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This Week's Top Articles

Poor start to 2016 is not a bad omen for Australian shares

Ashley Owen

The 2016 calendar year started with seven down days in a row for the Australian stock market index, falling nearly 7%. As expected, this triggered the usual scaremongering chatter in the populist media, and the so-called 'financial' media in particular. Self-proclaimed 'experts' argued the bad first seven days points to low returns and high volatility in 2016.

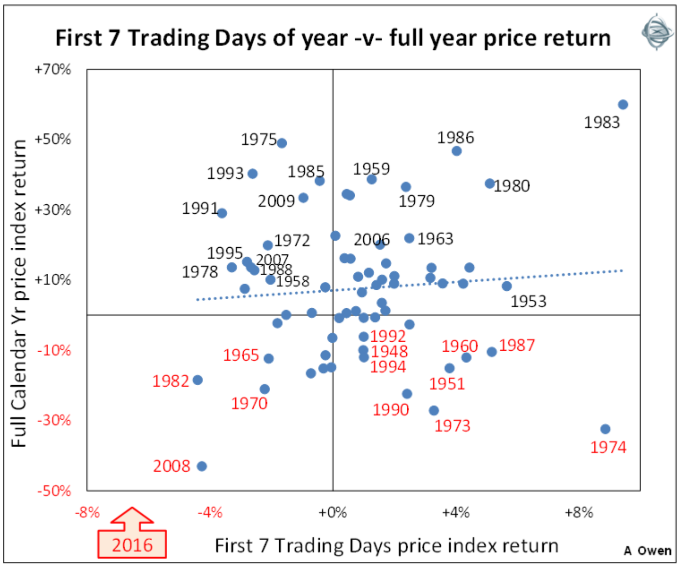
What should serious investors read into this? Nothing actually. It is easy to demonstrate that warnings about the poor start are nonsense and not supported by evidence or analysis.

No relationship to full year returns

Historically there has been no statistical relationship between returns in the first seven days of a year and returns for the whole year. Likewise, for the first five days, six days, or any number of days.

The first chart shows the price index returns for the first seven trading days of each year (horizontal scale) versus the subsequent return for the full calendar year (vertical scale). The chart uses the Australian All Ordinaries index since 1979 and the Sydney All Ordinaries and its predecessors back to the end of WW2.

The dots (years) are scattered all over the chart in no apparent pattern. The dotted 'trend' line is almost horizontal, which indicates that there is no statistical correlation. The top right-hand segment of the chart shows that in some years great returns in the first seven days did indeed turn into great returns for the whole year – eg 1983, 1986, 1980 and 1979. Conversely, the bottom left-hand segment shows years where negative returns in the first seven days turned into negative returns for the whole year – eg 2008, 1982, 1970 and 1965. So far so good.



But there are just as many examples when this neat pattern did not work. The bottom right segment shows that in several years, good early returns turned into negative returns for the whole year – 1974, 1973, 1990, 1951, 1960, and 1987. Yes, the 1987 crash year started off well, up 5%. Likewise 1974, the year of the great property finance crash, started the year up an incredible 9%, but the market crashed 52% between March and September 1974.

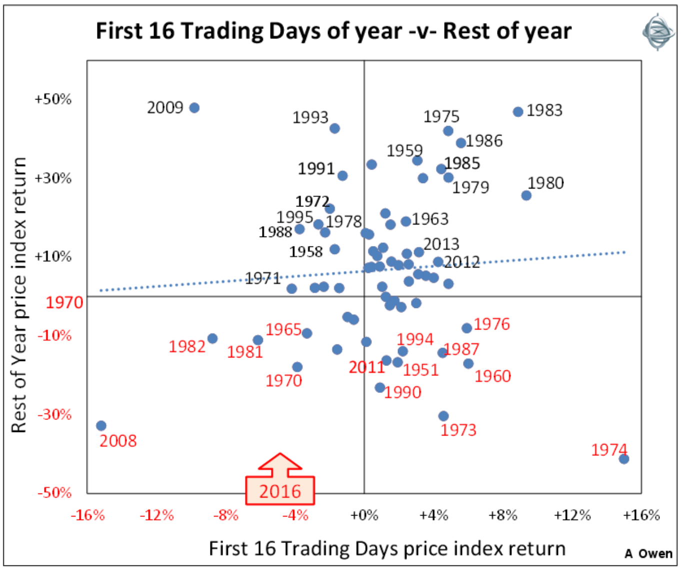
Likewise, the top left segment shows there were several years when negative returns in the first seven days turned into high returns for the whole year – eg 1991, 1993, 1975, 2009, 1972, 1995, and 2007.

So investors should not read anything into returns for the first few days of any given year.

Is there an Australia Day effect?

After the poor first seven days of 2016, the market recovered a little to Australia Day, but was still down 5.4% over the first 16 trading days to 26 January. Since the national holiday is another chance to pause and reflect on our investments, it begs another question – are returns in the first 16 days a guide to the subsequent returns for the rest of the year? The answer is once again 'no'.

The next chart shows the price index returns for the first 16 trading days of each year (horizontal scale) versus the price returns for the rest of the calendar year (vertical scale).



Again there is no pattern here. In several years, poor initial returns were followed by poor returns for the rest of the year, while in other years, good initial returns paved the way for good returns for the rest of the year. But in several years, poor initial returns were followed by high returns. These were mainly the great rebound years – which often started off poorly – eg 2009, 1993, 1991, 1972, 1995 and 1988 – in the top left segment.

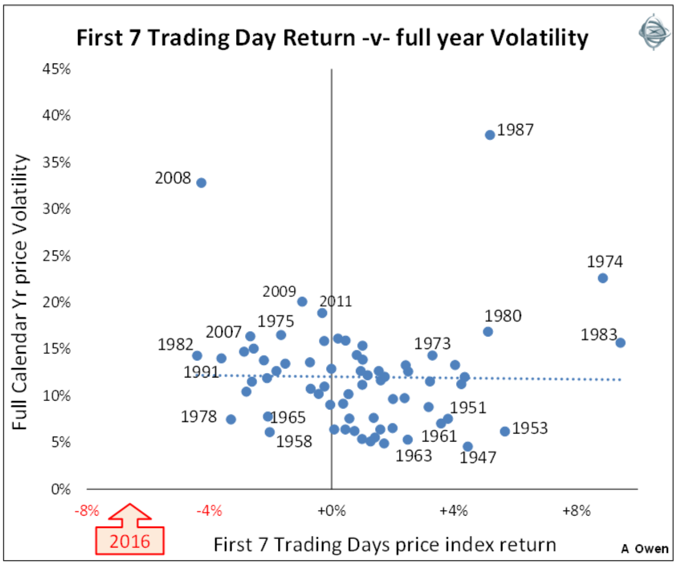
Likewise, in several years good initial returns were followed by poor returns for the rest of the year – notably the 1974 crash year, the 1987 crash year, the 1951 Korean War inflation crash year, the 1960 credit squeeze crash year, the 1994 bond crisis year, and other years in the lower right segment.

No relationship to volatility either

The other theme that has appeared in the media in the first few days of this year has been the usual 'these volatile times' nonsense that help to sell newspapers, and by brokers generating commissions. The run of down days at the start of 2016 somehow points to a 'volatile' year ahead.

This, too, is not supported by the evidence. The past four years have seen unusually low volatility in stock markets. Markets certainly were volatile in 2008-2009 (sub-prime crisis) and 2011 (Greece 2 and US downgrade crises), but have been relatively calm in the four years since then.

Our next chart shows the price index returns for the first seven trading days of each calendar year for the Australian market (horizontal scale) versus the subsequent full year annualised volatility of the price index since WW2 (vertical scale).



Again we see that the dots (years) are scattered all over the chart in no clear pattern. Once again the dotted 'trend' line is almost horizontal, indicating that there is no statistical correlation between the initial first seven days and how volatile the index turned out to be for the full year.

The top left-hand segment of the chart shows that in some years negative early returns did indeed turn into volatile years for the index – eg 2008, 2009, 2007, and 1975. Conversely, the bottom right segment shows years where positive early returns turned into low volatility for the whole year – eg 1953, 1947, 1963, and 1961.

However, the top right segment shows good early returns turned into highly volatile years – eg 1987, 1974, 1980, 1983. The most volatile year in the history of our stock market, 1987, started off with a nice +5% return in the first seven days.

Is a run of eight down days unusual?

If we also include the negative day on the last trading day of 2015, that makes eight consecutive down days – which also makes for catchy headlines. The problem is that eight day runs (of consecutive up days or down days) are not unusual at all, with **79** such runs or longer since WW2.

The longest run of consecutive down days was 16 days in Australia in July-August 1952 during the post-Korean War inflation crisis. Notably, that 16-day run marked the end of the 1951-1952 crash and the start of the subsequent three-year bull run for shares. Investors who were scared off by the record-breaking down run would have missed out on the start of a three-year bull run.

Conclusions

Investors should never base decisions on just a handful of days trading. Bad short term returns often give rise to unjustified fears and misguided knee-jerk responses, which inevitably lead to bad long-term decisions. Conversely, good short term returns tend to breed complacency and unfounded optimism, which can be equally damaging to long-term returns.

The added problem is that investors (myself included) have extra time over the holidays to review portfolios. The risk is that if we base our thoughts on the end of year balances we fall into the trap of thinking we have to re-do the numbers because the market has fallen 7% in the first seven days of the new year. The better approach is to ignore short term moves and keep the focus firmly on the fundamental drivers of long-term performance.

This is the case even with extreme price moves. For example in the 1987 crash the market index fell 50% in just 19 trading days. But not even that 19-day period would have made a difference to long-term investment decisions. Sensible analysis would have meant you were out of the market or at least under-weight from early to mid-1987 so the impact of the 50% September-October 1987 crash would have been avoided or lessened. The sudden 50% fall did not suddenly make the market 'cheap' and therefore a 'good buy'. The market did not become 'cheap' on most fundamental measures until late 1990 or early 1991. This was more than three years later – ample time to assess the market with a cool head and decide when the market was good enough value to start investing again.

The lesson is to not let short term moves distract attention from thorough research and analysis in long-term portfolios.

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What to do with your equity portfolio in 2016

Roger Montgomery

During the break, if you didn't completely turn off from finance and investing, you may have read one, two or a dozen columns about: where the markets are heading in 2016, 'how to make money in 2016' and where the best returns will come from in 2016.

Most are simply a waste of your time and you would have been better off ditching the articles and jumping in the water or heading down the slopes with your kids, partner or friends.

Forecasting doesn't work

The sagest advice I have received on forecasting is that if I wanted to be successful at predicting markets, I should simply do it often. As investing professionals, we are regularly asked for insights that stem from our crystal ball gazing and for many it pays to participate. Those that get it right are lauded as if they have an omnipotent connection to the future, and such is the brevity of our memories, those who get it wrong are forgotten.

And such is the ability of some self-proclaimed prophets to spin their incorrect predictions into divine prophesy that they see no diminution in their monthly newsletter sales. I recall one magniloquent and high profile commentator stating with almost daily certainty that the Australian equity market would end 2016 above 6000 points. At the time the prediction was made the market was indeed close to that level. Of course, the market ended significantly below 6000 and traded below 5000 points after the prognostication was made. But in early 2016, the commentator slipped in that he got the call right (emphasis added):

"… the return of stock buyers whenever we hover around 5000 or just below tells us that the majority of stock players don't see our market worthy of being at 6000, which we missed by five lousy points on March 23."

Desist from forecasting altogether

Long-term investing success has nothing to do with forecasting share prices, politics or economics and everything to do with buying businesses whose intrinsic values rise over the long run. The share price will look after itself if the value of the business is rising steadily over the years. To offer any forecast of where the stock market will be, demonstrates a lack of understanding of this basic investing principle. A forecast tells you a great deal about the forecaster but nothing about what is to come.

Those who presume to understand the machinations of the economy and the markets and then offer their 'insights' simply haven't learned that 1) they will never do better than 50/50 with their forecasts and 2) their forecasts aren't required by you for you to be a successful investor.

There's a constant temptation however to believe the facts one has collected amount to some undeniable insight about the future that one can bet the farm. To save ourselves at Montgomery from falling into this trap, with 50/50 outcomes, we developed a process. And much as one does when marrying - vowing to have and to hold for better or worse – we publicly committed to our investors, their advisers and the ratings houses to follow the process come what may.

At the beginning of 2015, I was asked whether I thought the market was expensive or cheap and I argued that the market seemed expensive because value did not abound, and that it would be difficult to generate meaningful returns.

It isn't wise for fund managers to say such things because rather than appearing knowledgeable, it risks influencing investors to zip up their wallets.

While we may have been right (50/50 remember!) with our prognostications – for the year to 31 December 2015 the Australian All Ordinaries Index declined by 0.8%, add in dividends and the return was just 2.8% – the Montgomery Fund returned 19.35% after all fees and expenses. If I had accurately predicted a 2.8% return for the market and decided the risks outweighed the benefits, so listening to myself, put all of my money into a term deposit, I would have missed a near 20% return.

Invest in strong businesses and be patient

And that's the point. The stock market index is not where you should be investing (my piece on the problems of index investing is here). You should be investing at rational prices in businesses you are reasonably confident, if not virtually certain, will be materially larger and at least equally profitable in many years hence. General stock market and economic forecasts are largely irrelevant over the timeframe I am contemplating.

When we observed early in 2015 that the market was expensive, we also noted that banks and mining companies, at the highs, were unsafe investments, but this was not a prediction about the direction of the share prices of these stocks or what would happen next. What we simply observed is that investors were behaving dangerously and without regard to risk when they were chasing high yields and ignoring whether those dividends they were chasing were being supported by growth. We were simply saying that it was a mistake to chase yield at the expense of growth.

A business adds value by retaining profits and redeploying that incremental capital at attractive rates of return. It's that simple. To maximize your returns, you have to fill your portfolio with companies able to retain large amounts of capital and generate large returns on that capital. The share prices of these companies will look after themselves over the long run.

The short run is merely the period over which stock prices for these companies overreact on both the upside and downside and therefore it is the period over which you can take advantage of the market's manic moods.

Ignore everything else in 2016 and you should do well over the long run.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'. This article is for general educational purposes and does not consider the specific needs of any individual.

Going defensive: option strategies

Sam Wylie

A combination of bank shares plus put options to protect against a fall in the value of those shares looks attractive at the moment. Grossed-up dividend yields are relatively high and the price of options on banks shares are relatively low. That is a happy combination, especially for SMSF investors.

Say that an investor thinks that ANZ shares have plenty of upside because the global search for yield will eventually bring investors back to all the major Australian banks, and especially to ANZ which is priced 25% lower than its high point of $36.80 in April 2015.

But the investor is concerned about the downside risk of bank shares in this period of greater economic uncertainty – there are many credible scenarios in which bank shares fall steeply over the next six months. Our investor wants to participate in any upside in ANZ shares, but for the next six months the downside risk is too much. What can be done?

A simple strategy for participating in the potential upside, but limiting the downside risk for a fixed period, is to own ANZ shares but protect them with put options.

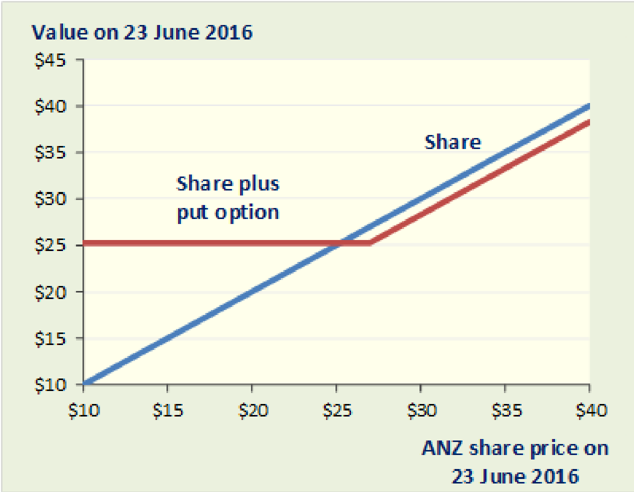
Put option example

Sophie owns 1000 ANZ shares which are currently priced at $27.25. She wants to hedge against a fall in the share price below $27.00 between today (early January 2016) and the end of June 2016. Sophie is investing through her SMSF which is in the pension phase (rather than the accumulation phase), so we can ignore tax.

Sophie can buy 1000 put options on ANZ shares with an exercise price of $27.00 and a maturity date of June 2016 at $1.68 each.

Each put option allows her to put one ANZ share to the ASX (the seller of the options) and receive $27 in exchange. The option can be exercised (at Sophie's discretion) any time up to the expiry date of 23 June 2016 (the Thursday before the last Friday in the month, a standard expiry date set by ASX).

Pay-off to hedged and unhedged ANZ shares



The graph above shows what the value of Sophie's investment in ANZ shares will be on 23 June 2016 (y axis) as a function of the price of ANZ shares on that date (x axis). The blue line is the value of shares that are left unhedged and the red line is the value of the shares plus puts (including the original cost of buying the puts).

The red line shows that once Sophie has purchased a $27, June 2016 ANZ put option for each of her 1000 shares, her investment in ANZ shares cannot fall below 27.00 - 1.68 = $25.32 in value. If instead of falling the share price rises, then Sophie doesn't need protection and will ignore the puts (which will expire unexercised).

Buying puts v 'going to cash'

Many investors have eliminated their exposure to the downside risk of ANZ shares by selling; that is, exchanging bank equity for a bank deposit. That achieves perfect capital preservation and locks in a six-month return of about 1.4% (based on 2.80% per annum for six-month term deposits).

The ANZ share and put combination does not provide full capital preservation but it does participate in the upside if ANZ shares rise, and it limits the damage to a return of no lower than -2.4% if the ANZ share price falls.

$$\text{Return} = \frac{\text{Capital gain} + \text{grossed up dividend} - \text{cost of put option}}{\text{Share price}}$$

$$\text{Minimum return} = \frac{(27.00 - 27.25) + \left(\frac{0.90}{0.7}\right) - 1.68}{27.25} = -2.4\%$$

I am assuming here that ANZ's dividend, due in mid-May, will be 90 cents per share – a rise of 4.7% from the 86 cent dividend paid 12 months earlier. The dividend could, of course, be cut (as it was in 2009), or even reduced to zero, in which case the return to the share plus put would be -7.1%. However, if ANZ is forced to cut its dividend then Sophie will be very glad that she protected her shares with a put.

Relatively cheap put options?

Above I said that put options on bank shares are currently relatively low cost, but low cost compared to what?

A crucial driver of option prices is the expectation investors have about the future volatility of the price of underlying shares. Volatility is an option owner's friend. For instance, after Sophie buys ANZ put options, then higher volatility in the ANZ share price can only help her. If the volatility expresses itself as a big increase in the share price, then Sophie will benefit from that increase through ownership of the share. If volatility appears as a big price fall then no matter, Sophie has the put option to protect her. The higher the expected volatility, the more investors are prepared to pay for options that allow them to participate in the upside but be protected from the downside of large price movements.

Implied volatility

The relationship between expected volatility and the price of options is direct. If we know the expected volatility, then the famous Black-Scholes equation gives us the price of an option. Likewise, if we know the price we can work backwards to the expected volatility. This is the implied volatility of the option (volatility being implied by the price). The implied volatility provides a means of comparing the price of options across different stocks. And, a means to compare the price of options on a single stock, like ANZ, from day to day to say whether they are 'expensive' or not.

For instance, let's compare the cost of protecting ANZ shares with options to the cost of protecting BHP shares. It cost Sophie 6.2% of the price of the ANZ share ($1.68/$27.25) to buy protection at close to the current price ($27.25) for six months. To achieve the same protection of a BHP share would currently cost her 13.1% of the BHP share price.

Protecting BHP shares is currently more expensive than protecting ANZ shares which reflects the difference in the implied volatilities of the shares. The implied volatility of BHP shares is currently about 40% but only about 20% for ANZ.

That 20% is not a historically low implied volatility for ANZ shares, but it is low when we consider how much uncertainty hangs over the global banking sector. If you think that more volatility is coming than the market is building into the put price (as I do) then you believe put options are currently selling at low prices.

Benefits of put option protection

Note that to participate in the upside but limit downside risk investors could use call options instead of put options. In that strategy the investor puts their money in the bank (instead of buying the share) and buys a call option (instead of a put option). In this strategy, if the share price fell then Sophie would have the money in the bank. If the share price rises, then Sophie can use the money in the bank to 'call' the share to her; that is, she can exercise the option to buy (not sell) an ANZ share for $27 (the strike price of the call option).

The equivalence of these alternative put and call strategies for eliminating downside risk creates a tight relationship between the prices of put and call options, which is known as put-call parity.

For an SMSF to be able to buy options, the fund's investment strategy and trust deed must allow the purchase of options. The fund must also have a derivative risk statement that sets out how options are being used to hedge risk.

Protecting shares with options for a short period of time can be a helpful strategy for investors, but there is a lot to know about option strategies, so seeking professional advice is highly recommended.

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Global turmoil likely to make Fed patient

Craig Swanger

Now that the question of when the US Fed will increase interest rates is answered, the next big question for global markets is how far will they increase rates?

The challenge for those trying to forecast the Fed's actions in 2016 and beyond is that we are in unchartered waters. Rates have never been at zero before, and the Fed has never increased rates when both inflation and economic growth are so weak.

Fed needs to avoid destabilising

The financial market turmoil in recent weeks adds weight to the argument for the Fed to be more patient. Markets are clearly nervous about global growth, whether it's in China, Japan or Europe, and the news isn't bright from any part of the world. Any move by the Fed seen to be constraining for the world's strongest economy, the US, has the potential to destabilise financial markets further. While the Fed's mandate doesn't require them to manage financial markets, any major corrections have the risk of spilling over into the real economy by damaging confidence.

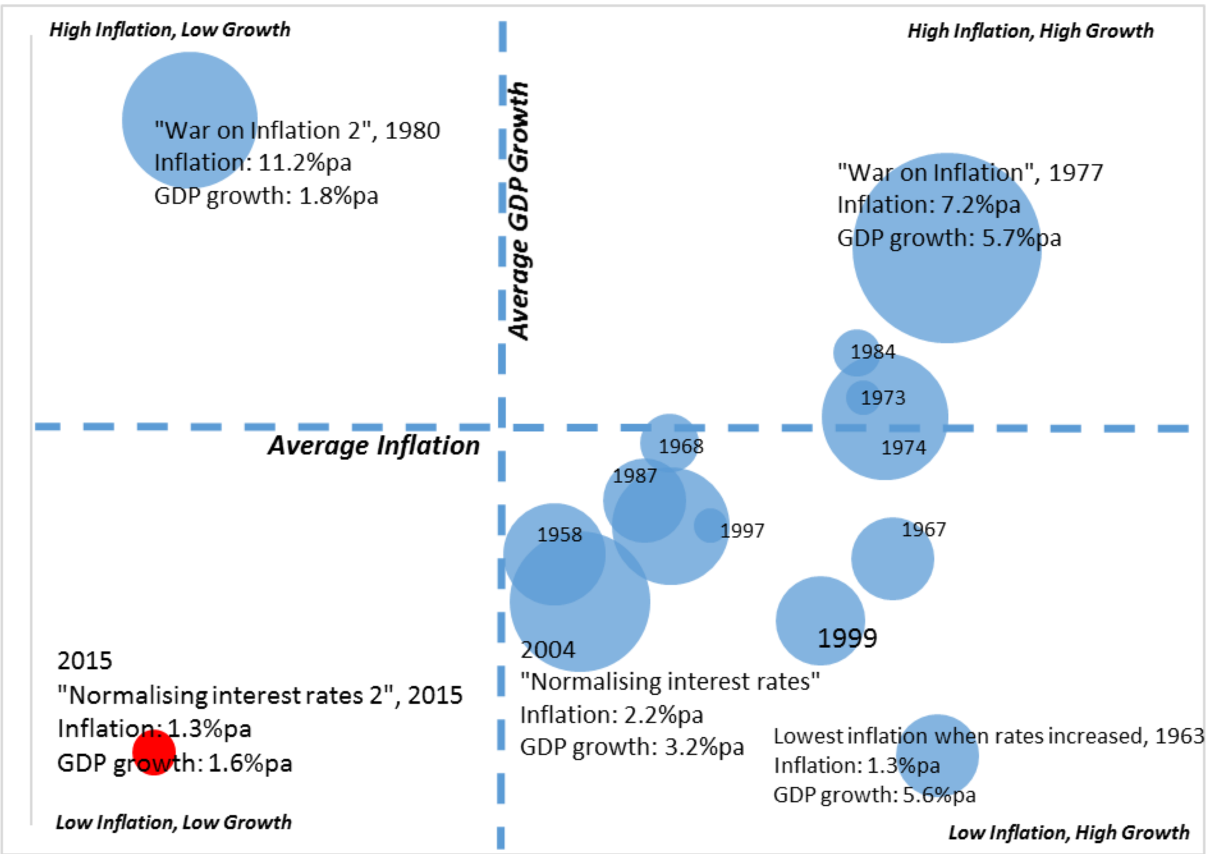
The chart below highlights how different 2016 is to any other interest rate increase cycle. The chart plots each Fed hiking (increasing) cycle against the inflation and GDP growth figures at the start of that cycle. The larger the circle, the larger the rate increase during the cycle.

What's happening this time?

The 2015 cycle, kicked off with the rate increase in December 2015, is the only cycle in which both inflation and growth are below average. In fact, growth is lower than the only other cycle in which the Fed has increased rates despite below average growth: the 1980 war on inflation in which inflation was running at 11.2%. And inflation is equal to the lowest of any cycle, but in the other cycle, growth was running hot at 5.6% and so inflation was a significant risk.

Figure 1: US Federal Reserve rate increase cycles, 1954-2015

Plotted against GDP growth (vertical axis) and Inflation (PCE) (horizontal axis), with cycle size indicating the size of the rate increase during that cycle



So this time it is different. There are two strong arguments suggesting the Fed won't be in a hurry to increase rates:

1. A weak global economy and raging currency wars

The global economy is weak, and getting weaker. China is clearly slowing, and possibly more than their official data states. The EU and Japan are caught in a multi-decade trap of falling population and imposed fiscal austerity due to their high debt. All three economies are engaging in a currency war in an attempt to make their exports more attractive and boost their economies.

China's weapon is to lower interest rates to make their currency less attractive, and then devalue their currency. Japan and the EU have zero interest rates already, so they are using massive Quantitative Easing programs to keep longer term rates lower and also make their currencies unattractive.

Lowering one's currency to make exports attractive works well unless everyone else does it too. Every currency is falling against the US. This puts enormous pressure on the US economy as it weakens their export competitiveness.

This leaves the US Fed in a risky predicament. If the Fed raises rates too quickly or too far, the USD will escalate even further. The Fed will obviously be acutely aware of this and so they will only raise rates further if they have to due to inflation rising above their 2% pa target level.

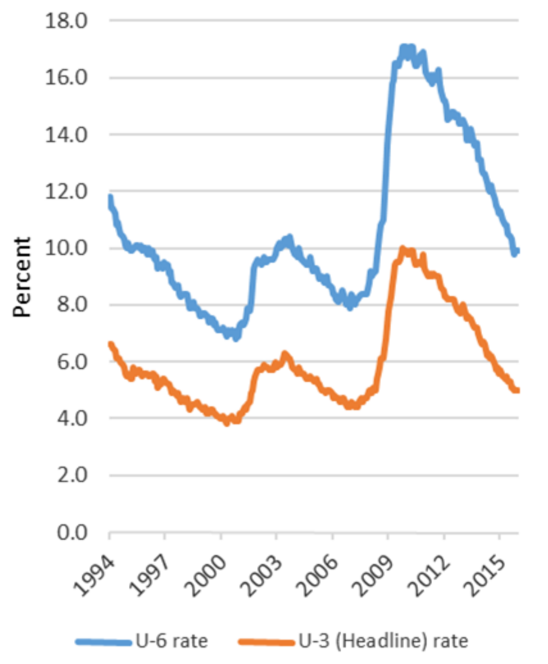
2. Weak inflation outlook

Central banks' role is to maximise employment while keeping inflation at or below a stated target level. The Fed's target rate of inflation is 2%, and it prefers "Core PCE" as a measure of inflation, which is the increase in personal consumer expenditure items excluding food and energy. Using this measure, US inflation is just 1.33% as at December 2015. Add back food and energy, and it is just 0.39%.

Typically, the signal of future inflation risks is wage inflation, i.e. rising wages will typically occur before goods and services' prices are increased. Wage inflation typically follows a labour market reaching the point at which employers have to compete for labour.

Many commentators have forecast for US inflation to jump in 2015 as the rate of unemployment is well below historic averages. This analysis is flawed as they are looking at the 'U-3' measure of unemployment, the measure used in the media headlines and currently 5.0%. But 'U-3' simply measures those people without any job, but doesn't count those in part-time employment that want more hours, or those working for a 'lesser' job but seeking better work.

Figure 2: The real rate of unemployment in the US tells a different story to the headlines
"U-6" rate of underemployment vs "U-3" headline rate, Jan 1994-Dec 2015



'U-6' includes this group and provides an indication of the pool of labour available before employers have to compete with each other for employees and therefore increase wages they are prepared to pay.

'U-6' is still well above long-term averages. 'U-3' below average simply means that while more people than usual have a job, there is a large proportion of the economy seeking more or better work, and therefore still a lot of slack in the economy.

Without pressure to increase rates, and with the currency wars underway globally, the Fed will be patient. Patience can be interpreted to mean increases will be slow and only if necessary. Looking at historic rate increases, there is no pattern or rule that says the Fed is obliged to increase more than once.

Given we are coming off zero interest rates, it is reasonable to assume that they will want to raise at least 3-4 times during this cycle to give some space to ease again if they have to, but there is nothing to stop them from pausing or even reducing rates along the way. This cycle will be very long and very flat.

Craig Swanger is Senior Economist at FIIG Securities Limited, a leading fixed interest specialist. This article is general information and does not consider the circumstances of any individual.

Lessons from Peter Lynch and Dick Smith

Graham Hand

"If you like the store, chances are you'll love the stock." Peter Lynch in *Beating the Street* (1993).

The biggest stock story of summer is the demise of Dick Smith Holdings (ASX:DSH). The high profile retailer listed on the ASX on 3 December 2013 at a valuation of $520 million only two years after private equity firm Archer Capital bought the business from Woolworths for not much (the exact amount is disputed). Most analysis has focused on the role of private equity in taking the spoils from an audacious play. In this article, we draw on the advice of the legendary fund manager Peter Lynch to look for investing lessons from the Dick Smith debacle.

Who is Peter Lynch?

Peter Lynch managed the Fidelity Magellan Fund for 13 years until his retirement in 1990, increasing the value of $1,000 to $28,000 over this time. *Time* magazine called him the Number One money manager in the United States, and he cemented his reputation when his first book, *One Up on Wall Street*, became a worldwide bestseller and compulsory reading for all fund managers.

In his 1993 follow up, *Beating the Street*, he has a chapter called 'Shopping for stocks: the retail sector' in which he says:

"Public companies on the way up, on the way down, on the way out, or turning themselves around can be investigated any day of the week by both amateur and professional stock shoppers. As an investment strategy, hanging out at the mall is far superior to taking a stockpicker's advice on faith or combing the financial press for the latest tips."

He then gives a detailed explanation of what he sees when he visits his local shopping mall, including kicking himself for missing out on Chili's Restaurants which his three children loved. He says a lot can be learned in one location because what sells in one town is almost certain to sell in another.

"I don't think of it as browsing. I think of it as fundamental analysis on an intriguing lineup of potential investments, arranged side by side for the convenience of stock shoppers. Here are more likely prospects than you could uncover in a month of investment conferences."

My Dick Smith shopping experience

What happens when I apply the Peter Lynch shopping advice to Dick Smith? I'm a 'typical' consumer of electronic goods rather than a tech geek. I don't need to be at the leading edge by buying every new gadget, but I like to keep up with technology. I have a basic understanding of what I want but often need technical assistance.

Going back a couple of years, I would regularly shop at Dick Smith for electronic needs, and even under the latter stages of the Woolworths ownership, I thought it was a good shopping experience. Young, enthusiastic techies knew their stuff, and were tolerant in explaining the obvious to an older generation. Prices were competitive and there was a willingness to price match.

One memorable incident sticks in my mind from a few years ago. The young salesman tried to upsell me into an extended warranty, but I knew these were usually expensive and not necessary.

I told him, *"I would never find the receipt and warranty in a couple of years when I need them."*

"Don't worry", he said confidently. *"We'll keep your records here and all you have to do is bring the goods into the store and we will fix them."*

That was an impressive customer service.

In private equity hands, I felt their offer remained at least consistent and perhaps improved, especially on the marketing side. The yellow Dick Smith brochures came into our home every week, and along with JB Hi Fi, Harvey Norman, Bing Lee and online retailers, I would usually check Dick Smith's prices. My impression as a consumer rather than a stock analyst was that Dick Smith and its private equity owners were building a solid business, but I made no attempt to analyse the company's financials, nor did I participate in the float.

At the time of the ASX listing, Dick Smith passed the basic Peter Lynch test of being a good, busy place to shop with enthusiastic staff, smart products and competitive prices for the serious consumer. Based on Woolies' experience, maybe this was never enough to make a decent return on capital and it was always doomed, but as a shopping experience, it looked on the money.

For the consumer, what went wrong?

Dick Smith was a listed company for only two years. In the post-float months, it retained the same external modus operandi as when in private hands. It increased store locations to an impressive 393, giving it scale and exposure.

But at some point, something changed. I have checked with friends who confirm my impressions. According to Lynch, I can make this judgement based on visiting just a couple of stores.

Most notable was the less experienced staff, and a need to check with the manager to answer questions. There was significantly more Dick Smith-branded product, when electronics and communications are obviously brand markets. Nobody wants a Dick Smith laptop. And fewer of the bright yellow signs that enticed with specials.

But the real surprise came towards the end of 2015. I was shocked by the local store's changes. Looking for a laptop, I had researched the market and knew what I wanted and the alternatives. Despite Dick Smith listing my chosen laptop online, the store range was pathetic. Old and inferior models, and no enticing price offers.

I asked a staff member if the laptop I wanted was in stock, and he did not know and checked his computer. This was a top seller which had sold out at a couple of Bing Lee stores, where their staff instantly knew the model. Then no attempt by Dick Smith staff to sell me something else. The store looked different. None of the eye-catching, large price posters you see in JB Hi Fi or Harvey Norman, but just shelves of tired-looking stuff. They had moved the checkout from a pod structure in the middle (where you were forced to pass heaps of other products) to a desk next to the exit door. The place looked like one of those standalone stores where no overall corporate marketing theme and look had been applied.

Many people in the media have criticised Dick Smith's bankers for calling in administrators, but based on my experience, they had to. The problems were endemic, not a matter of a poor retail cycle. Harvey Norman and JB Hi Fi have been trading well, and household goods sales were up over 8% in the year to November 2015. Retailing is fast-moving where the quality traders respond to customer trends and manage their inventory, and applying the Peter Lynch test, Dick Smith lost its way.

Two months before going into administration, on the day of its 2015 Annual General Meeting, Dick Smith issued this market update:

"Gross profit was adversely affected by increased promotional activity and unfavourable product mix, with strong sales growth in unlocked phones and fitness and disappointing sales in tablets, gaming and accessories. Channel mix was also negative, with strong online sales growth offsetting softer retail store sales, impacting gross margin."

Limitations of the Peter Lynch method … or me

Although there is great intuitive appeal in the Lynch method, I've often struggled with it. Maybe this says more about me than the company. I don't like the way Harvey Norman stores are split into separate franchises, so one person cannot help on another's product range. I hate loud music playing when I buy jeans, and I don't get a thrill watching an app showing where the Domino's Pizza delivery bike is located on its way to my house. I'd rather pay for an Italian gelato than a cheaper ice cream at Wendy's. I like shopping at Myer and David Jones but they have both struggled.

On the other hand, the appeal of Bunnings is obvious, and Lynch would love the Sunday morning queues, if not the terrible sausage sandwiches (and the direct exposure possible through the Bunnings Warehouse Property Trust and the less directly via Wesfarmers).

And I like roasted almonds in my homemade muesli, and in recent years, I've noticed the incredible increases in price due to the Californian drought, and they're still selling in my area for $13.99 for 500g. Yet Select Harvests' share price has halved to around $6 from a high of $13.48 in April 2015, mainly due to rain on the US West Coast, where most of the world's almonds are grown. I'm still waiting for cheaper almonds in my retail store.

Which shows that while ogling in a shopping centre can be part of the stock purchase decision, there are many other factors to check. So we'll finish with a couple of other Peter Lynch quotes:

"Behind every stock is a company. Find out what it's doing."

"The person that turns over the most rocks wins the game."

The analysts who were still recommending Dick Smith in late 2015 were too busy looking at numbers and not standing in a Dick Smith store, channeling Peter Lynch.

Graham Hand is Editor of Cuffelinks and has almost 40 years of experience in various segments of the finance industry. He has never worked in retailing.