SHARES MADE EASY: ARTICLE 1 – JULY 2000

A FUNDAMENTAL APPROACH TO INVESTMENT

Fundamental analysis is the most widely used method of identifying & selecting stocks for investment used by professional fund managers. Unlike technical analysis, which involves analysing historical charts of price, volume, open interest etc, fundamental analysts attempt to value a company based on its earnings, prospects, management etc. They then derive Buy, Hold & Sell recommendations based on whether the share price is below, in line with, or above their valuation. The trouble is that the process is intrinsically subjective & effectively ends up with a theoretical valuation ie. what the analyst believes the company should be worth.

But there are a number of simple “fundamental” checks that anyone can apply to their stock selection process, which are particularly important for investors who take a long term, “Buy & Hold” approach.

(i) Sustainable Competitive Advantage
Most importantly, does the company have a competitive advantage that is sustainable over the long term? This may be based on technology (eg. Computershare in share registries), or a dominant market position (eg. Telstra); it may be because they own a monopoly asset (eg. Hills Motorway owns the M4) or they may have capitalised on first mover advantage (eg. Brambles with Chep pallets globally) or because of great branding & marketing (eg. Harvey Norman) or simply because of the quality & depth of their management (eg. NAB or Lend Lease). Invariably these companies are highly rated because they are likely to show strong & consistent earnings growth, year on year.

(ii) Industry Structure
What is the structure of the industry? A monopoly, duopoly or oligopoly? Generally, monopolies make excellent investments as they do not have competitors reducing returns (witness Telstra’s monopolistic profits in local phone calls, until recently..). Stable duopolies can also make for excellent investments, such as the domestic brewing market shared between Fosters (via CUB) & Lion Nathan (via Tooheys), which generates great returns for both players - except during the occasional price war. Contrast this industry structure with, for example, the building materials sector where multiple players compete to produce commodity products (eg. bricks & tiles). No competitive advantage generally leads to lots of competition, which leads to price competition & thus poor returns for each participant. Hardly an exciting investment environment: a low market rating will be the usual result.

(iii) Potential Market Size
What is the size of the potential market ? Is it local or global ? Clearly a company like Aristocrat, which produces gaming machines for the global market (with new opportunities emerging in Nevada & Californian as well as South Africa & Japan) is likely to provide much more growth (& hence a much higher rated share price) than a domestically focussed business (particularly if it has few export opportunities) such as Email, the manufacturer of white goods for the domestic market. Not surprisingly, the former will trade at a huge premium to the latter.

(iv) Size & Track Record
Companies grow by being successful over a number of years. Thus larger companies will have a longer track record. This instils confidence among investors

who will consequently be prepared to pay a higher multiple than for a smaller rival with a shorter track record. This is because the larger company is less risky. But as you look at progressively smaller companies (& market capitalisation is a good measure) be aware that they will have shorter track records & be more risky. Hence, it is totally appropriate that in general, the smaller the company, the smaller the valuation multiple.

This article has looked at some of the important business characteristics used by fundamental analysts – the concepts of sustainable competitive advantage, industry structure, the size of a potential market & the company's size & track record. We have not yet begun to consider how we value these companies, indeed what measures or multiples to use. This will be the topic next month when we will consider earnings per share (eps), eps growth rates, price to earnings multiples (PEs) relative PEs, dividend yields, cashflow & discounted cash flows (DCFs)

As my first boss told me on my first day at work, "Remember that cash flow is real, profit can be an illusion!". Having just finished reading Nick Leeson's "Rogue Trader", I can only assume his bosses had missed this vital distinction!.

James Waggett
23 July 2000

SHARES MADE EASY: ARTICLE 2 – SEPTEMBER 2000

A FUNDAMENTAL APPROACH TO INVESTMENT #2

In my last article for SME, I discussed what I see as some of the principal issues to consider when valuing companies based on fundamental analysis. They were: (i) sustainable competitive advantage, (ii) industry structure (iii) potential market size & (iv) size & track record (which itself is a function of management). These then represent the "story" or why you might choose to invest in a particular stock. But equally important, at least to the professional investor, are the numbers, or valuation. There are many stocks where a great story is already reflected in the current price (CSL & Cochlear at $36 & $29 respectively come to mind). And sometimes stocks (& sectors) trade at big multiples without even a great story – then it is only a matter of time before their share prices come crashing down (witness 2000's tech wreck).

So how do the professionals evaluate the numbers ? Do they simply look at PEs, margins & yields? In my lectures at the Australian Stock Exchange, I identify 4 ratios, which I find particularly helpful in identifying & selecting stocks for investment.

(iii) EPS Growth Rate

As a general rule, share prices increase if earnings per share (eps) increase. I say earnings per share rather than net profit because profit can be acquired & can dilute eps but earnings (after tax, abnormals & minorities) on a per share basis reflect the real underlying growth rate of a company's profits – a subtle but important difference. And the faster a company grows its eps, the higher those earnings will be valued, especially if that earnings growth is consistent. Hence Brambles, which has a track record of growing eps by around 15% compound, trades on around 29 times historic earnings. In contrast, Email (a domestic diversified manufacturer & distributor) with a track record of only modest earnings growth trades on less than half that multiple.

(iv) Relative PEs

Whilst PEs (the current share price divided by eps) are often too simplistic for many situations, they do at least provide a common basis for comparing different stocks – preferably within the same (or similar) sectors ie. Banks, retailers, manufacturers etc.

So when comparing which retailer (below) is better value, we might look at their prospective PEs compared with the average for the sector (or the average for large industrial companies). Why use the prospective PE (based on next year's forecast earnings) ? Because the actual (or historic) numbers are already out of date by the time they are released !! This is why it is not uncommon to see a company's share price fall after a good result or announcement – it was already factored in !! Remember that the market is valuing companies based on what they are forecast to achieve over the next 12/18 months, not what they have just done !!

Table 1 – Comparing 4 Major Retailers based on Relative PEs

	Share Price	**EPS (2000a)**	**EPS**	**EPS (2001f)**	**PE (2002f)**	**RE (2001f) Relative**
CML	$6.62	40.5c	42.7c	49.2c	15.5	0.86
FOA	$7.46	79.5c	78.0c	85.4c	9.6	0.53
HVN	$3.77	10.8c	12.6c	15.6c	29.9	1.66
WOW	$6.64	31.5c	39.4c	46.8c	16.9	0.94
				Average	**18.0**	

Looking at the table using CSFB's forecasts (& these are generally only available to clients), we see that FOA seems very "cheap", trading on "only" 9.6 times earnings or only 53% of the sector average, compared with CML & WOW trading more in line with the average (85% & 94% respectively). HVN in stark contrast to FOA looks "expensive", trading on a huge 30 times forecast earnings or a 66% premium to the sector average. This implies potentially greater risk in holding HVN over FOA.

(v) Price to Earnings Growth Ratio (PEG)

A combination of the PE divided by the prospective eps growth rate gives the PEG Ratio which measures the price of earnings growth – a useful short term valuation tool. So for the above retailers, we can rework Table 1 as follows, using the average 2 year forecast eps growth rate (from CSFB).

Table 2 – Comparing 4 Major Retailers based on PEGs

	Share Price Ratio	EPS Growth (2000a)	EPS Growth (2001f)	EPS Growth	PEG (2002f)
CML	$6.62	5.9%	6.0%	15.2%	1.4
FOA	$7.46	8.5%	-2.2%	9.5%	2.7
HVN	$3.77	26.3%	16.0%	23.8%	1.4
WOW	$6.64	9.6%	25.1%	18.8%	0.7

This shows that far from being an average performer, WOW provides the fastest growth at the cheapest price. And HVN is not as expensive as it might first appear, simply relying on PEs. However, PEGs only remain valid if the earnings growth rate is maintained – if it slows (or indeed goes into reverse due to a cyclical slowdown) it could look very different, exposing a stock as genuinely expensive. Overall though, a comparison of PEGs shows it is perfectly reasonable to pay a higher PE for a stock with stronger eps growth – up to a point at least!!

(vi) Return on Invested Capital (ROIC)

The final ratio is a comparison of the Return on Invested Capital (both equity & debt) with the weighted average cost of that capital (WACC). Empirical evidence shows that there is a strong correlation between returns in excess of WACC & share price performance.

What does this mean in English? If Company A returns 15% on its capital base & its WACC is 10%, then it is making a real return of 5% on every dollar of invested capital – its share price should perform well. If it can increase its ROIC from 15% to 20% then it is making twice the return as previously. However, if Company B returns only 5% on its invested capital compared with a similar WACC of 10%, it is destroying shareholder value & its share price will go backwards.

It is alarming the number of major companies that do NOT even meet this basic threshold. They are burning shareholders dollars & their share prices are generally depressing. Companies such as Boral Building, Pacific Dunlop as well as Amcor & CSR (both until recently) & many other often commodity type, often cyclical businesses (eg BHP) seem particularly susceptible. My advice is simple – SELL, unless management is taking decisive action to improve returns (such as AMC, CSR & BHP under Paul Anderson).

So there we have it. By all means looks at PEs, margins & dividend yields but understand that on their own they will reveal little. Instead focus your attention on the numbers that count – eps growth rates, relative PEs, price to earnings growth & returns on invested capital (vs WACC). Therein lie the keys to identifying stocks, not just with good stories, but which still have plenty of share price growth ahead. And remember that with stocks, as with so many things in life, you get what you pay for !!

James Waggett
September 2000

SHARES MADE EASY: ARTICLE 3 – NOVEMBER 2000

A FUNDAMENTAL APPROACH TO INVESTMENT #3

In my first two articles for SME, I discussed what I see as some of the principal issues to consider when valuing companies based on fundamental analysis. I discussed the requirement for both a good macro "story" (sustainable competitive advantage, sensible industry structure, potential market size & quality of management) & compelling numbers (eps growth rate, relative PEs, price to earnings growth rate & return on invested capital). This analysis is the basis for fundamental stock recommendations.

However, fund managers & professional investors are generally likely to fall into one of two camps - "value" or "growth" orientated investors. More recently, a combined "price for earnings growth" approach comprising a mixture of the two styles is increasingly being employed. It is vital to understand the differences & depending on your investment objectives & risk profile, to combine them sensibly within your own portfolio, in order to maximise returns & minimise risk. It is also essential to fully understand broker research, which may state, for example, how a real dog can represent such magnificent "value"!!

(i) The "Value" Approach

Value investing is all about buying stocks "cheaply", as measured by a low PE ratio, a high dividend yield & a low price to book ratio. Value stocks are clearly companies that are not highly rated & are often at the unglamorous end of the market. Sectors such as food, builders, chemicals, paper & packaging & resources come to mind. Often a significant part of their total return comes not from capital growth, but from their (often) fully franked dividend yields. This may make them particularly attractive for income-orientated investors.

Value investors work on the principal that most valuations revert to the mean over any extended period of time, that "cheap" stocks will ultimately be re-rated towards the market average & hence provide long term outperfromance. One way the market achieves this is via takeovers where successful companies acquire poorly performing, unloved stocks that are trading on very low multiples (of assets & earnings). For example, North Ltd, a resource stock, trading around $2.80 in May 2000 (or around 11 times prospective earnings) was finally taken over by Rio Tinto at $4.75 – a 70% re-rating in a matter of months. Email is another unloved, lowly rated stock, which looks set to fall to Smorgons & One Steel, again at a healthy (40%) premium to its pre-bid price.

Examples of fund managers with a "value" approach include Tyndall, Maple Brown Abbot, Perpetual Trustees and Rothschild, who have found themselves at both the top and bottom end of various performance tables as the vagaries of the market constantly switch between "growth" and "value". Over the last few years, for example, "growth" has outstripped "value", despite the perceived value stocks' late resurgence with the move to more defensive earnings (eg. banks & infrastructure).

(ii) The "Growth" Approach

In contrast, growth investing is about identifying & investing in the high flying "growth stocks", often trading on lofty PE multiples & low or non-existent dividend yields with high price to book ratios. Such investors expect their investments to grow their earnings strongly & consistently over many years due to their perceived competitive advantages. Examples include Brambles, CSL, Cochlear, Computershare, Flight Centre, Harvey Norman, Lang Corporation & Westfield Holdings. This investment approach is fine so long as stocks deliver on high growth expectations. But revenge is quick for those pretenders who disappoint the market – just witness the recent tech rout. The demise in Melbourne IT from $8 to less than $2 in 2 weeks as Colonial First State, a noted & very successful "growth" fund manager, quickly exited their sizeable holding.

(iii) The "Price for Earnings Growth" Approach

These investors believe that buying "cheap" stocks alone is useless unless there is better than average earnings per share growth to provide the catalyst for a re-rating. Similarly they may believe that paying 50 times earnings for a growth stock growing at only 20%pa may not leave much room for share price appreciation. These investors believe in relativity – that is, there is a "cost" of any particular earnings growth rate – buying "growth" cheaply is the goal while avoiding pure value plays which show insufficient earnings growth. Macquarie's Greg Matthews was, until recently, one of the most public proponents of this investment style, which has been growing in popularity, as is his former home, Mercantile Mutual.

The above discussion should help you understand why stocks trade at such a wide range of earnings multiples. Why Computershare, for example, is currently priced at 77 times prospective earnings (but is growing at 65% this year) while CSR is priced at only 9 times (with negative earnings growth this year). It also explains how far some former glamour stocks have to fall before they become attractive to "value" investors. Just witness Telstra, which in January 1999 at $9.00 was trading on 33 times forecast earnings, but recently fell to $5.70 trading on "only" 18 times forecast 2001 earnings. Unloved by disappointed "growth" investors & not cheap enough for the real "value" players. Falling into no man's land can be a common problem for stocks that fall between the two principal investment techniques.

James Waggett
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James Waggett was educated at Oxford University & London Business School. He spent 5 years in Corporate Finance, in London & Sydney, advising on both private & public company mergers & acquisitions with a strong emphasis on valuation. He moved into stockbroking in 1995 initially with Macquarie Equities, then BT & is now a senior adviser with Credit Suisse First Boston Private. His clients include higher net worth retirees, professionals & business people either building wealth or managing wealth. He takes a holistic approach, looking at a client's investments across all asset classes, as well as their superannuation, to determine a suitable investment strategy. He considers himself not just a broker, but also an investment adviser. He is a Level 1 & 2 accredited Options adviser & a member of the Australian Technical Analysis Association (ATAA) and lectures regularly for the ASX. He can be heard on ABC Radio most days & has appeared on national TV & in the press.