Share trading profits revolve around low expectations

THE SHORT CUT

with ANDREW MACKEN

IT is interesting to think about what a share price actually means.

It is the result of competing investor expectations over the future prospects for the particular underlying business.

As expectations for a business rise, so too will the price of its shares as investors buy more of them on the stock exchange.

The idea can be taken one step further.

A company's share price, at any level, can be viewed as an average of all investor expectations for the future prospects of the business.

Through this lens, a share price can be viewed simply as a set of "market-implied" expectations about the future.

The key to investing is to buy shares when the market-implied expectations about the future are unreasonably low; and sell when they are unreasonably high.

You see, it's not just about whether or not the underlying business is attractive or not.

Take Alphabet (formerly Google) or Facebook, two of the highest-quality businesses in the world.

Should you buy these shares on this basis alone?

Absolutely not.

Your objective is to think about what expectations are already reflected in today's share price levels for these businesses — and buy only if you deem these expectations to be unreasonably conservative.

Hint: the share prices of Alphabet and Facebook already carry with them enormous expectations about their future growth prospects.

The danger investors face is the prospect of buying a share at a price that carries with it overly optimistic expectations about the future.

In this scenario, the underlying business will eventually deliver results that fall short of expectations.

The market will revise down its expectations in light of the new information and the share price will fall.

We observed this dynamic recently with Australia's Nine Entertainment Company Holdings (NEC).

Rewind to February and a review of analyst projections for Nine's revenue growth for the six months to June 30, 2016, was for a positive low single-digit result.

This was to be quite a recovery from the 5 per cent revenue decline observed in the previous half.

Furthermore, profit margin expectations for Nine were stable, if not slightly improving.

Such profit margin expectations make sense in the context of rising revenue expectations.

You see, Nine is a largely fixed-cost business.

This has the effect of creating expanding profit margins when revenue rises — though also declining margins should revenue fall.

Fast forward to the company's April quarterly update for the three-month period ending March 31, 2016, and the market is told Nine's television revenue was down by about 11 per cent for the period (and television revenue drives nearly 90 per cent of the company's total revenue).

So while the market was expecting growing revenue it was told revenue has been declining.

And the market's profit margin expectations were contingent upon the growing revenues, so in an instant the market needed to revise down its revenue expectations — and with it, its profit margin expectations.

That is an ugly combination.

No prizes for guessing what the share price did on the day. It fell by 24 per cent.

Investors need to be mindful of the expectations they are buying into when purchasing shares.

If you buy expectations that are too high — irrespective of how good the company is — you should not expect to achieve above-average returns.

Instead, buy when expectations are too low and sell when they are too high.

That is the key to investing success.

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