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LONG TERM COMMENTARY

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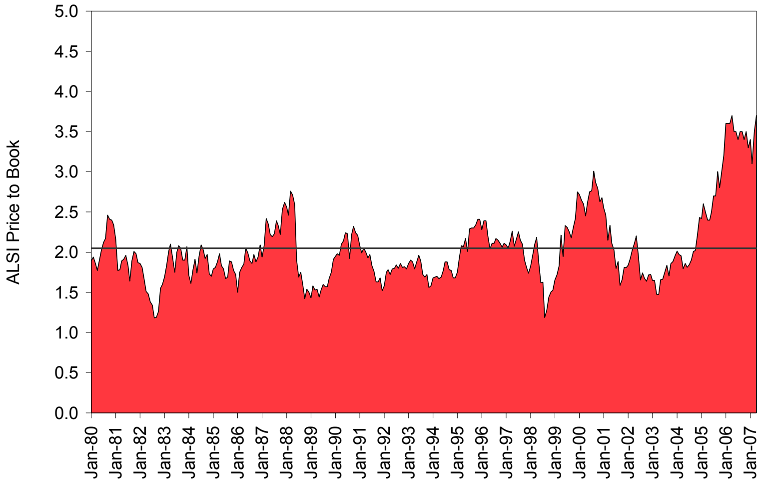
A different take on value

The significant rise in the All Share Index (ALSI) of over 21 500 points from a low of 7 322 in April 2003 to a high of over 29 000 points in May 2007 has naturally resulted in much discussion over current values and future return expectations. Much of this discussion has focused on the above average price earnings (PE) ratio (16x) that the market is trading on, weighed up against a very positive short-term earnings outlook.

As we have highlighted in previous articles, one of the problems with taking a PE at face value is that earnings are cyclical over time. In other words, if earnings are unsustainably high and revert to trend, buying the market on what appeared to be a reasonable PE can nonetheless result in very disappointing future returns.

A more stable variable over time is the book value or net asset value of a company. The book value is simply the value remaining after deducting all liabilities from the value of a business's assets. Instead of comparing price to earnings we can compare price to book (PB) value as an alternate valuation tool that can help look through the level of earnings. In other words a share can be on a low PE but a high PB and vice versa. Let's take a look at the long-term PB ratio of the ALSI. The current PB of the ALSI is 3.7x against a long-term average of 2.05x since 1980.

ALSI Price to Book (PB) ratio from Jan 1980 – Jan 2007



The price investors are willing to pay above (or below) book value should be determined by the returns the net asset value can generate (Return on Equity) relative to the cost of the equity and long-term growth expectations. A quick review of each of these three variables below highlights the strong tailwind each has provided to the strong performance of equities over the recent past.

Returns (ROE)
ROEs and operating margins are at or close to all time nominal highs for most businesses.

Cost of equity (Yield on long government bond + risk premium demanded by investors)
The long bond yield has declined from 13.7% in 2000 (having been 20% in 1998) to the current 7.9%. Part of the decline in yields has been the dramatic narrowing of risk premiums as highlighted by the very narrow spreads demanded by investors for emerging market and corporate bonds.

Growth rate
The long-term trend real earnings growth rate of the ALSI has been approximately 2.5% p.a. since 1960. Real earnings for the ALSI have grown at 28% and 20% p.a. compound over the last three and five years respectively. The natural inclination of investors is to up their long-term growth projections in the face of such impressive results.

It is clear from the simple review above that local companies have operated in an environment of declining cost of equity whilst *simultaneously* enjoying record profitability. This results in a very attractive spread between ROE and the cost of equity and when combined with investor's long-term growth expectations having increased, it would be difficult to imagine a better combination for business valuations based on PB measures.

So what are we concerned about? The variables being used to generate the appropriate PB ratio need to be sustained into the future. This is why we value businesses based on their long-term sustainable returns or profitability as distinct from what they are currently generating which may be well above (or below) normal. With current returns above normal in our view we are using lower ROEs as inputs in our valuations. Bond yields bottomed in February 2006. Rising yields not only increase the cost of equity (by providing an increasingly attractive competing rate of return for investors) but also typically tend to occur in environments when risk spreads widen and growth expectations are tempered.

In conclusion, when examining each of the variables determining the PB of local equities it is clear that the current price levels of many shares are a reflection of *very* favourable recent history. In our view it is highly unlikely the future will be as supportive. Return expectations from equities should therefore be lowered. We do however continue to find attractive businesses that are being rated similarly to more cyclical businesses but where we believe there is a greater probability of sustaining above average returns on their net assets over the medium-term.

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