

thebigpicture

guideposts for the private investor

Week Commencing 18 October 2004

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 or send an e-mail to: 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.

◆◆◆◆◆◆◆◆◆◆

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

STOCK PICKING MIGHT NEVER BE EASIER

There should be little excuse for active fund managers failing to beat the market in the last quarter. Unless a fund manager had a manic attachment to the banking sector, stock selection should have been relatively straightforward and rewarding.

The ASX 200 index rose by 3.7% in the September quarter. For those following company results during August, this might seem a surprisingly subdued outcome. Company results and more broadly based official statistics indicated quite buoyant business and economic conditions during the middle months of the year.

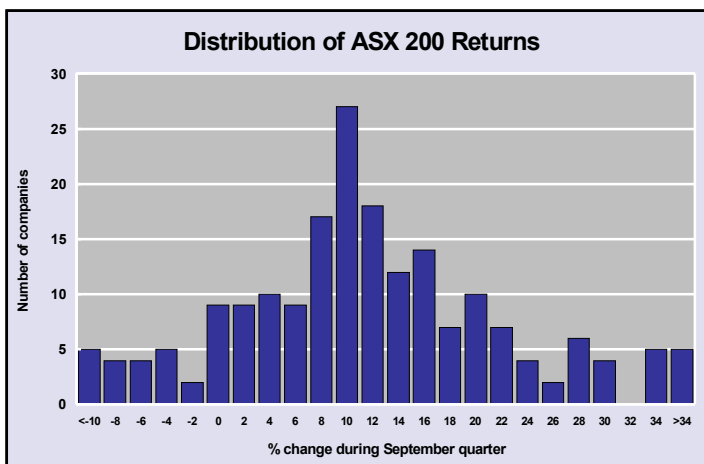
As *thebigpicture* has pointed out in recent weeks, business conditions in the past year have been some of the best encountered by Australian companies in recent memory. Favourable macroeconomic conditions, improved operating performance and conservative capital management strategies have combined to help boost the underlying value of listed companies and support higher share prices for many.

For most of listed Australia, the market indexes were not indicative of what was happening. Most of the companies in the ASX 200 actually did a lot better than the average.

The first chart shows the distribution of returns for the quarter and why even a randomly selected portfolio of stocks would have bettered the market averages. Three quarters of the companies in the index actually performed better than the average. One quarter of companies generated returns in excess of 15%.

The model portfolio of Australian equities run by *thebigpicture* generated a quarterly return of 14.7%, a full 9.5 percentage points higher than the return from the ASX 200 accumulation index.

But beating the index might not have been much of an achievement. At the risk of raining on its own parade, *thebigpicture* ran a simple experiment. What if it had simply substituted its research-based 25 stock portfolio with 25 stocks picked more or less at random?



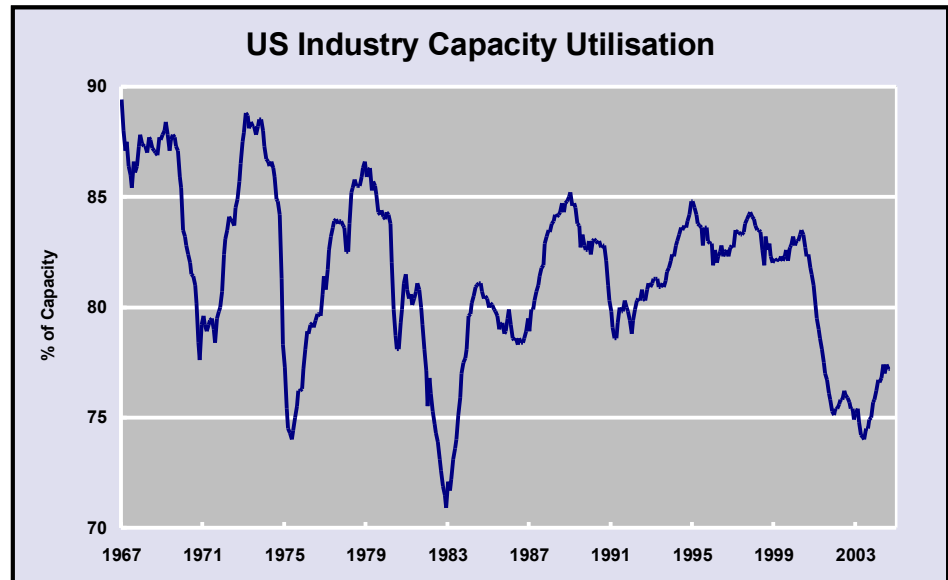
“Within the overall economy, financial services accounts for 12% of output compared with an ASX market loading of 37%.”

Choosing every eighth stock from an alphabetically arranged top 200 generated a stock portfolio with an average price increase among the stocks selected of 12.7%.

Another simple test: a random number generator was used to pick 25 stocks from a list of the top 200. The return was a rather more modest 6.3% but still above what the market indica-

(Continued on page 3)

THE WEEKLY CHART SPOT



Source: US Federal Reserve Board

US industry capacity utilisation rates have stagnated during the middle months of 2004. This is an ominous sign that investment spending, still very weak, is not about to pick up any time soon.

The recession-like utilisation rates partly reflect the strong increase in investment spending which occurred in the latter part of the 1990s. Record levels of investment have meant capacity has been more than adequate to cope with the relatively weak demand growth experienced subsequently.

On the other side, the persistently low capacity utilisation reading has helped contain the inflation pressures which normally arise during a cycle as shortages allow companies to price more aggressively. Consequently, some of the upside potential for interest rates normally apparent this far into a cycle remains absent. ■

“With an estimated cost of funds of 10.3%, these companies are now adding shareholder value, suggesting that their positive reappraisal by the market has been well-deserved.”

Mid-caps Raise The Standard cont'd

(Continued from page 4)

performance makes them more secure as investment alternatives.

Earlier editions of *thebigpicture* have emphasised the importance of companies beating their cost of capital to generate a significant share price reappraisal. Usually, a sample of larger companies has been used to illustrate this point.

The same message is apparent in an analysis of the mid-cap stocks. The chart shows the outcome of the analysis for the 31 stocks in the sample referred to above. The horizontal axis shows the ratio of the rate of return to the cost of capital. A move to the right indicates that the spread is rising. A reading below 1.0 indicates that the rate of return is falling short of the cost of funds and shareholder value is being eroded by management decisions.

The vertical axis shows the extent to which the market capitalisation exceeds the

value of the funds employed in the business. The dispersion of the results shows two trends.

- Companies which are able to widen the spread between their rate of return and their cost of funds are rewarded with higher share prices.
- Companies whose financial performance implies that they are continuing to destroy shareholder value tend to languish. Even when their performance is improving, there are few rewards until they are able to cross the divide between subtracting and adding value.

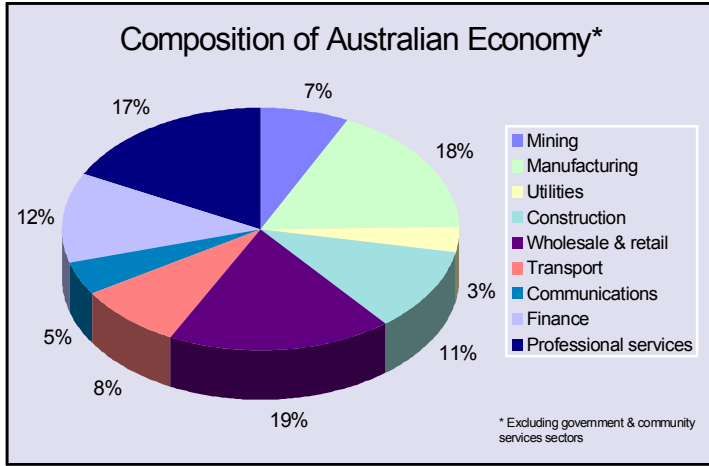
This has some important implications for stock selection in a portfolio. The strongest price appreciation will be seen among stocks with a positive (i.e. a ratio of return to cost of funds greater than one) and rising return spread. ■

STOCK PICKING MIGHT NEVER BE EASIER CONT'D

(Continued from page 1)

tor produced.

While hastening to caution that people



should not conduct experiments like this in their own homes, it is illustrative of what can happen as the sources of Australia's economic growth begin to change.

This simply shows, of course, that larger listed companies performed relatively poorly. ANZ, Commonwealth Bank, Foster's, National Australia Bank, News Corp, Qantas, Telstra and Westpac are examples of companies with small single digit or negative returns for the three months. Within this group of larger companies, the four major banks feature prominently.

This is a considerable change from what would have been a successful investment strategy through most of the 1990s. Admittedly, relying on the evidence from a single quarter to suggest a change in direction might be unwise. However, there is some broader basis for believing that the financial services sector might be unable to outpace the rest of the economy as it did during the latter 1990s and as the adjacent chart based on data from the Australian Bureau of Statistics illustrates.

Business efficiencies, more aggressive pricing practices, industry consolidation and government-inspired barriers to entry allowed banks

and financial services generally to outgrow their clients.

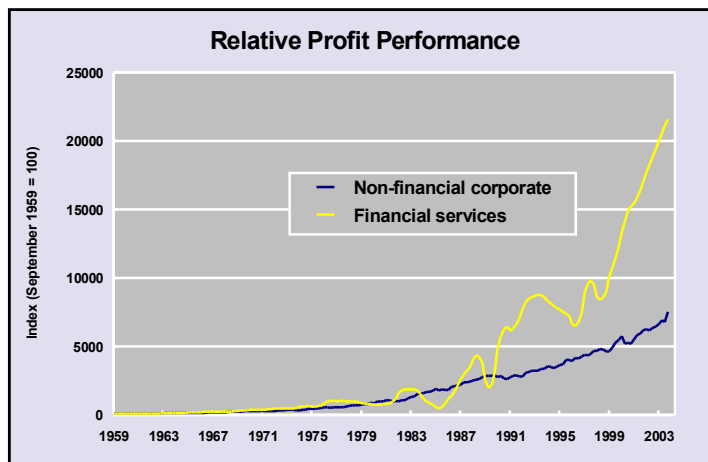
Since the principle companies in the sector also had large weightings in the equity market indexes, holding them as investments meant that returns approximated or were better than average market returns. This was a happy coincidence which benefited equity investors.

Unless banks can maintain this performance difference, the same bank dominated portfolio will lead to weaker returns than might be available if the portfolio reflected more closely the structure of the Australian economy. Within the overall economy, financial services accounts for 12% of output compared with an ASX market loading of 37%.

The composition of the ASX indexes is largely a historical accident and their use purely a matter of convenience. There is no economic rationale for adopting an official ASX index as the basis for long-term wealth management strategies.

If the financial services sector cannot outgrow the rest of the Australian economy, investors benchmarking their performance against market indexes will have their relative wealth position eroded in the future not enhanced. This will force a change in attitude. Investors will progressively become more discerning in their choice of objectives and standard measures of performance. ■

“There is no economic rationale for adopting an official ASX index as the basis for long-term wealth management strategies.”



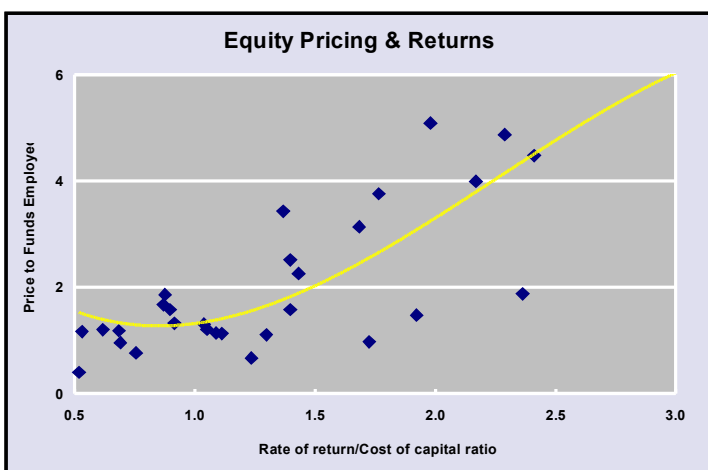
MIDCAPS RAISE THE STANDARD

The improvement in the financial performance of Australia's smaller companies has been a feature of the Australian market in the past year.

Two weeks ago, *thebigpicture* outlined the extent to which larger companies (i.e. those with a market capitalisation of more than \$1 billion) had improved their financial performance in the year to June 2004. In summary, an aggregate of 35 of the leading industrial companies (i.e. excluding finance and resource stocks) produced an 18% hike in profit and boosted their return on funds employed by 0.9 per-

The average unweighted profit improvement for the year was a robust 31.3%. Aggregate profit growth was a relatively modest 4.6% reflecting some relatively subdued gains by the larger companies within this segment.

On the balance sheet front, total debt declined by 5.2% and shareholder funds were built up by 7.6% reducing gearing from 38.2% to 35.3%. Gearing, by the end of June, was not significantly different from the 38.1% among the large market cap stocks but has been brought down by 16.8 percentage points from 52.1% in 2000/01.



Taut balance sheets have meant returns jumped sharply, reaching 11.6% in 2004 compared with a paltry 6.3% in 2001.

The poor 2001 outcome implied that investors' capital was being destroyed. With an estimated cost of funds of 10.3%, these companies are now adding shareholder value, suggesting that their positive reap-

percentage points to 11.6%.

Financial management was noticeably cautious with gearing (debt/(debt + equity)) declining slightly from 38.5% to 38.1% despite the sharp increase in profitability. In other words, the improvement came predominantly from more buoyant macroeconomic conditions and a commitment by managers to work existing assets harder.

Some of the same themes are even more evident in a review of mid-cap companies (i.e. those with a market capitalisation of less than \$1,000 million down to \$100 million).

As with the earlier survey, *thebigpicture* has summarised data for 31 non-financial, non-resource companies which reported their 2004 results before the end of September.

praisal by the market has been well-deserved.

The valuation model used by *thebigpicture* suggests that, as a group, these companies are also more undervalued than the large companies. Put another way, the prices of the larger companies are tending to assume a stronger growth outlook than the prices of the smaller companies. This might be significant if the macroeconomic environment is tending to be less supportive. It might imply less downside for the smaller stocks.

This might not have been the case in past cycles when smaller company returns were inferior to those of the larger companies. Then they would have been more leveraged to changes in economic circumstances.

Now, their improved relative financial per-

“The strongest price appreciation will be seen among stocks with a positive (i.e. a ratio of return to cost of funds greater than one) and rising return spread.”

(Continued on page 2)

thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). While the information contained in this publication has been prepared with all reasonable care from sources believed to be reliable, no responsibility or liability is accepted by the publisher for any errors or omissions or misstatements however caused. Any opinions, forecasts or recommendations reflect judgements and assumptions at the date of publication and may change without notice. This publication is not and should not be construed as an offer to sell or the solicitation of an offer to purchase or subscribe for any investment. In issuing this publication, it is not possible to take into account the investment objectives, financial situation or particular needs of any individual recipient. Investors should obtain individual financial advice to determine their investment objectives, financial situation or particular needs before acting on any information contained in this publication. This publication is not for public circulation or reproduction whether in whole or in part and is not intended for any person other than the recipient.