thebigpicture

guideposts for the private investor

Week Commencing 15 November 2004

New Brooms and Fallen Angels

A ferocious attack by the CEO of National Australia Bank on the bank's previous management has highlighted two important features of the Australian equity market: the paucity of worthwhile financial analysis to help investors when it is most needed and how unreliable the banks are as investments despite their 1990s re-rating.

In presenting the bank's 2003/04 results last Wednesday, John Stewart, the National Australia Bank chief executive, was scathing in his criticism of his predecessors. Not only did they allow their more well-publicised failures, such as the foreign exchange dealing debacle, but there was a more deep-seated corporate malaise.

Cultural and strategic failings were eroding revenues, artificially boosting short term returns to help reach bonus targets and causing a longer term margin collapse, according to the new management team.

Overall, Stewart painted a picture of a business heading toward catastrophic failure. Significantly, this was nothing new. The current predicament reflected years of neglect.

On the positive side, the bank continued to have a very strong franchise among potential clients in Australia which would save it from this fate, according to Stewart.

"….for much of the last ten years …. the National Australia Bank was being lauded as the one bank which had kept its head while others were wasting their resources …."

The 'New Broom'

It would not be unusual for a new CEO to paint as bleak a picture as possible about his predecessor's role so as to maximise credit for himself when improvements begin. The 'new broom' phenomenon is well known and has been discussed in ***thebigpicture*** before.

In its minor forms, it is a natural human tendency. At its most blatant, it is a ploy to mislead investors which, among other things, prompts questions about the role played by professional company analysts.

They supposedly make judgements all the time about corporate and managerial skill, performance and strategy and, one way or another, seek to be paid for their insights.

Broking analysts are one such group. One of their roles is to rigorously analyse management performance to help guide investors in their decision making. Where were they when one of Australia's highest profile companies was falling into such bad habits?

Certainly, broking analysts were not necessarily recommending that investors buy National Australia Bank stock. In many cases, they preferred ANZ or Westpac for banking exposure through the equity market and they would no doubt point to that in justification of their roles.

At the time of the results, for example, of the 16 analysts covered by one of the leading market consensus services, only two were recommending National Australia Bank as a 'strong buy'. Nine were suggesting that it was a 'hold'.

But even such a recommendation profile hardly reflects the scathing criticism of the CEO. Indeed, for much of the last ten years while the cultural characteristics now seen

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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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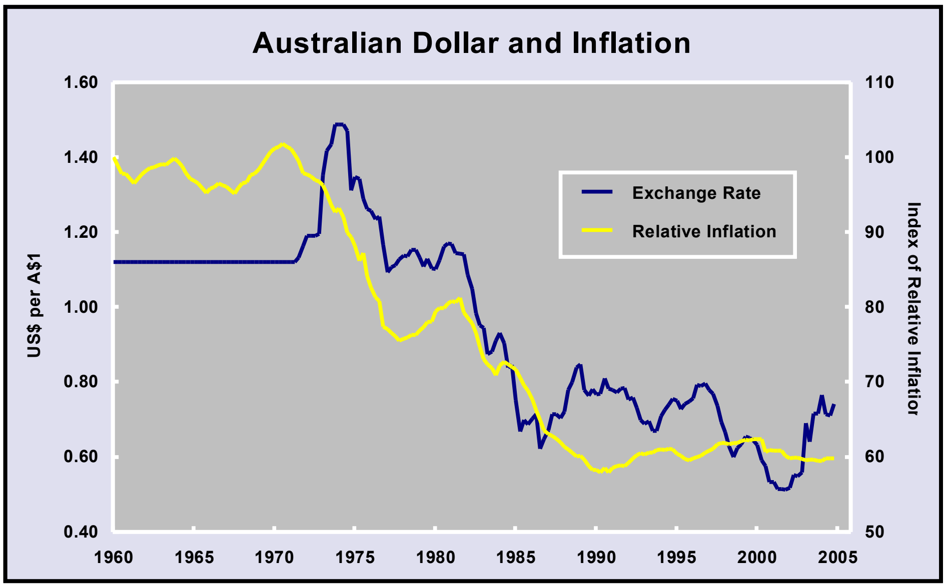
THE WEEKLY CHART SPOT



Source: Reserve Bank, US Federal Reserve Board & *thebigpicture* Economics

Few financial markets are more momentum-driven than foreign exchange. Whenever the Australian dollar is rising, forecasters think it is going to go higher. If it falls, the forecasters begin calling it lower. With it rising again, more people are guessing that it will break 80 US cents.

The broad direction of the exchange rate between the US and Australian dollars reflects differences in inflation performance between the two countries. When Australia's inflation rate was relatively high (and the yellow line was falling), indicating that Australia's global purchasing power was dropping, the exchange rate was in decline. More recently, with Australia's inflation matching more closely the outcomes in the USA, the currency trend has stabilized.

Market volatility, driven by short term factors and other global influences, continues but the fundamental anchor seems to be preventing any dramatic and continuing change in the exchange rate trend. ■

"There was sufficient difference in the pattern of market returns among the four banks that an investor could create a portfolio with better risk and return characteristics than individual stocks would have delivered."

BANKS: NOT 'WHICH' BUT 'HOW MUCH' CONT'D

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Since the principle companies in the sector also had large weightings in the equity market indexes, holding them as investments meant that returns approximated or were better than average market returns. This was a happy coincidence which benefited equity investors.

Within the overall economy, however, financial services accounts for just 12% of output compared with an ASX market loading of 37%.

Unless financial service providers continue to take a rising proportion of their clients' incomes, the same bank dominated portfolio will lead to weaker returns than could be obtained from a portfolio reflecting more closely the structure of the Australian economy.

We are already seeing signs that their claim on income is being constrained. Reduced pricing flexibility, diminished cost reduction potential and stable interest rates will make it harder to keep the share of income growing.

Another indicator of the banks' investment standing is the strong financial performance improvement among smaller companies.

thebigpicture recently reviewed the reported results for the year ended June 2004. They showed that the returns on funds employed among the mid-cap companies (defined as those with a market capitalisation between $100 million and $1 billion) had improved significantly over the past three years and were now in excess of their costs of capital.

In other words, the fundamental perform-

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New Brooms and Fallen Angels cont'd

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as so deleterious were becoming more deeply embedded, the National Australia Bank was being lauded as the one bank which had kept its head while others were wasting their resources on flights of fancy.

Now, even the virtue of strict risk management is being criticised because it made the bank too choosy and lost it business.

This puts investors in an awkward predicament because at least one of the groups they rely on for effective decision-making must have been wrong in their interpretation of what had been happening to the business.

Since they are not disagreeing with the Stewart diagnosis, broking analysts must be once again taking the current management at its word, just as they unquestioningly accepted the prior management missing the signs of its failure.

In observing this, keep in mind that this is not an obscure sector. The four major Australian banks account for 20% of the Australian market and a similar proportion of broking firm revenue. Consequently, their coverage is assigned to some of the highest profile analysts in the country. Any full service broker will have at least one analyst specialising in coverage of the banks exchanging views with similarly well-credentialed buy-side analysts. The emphasis on getting it right should be greater in this sector than in almost any other.

Unfortunately, this is the latest example of how analysts end up being mouthpieces for the companies they follow. They might quibble at the margin about relative performance but are highly reluctant to question managements aggressively or make strong calls about companies they follow as they seek to protect their continuing access to information.

Investors end up confronting a *de-facto* conspiracy between analysts and companies which acts against their best interests at critical times.

Another 'Fallen Angel'

The National Australia Bank experience also highlights another burden for Australian investors: having to deal with the fallen angel.

Australian companies are prone to performance fatigue and strategic overreach. Few companies are able to point to a lengthy track record without having to rejuvenate themselves. Among the banks, only the Commonwealth has avoided a catastrophic failure perhaps because it has only been free of government oversight for a dozen years.

Even then, one might be able to argue that the Commonwealth's foray into funds management qualifies as a setback which only its extraordinarily strong domestic franchise has forgiven.

ANZ, Westpac and now National Australia Bank have all gone far closer to the edge of the precipice. In each case, however, their own strong domestic franchises supported by government-protected monopoly powers have saved the day for them.

This record of repeated failure and rejuvenation means an investor cannot comfortably buy one of the banks for the long haul. He faces the ongoing risk of a falling angel eroding the value of the investment. History says it is just a matter of time.■

Banks: Not 'Which' But 'How Much' cont'd

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ance of a new group of companies across a broader part of the economy has improved greatly making reliance on a relatively narrow part of the economy for investment returns unsafe.

For an investor, a neutral exposure to the banks would be:

- a weighted combination of three of the four majors; and,
- a weighting in a portfolio consistent with the weighting of the banks in the Australian economy.

From that starting point, adjustments can be made. If one believed that the banks were going to outgrow the Australian economy, one could raise the weighting of the group relative to its importance in the Australian economy.

If one had a special insight into the performance of one of the banks, the weighting amongst the three banks could be changed. But an investor should be clear in his mind that such a move entails an explicit judgement about performance and assumption of additional risk.■

"….analysts end up being mouthpieces for the companies they follow. They …. are highly reluctant to question managements aggressively or make strong calls about companies they follow as they seek to protect ongoing relations to secure their continuing access."

Banks: Not 'Which' but 'How Much'

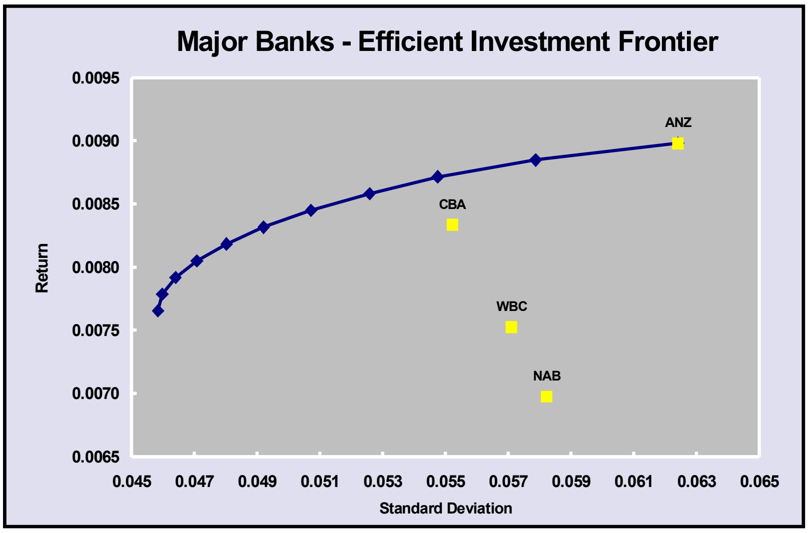
In making a bank investment, an investor needs to make a stock selection and an asset allocation decision. Two questions need answering: 'which bank?' and 'how much?'.

One lesson from the National Australia Bank experience is that neither bank management nor analysts are going to be especially helpful in the investment decision-making process.

Being able to switch deftly between banks as they progress through cycles of despair and rejuvenation is an ideal which few investors are likely to achieve. The ideal presupposes that financial analysts are more competent and management more forthcoming than experience is now telling us is reasonable to assume.

If banks do move through different performance cycles, a portfolio of holdings might be a preferable way to manage risk and deliver better returns.

Over the past fifteen years since the Commonwealth Bank first listed, the average annualised monthly capital return across the top four commercial banks has been 10.0%. The highest return was from ANZ, the lowest from National Australia Bank. However, the ANZ also had the most volatile return profile so that, on a risk-adjusted basis, the Commonwealth would have been the most preferred.



There was sufficient difference in the pattern of market returns among the four banks that an investor could create a portfolio effect with a combination of banks offering better risk and return characteristics than individual stocks.

The Markowitz efficient frontier analysis which is displayed in the chart illustrates that the lowest risk combination of 30%/30%/40% CBA/WBC/NAB would have delivered a superior return to holding either National Australia Bank or Westpac separately.

A combination of 40/10/25/25 for CBA/WBC/NAB/ANZ would have delivered the best risk-adjusted return available and one which would have been superior to the risk adjusted return from any of the four individual stocks.

The answer to 'which bank?' seems relatively easy. Choose a combination of three which can stay intact through the cycles. The more important question then becomes how much to commit to the banks.

thebigpicture discussed this recently in the context of the market performance in the September quarter. During the quarter, 75% of the stocks in the ASX 200 outperformed the index. Because of their weighting as a group, the banks underperformed the majority of the companies.

This was a considerable change from what drove a successful investment strategy through most of the 1990s. Business efficiencies, aggressive pricing practices, industry consolidation, cheapening credit and government-inspired barriers to entry allowed banks and financial service providers generally to outgrow their clients.

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