Chapter Two

> *The direction in which education starts a man will determine his future life.*
>
> *—Plato*

Investor profiles—understanding market players and where you fit in

Investing, in all its shapes, forms and stereotypes, is a proactive activity. We all 'fit in' somewhere to the bigger picture of the Australian financial market. Some influence it more than others, obviously. This chapter explores some stereotypical 'financial personas' found in the market as a means of outlining some of the approaches taken by other market players. This may help you decide which approach may be best suited to your individual circumstances. It's important that you formulate an approach that is most appropriate for your patience, nerves and emotions.

An 'investor profile' is indicated by the investment method a person uses in the pursuit of wealth creation. An investment method differentiates itself from all others by the degree of emphasis it places on the investment model criteria central to the 'philosophy' of its investment approach. Some model criteria may require years of patience, and some may require you to take a position in an unloved stock. Some criteria may mean investors are to adopt a rather 'awkward' or 'overtly courageous' or 'passive' investment position in a stock. As such, you are sure to find that not all investment theory will measure up to your scrutiny nor your taste. This is why it's best that individual investors take the time to sufficiently explore the myriad of ideas, methods and strategies available, then formulate the best possible marriage between their chosen approach, their goals and their risk comfort zone.

In order for you to obtain a broader understanding of the underlying human make-up of the market (which may lead to you discovering where it is that you fit into this list of market players) and what the most appropriate investment method for you is most likely to be, let's look in more depth at some investor stereotypes.

The contrarian investor

Contrarian investing is a cyclical method of investing, generally considered an approach of investing against the broader trend. The contrarian invests in neglected or depressed companies with good management. A contrarian typically chooses stocks with little positive market sentiment surrounding them. This technique is employed by contrarian investors in the pursuit of gaining positions in overlooked companies, with the expectation that these stocks are close to bottoming out and that soon the market will realise their value, re-rate them and turn bullish again towards them.

In believing that they are buying these stocks at their lows, contrarians believe that they are availing themselves of larger gains when and if the share price begins to pick up again. A contrarian approach is a *buy and sell* strategy as opposed to a *buy and hold* strategy. You've heard of the cliché, 'buy in gloom, sell in boom'. Well that's the contrarian all over. You only buy and hold for as long is necessary; that is, buy in gloom (when stocks are undervalued) then sell during the boom period (when stocks are overvalued).

For contrarian investors, one of the key factors is looking for stocks whose price is deflated while many of the other fundamental factors look reasonable. A typical contrarian approach generally takes the following into account:

- company management, its style and strength
- the nature of the business or enterprise, and its sustainability
- low price-to-earnings ratio (see 'P/E ratio', Chapter 9)
- a share price below net tangible assets (see 'NTA', Chapter 9)
- a good cashflow ratio (see 'cash flow to assets analysis' and 'current ratio', Chapter 9)
- higher-than-average to excellent dividend yield (see 'dividend yield %', Chapter 9), and
- despite all this, the stock remaining unloved by the market.

Does contrarian investing work?

Take the case of BHP Ltd (BHP). It's a blue-chip company but in 1998 its share price fell from a peak of over $20 to under $11. BHP, the 'Big Australian', the international resources giant, was very much out of favour with the broader market. This falling out of favour was primarily due to the downturn in global growth, principally in Asia. The downturn in the global resource sector was bound to negatively affect the profits of a global resource giant like BHP. Anyone who picked up the stock at anywhere in the vicinity of its lows certainly had something to smile about only half a year later when things began to turn around for the company. By this time, global economic factors had changed. The Asian crisis, for one, had started to evaporate away in the memories of many. The BHP share price ran from its low of $10.62 per share to $22.01. Not a bad percentage play for the courageous and patient contrarian who put their money in a temporarily unloved stock, which also happened to be a blue-chip company with a strong mining and oil base from which to leverage itself back into prosperity very quickly.

Fig. 2.1: Broken Hill Proprietary Co Ltd (BHP) weekly chart, Feb 1997 to Feb 2001

Chart provided by Paritech, www.paritech.com.au

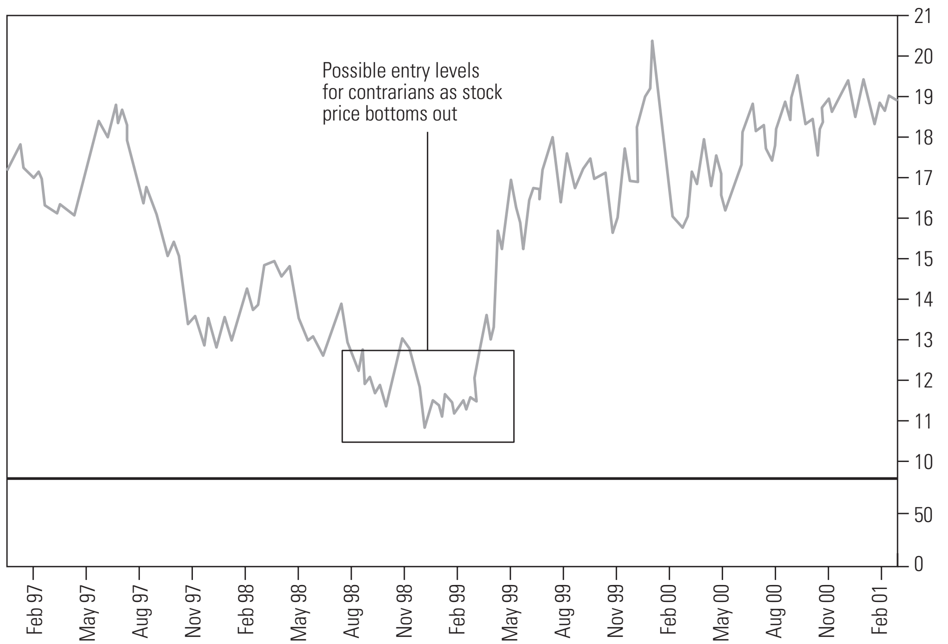

Fig. 2.2: Contrarian entry—BHP weekly chart

Chart provided by Paritech, www.paritech.com.au

- its profits were up 37% in 1999
- its end-of-year dividend increased by 7.5¢ over the previous year, and
- its price-to-earnings ratio was above 20.

It's this last figure that is revealing. It shows that the market saw additional growth potential in Tabcorp somewhere up to 20 times above its prevailing earnings. We would expect the price-to-earnings ratio to fall as the earnings rose in line with the prevailing share price. But share prices don't stand still and wait for the real earnings to catch up. In fact, the market still saw Tabcorp as a potentially strong growth stock with all the necessary qualities to outperform the market. In April 2000 the share price was not standing still at all. It hit a high of $9.85, as well as retaining a high price-to-earnings ratio of 18. Earnings were just under 50¢ a share and its annual dividend was now 39¢ per share. At the end of the 1999 financial year Tabcorp reported a 22% increase in company earnings. The full-year dividend payout was 47¢. In 1999 earnings per share (EPS) were 47¢. In year 2000, EPS was 50¢ per share. A 3¢ difference may not sound like much, but when you multiply 3¢ by the number of shares on issue the figure becomes quite impressive. It's this sort of increase in EPS that makes Tabcorp a growth stock.

Growth stock investors in Tabcorp have not only seen their capital investment appreciate over the years in line with EPS growth and profit increases, but they have also enjoyed the benefits of rising dividends as well.

Fig. 2.4: Tabcorp Holdings Ltd (TAH) weekly chart, Sep 1994 to Aug 2000

Chart provided by Paritech, www.paritech.com.au

Perhaps another high-growth company with a high risk-reward ratio that would appeal to the more aggressive investor is a stock such as Biota Holdings Ltd (BTA). If you look at the stocks price chart you'll see the volatility of this stock—all those troughs are evidence of the risk inherent with investing your money in it. At the same time, however, all those peaks are evidence of the rewards offered by this stock to astute traders or investors.

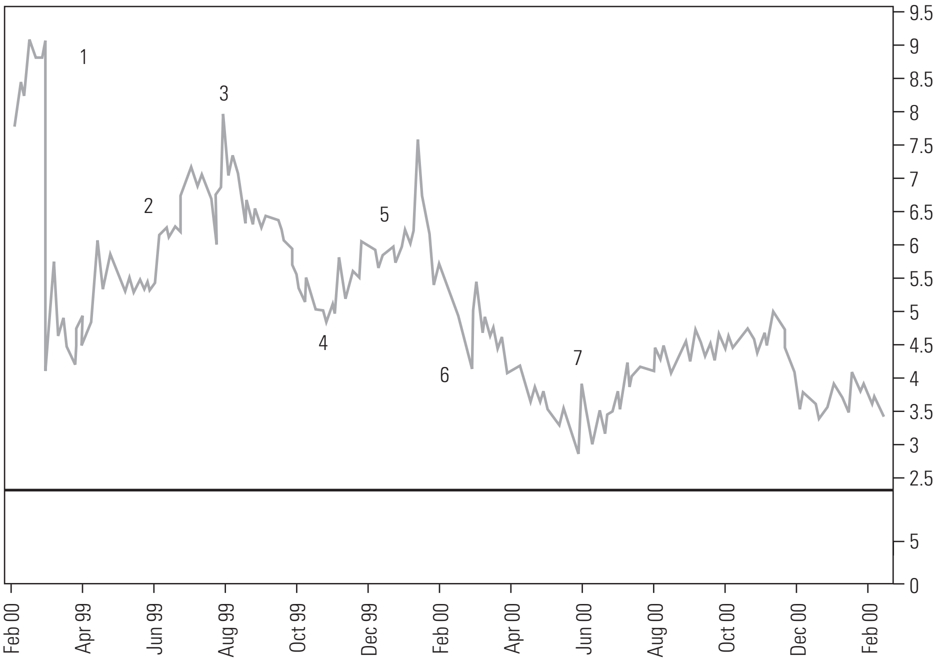

Fig. 2.5: Biota Holdings Ltd (BTA) daily chart, Feb 1999 to Feb 2001

Chart provided by Paritech, www.paritech.com.au

Legend

1. 25 February 1999: US Food and Drug Administration give non-approval for the anti-influenza drug Relenza. Stock falls $6 in a day.
2. 3 June 1999: regulatory approval received to market Relenza in all European Union countries. Biota set to run to new share price high.
3. Between July and August 1999, stock price trends downwards as investors and speculators grow impatient while waiting for the announcement of latest research results. The sentiment surrounding BTA grows uncertain as results are delayed.
4. 1 October 1999: Biota announces research results showing health care benefits of Relenza. Market begins to notice and share price begins to climb out of trough.
5. 24 November 1999: provisional approval granted for the marketing of Relenza in Japan. News give impetus to share price on its way to third price spike to $7.50 level in 12 months.
6. 29 February 2000: Biota releases half-yearly report. ASX queries Biota over share price fall from a high of $7.55 on 12 January 2000 to a low of $4.00 on 28 February. Biota responds that it has no explanation for price volatility.
7. 29 May 2000: Biota share price rises 40% after Relenza is approved for paediatric use in the US.