Cuffelinks
Connecting investors with ideas

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Judging big profits beyond the big headlines

Hugh Dive

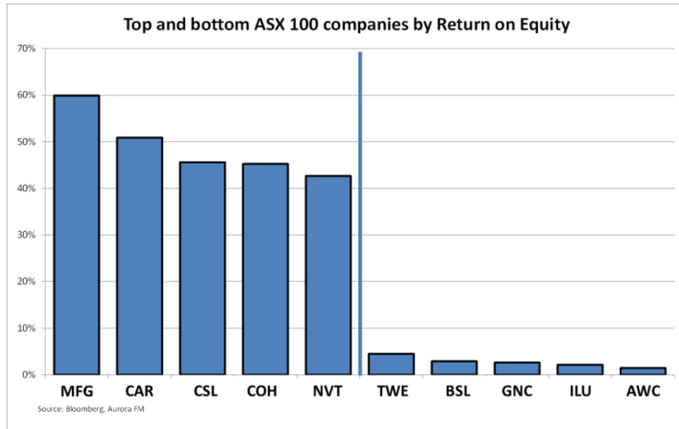
Over the last month, Westpac, NAB and ANZ collectively reported profits of $20.8 billion. This resulted in commentary in the media about banks being too profitable, especially in light of recent moves to reprice loan rates upwards for both investors and owner occupiers. Whilst large corporations generate big profits in dollar terms, debate often ignores the extent to which these profits have to be shared amongst millions of individual shareholders. For example, Commonwealth Bank has 790,000 shareholders with 1.7 billion shares outstanding, all of which have a claim over the $9.1 billion in cash profit that the bank reported in August. This article looks at different measures of corporate profitability for large Australian listed companies, beyond the billion dollar headlines.

Different measures of profitability

As a fund manager, the $7.8 billion of raw profit generated by Westpac does not mean much. I look at the underlying earnings per share (EPS) which is what the owner of a single share of the company receives from the profit generated in a particular year. We also look at growth in EPS, as often a company's profits can grow substantially when they make an acquisition, but if that acquisition is funded by issuing a large number of additional shares, profit per share might not actually grow. For example, in 2015, toll road operator Transurban reported revenue growth of 39.6% post the acquisition of Queensland Motorways, sensational growth for a steady business. However, distribution per share grew at a still respectable 14% after issuing additional shares to fund the purchase of the new asset. Additionally, at a company level we also look at measures such as returns and profit margins, which can be better measures of how efficient a company's management team is in generating the annual profits. Furthermore, these measures allow the investor to compare different companies in similar industries.

Return on Equity

Return on Equity (ROE) looks at the profit being generated by the equity that the owners have contributed to establish the business. ROE is calculated by dividing a company's profit by the money which shareholders have invested in it. This investment by shareholders includes both original share capital from the IPO plus retained earnings. Retained earnings are the profits kept by the company in excess of dividends and are used to fund capital expenditure to either maintain or grow the company. Companies with high ROE typically require little in the way of dilutive equity raisings from shareholders to run their business, or may be highly geared.

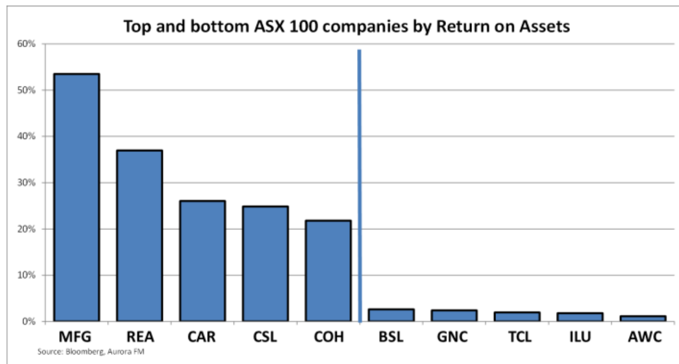


The chart above shows the top and bottom five companies in the ASX as ranked by ROE. The top ROE earners contain a fund manager (Magellan), an internet company (Carsales.com), two healthcare companies (CSL and Cochlear) and an education services provider (Navitas).

The common factor in these businesses is minimal ongoing capital expenditure to run the company. Bringing up the rear are a range of capital heavy businesses that require both large amounts of initial capital to start the business and regular capital expenditure to maintain the quality of their assets and finance their ongoing activities. This sub-set includes a winemaker (Treasury), miners (Iluka and Alumina), a steelmaker (BlueScope) and a gain handler (Graincorp).

Return on Assets

Return on Assets (ROA) differs from ROE, as it measures the return a company makes on its total assets. This measure accounts for both the equity and the debt used to purchase the assets that generate a company's profits.



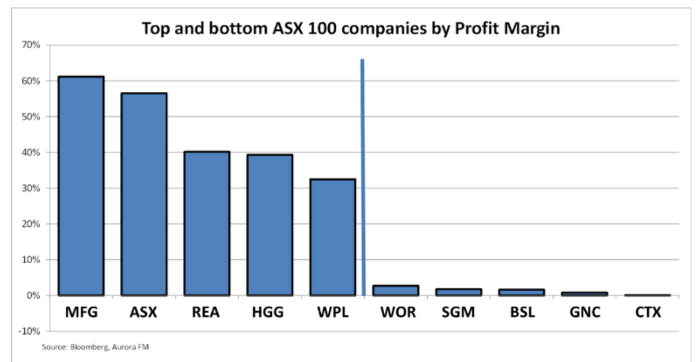
This chart shows the top and bottom companies in the ASX ranked by ROA. Companies generating a high ROA are generally companies with no debt such as Magellan and Realestate.com or very low debt such as CSL and Carsales. Here the factor driving profits in internet and healthcare companies is generally a smart idea (online real estate listing replacing paper) or a piece of medical research, rather than tangible assets such as steel mills or airplanes bought with capital raised from both shareholders and lenders.

Similarly, fund managers (Magellan) enjoy significant operating leverage, as once the fixed cost of fund distribution, office rent and fund manager salaries are covered by a level of funds under management, each additional dollar of revenue is almost pure profit that requires minimal capital.

Alternatively, companies that have a low return on assets typically require expensive hard assets to generate profit and operate in industries where they are price takers. These assets range from mines (Iluka and Alumina), steel mills (BlueScope) and toll roads (Transurban).

Profit margin

Profit margin is calculated by dividing operating profits by revenues and measures the percentage of each dollar received by a company that results in profit to shareholders. Typically, low margin businesses operate in highly competitive mature industries. The absolute profit margin is not what analysts will look at, but rather the change from year to year, as a declining profit margin may indicate stress and could point to large future declines in profits.



The chart shows the highest profit margins are generated by companies that are monopolies (ASX), fund managers enjoying operating leverage (Magellan and Henderson) or infrastructure owners (Spark, Duet and SP Ausnet). Woodside enjoys a high profit margin, as once large offshore LNG trains are built, these assets have a low marginal cost of production per barrel of oil.

Reporting season scorecard November 2015

Code	Share Price	Revenue growth	Cash earnings growth	Dividend growth	Net interest margin (reported)	Impairment charge as % of loans	Return on Equity	Forward PE Ratio	Forward dividend yield	2015 total return	Summary of 2015 result
WBC	$31.33	3.6%	4.6%	2.7%	2.08%	0.12%	16%	12.4	6.10%	-2.0%	Pros: Margin growth, Costs low, low bad debts, good cash earnings growth Cons: Tax benefits slightly reduced earnings quality
ANZ	$25.67	4.8%	-3.7%	1.6%	2.04%	0.21%	13%	10.7	6.9%	-14.0%	Pros: Revenue growth, good dividend yield Cons: Asia, higher bad debts
NAB	$28.53	2.0%	2.8%	0.0%	1.87%	0.14%	14%	11.3	6.9%	-8.0%	Pros: New management being proactive Cons: Weak earnings, interest margin, weak business bank
CBA (Aug)	$75.83	5.3%	5.0%	4.7%	2.09%	0.15%	18%	13.8	5.70%	-6.0%	Pros: Solid headline number, well capitalised Cons: 5b raising will make it tough to maintain high ROE

Source: Company reports, IRESS, Aurora Funds Management

Low profit margin companies characteristically receive large revenues, but operate in intensely competitive industries such as petrol retailing (Caltex), engineering (Worley Parsons) and steel (Sims and BlueScope). Graincorp makes this list due to lower grain exports due to a relatively poor East Coast wheat harvest. Companies with low profit margins are obviously forced to concentrate closely on preventing their profit margins from slipping, as a small change in their margins is likely to have a significant impact on the profit available to be distributed to shareholders.

Whist the banks and the diversified miners generate large absolute profits and generate headlines often gasping at the amount, they are not actually amongst the most profitable large listed Australian companies in terms of profit margins and returns on assets. Westpac's 35,241 employees produced a $7.8 billion profit in 2015, but this represented a ROE of 15.8% and a profit or net interest margin of only 2.11% on a loan book of $623 billion!

We approach the end of 2015 with our reporting season scorecard for the major banks (above), including a Gold Star awarded for the best in each category.

Hugh Dive is Senior Portfolio Manager at Aurora Funds Management. This article is general information and does not address the personal circumstances of any individual.

Commodities prices and the Australian stock market

Ashley Owen

This article describes how commodities prices affect Australian stock market returns. My focus is not on how the price of one commodity like iron ore affects a particular stock such as Rio or Fortescue, but how commodities prices in general have affected overall returns from the broad stock market over many decades.

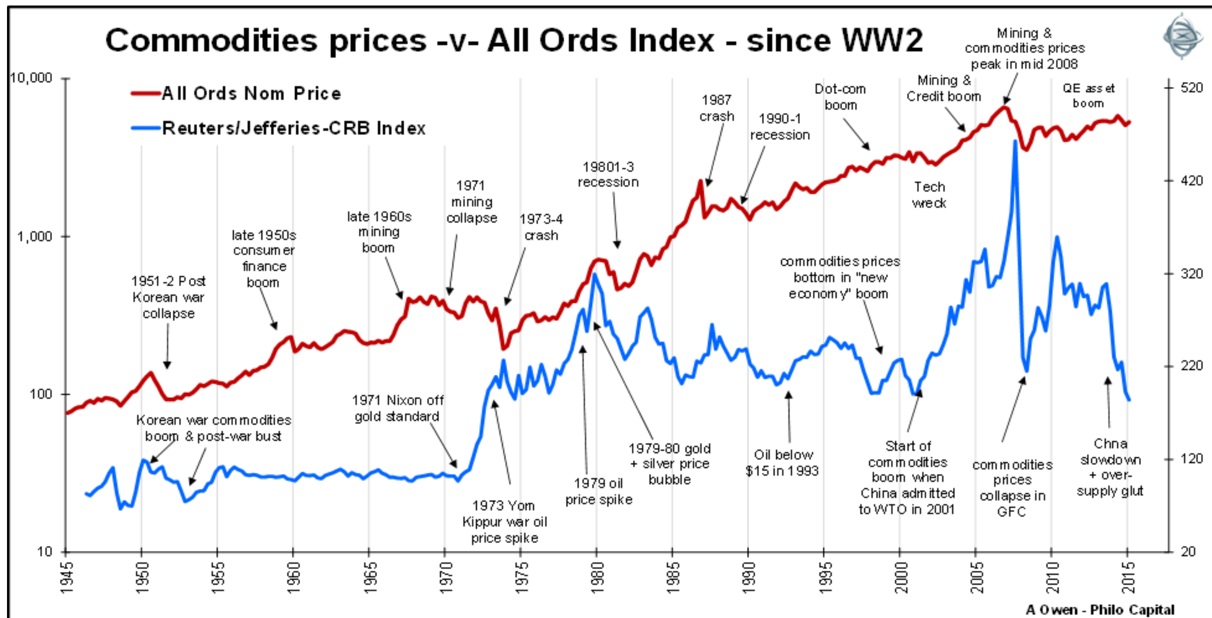
Everything we eat, wear, read, sit on, drive, ride, communicate with, and use in our lives every day is made by companies using commodities – crops, livestock, energy, minerals, metals, timber, etc. Commodities prices have cyclical impacts on corporate revenues, earnings and share prices.

The commodities price factor described here is one of several factors used in my fundamental multi-factor, multi-time frame process that is used to make asset allocation decisions.

Changes in the rate of change matter most

What happens to commodities prices is related to subsequent returns from the overall stock market. It is not the *level* of commodity prices (ie high or low) or *changes* in prices (direction) that are important, but changes in the rate of change in commodities prices (ie changes in direction) that are related to subsequent equity returns.

My analytical process requires the relationship to have worked for at least 50 years over many different types of market conditions, so I use the Reuters-Jeffreys CRB index. It measures prices of a



broad basket of commodities and the composition of the basket changes to reflect changes in global commodity usage and importance.

The above chart shows the commodities price index and the Australian stock market index since WW2.

The more recent swings in commodities prices are the late 1970s oil spike and gold/silver bubble, the 2000s China-led mining boom and bust, the GFC price collapse and rebound, and the current price slump caused by the China slowdown and global over-supply in virtually all commodities. These big commodities boom-bust cycles are when the commodities factor in my analysis generates the strongest signals for subsequent stock market returns.

The commodities price factor works best when used in the short term (within 1 year) outlook models for the broad stock market.

How it works

In my model, it doesn't matter whether commodities prices are high or low, nor whether they are rising or falling. What matters is changes in the rate of change of commodities prices. For example, if prices having been rising (or falling) steadily for a while, investors get used to this and price their expectations of 'more of the same' into share prices. But when the rises (or falls) suddenly accelerate or decelerate this changes investor expectations and accelerates the buying or selling of shares.

Slowing rates of commodity price growth (or decelerating rises) are usually followed by relatively low equity returns:

- Investors price in lower export prices and revenues
- Foreign investors lose their interest in Australian shares (not just mining related stocks)

Rising rates of commodity price growth (or decelerating falls) are usually followed by relatively high equity returns:

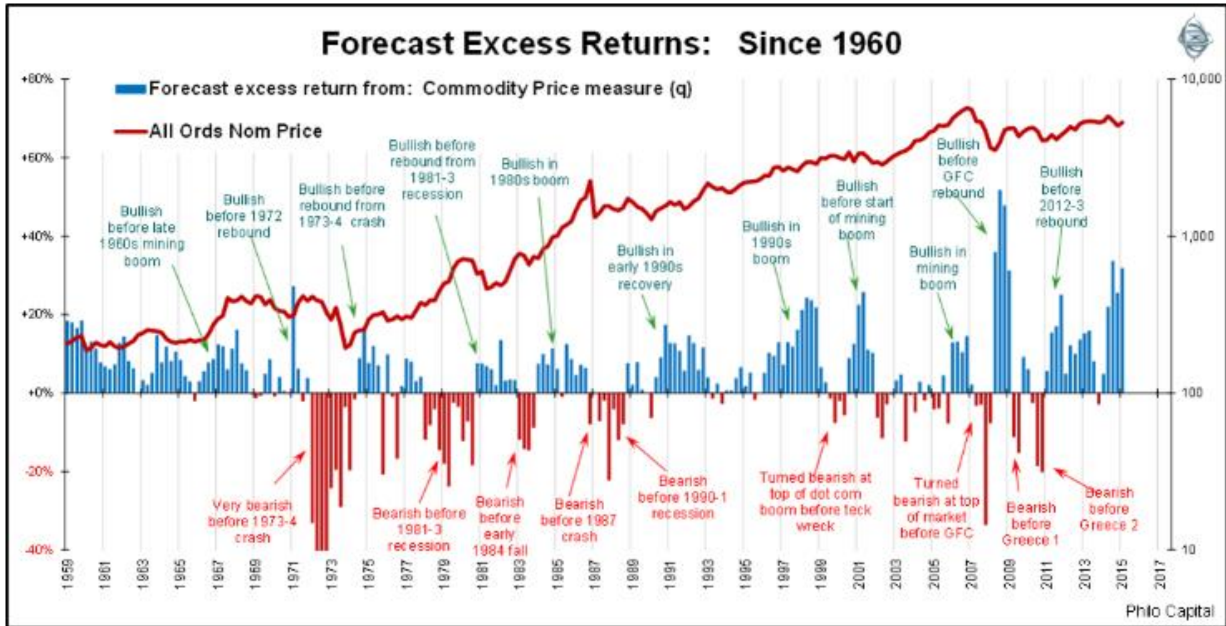
- Investors price in higher export price and revenue growth
- Foreign investors are more attracted to Australian stocks.

Forecast excess returns using this factor

The following chart shows quarterly forecast excess returns (above prevailing cash rate) from this factor since 1960.

This factor has worked well by providing warning signals before the biggest stock market downturns and upturns. The biggest negative signals (lowest red bars) were immediately before the 1973-1974 stock market crash and before the 2008-2009 sub-prime crash.

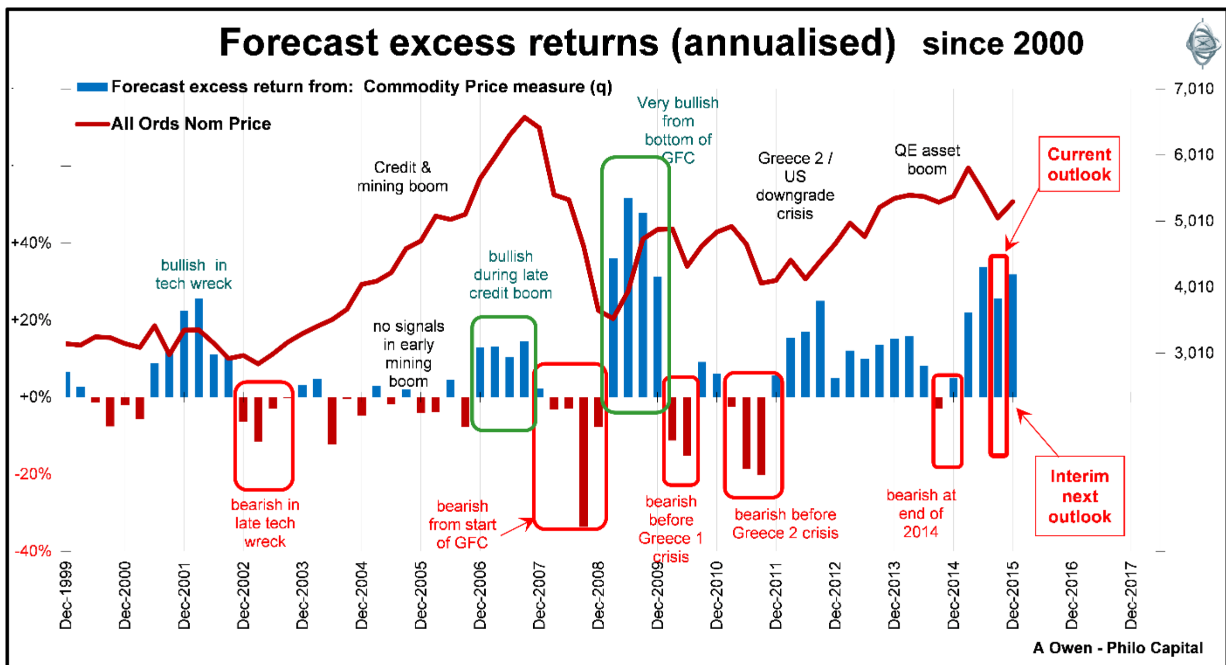
It has also worked well through most of the other less severe upswings and downturns, even in cycles that did not involve mining booms or busts.



Like the other factors used in the models, the commodities price factor will often generate small positive or negative signals (short blue or red bars in the chart), for example, the small signals during the middle stages of the 2003-2007 boom. These small signals provide no information to the process and in these cases at least one of the other factors in the model are usually providing more meaningful signals as they measure different aspects of the overall market environment. What I am looking for is big positive or negative signals and these big signals have provided reliable outlooks for subsequent returns from the broad stock market.

The next chart [below] is the same as the last (forecast return above the prevailing cash rate) but in more detail since 2000.

This factor was bullish during the middle and late stages of the 2000s boom then turned bearish at the end of 2007, at the start of the downturn. It then turned extremely bullish right at the bottom of the GFC before the big 2009 rebound. It was bearish before the 2010 Greece crisis and again before the 2011 Greece 2 crisis.



Current position

The short term outlook from this factor is currently bullish.

One may think that because commodities prices have been relatively low and falling further recently this would be bearish for shares prices. But it is not necessarily. What is important is the changes in the rate of change in commodities prices, not the level or direction.

The factor lost its bullishness in late 2014 but only mildly and briefly, indicating two things. First, it was not bullish for shares in 2015. Second, the stock market pause or decline in 2015 would probably not be sustained or serious (unlike the big and sustained bearish signals before and during the tech wreck, the GFC, Greece 1 and Greece 2). The factor has been bullish from mid-late 2015.

Warning

The commodities price factor described here is only one of the several factors used in our short term outlook for Australian shares. Often the different factors provide conflicting signals because they are measuring different aspects of the overall capital markets environment.

In addition to the several factors in the short term models, I also use several 3 year medium term cyclical factors and also factors in the long term 7-10+ year fundamental pricing models in arriving at the overall outlook. As Australian shares is just one asset class in multi-sector portfolios, I also use a range of processes to determine outlooks for the other asset classes. All these factors are taken into account when making asset allocation settings in portfolios.

For those requiring more detail, a brief outline of the process is attached here.

During 2016, I will write a series of articles further describing the factors I consider in my models and asset allocation techniques.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund. This article is for general education only and is not personal financial advice. It does not consider the financial circumstances of any individual.

Long-term investing: destination is better than the journey

Peter Gee

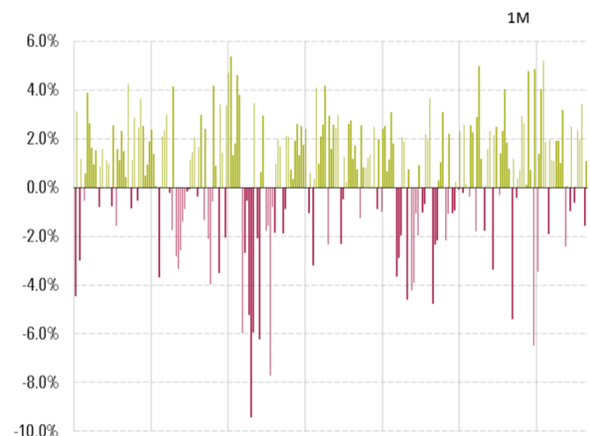
The old adage 'time in the market, not timing the market' is frequently used in articles like this one, with good reason – it often holds true. One of the key elements of successful investing is patience, as a long-term mindset is required to achieve investment goals. Returns in the short-term can be unpredictable and volatile, so investing with a short-term focus produces difficulties and can be counterproductive. It is easy to be fixated on the daily market movements and become distracted from long-term investment goals. It is often better to take a step back and allow investments to grow steadily over time.

Returns over different time horizons

To highlight the merits of having a long-term perspective, we assessed the historical returns after fees and tax of a 'balanced' superannuation strategy over three distinct time intervals: rolling one-month, rolling one-year, and rolling 10-years.

Exhibit 1 shows the rolling one-month returns or the portfolio's individual month-to-month performance. The green bars above the x-axis represent positive performance and a gain in the portfolio's value. A red bar below the x-axis represents negative performance and a loss in the portfolio's value.

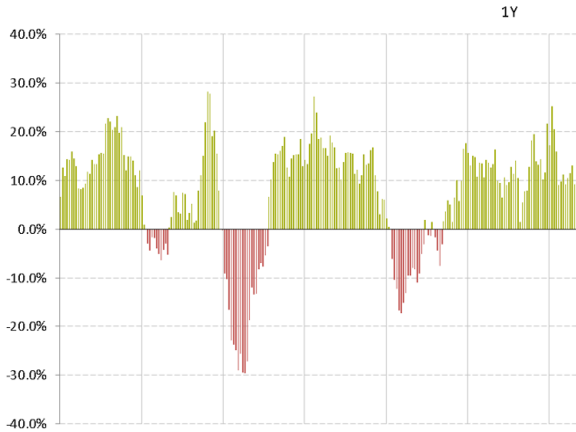
Exhibit 1 Rolling One-Month Returns (September 1995 – August 2015) of a Balanced Superannuation Portfolio



Source: Morningstar Direct

There are no clear patterns or sequence to the returns. In the short-term, even a well-diversified portfolio exhibits volatile and unstable returns.

Exhibit 2 Rolling One-Year Returns (September 1995 – August 2015) of a Balanced Superannuation Portfolio

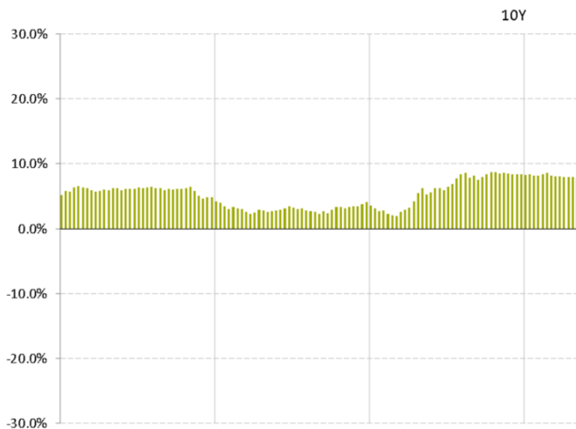


Source: Morningstar Direct

Exhibit 2 illustrates the rolling one-year returns, so each bar includes 12 months of performance.

Here we observe smoother and more persistent positive returns over time, with less frequent periods of negative performance.

Exhibit 3 Rolling 10-Year Returns of Balanced Superannuation Portfolio 1995 – 2015. Bars Represent Rolling 10 Year Returns Each Month-End from the 10 Years to 30 September 2005 through to the 10 Years to 31 August 2015



Source: Morningstar Direct

Exhibit 3 depicts the balanced portfolio's returns over rolling 10-year periods and each bar accounts for 10 years of performance. The benefits of long-term investing become apparent, with two important takeaways:

- In this period, there are no periods of negative returns, which means that no matter what 10-year period an individual was invested over, the portfolio delivered positive performance. This is because the well-diversified balanced strategy recovered from any losses or periods of underperformance within each 10-year window.
- The returns are significantly smoother and considerably less volatile compared to shorter time horizons. Investors can see past the haze of short-term market movements and focus on achieving long-term investment goals.

Peter Gee is Research Products Manager with Morningstar Australasia. Information provided is for general information only, and individuals should seek personal advice before making investment decisions. The objectives of any individual have not been considered in this article.

A lifetime of investing insights

Noel Whittaker

Looking back over the last quarter of a century, the main theme – despite the enormous changes during the period – has been history repeating itself. Bust follows boom, boom follows bust, and today's investment fashion is quickly replaced by another.

In fact, when I was at the State Library of Queensland researching newspapers back to 1988, I was struck by how often the same headlines kept popping up.

But there are two crucial factors that are unique to the world we live in today – rising life expectancies and record low interest rates. It is the perfect storm, because people retiring now face the daunting prospect of making their money last as long as they do. Many are averse to growth assets like property and shares, which they regard as 'risky', but the grim reality is that sticking with low-earning cash may be the riskiest strategy of all over the long-term.

By 2017 a couple with assets in excess of $823,000 (excluding the family home) will not be eligible for the aged pension. Yet, if all they have is $900,000 in bank accounts, their income may be just $18,000 a year – not much more than half the aged pension that is paid to a couple with no assets. And running down capital to become eligible for the aged pension is a dangerous strategy indeed. The present rate of aged pension is unsustainable in the long term, which means further tightening of pension eligibility is a certainty. There may well come a time, sooner rather than later, when the question will be asked

"Why should a couple with $500,000 of financial assets be eligible for welfare?"

And there's more. Already there are moves to remove the asset test exemption for the family home currently enjoyed by age pensioners, to bring in universal land tax on the family home, and to tinker with superannuation even further. These ideas will gather momentum as the number of retirees grows, and government budgets come under further pressure. All spell tougher times for senior citizens.

Fortunately, there are lessons to be learned too: one for each main stage of life.

If you are young it is surely obvious that you will need to rely on your own investments when you retire; governments around the world are running out of money. Understand that you have one unique advantage – time – and start a savings and investment programme now to give compound interest time to work its magic.

If you are middle-aged, medical advances sure to occur in the next 30 years make it an odds-on bet that you will make it to 100. Therefore, it makes sense to form a relationship with a good financial adviser as a matter of urgency and get yourself a quality growth-orientated portfolio. It is my strong belief that shares are the only asset that will give you the returns you are going to need and the sooner you get acquainted with them, the less scared you will be when markets go through their regular down periods and the papers have a field day with scary headlines.

If you are elderly, dramatic medical advances may come too late for you. It is quite likely that you will face the challenge of running two homes, with one partner in care. It's natural to dodge this issue of accommodation but the sooner you face it the better you may be able to cope. Home care is becoming the norm and will be much easier if your home is able to be equipped for people who need assistance.

For everybody, building or retaining wealth is an important part of achieving a comfortable family lifestyle now and in the future. This means being aware of probable futures and having the resources to cope with whatever challenges lie ahead. It is my fervent hope that my new book will make a significant contribution to helping you take control of your future, and achieve your goals.

Noel Whittaker has been a great supporter of Cuffelinks since the day we started. He ran his own financial advice company, Whittaker Macnaught, for 30 years, and in 2011, he was made a Member of the Order of Australia for raising awareness in personal finance. For more than 25 years, his articles have been published in leading newspapers and journals. He has personally selected his highlights and brought them together in one book, '25 years of Whitt and Wisdom'*, which can be ordered on the link here.*

Where is superannuation research heading?

Iain Middlemiss

What is discussed when 80 delegates from the superannuation industry, as well as Government, regulatory and academic bodies, come together for a day? How about superannuation and the economy, ambiguity of system and participant purpose, governance, wealth and health, big data and member behaviour, asset pricing and returns, changing work patterns and retirement outcomes, and retirement product design.

These were the focus of research presented this month at the 2015 CSIRO and Monash University Superannuation Research Cluster conference.

Founded in 2013, the Cluster is a collaboration between the CSIRO, numerous universities and industry participants in the retirement system. Its broad aim is to develop a research agenda establishing an evidence base for improved decision-making in the interests of better retirement outcomes for all. A select few topics are highlighted below.

Health costs in retirement

The health costs of older Australians are a core Government and private savings expense, yet the variability of costs between individuals is significant. Some will experience good health and be able to allocate a greater share of private retirement income to discretionary leisure. Others will experience a costly health event, the sequencing of which can be significant in impacting future retirement incomes.

Medical technology enhancements will decrease costs for some health episodes, while longevity will create new and expensive costs related to aged care and support, and dementia management. A key challenge is how to integrate policy settings with product design, and plan for a share of health costs from public and private savings. The overlaying

complication for individuals is how to insure retirement income for events that can't be predicted and where associated costs aren't certain.

Much retirement income longevity modeling is based on the standard consumer price index (CPI) definition and inflation. But medical inflation is a different beast with greater adverse impact on older people. Is it worth considering an age-based CPI in modeling the longevity of retirement incomes, to enable greater consideration of the aged care and health costs facing retirees?

Changing work patterns

The world of work is changing with increased casualisation of the workforce and more workers experiencing frequent role changes and breaks from full-time employment. A linear pattern of consistent and steadily increasing superannuation contributions will not be the future norm. The impact of maternity-related career breaks on lower retirement outcomes for women is increasingly well known, and a similar pattern will play out for a greater number of workers.

What policy settings and product design might be considered to enable people with career breaks to maximise contributions when they can and with the same tax benefits of the traditional linear employment model?

Retirement income expenditure and big data

A common theme across papers was the industry's lack of knowledge about how retirees spend their private retirement savings and income. Some research has suggested on average 90% of retirees' wealth across their home, superannuation savings, and other non-super savings and investments remain unspent upon their death.

Research presented suggested some retirees frame minimum drawdown levels as a form of default target expenditure, and struggle with the shift from accumulation and saving to consumption. Concerns about income longevity and a desire to transfer wealth to the next generation are key motivators.

Government has signaled intent through recommending comprehensive income products for retirement (CIPRs) to revisit income distribution in retirement. Superannuation's potential as a tax effective wealth transfer vehicle is also being reviewed.

Improvements in management information system capability present the opportunity for wealth financial providers and researchers to leverage big data in better understanding retiree spend patterns, and help frame policy settings and product development.

Industry and research cluster collaboration

Increased investment in academic research into the superannuation sector demonstrates greater Government demand for evidence-based policy development and settings. Industry providers can also benefit from the research findings. The need for greater collaboration between industry participants in developing policy, products, and services has never been greater.

The conference program and synopsis of papers presented is available here.

Information about the research cluster, projects, and research papers is available at: www.superresearchcluster.com/

Iain Middlemiss was Executive Manager Strategy at Colonial First State and Head of Strategy at Superpartners. This article is for general educational purposes only. Cuffelinks attended the conference at the invitation of the Australian Centre for Financial Studies.

Capitalising on China's healthcare trends

Sebastian Evans

China has proved a powerful partner in supporting the growth of Australian businesses, aided by our geographic proximity, political stability and governance-led business practices. We have a long and reliable history of high quality, reasonable cost, goods and services manufacture which has led us to be 'first-hand receivers' of China's attention when it comes to meeting the demands of its growing population.

Australian business sectors that have to date benefited exponentially from China's attention have included the mining and resources sector, the tourism sector and most recently, those involved with the manufacture of health supplements and vitamins.

Changing Chinese demographics

Like many countries, China has an ageing population. According to an article, 'How can China

Care for its Ageing Population?' distributed by the World Economic Forum, its population aged 65+ is forecast to grow to 167 million by 2020, accounting for 11.5% of the population or nearly double what it was in 1995. In addition, studies undertaken by the Wharton Business School state that China is now also facing an epidemic of chronic diseases and lifestyle issues (such as hypertension, stroke, diabetes and heart disease) that were typically associated with the 'West', mostly due to economic changes such as a growing middle class, rising GDP per capita and rising disposable income.

The cost of China's evolving health and demographic trends has been enormous. It has been estimated that the country's annual expenditure on health will grow at an average rate of 11.8% a year from 2014-2018, reaching a total spend of $892 billion by 2018. Yet according to a recent research paper issued by Deloitte, China's healthcare spending, estimated at 5.4% of GDP in 2013, is still much lower compared to other OECD countries, as shown in the chart below.

Growth and competition in healthcare

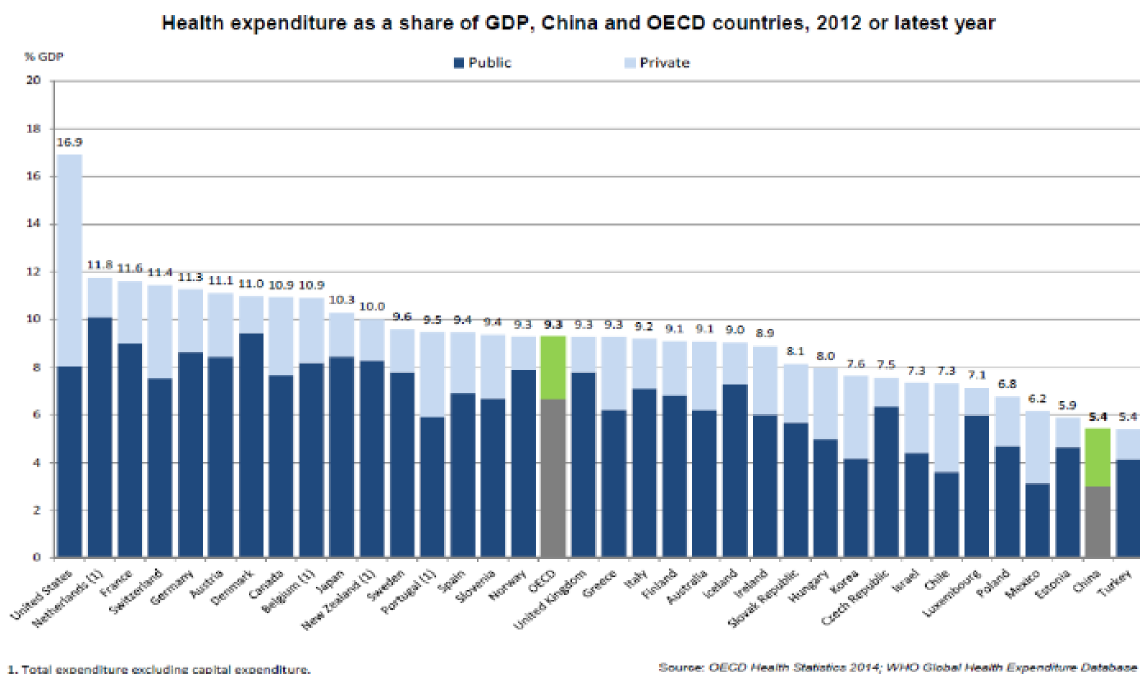
In response to the rising cost and need for healthcare services, the Chinese government recently announced several initiatives aimed at promoting growth and development in the health sector. According to research by Deloitte, 'Projects that meet strict operational guidelines are expected to receive full government support, especially around land transfer, preferential financial and tax policies and related subsidies'. The research states that private and wholly owned foreign hospitals account for almost half of China's total number of health care facilities and growth from this sector in China will bring the benefit of 'leading medical technologies, advanced management, clinical practices and service models'. Additional service providers are considered good for competition, potentially leading to better pricing and satisfaction levels for patients. It may also help with raising the profile and use of private health insurance in the country, as commercial insurers develop plans to help consumers meet the rising cost of hospital care.

Of course, growth in the service and provision of healthcare services in the hospital and insurance areas in China will also promote growth in the supply chain such as in aged care, medical tourism and medical devices.

Australia's recently agreed Free Trade Agreement (FTA) with China promises unprecedented access for our healthcare providers to expand their services into China. The benefits of the FTA to the sector were summarised in a recent article published in *Business Spectator* titled 'The China FTA is just the tonic for Australia's healthcare operators', by Kim O'Connell and Suzy Madar.

The article outlined the key benefits as:

1. For hospital providers, China now offers Australian businesses the opportunity to establish wholly foreign owned hospitals.



2. Medical and dental service suppliers can also establish Australian majority-owned joint venture hospitals and clinics with Chinese partners, provided the majority of medical professionals are Chinese.
3. In the aged care space, Australian providers may now establish wholly foreign-owned aged care facilities with tax incentives and fee waivers.
4. For R&D service providers, Australian companies looking to conduct R&D in China will be permitted both to carry out and offer R&D services through Australian-owned subsidiaries based in China.

Those ASX listed companies set to benefit from the growth and development of the healthcare service sector in China and the introduction of the FTA include Cochlear Limited (COH), CSL Limited (CSL) and Ramsay Healthcare Limited (RHC).

Sebastian Evans is Chief Investment Officer and Managing Director of NAOS Asset Management. This information is general only and does not take into consideration the investment objectives, financial situation or particular needs of any reader. Information contained herein may not be appropriate for your personal situation and we encourage you to consult a financial advisor before making any investment decision.

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