

FairfaxDigital

NEWS | MYCAREER | DOMAIN | DRIVE | FINANCE | CITYSEARCH
member centre | login | register



Market offers little reward for risk taking

By Alan Kohler

February 23, 2005

Maybe it's time for some straight talking about the Australian sharemarket.

It has gone up 25 per cent in the past 12 months, with upward momentum still going strong, yet valuation remains below the long term average because profits have gone up more. That's what your stockbroker murmurs down the phone each day. But it's also because interest rates are at historic lows.

The bigger question for investors is whether shares are providing a decent return for the risk involved in handing your hard-earned over to a bunch of corporate empire-builders and option-harvesters, plus a few honest, well-meaning goofs - especially now that interest rates are going up.

A bewildering array of measures is used to figure out whether company shares are good value, including the dividend/bond yield gap, price/earnings ratio, EBITDA multiple and DCF valuation, among others.

In my view, the main thing you need to look at is earnings yield. And you should approach it with plain common sense, not quantitative analysis.

How much net profit, after paying tax and interest and maintaining its assets, will a company make this year as a percentage of its market price? And is that profit an aberration or is it stable and growing?

Net profit is the "interest" a company produces for its owners; the earnings yield (profit as a percentage of share price) is therefore the "interest rate" on the security called an "equity".

Earnings before interest, tax, depreciation and amortisation (EBITDA, or cash flow) is irrelevant to investors because interest and tax both have to be paid before they get what's left and depreciation generally equates to "stay in business" capital expenditure. The same goes for the present value of future cash flows (discounted cash flow, or DCF).

The price/earnings ratio is fine because it is simply the inverse of the earnings yield ($P/E = 100/EY$), but it is better to use the earnings yield because it's easier to compare that with other interest rates on offer, such as government bonds.

And as for the dividend, it's only a part of the shareholders' return. The rest is reinvested in the business. What's more, dividend yield has become a useless comparative measure because payout ratios vary so much and because dividends are commonly used for big lumps of tax-effective "capital management" (repaying to shareholders any capital that directors don't know what to do with).

Profit that is retained in the business rather than paid out as a dividend still belongs to the owners and contributes to capital growth. In fact, in the long term it's the only thing that contributes to capital growth. In the short term it's about market psychology, but that's a whole different subject.

Warren Buffett used to say he only wanted to invest in companies that paid no dividend and retained all earnings, because dividends in the US are taxed in investors' hands whereas retained earnings are not, and they end up generating capital gain. And Buffett hates giving any money to the Internal Revenue Service.

Anyway, where does the sharemarket currently sit on earnings yield? Well, here are a few random examples.

Billabong produced a brilliant first-half profit this week, so good that excited investors promptly bid up the shares to a level where this year's forecast full-year earnings provide a yield of 4.4 per cent.

This is 1 per cent less - from a company with a bad track record - than you get now for investing in

10-year Government bonds and taking no risk at all. Does that sound like a good idea?

John Fairfax's 2005 earnings yield is about 5.4 per cent - roughly the same as 10 year bonds. What about that for a bet?

Yesterday's result and share price jump for Aristocrat Leisure - which has an atrocious governance record - puts it on an earnings yield of 6.4 per cent, 1 per cent above the risk-free long bond rate.

The earnings yield for the market as a whole is 6.8 per cent, slightly better than the long term average of 6.7 per cent.

The 10 year bond yield is 5.47 per cent, about the same as the cash rate.

Now forget about long term averages - is 1.33 per cent enough extra return for possibly giving your money to corporate empire-builders, option-harvesters and goofs?

And what about when the Reserve Bank raises the cash rate from 5.5 to 6 per cent? The long bond rate is unlikely to stay below 5.5 per cent. More likely the extra return for investing in shares will shrink below 1 per cent (unless share prices fall in the meantime).

In the United States, the average earnings yield of the S&P 500 is 6.1 per cent and the 10-year bond rate is 4.26 per cent, so the premium for shares is 1.84 per cent. Better than here, but still not great.

In Japan, the average earnings yield is 6.2 per cent and the long bond rate is 1.44 per cent - a difference of 4.76 per cent. That's more like it.

For the Australian market to produce an earnings yield premium of 4.76 per cent over the current 10-year bond rate, the ASX 200 would have to fall to 2784 - 33 per cent below the current level.

But that won't happen. Surely.

mail@alankohler.com

Our Advertisers

[Home](#) > [Business](#) > [Alan Kohler](#) > Article

Copyright © 2005. The Sydney Morning Herald.