Rates of Return

I am sometimes asked: which is the best rate of return to use in evaluating a company? There are two problems with this question. The first is that the questioner is looking for a simple answer to a complex problem. Their approach is similar to another question that I get all the time: what is the best book to read about investing? These questions are attempts to evade the depth and breadth of thinking that is necessary to master the craft of investing. The second problem explains why this is so: every company is different and we have to tailor our analysis to the situation at hand. Moreover, different rates of return study different aspects of the performance of the company management and to get a complete picture more than one rate of return is needed. Thus, there can be no single best rate of return to use.

Return on Equity

The return on equity (ROE) is very popular and for good reason. The Statement of Financial Position sets out the assets of the company (what it owns) and the liabilities (what it owes). If we subtract the liabilities from the assets, we get the net assets, or the equity that shareholders have in the business. We then go to the Statement of Financial Performance and look for the profit after tax. The return on equity is simply the profit after tax divided by the equity expressed as a percentage.

In the half year to 31 December 2012, Telstra's profit after tax was $1.623 billion. Its equity at 31 December 2012 was $11.871 billion. Its return on equity was:

$ROE = 1.623 \div 11.871 \times 100 = 13.67\%$

However, this profit after tax was for only half a year, so the annualised return is double that or 27.34%.

This rate of return is of great importance to investors because it measures the return that management is getting from the funds that the shareholders have in the business.

While the absolute rate of return is important, it is also vital to look for the trend in the rate of return on equity. Investors ideally want to see the return on equity growing. If it is high and fairly static it may also be alright, but if it is falling smart investors will want to know the reason. Nevertheless, a constantly rising return on equity over many years is difficult to achieve, especially if the business is cyclical in nature. As I said at the start, there are no simple answers to complex problems. Calculating the rate of return is just the start. The payoff is in the interpretation of the ratio in the full picture of the business we are looking at.

Return on Assets

The return on assets (ROA) is also very popular. It is not an alternative to the return on equity. It is looking at something quite different. To calculate it we go back to the Statement of Financial Position and find the total assets. We already have the profit after tax from the Statement of Financial Performance used for the return on equity. The return on assets is simply the profit after tax divided by the total assets expressed as a percentage.

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In the half year to 31 December 2012, Telstra's profit after tax was \$1.623 billion. It total assets at 31 December 2012 was \$37.855 billion. Its return on assets was:

ROA = 1.623 ÷ 37.855 × 100 = 4.29%

Again, this profit after tax was for only half a year, so the annualised return is double that or 8.58%.

This rate of return is important to investors because it measures the return management are deriving from the assets employed in the business.

The return on assets will necessarily be lower than the return on equity. This is because equity is assets less liabilities, so the denominator in the return on equity must always be smaller while the numerator in both rates of return, profit after tax, is the same.

Like the return on equity, the absolute rate of return on assets is important, but it is also vital to look for the trend in the rate of return on assets. Investors ideally want to see the return on assets growing. If it is high and fairly static, it may also be alright, but if it is falling, smart investors will want to know the reason. Nevertheless, a constantly rising return on assets over many years is difficult to achieve, especially if the business is cyclical in nature. A particularly low return on assets may suggest that management is not using the assets well. Among other possible measures, it may be practical to sell poorly performing assets, repay debt and so improve the rate of return on the remaining assets.

As I said at the start, there are no simple answers to complex problems. Calculating the rate of return is just the start. The payoff is in the interpretation of the ratio in the full picture of the business we are looking at.

Variations

There are many different ways to define these ratios. Some sources will use average capital rather than year-end capital. I doubled the half year return to annualise the rates of return. This is generally fine if the business is non-seasonal and only lightly cyclical. When there is distinct seasonality or cyclicality, it is better to use the profit after tax for the last two half years. Some analysts will also exclude unusual, supposedly one-off, losses by adding them back to the stated profit after tax.

Another problem is that the statutory profit – Net Profit After Tax is an accounting construct and can hide problems, at least for a time. Many analysts prefer to use net operating cash flow instead in these ratios because it is more difficult to manipulate. Many businesses have been profitable at the NPAT level, yet failed because there was insufficient cash flow.

The key point here is to always know the definition for the rate of return we are taking from a source. When we are calculating rates of return, the main thing is to be consistent, rather than agonise over the various different definitions. After all, it is the trend in the ratio that is our most important observation.

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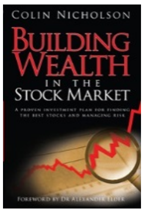

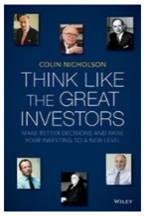

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I am one of the very few investors who publishes their investment results each year, which I have done since 2000 – see the Investment Returns page on the About Colin menu on the website