Why blue chips let you down

Most of them are mature businesses whose best years are behind them, with modest growth

ROGER MONTGOMERY

Are your returns stuck in a time warp? Are you surprised to hear Telstra's share price is lower than it was in 1999? The NAB share price is also lower. That's sixteen years with no price growth.

Rio and BHP's share prices are lower than 11 years ago and Woolworths is lower than almost a decade ago. You might put it down to the resource cycle, disruption or poor management, but in each case I put it down to a poor definition of what a blue chip company is.

A portfolio of conventional blue chips will only ever provide investors with mediocre long-term returns. The arithmetic of poor returns is straightforward. Most large, high-dividend-yielding companies are mature and their earnings aren't growing.

Take Telstra for example; its first-half 2016 net profit after tax, EBITDA and earnings per share are the same as they were precisely 10 years earlier.

Separately, the profit achieved at BHP, now run by Andrew MacKenzie, is less than it was seven years ago and its shareholders have entrusted three times the equity it had back then and banks have lent it three times as much. If I gave you three times more money, you could put it in a bank and you'd earn three times as much interest without any effort and a lot less risk. Why would anyone take the risk of running or owning a business for a worse return than bank interest?

The boards of conventional blue chip companies have created another problem for investors. They have acquiesced to shareholder demands for more dividends and have increased their earnings payout ratios. As a result, they retain less profit for reinvestment and growth.

What's more, because these major companies, such as the banks, Telstra, BHP and Rio, dominate the major ASX indices, you can say goodbye to high returns from index investing too.

Australian retail investors have been putting their financial faith in conventional blue chip shares for decades. They're described as stable, well known, pay steady dividends (until they suspend them) and they're big — that is, they are usually found in the top 50 companies in Australia by market capitalisation.

But investor faith is misplaced and the low-return environment we have entered — which I wrote about in my last column on April 2 — will invalidate any perceptions of safety and long-run value creation from blue chips.

So if many of the companies to which the blue chip label has been attached aren't really blue chip, what and where are they?

I have a very specific definition of what a blue chip company is.

1. It is a business that can retain large amounts of capital.

2. It can generate high rates of return on that incremental capital. A business that can do this is like a bank account earning a 20 per cent interest rate and one which allows you to reinvest all the interest.

3. It is not exposed to external global dramas. A company where the equity grows at 20 per cent is like a bank account where the interest earnings grow at 20 per cent. If the bank account was listed, over time, and irrespective of what might happen in the wider world — a Brexit or troubles in Greece, the Middle East or China — the share price would grow by more than 20 per cent as its desirability gets recognised by the wider market. Build a portfolio of these businesses and you can't help but do very well over the long run.

Telstra, Woolworths, BHP, Rio, Santos, AMP, Lend Lease, Boral and Qantas are not businesses able to do this.

Of course their share prices may rise spectacularly and people might refer to them as blue chips but the bubble will always pop and you have to be very clever to time your entry or exit from these stocks. Instead seek out companies such as:

- REA Group — the online real estate listing group (a subsidiary of News Corp, owner of *The Australian*).
- Challenger Financial, the financial services group led by Brian Benari, which has specialised in annuities.
- Isentia, the media intelligence and social media measurement group.
- IPH, the intellectual property services group.

The short-run influences of fear and varying popularity will ensure their share prices will wax and wane, but over time their true value should increase.

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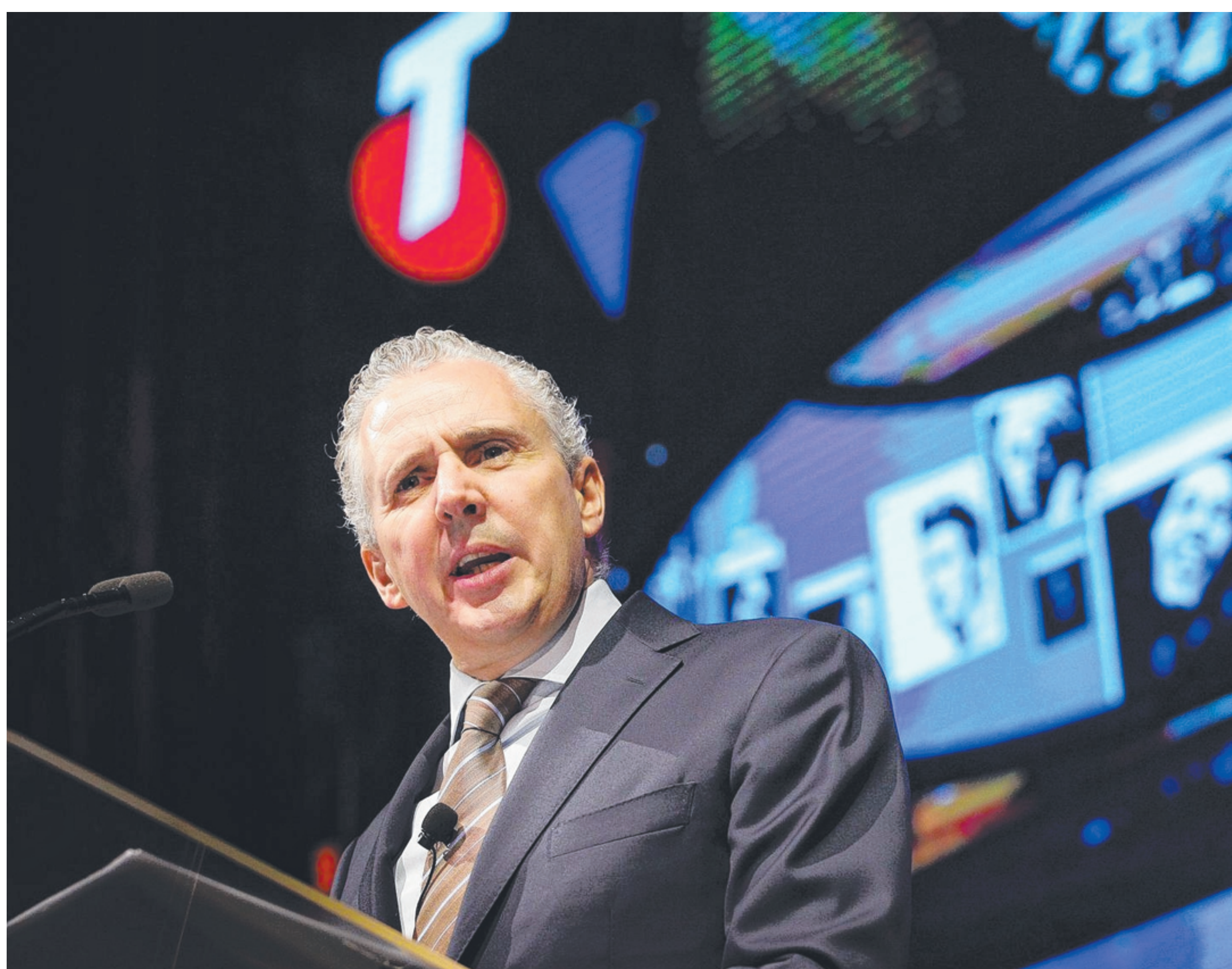

Telstra CEO Andy Penn might do a good job, but the company's share price hasn't risen for years

HOLLIE ADAMS

The recession the US needs to have ... and how to make the most of it

STIRLING LARKIN
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We've all heard the expression. Be careful what you wish for.

And when it comes to market commentaries in mid-2016 most wishful thinking still argues the case for why avoiding a recession in the US benefits investors.

There exists an even stronger case for why a US recession — which is inevitable — benefits Americans, Australians and the global economy at large. And good cause to suggest that a recession would be welcome this year.

Analyst consensus suggests the US has a 15 per cent probability of recession this year, but it must be remembered that these consensus contributors have a woeful track record when it comes to accuracy.

Australian ultra high net worth investors have time and patience for this particular conversation, if for no other reasons than that many amassed their respective wealth during periods of economic flux and respect that, as important it is to grow their net position, "capital preservation" becomes front-of-mind when economic cycles turn, as they are about to.

Even more poignantly, recessions, albeit painful, are healthy and unavoidable.

Unless, of course, you happen to be "Australia", which has magically avoided a technical recession since September 1991 — but more on that later.

Behind investment markets sit real economies, and more than two centuries of aggregated economic knowledge has taught us that these economies, through one process or another, predictably roll through "business cycles".

These cycles represent the journey that any economy takes through times of expansion and then contraction, known as "recession".

During expansions, economies grow in real terms — meaning they develop organically and not through artificial means such as asset or price inflation, such as the recent quantitative-easing programs — as evidenced by increases in indicators such as employment, industrial production, sales and wages.

During recessions, economies contract, and these contractions are particularly healthy because they correct over-allocations of investment, spending and inefficient uses of employment, but they also help bring real prices back into line.

In other words, recessions are the only natural way for runaway prices or gross inefficiencies in real economies to be corrected — there exists no other way of achieving these disciplines. None.

Those across investment communities who argue that the era of recessions can be avoided or indefinitely postponed, need only look to Australia as the world's best example of a real economy that may, indeed, need a recession it has to have:

- Real inflation metrics in Australia have never successfully gauged the creep of prices across both the real economy and asset markets, particularly Australia's residential housing market.
- The immediate consequence of perennially avoiding nationwide recessions in Australia is that real economic costs balloon, as evidenced by this week's graph.
- Australia remains "expensive" across numerous measures and this ultimately benefits nobody. Except, of course, our nation's competitors.

However, as a global investor, the advent of a US recession could be beneficial for a number of key reasons.

First, no matter what style of investing to which one subscribes — technical, event-driven, value or fundamental — over time investment markets always remain correlated to their respective underlying real economies.

For the global investor wishing to continue participating in the world's most robust, developed and deep markets, found in the US, identifying where in the business cycle the US economy is currently at allows for proactive tactical positioning today. In other words, if we accept that the US real economy is about to turn towards recession, and we know from experience that recessions take about 12 quarters (or three years) to unfold, then it becomes crystal clear where we should tactically allocate today to remain safe during these contraction phases, and then actively position our portfolios for the foreseeable recovery at or nearer to 2019.

Traditionally, during bouts of recession "defensive" stocks — those that deliver constant dividends and stable earnings regardless of economic conditions, such as utilities — perform well and, then, when economies begin to recover, cyclical sectors, such as consumer discretionaries, most often prosper better than most.

Given that most US financial variables are now at levels usually associated with recessionary or near-recessionary conditions — S&P 500 prices slumping and benchmark fixed-income yield curves remaining stubbornly flat — we know that:

- During 13 US recessions since 1937, the median S&P 500 earnings per share declined an average of 12 per cent.
- Also, remembering that the median peak-to-trough fall of the S&P 500 during these prior business cycles averaged 21 per cent, if we accept that the US is turning into recession then we can statistically predict the S&P 500 will fall to a level nearer 1700 or 12 per cent below today.
- Of course, relying on "medians" can be deceptive, as the minimum US EPS drop was 4 per cent during the 1945 downturn while the maximum occurred during the Great Recession, when EPS plunged 57 per cent.

But, for all those investors crying that markets remain distorted — due to unconventional stimulus programs — overvalued and misrepresentative of their true underlying real economies, a recession in the world's flagship economy should be welcomed.

And, for Australian investors who cannot discernibly match real local economic conditions to domestic investment markets, such as the ASX200 or local real estate markets, seeing that global markets such as the US do ultimately match brings some reassurance long-term, fundamentally-driven investing still does reward the diligent and patient global investor.

No one enjoys recessions, but denying the inevitable makes for a horrible investment plan, whomever you are.

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How to determine what is ethical ... and what is not

WILL HAMILTON

Investors are increasingly balancing risk and return with environmental, social and governance responsibilities as a strategy

ESG- focused investments can be made across individual securities, be they equities, bonds or managed funds.

In its 2015 report on the ESG sector, the Responsible Investment Association of Australasia estimated that, at the end of 2014, core responsible investment or socially responsible investing portfolios exceeded $36 billion.

This is against Morningstar's estimate of a total pool of $1.26 trillion of investments, which means responsible investments represent just 2.51 per cent of the market (up from 2.34 per cent the year before).

However, it is worth noting that assets in Australia managed under responsible investment strategies are now the norm, with total assets under management of $630 billion or 50 per cent, and investments undertaking ESG integration representing $598bn or 47.5 per cent.

The reasons being given to explain the large uptake in ESG in Australia as considered by the Responsible Investment Association of Australasia include:

- An increasing number of examples of a company's poor management of ESG impacting shareholder value.
- The growing demand by investors to align their savings with their beliefs.
- An increase in activist groups engaging with the finance sector.
- The increasing awareness by fiduciaries that consideration of ESG issues is an important element of their responsibilities.

I understand that, for an investor looking at ESG, the different definitions of what is ethical can be confusing.

It's not like comparing apples with apples.

Nevertheless, the reality is that increasing numbers of institutional fund managers are taking ESG very seriously as the demand from their investors rises.

Everyone, it seems, has a different definition.

In December, at the historic Paris 2015 UN Climate Change Conference, COP21 countries committed to pursue efforts to stop warming beyond 1.5C.

To achieve this will force businesses globally to sharply reduce the use of fossil fuels to zero.

One of the issues in Australia is that we as a country have an abundance of cheap coal.

To exacerbate this situation further, until recently, wind and solar power generation experienced what can only be described as antagonistic government policies under the former prime minister Tony Abbott. However, the switch to Malcolm Turnbull is leading to more favourable policy support for renewables.

There is also the concern around where to draw the line as to what is ethical and what is not.

For example, there are some investors who would say that uranium is more ethical or responsible than coal, yet ethical investing convention currently holds the reverse view.

Many listed companies, among them the big four banks, are responding to pressure from both shareholders and activist groups.

Westpac has announced that all new financing proposals will be judged against the transition to a model aligned to a two-degree-temperature-rise economy, meaning that coal and oil and gas projects will struggle to gain support.

This is a tangible way of making Westpac more accountable than its other peers on climate change.

> For example, there are some investors who would say that uranium is more ethical or responsible than coal, yet ethical investing convention currently holds the reverse view

There is also a negative perception that sustainability and profitability are mutually exclusive.

As recently observed by a trustee of a leading Australian charitable fund: "To those of us with the luxury of investing perpetual funds, the focus has to be return over the long run while not ignoring annual yield requirements. Applying such a focus, sustainability and profitability generally go hand in hand."

In a June 2015 paper, *Can ESG add Alpha*, MSCI concludes ESG overlays do contribute to outperformance of the MSCI World Index and lead to stock-specific decisions indirectly attributed to ESG signals.

ESG is going to continue to grow as an additional investment approach as both not-for-profit clients and increasingly families and individuals seek to align their investment approach with wanting to invest to ensure a better world can exist.

The important takeaway is that these investors want their money to be run ethically — and the various categories of what is and is not ethical need to align with investor interest.

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