

# thebigpicture

guideposts for the private investor

Week Commencing 22 November 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.

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## YES, YOU CAN LEARN

**Individuals do learn from their investing experiences. They make fewer mistakes and their performance improves with practice, according to recently published research.**

Individual investors are generally thought to suffer from several shortcomings in their investment decision making, among which:

- they trade excessively, with those trading the most earning the lowest average returns;
- they are often reluctant to realize losses; and,
- their trading activity is affected by past returns and historical price patterns.

These are the arguments for individuals being guided by advisers toward managed funds, where their money is put in the hands of professionals and is less exposed to these risks.

If, however, they are not doomed to keep repeating the same mistakes and investors are able to learn from their market experiences, they could more reasonably consider managing their investments directly.

A paper entitled 'Do Individual Investors Learn from Their Trading Experience?' by Gina Nicolosi, Liang Peng and Ning Zhu (Yale ICF Working Paper No. 03-32) aims to shed some light on whether individual investors learn from their stock market investing experiences.

There are two types of equity market decisions which an investor has to make:

- a stock analysis decision aimed at forecasting individual stock price movements relative to the market; and,
- a market timing decision aimed at forecasting movements in equity prices relative to the prices of fixed income securities.

The Nicolosi, Peng and Zhu study focuses on the first of these skills, namely, the stock analysis decision. The authors had access to data from a large national US discount broking house so that they were able to track the investments of 78,000 households over six years to measure the extent they learnt from their trading experience.

Evidence of learning does not imply that individuals stop making mistakes. The test of learning is that systematic errors diminish over time as trading occurs.

The research has significance at both a practical and academic level. If investors did not learn from their mistakes, assumptions of rationality in many capital market theories would be thrown into doubt potentially undermining many of the investment decision making models which are used on a day-to-day basis by investors and their advisers.

The authors find that investors do learn as they invest.

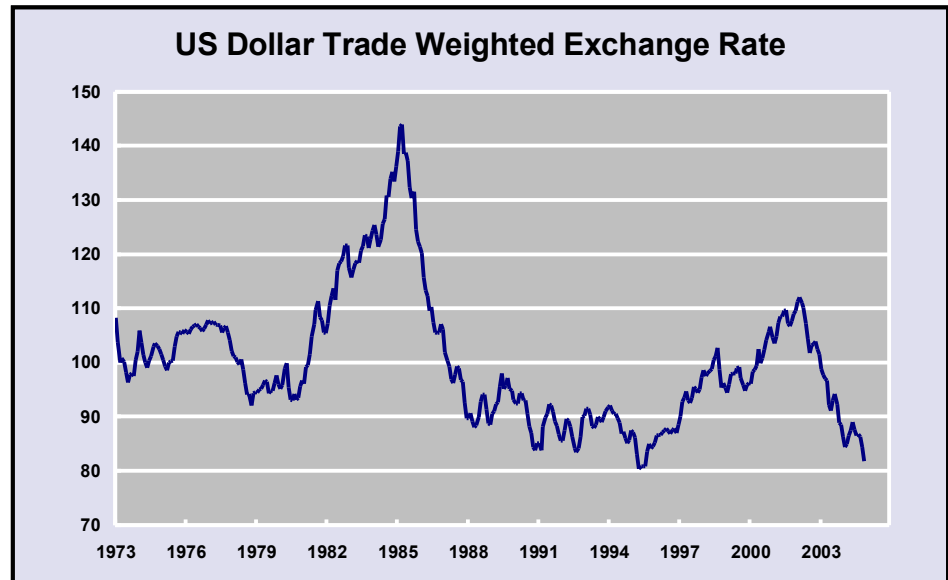
- Consistent with the rationality hypothesis, when investors believe they are able to forecast excess returns, they do purchase more actively; when they do not believe

***“If investors did not learn from their mistakes, assumptions of rationality in many capital market theories would be thrown into doubt....”***

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## THE WEEKLY CHART SPOT

Since February 2002, the US dollar has depreciated by 27% against the currencies of its major trading partners and is now pushing toward levels last seen in July 1995. The possibility of breaking through that historically low price point could prove a strong temptation for exchange rate speculators who will bet that, if the dollar value breaks through, the selling will intensify.



Source: US Federal Reserve Board

## Yes, You Can Learn cont'd

(Continued from page 1)

in their ability, they reduce their stock purchases.

- As an investor completes more purchase transactions and purchases more unique stocks, the portfolio's subsequent risk-adjusted monthly return is higher.

At face value, these results contradict conclusions from other research which suggests that economic agents are not always fully rational but these latter conclusions have been based on aggregated data. Because Nicolosi, Peng and Zhu trace the behaviour of individuals, their study throws new light on how individual economic

agents, within the aggregates, learn to reduce their mistakes over time.

Both might be right. New entrants might affect the composition of the aggregates being studied. The benefit of learning might be offset by others joining the group who display tendencies to systematic errors.

This distinction between observable individual behaviour and the aggregated performance suggests that the composition of those participating in the investment market (e.g. the split between experienced and inexperienced investors) could potentially influence how markets function. ■

## MIDCAPS: MARGINS DELIVER VALUE CONT'D

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midcap equity value model used in earlier issues of *thebigpicture* highlighting how an improvement in rates of return helps to drive market value higher.

It shows how a company with a rate of return 1.5 times its cost of capital, for example, would have a share price slightly under twice the book value of its funds employed.

Based on an average cost of funds estimated at 10.3%, the rise in the rate of return from 6.4% to 11.3% would imply a 40% value boost.

Higher share prices for smaller companies are not simply a bull market looking for

laggards to support. There is an underlying economic improvement which validates the higher prices.

Closing the performance gap between smaller companies and larger ones also reduces an important source of risk for investors. The smaller companies should become less susceptible to the late cycle sell-off which assumes that they will always be the poorer financial performers.

Of course, among this group there is a wide range of outcomes making up the average. Investors still need to choose companies which meet the key investment criteria of a positive and rising return spread, no matter what their size, to maximise potential investment returns. ■

## EARNINGS GUIDANCE: DOES IT HELP?

**There has been increasing emphasis on earnings guidance for 2004/05 as companies report their results for the prior year. The nature and value of the guidance on offer varies considerably.**

Formal earnings guidance statements are becoming more common as corporate disclosure practices are policed more rigorously.

It used to be common practice for companies to discuss likely profit outcomes with selected analysts, mainly those from the larger broking firms and institutional investors, in face-to-face briefings. When business conditions changed, they would also be notified more promptly than other investors. They were the conduits through which information flowed to the market.

Any doubts about what was appropriate were removed in 2002 when the then head of investor relations at Southcorp precipitated an ASIC investigation after sending out an e-mail to selected analysts containing a profit warning which had not been given general circulation.

As regulators have encouraged companies to disseminate market sensitive information as widely as possible, companies have begun to craft their forward looking statements more carefully with an eye to the impact on the larger audience.

Nonetheless, what counts as earnings guidance varies considerably.

- Some companies do not give any and stick to that as a matter of principle.
- Some offer an indicative growth rate: something along the lines of “we expect to achieve double digit growth” in sales or EBIT.
- Some offer a range for their potential net profit outcomes (eg \$180-195 million) although the range can vary considerably from as little as 3-5% to as much as 10% or 15%.
- Some provide a divisional breakdown of anticipated performance so that investors are able to understand where changes are coming from.
- Some offer selected measures (e.g. EBIT margins, rates of return, sales growth *et al*) depending on what they are seeking to emphasise.

The differences in approach make it hard

for investors to compare potential outcomes. The guidance from some is so nebulous as to be of questionable value.

References to ‘double digit growth’ are still common. This is an example of guidance being used to mislead while still trying to be technically accurate. We have come to understand that this means growth just reaching 10%. Any company expecting outcomes significantly higher is likely to refer to growth being ‘around 15%’ or ‘20-25%’, for example.

Investors might be served better if companies adopted three conventions when giving guidance:

- keeping dollar ranges to within 5%;
- percentage growth bands no wider than three percentage points; and,
- net profit to be the variable reported.

In managing earnings expectations, companies are also attempting to err on the side of surprising investors with a better than anticipated result. Directors prefer to exceed prior guidance rather than fall short. That bias in the way in which the market is informed is another form of misleading conduct which investors need to take into account in deciding how to react to any earnings guidance.

The growing prevalence of formal earnings guidance alters the role of equity analysts who will be less valued for their modelling and forecasting skills since their published numbers are likely to mirror closely the guidance they are receiving from the companies.

In these circumstances, they will only be able to add value for an investor if they can:

- analyse more completely the strategic positioning of a company (to highlight shortcomings or strengths which are not generally known but which are likely to have an unanticipated impact on longer term corporate performance); or,
- link corporate performance to the macroeconomic environment to highlight how different assumptions about macro factors affect financial performance.

This is typically a rarer skill set which will mean fewer broking houses being able to offer the research quality investors need for their decision making. ■

***“As regulators have encouraged companies to disseminate market sensitive information as widely as possible, companies have begun to craft their forward looking statements more carefully with an eye to the impact on the larger audience.”***

## MIDCAPS: MARGINS DELIVER VALUE

**The sharp improvement in the financial performance of Australia's smaller companies, driven by margin improvement, has made these companies more secure investments.**

*thebigpicture* reviewed the performance of smaller listed companies (i.e. those capitalised at more than \$100 million and less than one billion dollars) after they reported their 2003/04 results.

For the 40 company sample tracked by *thebigpicture*, there was a 50 basis point improvement in the aggregated rate of return on funds employed from 10.8% to 11.3%. However, the more dramatic changes occurred over the past two years. Between 2001/02 and 2003/04, the rate of return jumped from 6.4% to 11.3%.

In 2003/04, 73% of the companies in the sample exceeded their estimated costs of capital. In 2001/02, that proportion was only 56%.

There are five levers companies can work to extract an improved return on funds employed:

- pay less tax;
- reduce unit production costs;
- improve pricing;
- produce and sell more without additional investment spending; or,
- utilise underemployed financial resources to acquire new productive capacity.

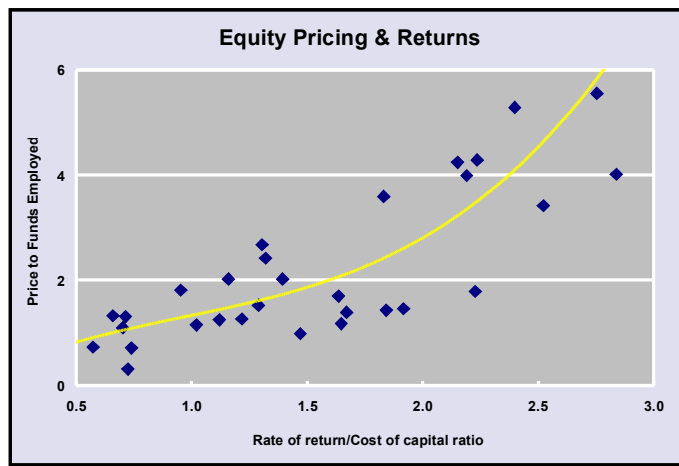
The link between these five levers and the return on funds employed is shown in the following formula:

$$\frac{NOPAT}{Funds\ employed} = \frac{NOPAT}{EBIT} \times \frac{EBIT}{Sales} \times \frac{Sales}{Assets} \times \frac{Assets}{Funds\ employed}$$

As discussed in previous issues of *thebigpicture*, the NOPAT return is a measure of financial performance prior to any interest

payments so that financial structuring does not affect the return calculation or comparisons among companies.

Over the two years to June 2004, the most important contributor to the improvement in financial outcomes was the rise in operating margins reflecting the combined effect of lower costs and higher prices. The rise in the EBIT to sales ratio from an average 5.6% to 8.1% accounted for two thirds of the overall improvement in financial return.



The next most important factors were lower tax payments (contributing 14% of the improvement) and better usage of existing assets (contributing 13%). The remaining 6% came from using existing financial resources to acquire new productive capacity.

The dramatic nature of the improvement over the two years will be virtually impossible to repeat. From this point, the primary objective for each company should be to keep its rate of return above its cost of capital to ensure that it remains an attractive investment by adding value for shareholders.

There will be scope at the margin for some companies to boost existing rates of return by using one or more of the levers at their disposal or by raising new funds to expand (without forsaking improvements in rates of return) to add further shareholder value.

The chart is the updated version of the

*(Continued on page 2)*

*“Closing the performance gap between smaller companies and larger ones also reduces an important source of risk for investors. The smaller companies should become less susceptible to the late cycle sell-off....”*