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Monster minutiae

How the difference between little fees is very, very large

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Make the most of mixed offerings

Corporate results Smart Investor asks a panel of fund managers to pick over the reporting season for risks and opportunities.

What's written in the past

If you are a global market leader in your industry the world is your oyster.
Catherine Allfrey, Wavestone

The banks will find it difficult to grow dividends.
Vince Pezzullo, Perpetual Investments

It's difficult to point to factors that suggest growth rates will pick up.
Johan Carlberg, Alphinity Investment Management

In our view, dividend payout ratios have not changed significantly.
ST Wong, Prime Value Asset Management

What did we learn from the most recent reporting season?

Catherine Allfrey: The 2014 reporting season has delivered good earnings growth broadly in line with expectations, up 9 per cent year on year. Excluding **Qantas** and mining services, industrial earnings growth has been solid, up 7 per cent despite a soft economy during the budget period [April to June]. Resources had a very strong first half, up 40 per cent, but the collapse in the iron ore price saw the second half up 13 per cent.

Johan Carlberg: It confirmed that we are stuck in the low-growth, low-interest-rate environment and that the May budget's negative impact on consumer spending many companies reported in June is still around. However, 2013-14 was still a better year than both 2011-12 and 2012-13 in terms of earnings growth, with growth across the banking, industrial and resources sectors.

Vince Pezzullo: We've seen mixed results. Some companies reported in line with consensus results and provided an element of capital management over and above the regular dividend. This was typical of the defensive businesses such as **Telstra**, **CSL** and **Wesfarmers**. Other companies, such as **Sims Metal** and **Transpacific Industries**, reported major restructuring programs. Revenue growth was particularly difficult to achieve, with quite a few companies achieving market estimates through cost cutting. Cash flow growth was another trend with traditional industrial companies like **Boral**, Sims Metal and **BlueScope** producing excellent cash flow performance and continuing to delever balance sheets.

ST Wong: Fears of significant downward earnings revisions were not realised. The soft demand environment was confirmed but operating cash flows got better as companies improved margins by raising productivity, and deployed capital more efficiently. Share price volatility has been high. Some share prices declined sharply after management's conservative profit guidance.

What is the outlook for top-line growth over the next one to three years, or will profit growth come from cost cutting?

Allfrey: Outlook for top-line growth is subdued if you are a domestic-only business, but if you are a global market leader in your industry the world is your oyster. Industry leaders like **SEEK**, **Domino's**, **Crown**, **Amcor**, **Resmed** and **Ramsay Health Care**, where earnings growth is being driven by global footprint expansion, are executing well. Profit growth from cost cutting alone is not a sustainable strategy. Companies will also continue to benefit in 2014-2015 from lower interest expense.

Carlberg: The low-growth environment is likely to continue, certainly for the next 18 months. Apart from a potentially weaker Australian dollar, it's difficult to point to factors that suggest growth rates will pick up. This implies profit growth will continue to come from cost cutting. The companies we believe will continue to enjoy strong top-line growth are in more secular growth segments of the economy, such as healthcare, or can leverage disruptive technologies, such as the internet.

Pezzullo: Companies exposed to residential and commercial construction and slowly improving consumer spending will see the largest improvement in revenues and profit growth. These cyclically exposed companies are where some of the disappointment in reporting season was felt, as the market got ahead of itself regarding the earnings leverage of these businesses. This is where we see the most opportunity at the moment as prices have dropped.

Wong: A broad-based acceleration of top-line growth seems unlikely. The demand environment is clearly subdued. But companies in sectors enjoying structural growth, introducing new products or gaining market share will post robust top-line growth. Ramsay Health Care and **Healthscope** will enjoy structural demographic tailwinds while Resmed will benefit from its new products over the next year. The focus on cost cutting will still be a feature of profit growth but it will diminish in contribution.

Should investors be worried that dividend payout ratios are too high and that management is not reinvesting to boost earnings growth?

Allfrey: For industrials and property trusts,

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The panel

- Wavestone principal **Catherine Allfrey**.
- Alphinity Investment Management lead portfolio manager **Johan Carlberg**.
- Perpetual Investments portfolio manager **Vince Pezzullo**.
- Prime Value Asset Management joint CIO and senior portfolio manager **ST Wong**.

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Fund inception date 17 January 2013

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Small numbers make big messes

Steve Johnson

Most of what you need to know to be a good financial analyst was written a long time ago. *Security Analysis*, Benjamin Graham's bible for value investors, was written in 1934. His more widely read *The Intelligent Investor* was written in 1949 and remains as relevant today as when it was written. Throw in some accounting training and 40 years of **Warren Buffett**'s Berkshire Hathaway letters and you will have all the basic tools you need to be an analyst.

You still won't make any money.

Being a good investor involves a lot more than analysis. There are more than 120,000 holders of the Chartered Financial Analyst designation in the world, and many multiples more than that with the ability to deconstruct a balance sheet and calculate a Herfindahl-Hirschman Index. Being a good investor requires taking all that analysis and turning it into the right decision. And that's where our human brains tend to let us down.

A most important book for all investors has nothing to do with balance sheets or discounted cash flow analysis. It's *Thinking Fast and Slow*, the culmination of **Daniel Kahneman**'s lifetime of work analysing human decision making, and all the shortcomings that make us ill-equipped to make rational decisions in the modern world. If you

Steve Johnson is chief investment officer of Forager Funds Management.

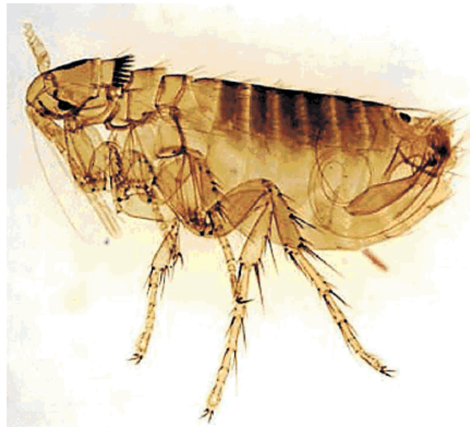
want to understand why making good decisions is so difficult, Kahneman's book is the bible.

Take, for example, our inability to deal with very unlikely events.

Last week **Commonwealth Bank** launched a new version of its hybrid securities, the Perls VII. Christopher Joye did an excellent job of pointing out some of the pitfalls with these securities in this paper, and then followed it up on August 25 suggesting the hybrids could fall 35 per cent or more in a crisis.

That article included this paragraph: "Nevertheless, my stockbroking interlocutor maintains that 'the conversion of the hybrids [into bank equity] is a one-in-a-thousand event'. He later revises this rather radically to 'about a 100 to one shot'."

Irrespective of your view on the respective risks, Joye is right that mathematically there is a radical difference between one in 100 and one in 1000. But to our human brains, both are close enough to zero to be ignored. Kahneman says: "Probabilities that are extremely low or high (below 1 per cent or above 99 per cent) are a special case. It is difficult to assign a unique decision weight to very rare events, because they are sometimes ignored altogether, effectively assigned a decision weight of zero ... Furthermore, people are almost completely insensitive to variations of risk among small probabilities. A cancer risk of 0.001 per cent is not easily distinguished from a risk of 0.00001 per cent, although the former would translate to 3000 cancers for the population of the United States, and the latter to 30."



Minor irritants can inflict monumental damage.

The prevailing view is that CBA is highly unlikely to get into trouble. Our human brains take "highly unlikely" and choose to ignore it. Therefore the 2.80 per cent margin on the hybrid securities is appealing relative to the 0.8 per cent margin you get on a government-guaranteed CBA deposit.

To make a sensible decision you first need to recognise that your brain does stupid things when dealing with small probabilities. Second, try to put the numbers into a context your brain can better deal with. Psychologists call it "framing" information differently.

Let's reframe the Perls issue. You are paid an extra 2 per cent a year in margin. Therefore, you can afford to lose your money once every 50 years and you'll be in the same position as those who left their money on deposit. So now, instead of asking yourself what are the chances of CBA getting into trouble, to which your brain immediately jumps to the conclusion "not going to happen", ask yourself what are the chances of CBA getting into trouble at any point during the next 50 years? All of a sudden the Perls don't seem quite so risk-free.

Another application of this small number blind spot relates to fund manager fees. David Murray's Financial System Inquiry has added its voice to the chorus of frustration among regulators and reformers about the "stubbornly" high costs of funds management in Australia. If there is so much evidence suggesting that active managers, on average, don't beat index funds, why do people keep paying such high fees? If the regulators understood our inability to deal with small numbers, they wouldn't be so surprised.

Here's the problem. To the human brain, 2.0 per cent is a small number, 1.0 per cent is a small number and 0.5 per cent is a small number. The difference is mostly indistinguishable.

So, if regulators want more competition on fees, they need to change the frame of reference. The long-term return from owning Australian equities is between 8 and 10 per cent per annum. So instead of letting fund managers quote their fees as a small number that our human brains think is pretty close to zero, make them quote it as a percentage of expected return, as per: "Our 2 per cent fee is between 20 and 25 per cent of the historical long-term return from owning equities." Comparing a fund manager who takes 12.5 per cent of your expected return with a competitor who takes 25 per cent would make you think twice.

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dividend per share growth and double earnings growth is unsustainable. Asset sales, benign insurance claims and low bad debts for banks have boosted earnings and dividend payout ratios. High dividend payout ratios address investor income preferences, but there will be limited scope to smooth dividends should conditions deteriorate, so to expect any fall in earnings per share now means an immediate cut to dividend.The market is evolving towards service companies that have low capex requirements and are highly cash-generative.

Carlberg: We are in favour of capital discipline, but there is also a risk the pendulum swings too far.

Pezzullo: Since the GFC, payout ratios have steadily climbed to 80 per cent, but the 20-year average is closer to 70 per cent. In our view, the area where payout ratios are unsustainably high is in the banks; half of the profit growth in the Australian banks has come from falling bad debt charges. The banks will find it difficult to grow dividends if there's a return to more normal level of bad debts.

Wong: Dividend payout ratios have not changed significantly. We haven't reached a critical juncture where the lack of reinvestment hinders earnings growth. There are companies exploring longer-term growth options, such as **Aurizon**, but we would only be comfortable if the returns are justifiable.

> *We haven't reached a critical juncture where the lack of reinvestment hinders earnings growth.*
> ST Wong, portfolio manager

Which companies surprised on the upside, including with their outlook statements?

Allfrey: Despite a heavy reinvestment in clinical trials, administration and manufacturing, **Sirtex** delivered 31 per cent growth in 2013-14, with the March 2015 trial results set to quadruple the size of the market. **Caltex**'s result was at the upper end of guidance and the outlook is solid with the Kurnell closure, as there will be lower volatility in earnings. Telstra, **iinet** and **M2 Group** all reported solid results. The NBN rollout is helping the industry to grow again.

Carlberg: Some of our company highlights were **Cover-More**, **Goodman Group** and **Spotless**. Amcor and CSL also reported good results. Resilience of general insurance margins for **IAG** and **Suncorp**, despite slowing premium rate increases, was also well received. Despite the mixed share price reaction, many resources companies reported better than expected earnings based on productivity improvements and commodity prices holding up, with **BHP Billiton** the exception. A maintained cost focus will provide leeway but we see downside to most commodity prices and thus earnings this year.

Pezzullo: Caltex delivered good margin expansion and positive outlook regarding margins and the shutdown of the Kurnell refinery. **Orora**, which was spun out of **Amcor**, reported strong revenue and margin growth and guided to a continued improvement and good cash flow performance.

Wong: Among large caps, improvements in AMP's Wealth Protection division and in income protection experience were a major positive change for **AMP**. In small caps, **Austal**'s 2013-13 earnings were not a major surprise on the upside.

Which companies disappointed?

Allfrey: **Breville's** change of chief executive and US sales that were slower than expected have left it in a weaker than expected position. Weak July sales which re due to increased competition have stifled growth for **JB Hi-Fi**. BlueScope's second-half result was weaker than expected, and July to December guidance was cautious. **Ainsworth**'s domestic outlook was flat and analysts are questioning US growth prospects.

Carlberg: Retailers, media companies and domestic pathology service providers hit by the May budget were disappointing, particularly in outlook.

Wong: Pricing pressures affected **Coca-Cola Amatil**'s core products. The outlook is challenging, with volumes under pressure and product price deflation.

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