

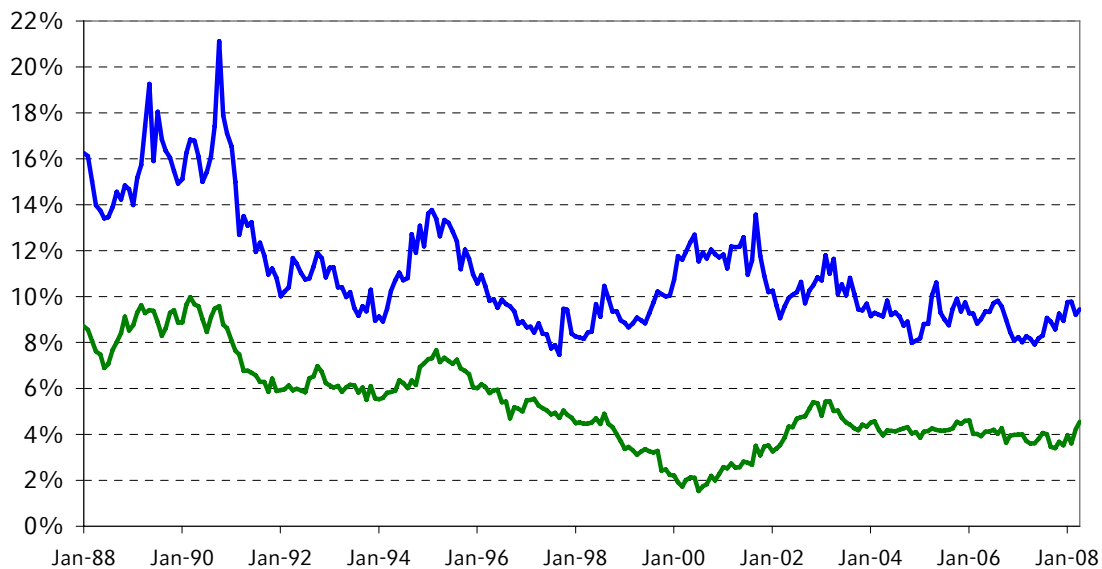
# Time for Value?

At first glance, the equity market is offering a wider valuation dispersion than we have seen for a while, and is somewhat cheaper than its highs of 2007. What does this mean for value investing? Below we look at valuation and earnings over the past few decades to get some perspective.

## *What's been happening with valuation?*

The chart below examines the dispersion of earnings yields (the reciprocal of price earnings multiples) over the last few decades for the core industrial segment of the market. This avoids any distortion from resource or financial stocks and excludes property and infrastructure where reported earnings are less relevant. The chart shows the ninetieth and tenth percentiles over time.

### Earnings Yield Dispersion



Source: Macquarie Equities

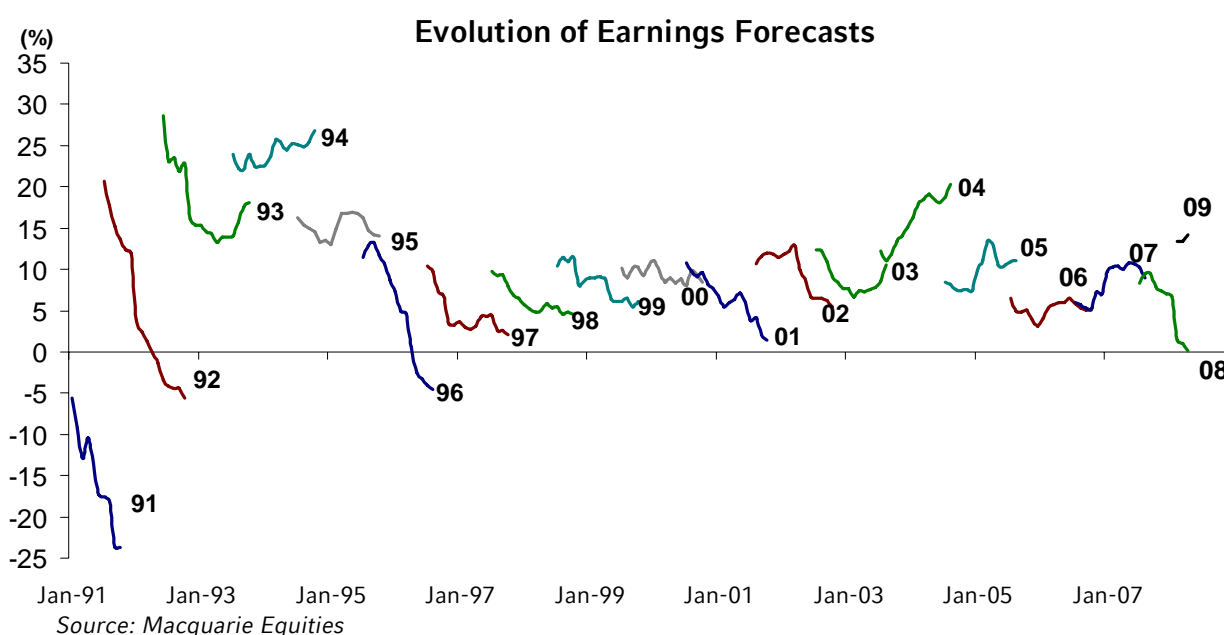
The most significant widening in recent years was the tech/growth bubble in the period leading up to March 2000. Subsequent to the bursting of that bubble, value managers enjoyed a nice run, despite a mild hiccup in the economy. Shunned industrial companies such as Amcor, Ansell, and Wesfarmers almost halved their earnings yields over the next two years, as the market's growth stupor faded. This was the textbook value revelation whereby companies were priced cheap because the market had underwhelming expectations of earnings growth, then realized it had been far too harsh.

In 1990 there was a different reason for valuation dispersion. The economy had turned sour with exceptionally tight monetary policy having finally brought down the credit binge. The market was rightly circumspect of highly geared companies and how they would fare, pricing them on deceptively attractive multiples. John Spalvin's Adelaide Steamship conglomerate was an example of a value mirage that caused some pain for value managers at that time. In 1990, valuation dispersion was as much about earnings risk as lack of glamour. The rapid transition from wide to normal dispersion as happened in 1991 and again in 2001 provided a strong but brief ride for traditional value investors. As discussed further on, the earnings environment has been a more pervasive influence.

## *The Earnings Environment and Value/Growth*

The earnings environment and the value/growth question are interwoven. In his fine book, 'Style Investing'<sup>1</sup>, Merrill Lynch US Strategist, Richard Bernstein, argues a coherent thesis that value investing thrives when earnings growth is abundant, whereas growth investing is more effective when growth is scarce. In Australia the abundant years for earnings growth were 1993 to 1995 during which value thrived. In the late 1990's as earnings growth faltered, value struggled. US experience also confirms his argument.

The current concern in the industrial segment of the market is earnings sustainability. The typical profit margin (before interest and tax) for an industrial company through the 1990's was around 9%. In recent years it has moved to around 14% thanks to a benign cost environment. But input prices are now increasing, interest costs have risen and the elevated exchange rate is a strong headwind for exporters and import-competing companies. The chart below shows how earnings forecasts for core industrial stocks have evolved for financial years in terms of earnings growth.



The nature of earnings forecasting is that analysts tend to miss turning points by a long way as seen in 1991, 1992, and 1996. The fact that 2009 earnings forecasts have held up well so far may be false comfort. In the upcoming reporting season the outlook statements will be scrutinized even more thoroughly than usual. But if earnings lose momentum, orthodox investment thinking suggests the traditional value style may hit some turbulence.

## *Incorporating value in a robust way*

In an earlier Newsletter<sup>2</sup> we explained how the performance contribution of relative valuation is more robust than traditional value. Subsequently other researchers<sup>3</sup> have confirmed the importance of neutralizing industry biases when exploiting value, rather than making broad market valuation comparisons. Over recent years sophisticated interpretations of value management have taken into consideration the accounting quality of earnings, and measures of earnings risk. In addition to the distinction between relative value and traditional value, these aspects provide some insulation from the value traps that pervade market turning points.

<sup>1</sup> Bernstein, Richard, 'Style Investing: Unique Insight Into Equity Management', John Wiley & Sons, 1995

<sup>2</sup> 'Fallen Angels and Old Dogs', March 2004

<sup>3</sup> Cavaglia, Stefano, James Sefton, Alan Scowcroft, Bryn Smith, 'Global Style Investing', Journal of Portfolio Management, Summer 2006

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