thebigpicture

guideposts for the private investor

Week Commencing 11 April 2005

Stock Selection Becomes More Difficult

Stock selection was relatively difficult in the March quarter.

The ASX 200 index rose by 1.5% in the March quarter after increases of 10.5% and 3.7% in the December and September quarters, respectively.

Active fund managers would be seeking to do better than the index through their stock selection skills. Whether they can will depend in part on how performance is spread across stocks contained in the index. The more stocks performing better than the index, the easier it will be to achieve better returns than the average.

An example of relatively easy stock selection conditions was in the September quarter. ***thebigpicture*** reported a simple experiment in its 18 October edition after compiling a 25 stock portfolio picked more or less at random.

Choosing every eighth stock from an alphabetically arranged list of the 200 largest listed companies generated a stock portfolio with an average price increase among the stocks selected of 12.7%, nine percentage points better than the increase in the ASX 200 index.

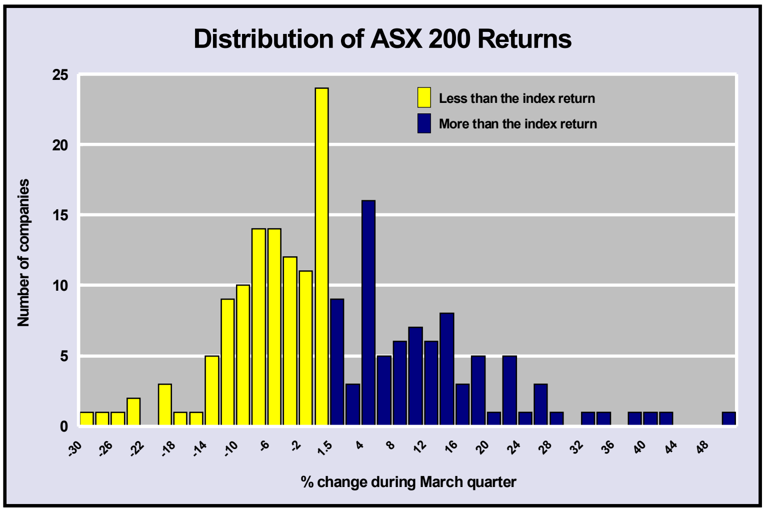
> *" [In March] it would have been unlikely for an investor to pick a portfolio of stocks at random and outperform the market."*

The pendulum swung back the other way in the just completed March quarter. The average stock price increase in the quarter was a more subdued 0.2%, a lower rate of appreciation than for the index as a whole.

The chart shows the distribution of stock returns for March. The yellow highlighted bars show the number of stocks for which returns were below the index and the extent to which their performances differed. The blue highlighted bars show the number of stocks for which returns exceeded the gain in the index.

Only 76 out of 200 stocks rose in price by more than the index suggesting that the relatively strong performance of a few larger capitalisation stocks had a disproportionate impact on performance. Resorting to random stock selection would have led to a portfolio rising by less than the market index rose.

In contrast to the September quarter, it would have been unlikely for an investor to pick a portfolio of stocks at random and outperform the market.



For the record, ***thebigpicture*** benchmark value portfolio fell by 1.6% in the March quarter after rises of 13.7% and 14.7% in the December and September quarters, respectively.■

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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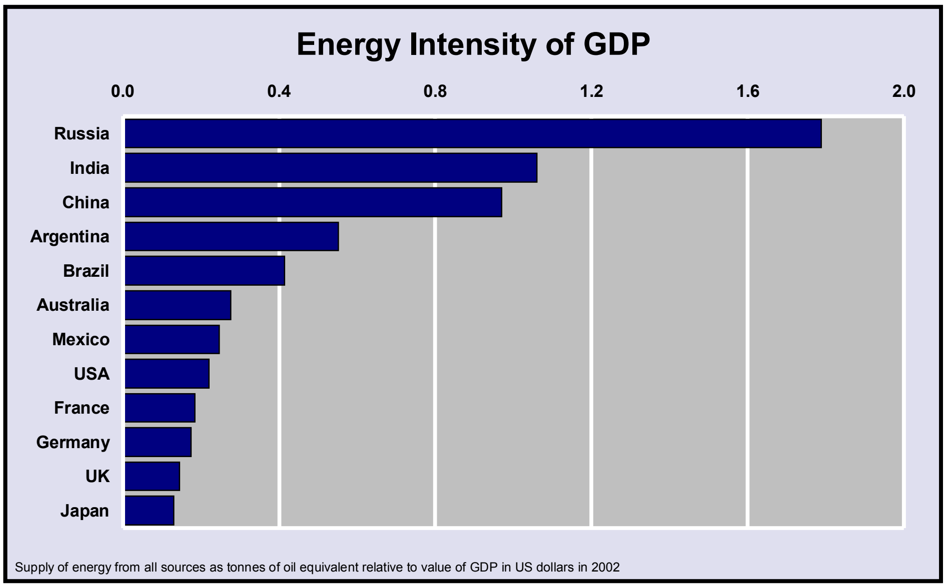
THE WEEKLY CHART SPOT



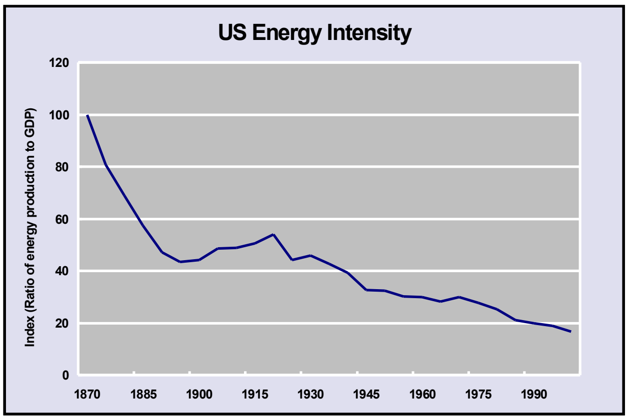
Source: International Energy Agency and United Nations

"...both the USA and China are experiencing a decline in energy intensity. The energy intensity of the US economy has been dropping for 140 years. Over the last thirty years, China's energy intensity has declined by two-thirds."

Economies become less energy intensive as economic development proceeds.

Energy supply data from the International Energy Agency (IEA) suggest that developing countries like China and India use more energy raw materials per unit of national output than more developed countries like the USA and Australia. The chart highlights that, in 2002, the latest year for which the necessary data are available, China used 4.4 times the amount of energy resources to sustain the same level of output as the USA.

The IEA data for each country quantify the current energy resources used (eg tonnes of coal, barrels of oil, etc) in tonnes of oil equivalent. Energy intensity measures the number of tonnes of oil equivalent per US$ of GDP.



The differences in energy intensity are likely to reflect several factors including:

- how efficiently energy raw materials, such as coal, oil and gas are processed to produce power;
- the relative importance within the economy of expenditure on investment goods and manufacturing output;
- the relative importance of less energy intensive activities such as the provision of services;
- the efficiency of production processes with economies of scale likely to contribute to less energy usage.

Despite the disparity in usage rates, however, both the USA and China are experiencing a decline in the energy intensity of their output. The energy intensity of the US economy has been dropping for 140 years. Over the last thirty years, China's energy intensity has declined by two-thirds.

These outcomes suggest that China's appetite for energy resources is less straightforward than simply extrapolating current usage rates based on prospective economic growth rates. China's energy needs will expand as the economy grows. However, the expansion will be modified by the long term decline in energy usage as the structure of the economy drives it to more energy efficiency.

Value Chain Tug-Of-War cont'd

(Continued from page 4)

ence. Woolworths, in particular, changed the landscape in the milk market in August 2000 when its competitive tender for suppliers resulted in sharply lower milk prices. Woolworths estimated that the price of milk was reduced by 27 cents a litre for its customers.

Technically, the Woolworths tender was only for its house brand products but the radical change in pricing altered the competitive positioning of the branded products, too. National Foods, one the largest national milk suppliers, estimated in March 2002 that the share of house brand milk in the grocery trade rose from 19% in June 2000, before the Woolworths tender, to 46% by December 2001.

One of the difficulties in replicating this outcome across a wider product range is that house brands have generally been seen as lower quality, a consideration of less significance for milk than in other markets.

Coles Myer is dealing with this challenge, recently announcing that it has set a 2007 target of having house brands account for 30% of the goods on its supermarket shelves. Its house branding strategy involves having three tiers of brands including an upper end premium brand.

At the same time, it intends to limit to one or two the number of external brands it carries in any product category. The external branded products will be relatively profitable reflecting their ability to attract customers. Any other manufacturers currently selling lower ranked brands will be forced to let them wither as they supply Coles with its non-brand product. Inevitably, a supplier's margin on house brands will be lower than the margin it used to have on branded goods and some value will be transferred to the retailer.

While Coles and Woolworths will seek to dominate the value chain, they will have a vested interest in ensuring that all their suppliers are sufficiently profitable to run their businesses efficiently. However, any hints of abnormal profitability will be seen quickly especially if the supplier is a listed public company. Almost inevitably, there will be attempts to claw back some of that additional profitability by the economically more powerful part of the value chain.

Despite losing some of their independence, this might still be a liveable environment for many companies. Once accepted as a supplier, some certainty will have been added to the commercial life of a manufacturer. Business risks might be lowered. The risks associated with brand management and innovation might be reduced. However, so will the profit upside.

All of this means that some suppliers of goods to retailers will risk losing investment appeal. A relentless pressure to constantly raise efficiency to simply maintain profitability will characterise their daily lives. New product offerings, long term margin building or packaging innovations – normally signals for investors seeking new opportunities – would no longer be so likely outside an increasingly select group of premium brand managers.■

> ***"In a retailer's ideal world, there would be one brand of beer and that brand need not be identified with a particular manufacturer."***

Monopolies May Not Be All Bad

Monopolies are supposed to be bad but they can get the job done.

The Queensland coal loaders, such as the one at Dalrymple Bay, have been cited as examples of the infrastructure bottlenecks which are limiting Australia's economic performance. According to their owners, government regulation of pricing has removed the incentive to expand.

Continued government regulation was aimed at preventing above-normal profits at the expense of the coal mining industry which had to compete on international markets as a price taker. It was also a political condition for to allow divestment of government assets to proceed.

Now, the contrast is being made with the iron ore ports in Western Australia which are under the direct control of fully integrated mining companies able to set port capacity in line with their mining intentions. In practice, these fully integrated monopolists are delivering better outcomes for the national economy.

But dare we generalise this experience? The acceptability of unregulated monopoly services is at the heart of the current debate about the most efficient way of delivering telecommunications services, for example, and how heavily regulated Telstra should be after the government quits its shareholding.■

VALUE CHAIN TUG-OF-WAR

A company's position in the value chain can determine much of its economic success. The grocery trade is shaping up as another example of why investors should be conscious of this guidepost.

thebigpicture for 13 December 2004 discussed how Amcor was probably disadvantaged economically by having to manage customers with far more economic clout than it could muster. Amcor was a topical example of value chain positioning at the time since allegations had been made that several Amcor executives had been engaged in anticompetitive activities to boost profits.

However, Amcor was also an example worth closer attention because the company has hardly ever been able to achieve an acceptable rate of return on the funds employed in its business and remains a classic Australian example of how value chain positioning can affect investment performance.

Value chain battles are occurring all the time, sometimes with little publicity. There has been a longstanding economic tug-of-war between the larger grocery retailers such as Coles and Woolworths and their suppliers, for example.

Retailers prefer high volumes and are prepared to trade on low margins. They have an incentive to reduce the number of their suppliers and often play them off against one another to achieve higher retail margins.

Pulling in the other direction, suppliers often with multiple competitors, struggle for shelf space at the expense of each other to reduce unit costs and typically have to achieve high margins to be able to service their capital bases.

Sometimes, suppliers can steal an advantage through their brands. The better known a brand, the greater the pressure on retailers to keep it on their shelves. Well known brands imply economic leverage for the supplier. For those brands, retailers might have to accept lower levels of profitability because more of the value will accrue to the brand manager. That might be tolerated in exchange for extra foot traffic.

While the tug-of-war between retailers and suppliers is usually conducted out of sight of investors and customers, the tension between the two has occasionally boiled over. For example, Coles Myer banned the wine brands from Mildara Blass when it thought that Foster's, the group's owner, was becoming too strong in the retail market and Woolworths effectively restructured the domestic milk industry once government de-regulation reduced its economic bargaining power.

The beverage market highlights some of these issues most clearly. Beer, for example, has been characterised by strong brands. The two largest beer manufacturers spend tens of millions of dollars every year directly cultivating consumers by enticing them to ask for their products when they come to shop.

To maximise their market penetration, however, the beer marketers have developed a plethora of brands. Only a few of these brands account for most of the beer sold. Most of the brands are minor and many would be individually unprofitable for both the marketer and the retailer.

In a retailer's ideal world, there would be one brand of beer and that brand need not be identified with a particular manufacturer. It could be a so-called house brand.

One of the reasons retailers have not achieved the ideal in the beer market is that beer brands are so highly developed that consumers could end up buying less overall without brand competition exhorting them to consume more.

Consequently, and happily for the beer producers so far, the retailers have continued to support the major beer brands to take advantage of the money they spend on building volume.

However, milk might be closer to the retailers' ideal. Until mid-2000, milk prices had been supported by government policy. Once the government props were removed, retailers moved to exert their influ-

(Continued on page 3)

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