thebigpicture
guideposts for the private investor
Week Commencing 6 June 2005

LOWER P/E'S: SO, WHAT?

Market P/E's, according to some commentators, are lower than they have been before. Does this mean that equities are cheap? Not necessarily.

The P/E is a long cherished summary measure of value. A low P/E says 'cheap' and a high P/E 'expensive' and 'sell'.

As an investment measure, its greatest advantage is its simplicity. It allows easy comparison across companies and makes intuitive sense: everything else being the same, the company with the lowest share price is the cheapest.

The problem is that everything else is rarely the same. ***thebigpicture*** looked at the shortcomings of the P/E measure in some detail in its issue for the week commencing 17 may 2004. That article identified six shortcomings in the P/E as a value analyser.

1. Expectations about business performance
Since the P/E embodies many expectations about prospective business performance, a low P/E might not foreshadow market outperformance. The P/E could remain low indefinitely because of assessments in the market about the skill of the people running the company, for example. A high P/E might be signalling above average growth and capital appreciation potential.

"….as an analytical tool the P/E is overrated and often confuses investment selection processes."

2. Losses
For its P/E to be at all meaningful, a company needs to be making a profit.

3. Earnings Definitions
Earnings definitions might not be the same among companies being compared. Reported earnings might include non-cash items, the effect of one-off asset sales or outcomes from discontinued businesses, for example.

A company depending on one-off contributions to its earnings will generally have a persistently lower P/E than one with a higher proportion of sustainable income sources.

4. Gearing
Financial gearing will have an effect. The higher the debt levels (everything else being the same), the lower the earnings. A higher P/E might be justified if the added debt is improving returns for equity holders. On the other hand, if the higher debt is dangerously increasing risk and foreshadowing the need for more equity, the same company could attract a lower P/E.

5. Earnings Cyclicality
The P/E is especially hard to interpret when choices are being made between companies with strongly cyclical earnings patterns and companies with less volatile earnings profiles.

6. Economic Cycle
The appropriate level of the P/E also varies with the economic cycle. The appropriateness of a P/E will depend on the level of interest rates. The lower the interest rate, the higher the P/E.

For these reasons, the first issue investors should address is whether much store

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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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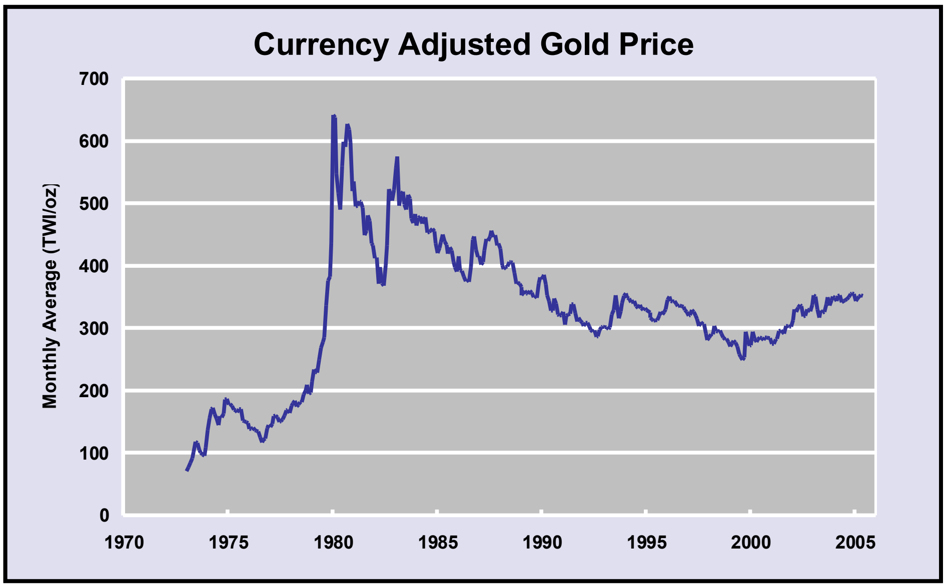
THE WEEKLY CHART SPOT



Source: World Bank and US Federal Reserve Board

"….with global financial markets freer than they have ever been, the need for gold as a cash substitute has been reduced."

The gold price is a monetary phenomenon. Unlike industrial commodities whose prices reflect scarcity, gold is readily obtainable in large quantities so its price is linked to the prices of other financial assets and expectations of their likely movements.

The role of gold as a store of value is steeped in history. However, with global financial markets freer than they have ever been, the need for gold as a cash substitute has been reduced. There is an abundance of cash and investment alternatives with fewer governments preventing their citizens from using them. While inflation continues to erode spending power, it seems less of a threat than in earlier times.

As the de-facto world currency, movements in the US dollar are likely to move the US dollar denominated gold price. The weaker the dollar, the higher the gold price; the stronger the dollar the lower the gold price.

Looked at on a currency-adjusted basis, the gold price appears to have been on a targeted decline after the inflation scare of the early 1980s, reaching a level which is consistent with where people think it should be and below which there has been speculative buying support.■

LOWER P/E'S: SO, WHAT? CONT'D

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an estimated cost of capital of 8.6%.

Higher returns suggest that the market should be prepared to pay more for any given level of existing earnings, everything else being the same.

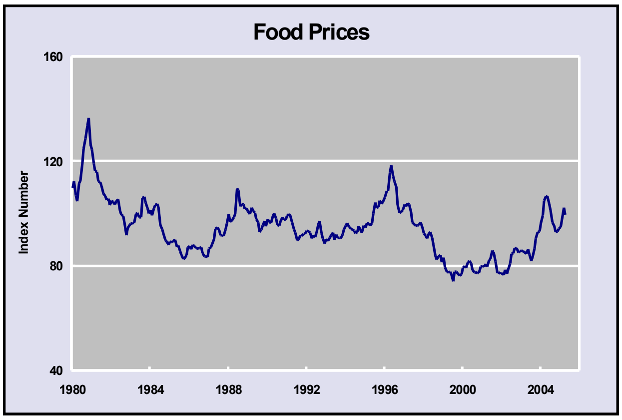
So, what?
When there is a report that market P/E's are lower than they have been before, as there was in the Australian Financial Review recently, what does that mean. Should investors buy more? Unfortunately, the answer is that we really do not know.

Aggregated in this fashion, the interaction of the compositional effects (which imply P/E's should be generally lower) with the macroeconomic influences (which suggest higher P/E's might be appropriate) is too hard to gauge.

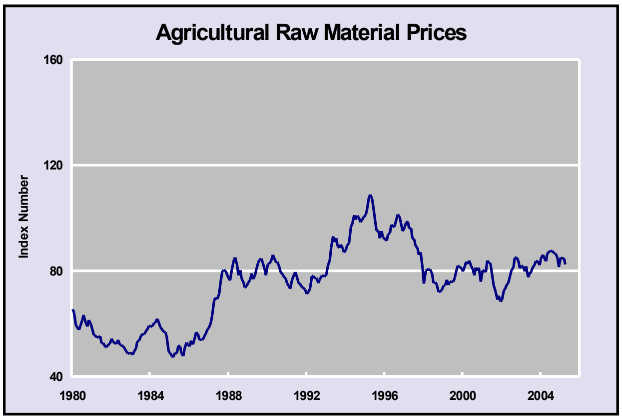
Probably, the macroeconomic influences have been so large that they could have overshadowed the compositional changes. However, the extent to which this has been the case depends on precisely the period over which the comparison is being made.

As ***thebigpicture*** has argued, as an analytical tool the P/E is overrated and often confuses investment selection processes. These market effects, and their uncertain impact on analysis, simply reinforce the conclusion that there are superior analytical tools to be used in making investment decisions.■

Commodity Prices: The Miners Are Doing Best



Food Prices



Agricultural Raw Material Prices

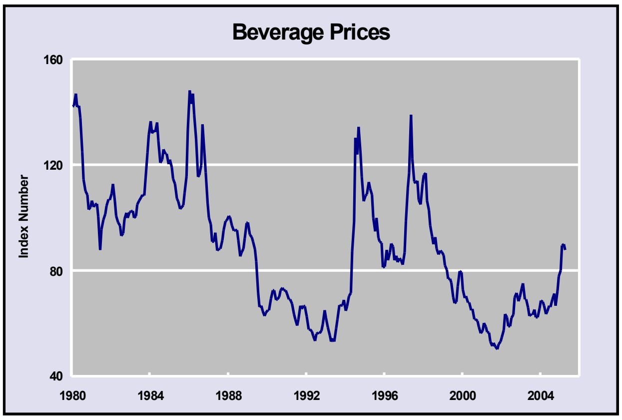
Metal and energy prices are in a strong upswing but other commodity price movements have been more subdued.

The charts show summary measures of price movements for some of the principal commodity groupings compiled by the World Bank.

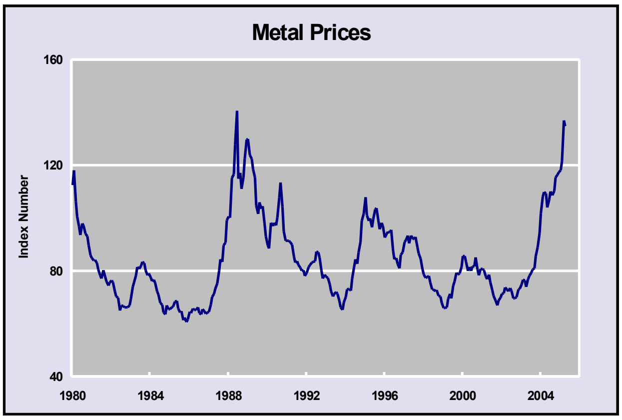
Each of the indexes summarises average monthly prices for groups of commodities.

- *Food*: Cereal, Vegetable Oils, Meat, Seafood, Sugar, Bananas and Oranges
- *Beverages*: Coffee, Tea and Cocoa
- *Agricultural raw materials*: Timber, Cotton, Wool, Rubber and Hides
- *Metals*: Copper, Aluminum, Iron Ore, Tin, Nickel, Zinc, Lead and Uranium
- *Energy*: Crude oil (petroleum), Natural Gas and Coal

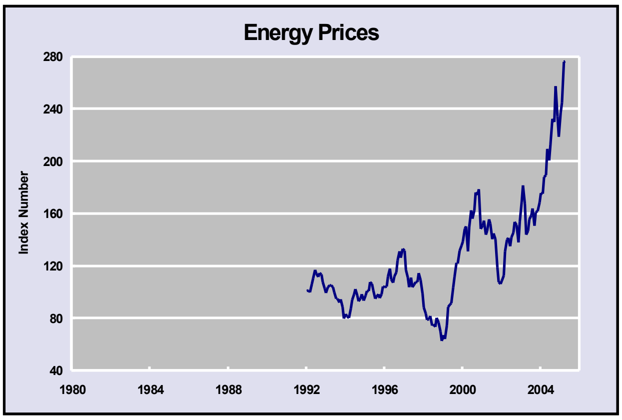
The strength of the 'mined' commodities reflects the strength of industrial demand especially within the Asian region but also a lack of investment in new capacity in recent years. Inventories have been depleted to the point that fears of shortages have helped support speculative activity.



Beverage Prices



Metal Prices



Energy Prices

While mined commodity prices were also relatively high in the early 1980s, the buoyancy in commodity prices was more generalized. Beverage and food prices were also historically strong and agricultural prices were beginning to stabilize before rising in the mid 1980s. This was a period of more generalized expectations of commodity price rises.

One point of significance in this difference is the impact on policy: despite central bankers having their finger on the interest rate trigger, they have been given little opportunity to fire the gun because a generalized change in inflationary expectations has not been evident.

LOWER P/E'S: SO, WHAT? CONT'D

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should be put in the P/E in the first place. The second question is whether there is merit in making comparison s across time to gauge whether the Australian equity market is cheaper or more expensive today than, say, five years ago. In this case, there are several structural changes which make these comparisons hard to interpret.

1. More banks
The P/E's of banks tend to be lower than the P/E's of industrial companies. Historically, banks have been capital hungry requiring additional equity funds for prudential purposes to sustain their business growth. Earnings have been susceptible to swings in the interest rate cycle and to economic activity generally. The quality of earnings tends to deteriorate in the latter stages of an economic cycle and it takes time to restore the quality in the upswing.

As the weight of the banks in the Australian market has risen, the average market P/E would have declined simply due to the compositional effect.

2. Less mining
The mining sector typically showed a higher than average P/E. Many mining companies, including the larger ones, have had a poor return on invested funds with the share prices reflecting expectations of commodity price appreciation or new developments likely to have an impact on earnings. This has been a sector of the market prone to disappoint. When the earnings cycle did turn, the P/E's tended to contract because of expectations that the buoyancy would be short-lived.

As the mining sector in the Australian market has declined in importance (from around one third of the total to around 15% over 10 years), the average market P/E would have declined.

3. Lower gearing
In recent years, Australian companies have displayed less balance sheet gearing. The aggregate debt level of a sample of 55 larger industrial companies followed by ***thebigpicture*** fell by 1.3% over the past three financial years and, as a percentage of equity, debt declined from 85% in 2000/01 to 62% in 2003/04.

Lower gearing reflected a more conservative approach to financial management. To that degree, risk was reduced and investors should have been prepared to pay more for any given earnings stream. However, there were two corollaries:

- companies were selling assets reducing the chance of an earnings improvement based on better operational outcomes; and,
- there were insufficient investment opportunities available to soak up the cash flows.

Both these factors suggested that lower P/E's were more appropriate.

4. Lower profit growth rates
Factoring in lower growth outcomes for longer-term valuation purposes has made sense. Slower global population growth alone could take a percentage point or more off potential volume growth. With inflation expectations radically changed over the past decade, the anticipated pricing flexibility of Australian companies has been greatly reduced. Globally, the emergence of China as a driver of industrial productivity has also meant reduced pricing power.

Lower expected profit growth rates among industrial companies imply lower market P/E's.

5. Lower inflation
The flip side of lower inflation outcomes is sustainably lower global interest rates. Australian bond yields have halved in the past decade implying that market P/E's should be significantly higher than they otherwise would have been.

6. Higher returns
Over the past ten years, the underlying financial performance of Australian companies has improved considerably. Australian companies have gone from struggling to achieve a return higher than their cost of capital to beating it on what appears to be a sustainable basis. According to ***thebigpicture*** sample of 55 large industrial companies, the return on funds employed in 2003/04 was 11.3% against

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