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Taking Stock

I can see clearly now. The way forward.

By Martin Conlon, Head of Australian Equities

Johnny Nash could see clearly, and what he saw was a bright, bright, sun-shiny day. If only it was so easy for investors.

Some of you may have seen the program "The New Inventors" on the ABC. One of the guys who is occasionally on the panel describes his occupation as 'Futurist'. This occupational description has always intrigued me, as I have absolutely no idea what the day to day activities of a futurist might involve. The Oxford dictionary defines a futurist as "One who studies the future and makes predictions about it". Making predictions about the future sounds relatively easy (and particularly attractive, as the normally uncomfortable annual assessment process endured by most employees could be deferred annually on the basis of one's predictions having not yet come to fruition), however, studying the future strikes me as somewhat more problematic, given that it hasn't happened yet. This job is sounding more attractive by the minute! In the comfortable position of knowing that it will prove difficult (at least for a while) to prove my predictions totally wrong, I have decided to try and 'study the future'.

The tendency for analysts and humans generally to extrapolate, has always interested me. Much of the sentiment that drives economies and markets stems from extrapolation. For some reason, humans feel more comfortable assuming that the future is likely to resemble the past. In my newly adopted role of Futurist, I am going to make a few bold predictions that question the wisdom of this extrapolation and highlight a few areas in which investors might want to reconsider this approach.

Growth rates

Prior to 'studying the future', I thought it wise to recap on a few basic mathematical principles which are useful in simplifying the extrapolation process. Firstly, when talking about growth rates, I think it is extremely useful to condense these growth rates into the time in which it takes to double (doubling times). For any of you with an hour or so to spare, I'd recommend watching Dr Albert Bartlett's presentation on Arithmetic, Population and Energy on YouTube, as it discusses the issue of growth rates, doubling times, and their impact on population and energy, extremely well. The concept is simple, but often ignored. Let's take iron ore. In order to arrive at the period of time which it takes for something to double, the easiest method is to divide the growth rate into 70. Whilst the current ebullient sentiment on Chinese growth prevails, no-one would think it overly bullish to predict volume growth of 7% over the next decade. If this proves correct, the annual volume of iron ore sold will double in the next ten years (70/7). Secondly, it is useful to remember, that the growth in any doubling time is greater than the sum of all the preceding growth. Again, in the case of iron ore, if the 7% growth rate proves correct, more ore will be consumed in the next decade than in all of previous history. This is sometimes a difficult concept to grasp, but even if iron ore has been used for hundreds of years, a 7% growth rate will ensure that the next decade's usage will exceed all previous usage. This is in no way suggesting that this cannot happen, it is just trying to give some perspective to what these growth rates mean. It is also testament to the importance of compounding and why we spend so much time as analysts trying to work out whether expectations are realistic or fanciful. When stock prices encapsulate an expectation of high growth rates, the path back to earth when these expectations aren't delivered is usually painful. As I've mentioned previously, one of the drawbacks of the 'fill right' function in Microsoft Excel, is that it makes the extrapolation of growth rates into the distant future, totally painless. Add a few hundred lines to the model and some extremely complex formulae and no-one will ever be brave enough to suggest the results are total bollocks.

Having agreed on the basic maths, I thought it might be useful to apply them in a few areas which are likely to be fairly important for investor returns in the future.

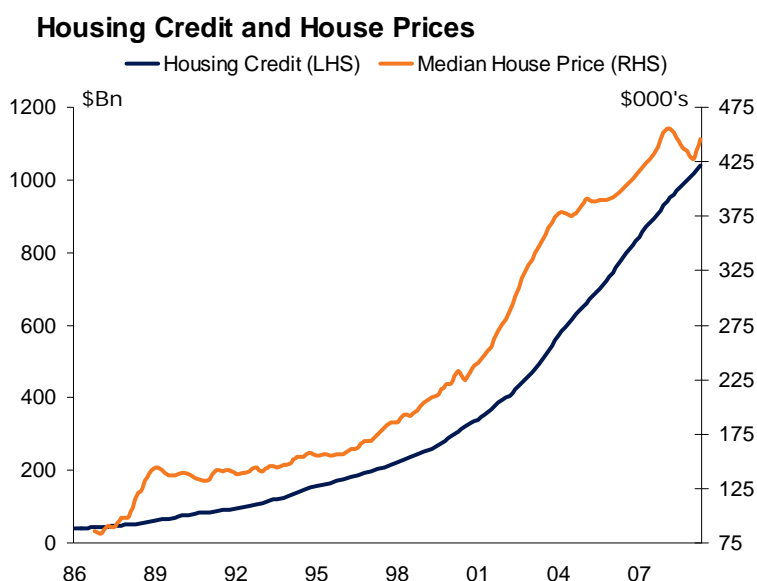
Credit growth

After the controversy which surrounded the takeover of Merrill Lynch by Bank of America late in 2008, and the subsequent payment on multi million dollar bonuses to a huge number of staff who had been instrumental in destroying vast quantities of shareholder and taxpayer money, I confess to having been hopeful that such egregious displays of greed and total absence of remorse, would spur policymakers and shareholders into action to ensure that such action would not happen again in a hurry. I have been sorely disappointed! Barely months afterwards, the credit drug has proven too powerful for policymakers to resist, and they have caved in to the demands of a credit hungry constituency (probably not surprising when the Treasury Secretary was a Goldman Sachs banker). Whilst the injection of liquidity into global economies was almost certainly necessary, the lack of ancillary action to orchestrate an outcome which may differ from the past was sadly lacking. Meetings of global central bankers, led by Ben Bernanke, must be like Woodstock for credit junkies. Investment bankers are happy again, and confidence that central bankers will be there to bail them out of any future 'shocks' is unwavering.

This brings me to my first grand vision for the future. Credit growth cannot continue at anything like its current rate in western countries. Most of you are more than aware of the inexorable rise in credit over the past couple of decades. Credit growth has consistently grown at 2 to 3 times nominal GDP and has been the engine of GDP growth. At growth rates north of 10% p.a. in Australia and most other western nations, the doubling time for credit is barely more than 5 years (and you think the current stock of debt is scary). It has been instrumental in allowing us to spend more than we earn, shift dramatically towards consumption based societies and propel the prices of houses and just about every other asset substantially higher in an almost linear path. Rapid credit growth is transferring the burden of repaying debt to the younger generation and has made western countries increasingly reliant on funding from developing nations with a greater propensity to save. Having lent us the money so far, there is little that developing nations such as China can do to protect their initial investments as western central banks have significant ability to prop up their economies by lowering interest rates and hence the repayments on this debt, however, that is likely to come with an ancillary impact of a reduced appetite for future debt from these lenders. As with any investment, if the rate of return plummets or the currency of the investment collapses, enthusiasm for repeating the dose is likely to wane. Housing debt, in particular, seems the villain in this western debt explosion.

Unsurprisingly, the warm, fuzzy feeling home owners get when their house increases in value every year and the ability to never put off till tomorrow what one would like to buy today, has left very few questioning the merits of ongoing growth in housing credit. No-one wants to shatter the Australian dream of owning a home. I'm not keen on being the grim reaper either, but I'm a little tired of waiting for a few voices of sanity to combat the chorus of real estate agents heralding the next 'once in a lifetime opportunity' to get into the market.

Residential property should not be an extremely complicated asset. After acquiring a block of land, one proceeds to arrange a combination of building materials into a habitable dwelling. Over time, one might expect the value of the house to depreciate (as it gets older), whilst the land would probably be expected to appreciate with inflation (same size, same place). Not so. The universal expectation is that this assemblage of building materials on said piece of grass can go no other way than perpetually upward. As Professor Julius Sumner Miller used to ask: Why is this so? My answer can be broadly summarised in the chart below:



Source: GSJBW Research Estimates, ABS, REIA

Property prices seem almost perfectly correlated with the rise in credit. As long as more housing credit is available, it will find its way into higher property prices. Similarly, if we want property prices to continue to rise, it will require more housing credit. At present, despite the cash yields on Australian residential property being incredibly low (well below the cost of debt in most cases), banks are more than happy to continue to provide credit to eager 35 year old borrowers keen to take out 30 years mortgages which suck up most of their income. Full recourse lending ensures that Australian borrowers will find it nigh on impossible to walk away from their home, meaning that loss rates on residential property lending are negligible. Together with risk weightings which ensure that banks allocate minimal capital against housing loans, we ensure that banks will remain eager to lend against unproductive assets.

Housing credit needs to change. Rather than using credit as the fuel for rising property and land prices, it needs to be directed more wisely. No productivity gains stem from rising land prices, no employment is generated and if anything, our cost position relative to competing countries deteriorates. Low risk weightings on housing lending and first home owner grants do nothing but encourage more borrowing against unproductive assets and ensure that the younger generation takes on a greater debt burden. It strikes me it might be time for some policy change.

Financial leverage

The experience with debt in the Australian housing market has been mirrored more broadly in the economy. With plentiful credit fuelling strongly rising asset prices, we have developed a culture which embraces leverage. Rather than employing leverage on the basis that the sustainable cash yield allows leverage to be employed to enhance the returns to equity holders, leverage is most commonly employed on the basis that asset prices will continue to rise at a faster pace than the cost of debt, and therefore result in windfall gains. Rather than focusing on the cash generation of an asset, the focus of buyers and bankers routinely turns to asset value.

Financial leverage is a relatively simple concept. When you buy an asset, along with the decision on how much the asset is worth (which should be driven by its cashflows), you need to decide how the purchase price will be funded. Although these should be separate decisions, in most cases the amount which the bank will advance a purchaser is a crucial factor in the price they are willing to pay. This is dumb. The more debt that is added, the more sensitive you become to the movement in value of the underlying asset. As the owner of the equity, making yourself extremely sensitive to a small change in the price of the asset when its price is extremely high is probably not that smart. Kerry Packer famously said that "You only get one Alan Bond in your lifetime". There is a reason Alan Bond went broke. Buying Channel Nine and Van Gogh paintings with debt funding at the peak of the market was it. I'd suggest that aggressively replicating his strategy in the future will not lead to an entirely different outcome.

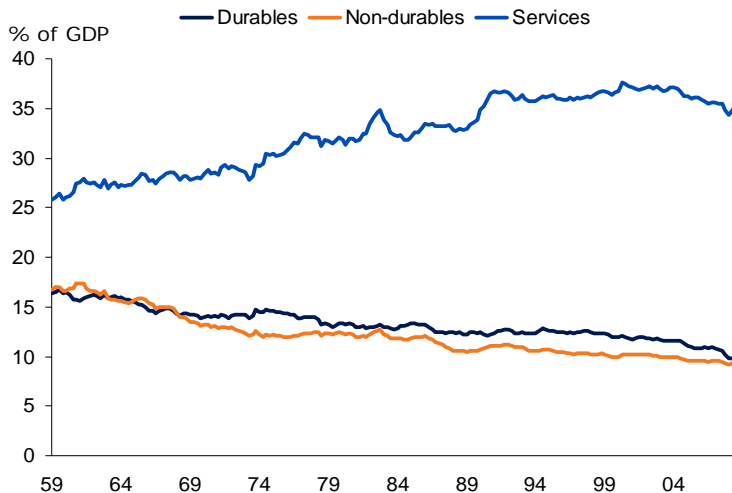
Bankers are inherently pro-cyclical. They like to lend money when it is plentiful, and will reduce the price of money accordingly. When money becomes scarcer, they are likely to change their mind instantaneously. Not only are they likely to be averse to advancing further funds at low prices, they are likely to want far higher prices on the existing amounts outstanding. The global financial crisis could be succinctly summarised as lots of bankers panicking simultaneously. We have been through an extremely extended period in which bankers have been pro-cyclical. As a result, the cashflow on a significant proportion of assets produces insufficient cashflow to fund the interest costs on the debt. Where I come from, this is known as speculation. Buying something with a ludicrously low cash yield on the assumption that a buyer will come along at a higher price is the greater fool theory. Our attitude to leverage needs to change. It should be employed when the cashflow yield on an asset justifies an element of leverage in order to enhance the returns. It is normally at its most useful when it is most difficult to come by. As populations age and the need for new capacity across a range of industries dwindles, the age of aggressive financial leverage is unlikely to be on the rise. Use debt cautiously and be aware of its risks.

Services and consumption

In tandem with the growth in credit, the shift of western economies away from industry and manufacturing and towards services and consumption has been marked. The sectors which drive economic growth domestically are based around consumption (retail) and services (financial and professional). A far greater proportion of us shuffle paper, make coffee and sell plasma TV's than was the case a few decades ago. As a result, if short term economic stimulus is your aim, then it is these sectors which must be the target. Again, extrapolators anonymous would have us conclude that this situation will prevail indefinitely, and these sectors will continue to grow at rates far beyond their old economy peers. Already, a DVD player can be made, landed in Australia and sold with a reasonable margin for a retailer for about the cost of a 10 minute visit to your GP. Continued extrapolation of some of these extraordinary price and value trends for the next couple of decades would probably see the DVD player come down to less than the cost of the harbour bridge toll. I doubt it's going to happen. The expectation that the prices of all our raw materials are going to rise indefinitely whilst the prices of all our consumer goods fall, is another area in which I'm going to beg to differ with the extrapolators. Just as I suspect China will need to rebalance its economy away from fixed investment and towards consumption and services, we'll need to move the other way. The trend of every western country shedding manufacturing and outsourcing everything to Asia has caused a boom in global trade and

a boom in services and consumption relative to fixed investment in western nations. Globalism is the term often used to describe this trend. Although Australia is undoubtedly better positioned than nations without a large, resource rich land mass, I suspect many nations may look to reverse some of these trends and rebuild efficiency in sectors which add balance and breadth to the economy. Competitive advantage applies to economies as well as companies, and the more of it you have, the better off you are. Labour cost advantages are generally transitory (China included), and once lost, must be replaced with another, or else the outcome is generally not great.

Australia: Consumption Shares



Source: GSJBW

The resource boom

The use of natural resources in Australia is an even touchier subject. Having ridden on the sheep's back for some time, we are now happily riding on the back of a big yellow truck laden with iron ore and coal. The masters of extrapolation are convincing us that this will continue indefinitely and that prices will be propelled ever higher by the voracious appetite of the Chinese. I doubt it. Through pursuing extremely high growth which has been almost solely driven by fixed investment, the Chinese have played a key role in shifting wealth to Australians through the creation of a supply-demand squeeze. Working out the length and extent of this squeeze is an almost impossible task, however, it's nice to be a seller of raw materials whilst the dynamics are in place.

It is a relatively indisputable observation that most of the natural resources we are currently using are finite. Although Hubbert's peak and its prediction on the world running out of oil has not proven entirely accurate, there is no doubt that continuing to use the world's stock of such finite resources at an ever increasing rate will eventually result in their exhaustion. We can debate growth rates and doubling times, but not the fact that they will eventually run out, if usage continues to grow. The faster the growth, the quicker the utilisation. The drive towards renewable energy may have taken some time to gather pace, but those countries without the luxury of significant natural resource wealth are finding out that rising raw material prices act significantly to their detriment. If the potential paths in the longer term for resources are 1) Continued aggressive growth in usage resulting in escalating commodity prices, exploration and development costs together with more rapid utilisation of remaining resources or 2) Reinvestment in alternative technologies and reshaping of resource intensive industries to reduce dependence on finite resources and prolong resource life, it strikes me that path 2 might be more logical. Just because Australia is positioned as a beneficiary of higher resource prices and rapid usage growth doesn't make it right. The expectation that path 1 might continue for some time yet has been sufficient to convince a large amount of domestic and global capital to chase higher prices and create an Australian stockmarket littered with bets on the development of new and lucrative resource tenements. I suspect it may be an idea to re-invest some of the cashflow that has arisen from our country's fortunate positioning in broadening out the basis for future economic growth, rather than doubling up on the last decade or so repeating itself.

So how do we move forward? While it's not always comfortable, I think we need to embrace change. Let me highlight one example.

Telstra and the NBN

The plight of Telstra and the scepticism with which plans for the National Broadband Network (NBN) have been greeted are a prime example of our reluctance to embrace change and a refusal to acknowledge the need for it. How many developing countries have plans to develop a copper telephone network capable of delivering speeds 50

times slower than fibre? Why are investors determined to try and preserve the cashflows of an outdated and expensive network rather than invest in a new one?

The copper network has served us well for an extended period of time. Unfortunately it is outdated and obsolete technology which needs replacing. The government sold an old and exceptionally profitable telephony network to taxpayers and institutional investors (including me) during the 90's, and they sold it well. The realisation that technology was changing and the cashflows from the old network were not sustainable has taken some time to sink in. It probably still hasn't. The network is a crucial part of the country's infrastructure and will be vital to how we compete in the global marketplace. Having an expensive, slow network run by a monopolist keen to extract usurious returns is probably not a great idea. As investors, we need to understand that every investment has a life cycle. Returns on capital in nearly every business start off low, usually involving losses. As a well run business develops, it gains market share, delivers a value proposition that customers want, and its returns and profitability grow. Over time, most businesses find the process of reinvention and reinvestment difficult. For this reason, it is often new businesses, willing to commit new investment that garner revenue and profit from existing players. Often the older players wither and die. Understanding where a business is positioned in its life cycle, is crucial to its value. I'm no rocket scientist, but my guess is that Telstra's fixed line network is pretty late in its life cycle. Rather than battling to support the investment of shareholders (like me), who failed to fully appreciate that it was 2 minutes into overtime when we bought the shares, we need to move on. The ref has blown full-time! Telstra's business is still worth something as it fades, and given its significant expertise in running networks, could undoubtedly play a key role in rejuvenating the business, but prolonging the life of the old network is not the solution. The responsibility of capital allocators is to try and allocate it wisely. We're better off taking the cash and re-investing in the new network with the prospect that returns on a modern state of art network are likely to rise. Australia, and most of our western peers are sitting on outdated and inefficient infrastructure in a wide range of areas. When the current network was rolled out and the dams and highways of the country first built, I doubt the proponents were pre-occupied with demanding a 20% return on capital in year 1. We do not have a track record of enthusiastically devoting capital to enterprises that don't have a proven history and positive cashflow. The venture capital industry in this country is almost non-existent. Developing a tolerance for investments that have a longer term pay-off (which is not necessarily lower) is a lesson we'll need to learn.

To the credit of the government, they have embraced the issue with the NBN and are keen to initiate the process of renewal. I hope they have the guts to keep going.

Every investment has a life cycle, and investors should do their best to understand it before they make an investment. Earnings before interest, tax, depreciation and amortisation (EBITDA), should be banned as a measure of cashflow. Depreciation is a real charge aimed at estimating the replacement cost of an asset over its life. Just because an asset can be starved of re-investment capital for extended periods during the life of an asset doesn't make this capital requirement disappear. To the contrary, it is exactly the reason we have so many dilapidated assets. The entire REIT sector has gone forward happily paying out 100% of EBITDA on the assumption that depreciation doesn't exist. Countless hundreds of millions are written off by the stockmarket in "abnormal" charges which result from the fact that a factory became uncompetitive or an acquisition didn't perform quite as well as expected. I think these events have probably now occurred with sufficient regularity that we may now conclude that they're not that "abnormal". We spend a fair amount of time trying to understand what the lifecycle of every business we buy looks like, as failure to take this precaution usually results in a nasty shock. We are eager to provide capital to companies that can use it sensibly. In return, we expect companies to be honest about the return prospects of the business, its life cycle and its capital requirements. Once we've established this picture, we can then think about whether it's sensible to introduce financial leverage. Every asset works the same way and it's not that complicated. A future with a little less complexity and a few less intermediaries would be a step in the right direction.

It seems to me that a crisis should induce some sort of alteration in behaviour in an effort to prevent the future becoming a repetition of the past. The significant behavioural changes which are being pursued in western economies as a result of the global financial crisis are less than apparent. Without significant efforts to try and engineer more productive outcomes internally, it would seem to me that we are conforming closely to the definition of stupidity; doing the same thing and expecting a different outcome. Like Johnny Nash, I'd like the future to be a bright, bright sun-shiny day, but it strikes me, that for this to happen, we might want to think about a bit more change than is currently being contemplated.

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