thebigpicture

guideposts for the private investor

Week Commencing 17 January 2005

Equity Market Prospects

The investment guideposts used by *thebigpicture* would have helped deliver superior investment outcomes in 2004 but they also suggest it will be hard for companies to duplicate the performance in the year ahead.

The last issue of ***thebigpicture*** Newsletter for 2004 reviewed some of the macroeconomic factors having an impact on equity market conditions. The “top down” view suggested some slowing in global growth was ahead of us.

For Australia, the most favourable macroeconomic circumstances in recent history supported a 24% equity market appreciation in 2004. Although economic growth in the coming year might be marginally weaker, there is nothing evident so far to upset record business profit levels which have been building for several years.

The favourable economic backdrop and the improved business performance mean the Australian market begins 2005 showing few signs of overstretch after its strong recovery in 2004.

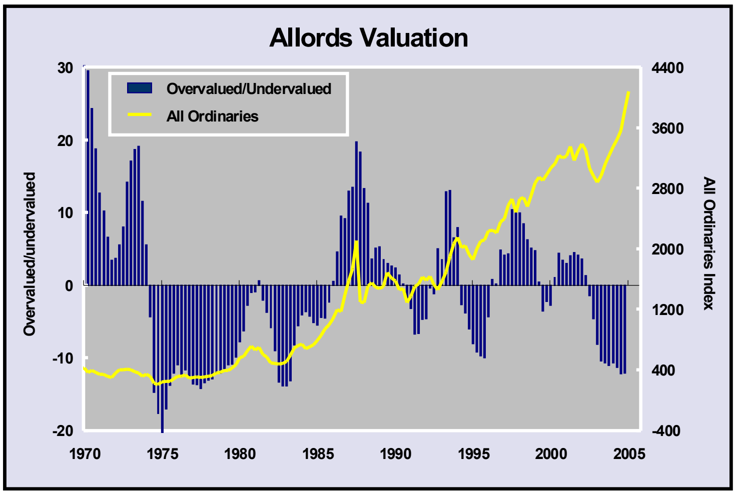
The “top down” valuation model used by ***thebigpicture***, illustrated in the first chart, continues to indicate propitious conditions for market upside in the period ahead.

“In 2004, thebigpicture value driven portfolio produced a 46% return….compared with a 28% increase in the ASX S&P200 accumulation index.”

Signs of equities being overpriced, the precursor to market falls in prior cycles, are not apparent at this point. Importantly, there seems to be some market catch-up potential based on the business profitability already delivered.

Having this profit performance in the bank is an important consideration since the “bottom up” view on its own suggests similar market gains might be harder to achieve in 2005.

The essence of the “bottom up” model, outlined in earlier editions of ***thebigpicture***, is that the better the rate of return on funds employed in a business, the more the business is worth.



The way ***thebigpicture*** puts this value proposition into an analytical framework is illustrated in the second chart. The horizontal axis in the chart shows the extent to which the return on funds employed exceeds (or falls short of) the company’s cost of funds. The vertical axis in the chart shows the premium currently being paid by the market over the

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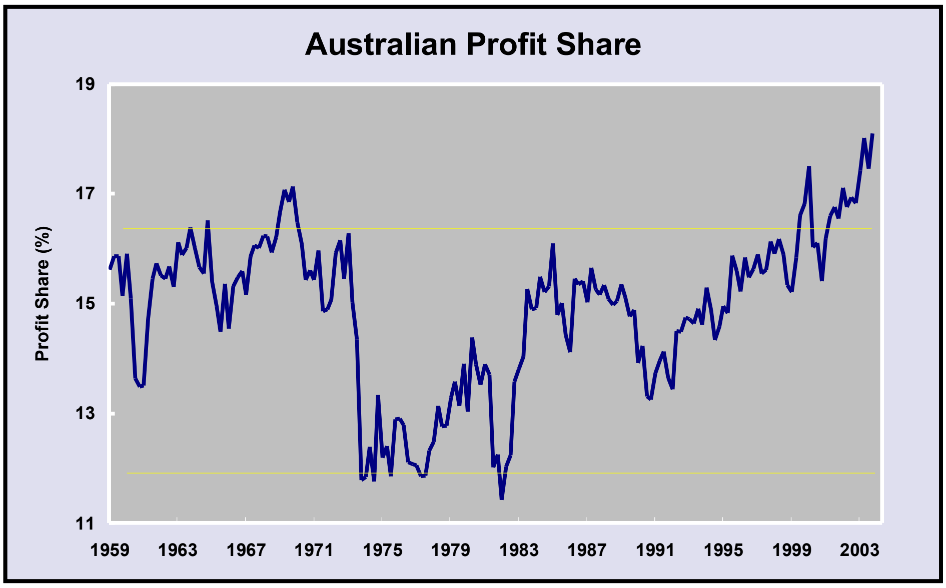
“….the changes which have permitted a historically high profit share are, for all practical purposes, permanent. The investment market ramifications of this are significant. The recent share price gains will probably not be threatened in this cycle as they would have been in the past.”

The Weekly Chart Spot



Source: Australian Bureau of Statistics

The profit share of Australian companies has reached levels once thought impossible. This ‘breakout’ is at the heart of Australian market action.

The chart shows gross operating surplus for private sector (non-financial) companies as a proportion of total non-farm income over the past 45 years. Before 2004, the empirical evidence suggested the profit share had a lower bound slightly under 12% and an upper bound around 16½%. The impression from the data was reinforced by institutional arrangements which appeared to assist in maintaining these limits.

The principal control on the profit share had been a highly organized labour movement supported by a centralized wage system. The union movement would use improved profitability as an argument to support its wage claims. During much of this period, higher prices alone were sufficient justification for higher wages.

At the other extreme, confronted by a loss of profitability, companies would take a harder line against labour costs rising or take other initiatives to boost profitability. There were occasions, too, when business enlisted the support of the government of the day to provide fiscal support to establish the floor, arguing that macroeconomic performance was being detrimentally affected by the weakness in the profit share.

The forces imposing the upper limit have lost their influence. In particular, the labour movement is less powerful and, in any case, has become more concerned with job security and employment growth and less pre-occupied with wages as a primary goal.

An industrial sector more open to international trade has also made a difference. The threat of international competition should impose some limits on profitability but has also offered opportunities to restructure business operations to take advantage of low cost production offshore. Having to compete against all comers has made managers more aggressive in the way they run their businesses with labour costs being tagged more frequently to productivity and more flexibility in the hours they work being demanded from employees . Greater recourse to technology has also been a feature of recent years.

On this view, the changes which have permitted a historically high profit share are, for all practical purposes, permanent. The investment market ramifications of this are significant. The recent share price gains will probably not be threatened in this cycle as they would have been in the past.

Sooner or later, new countervailing forces are likely to emerge. Labour scarcity, higher interest rates, lower global growth rates and management complacency are all possible threats, among others, which could eventually force an adjustment. For the time being, however, the balance of risks seems to favour the profit share continuing to support higher market values.

Equity market Prospects cont'd

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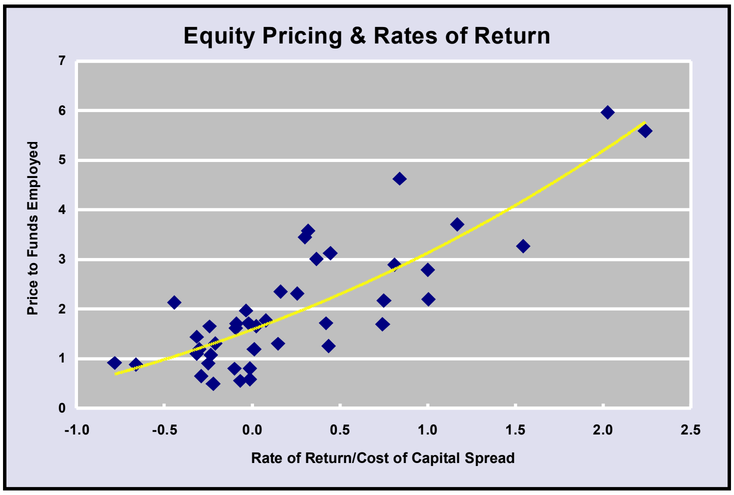
book value of the funds employed (debt plus equity) in the business.

A company with a positive return spread is adding value for its stakeholders and should be accorded a higher market rating than one destroying value through a negative spread. Generally, investors should steer clear of the latter and embrace the former.

In practice, this is just what has been happening. The model's relationships have been at the heart of the market's performance in the past year. At current market prices:

- there is a positive correlation between return spread and market reward: the wider the spread, the more the market premium; and,
- the return spread-market premium relationship is non-linear with market rewards being disproportionately higher as the return spread widens.



The chart shows observation points for 45 listed industrial companies which have a market capitalization greater than one billion dollars. This market size cut-off is only a matter of convenience to simplify the illustration. The same analysis can be carried out for companies of any size and the same broad patterns are evident in sub-$1 billion companies, too.

This empirical relationship provides a focus for equity investment decision making with the most attractive companies being those:

- adding value consistently, allowing relatively high market ratings to be sustained;
- undertaking business expansions involving relatively low quantities of extra capital (i.e. where the marginal returns are above average);
- selling assets and redeploying capital to higher returning opportunities elsewhere;
- changing the business sufficiently to eliminate a negative return spread within a year or two; or,
- having an ability to significantly reduce the cost of funds employed.

The first four of these guideposts normally depend on management initiating changes to business operations. Examples of companies highlighted within this framework earlier in 2004 as benefiting from changes driven by new management include Nylex, David Jones and Orica. Others, such as Leighton, Publishing & Broadcasting and Coates were flagged as likely strong market performers by driving already positive return spreads still higher.

The fourth guidepost generally reflects changes in financial strategy rather than operational initiatives although the macro-economic environment, through its impact on interest rates, also has an impact.

- Falling longer term interest rates will reduce debt servicing charges and lower the imputed cost of equity widening the return spread and, in line with the relationship in the chart, enhancing equity values.
- Substituting relatively high cost equity funding with relatively low cost debt funding reduces average funding costs. That is why share buy backs attract interest. They reduce the average cost of funds, widening return spreads and creating circumstances for the market to revalue a company.
- The equity risk premium attributed by the market to a stock might change through business restructuring or personnel changes, for example. A positive risk re-rating will reduce the cost

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of funds, increase the return spread (underlying profitability being unchanged) and create the opportunity for market value appreciation.

To provide continuing reassurance that the analysis is worthwhile (by adding value for potential users), ***thebigpicture*** runs an analytical portfolio with stocks selected using this approach.

In 2004, ***thebigpicture*** value driven portfolio produced a 46% return (after tax within a superannuation fund structure) compared with a 28% increase in the ASX S&P200 accumulation index.

A key ingredient in the market return in 2004 was the sharp improvement in financial performance among smaller companies. ***thebigpicture*** estimates that sub-$1 billion industrial companies boosted returns from 6.7% in 2001/02 to 10.7% in 2003/04. There was also further improvement in returns from large cap stocks in the past year with the average increasing from 10.6% to 11.3%.

All this was happening at a time of generally stable to falling bond yields providing another source of downward bias to the cost of funds.

This combination makes it harder to duplicate recent market outcomes in subsequent years .

In particular, the smaller company performance of the past two years seems unlikely to recur. Smaller company returns now approximate those from larger companies and, even if some further improvement is possible, assuming sustainable gains over large companies might not be realistic.

The flipside of the smaller company improvement is that investors should be more willing to hold smaller companies through a cycle. Conventional wisdom has suggested that, as the economic cycle turns, smaller companies should be sold because they are more leveraged to a change in economic conditions. That leverage, in part, used to be associated with their poor underlying returns.

Since the historical correlation between size and performance is no longer so obvious, the "sell large cap – buy small cap" recommendation based on the swing in the economic cycle should probably be treated more sceptically.

Especially in Australia, more competitive market conditions, an upgrade in management skill among smaller companies and a lengthy period of growing demand permitting a relatively undisrupted business environment have benefited small companies.

At the same time, the relative performance of many larger companies has been hindered as they were increasing their offshore exposures, sometimes through investments which fell short of the returns available from their existing domestic businesses.

That said, based on current profit forecasts, there are companies whose financial performances will be sufficiently strong for them to offer the prospect of continuing capital gains. One collector of analysts' earnings forecasts suggests a median growth rate of 17% in 2004/05. Of course, basing investment decisions on this forecast requires some confidence that the operational improvements upon which the financial forecasts are based will eventuate.

As the cycle turns, further bond yield reductions will be less likely and the valuation impetus from this source removed. A 50 basis point change in yields would imply a 45 point change in the average cost of funds for Australian companies and, within the context of ***thebigpicture*** valuation models, a 4-5% variation in market value.

Capital management initiatives by some companies might compensate for value erosion from higher interest rates. More equity reduction plans (through debt funded share repurchases) are likely as companies look to structure their balance sheets to help boost value. This is likely to be more evident among larger companies for whom meaningful investment opportunities might be scarcer than among smaller companies.■

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