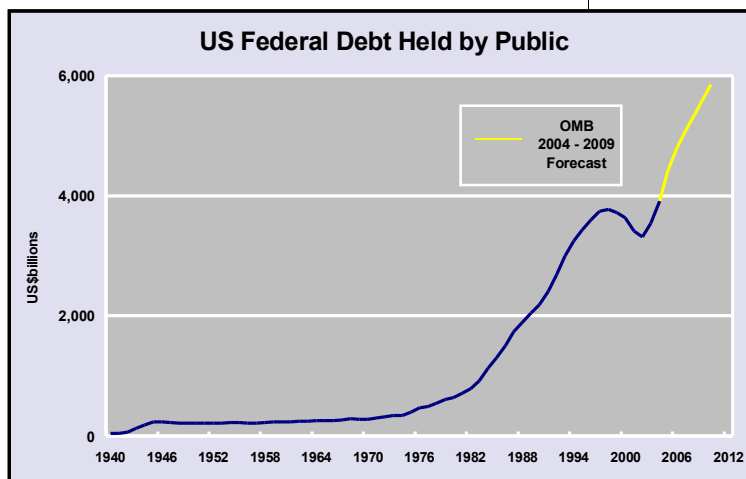
This is something the rest of the world accepts. It needs enough US dollars to facilitate world trade and act as a store of value. There is no competing currency. The euro has not established itself and the yen, which had once been seen as a potential rival, can no longer aspire seriously to that role.

But how much is the right amount? The US has proven that it can sustain budget deficits for lengthy periods. Since 1930, it has run an annual surplus on only 13 occasions, four of which were between 1998 and 2001.

Continuing deficits have been sustainable because investors have been prepared to fund them. At the end of the 2003 fiscal year, there was US\$3,913.6 billion of federal debt in the hands of the public. This is expected to rise by 12.6% by the end of 2004 and continue to rise at an average annual rate of 5.1% until the end of 2009.

While the jump in government debt holdings in 2004 is relatively sharp, the forecast growth in debt is not significantly out

“Most likely, the upside in business profitability as the US economy expands will not be reflected as fully in market values as higher interest rates offset some of the impact of higher profits.”



(Continued on page 2)

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