Market is painting itself into a corner

THE SHORT CUT

ROGER MONTGOMERY

IN this column we generally write about investing with an unconventional perspective.

We write about what we don't like. Individual companies that are expensive and those in industries we believe are being fragmented, disrupted or in structural decline are the topics you will usually find here.

Today, however, I want to lump the entire market into the 'Don't like it' bin.

You see, your returns are determined by two things: price and growth (quality).

The problem right now is that prices are expensive in aggregate.

The price-to-earnings ratio for the S&P 500 in the US is now 18 times and the ratio for the Australian ASX 200 excluding banks is also 18.09 times.

That's a lofty multiple, justified only by the very low interest rates. Since 2010, ASX 200 companies have not grown their earnings per share at all according to data provided by Factset.

And earnings are unlikely to grow much in the future because those same ASX 200 companies have increased their dividend payout ratio from 55 per cent to almost 80 per cent today. That means there are a lot less retained earnings available to reinvest in projects that will grow earnings in the future.

That leaves the possibility of growth coming from increasing borrowings. The problem is debt is already high. In the US total credit market debt has risen from 175 per cent of GDP in 1981 to almost 375 per cent of GDP today. There is simply not the capacity to raise debt much further.

The only option to grow would be to raise capital by issuing new shares.

But that would be odd because the bulk of the recent debt increase in the US has been deployed on share buybacks and mergers and acquisitions. If companies have been using debt to buy back their shares, surely they aren't going to start issuing new shares. If they did, it would dilute everyone's ownership of the non-growing earnings and share prices would fall.

When a company buys back shares at the highs and issues new shares at the lows, it's a guaranteed way to destroy value. Perhaps that is what is going to play out and maybe that is what causes the market to correct.

What I do know is that when interest rates rose quickly between 1960 and 1981, the S&P 500 index retuned just 3.6 per cent per annum. When interest rates fell heavily between 1981 and 2000, the S&P 500 returned almost 15 per cent per annum.

And more recently, between 2000 and 2016, when interest rates and the equity market risk premium combined was flat, the S&P 500 returned 2.5 per cent per annum.

So the debate about whether rates stay flat or rise is moot. History tells us neither are great for long-run returns from the index.

If profit growth is likely to be low and if interest rates can only stay flat or rise, it is not inconceivable that the market will produce low returns and even a few nasty contractions along the way.

The silver lining?

It should be easy to beat.

You simply have to stay invested in companies able to redeploy capital at very high rates of return, and hold cash as an option over cheaper prices when you can't find companies that meet those exacting criteria.

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Remote control

Telstra looks to dominate smart home market

LILLY VITOROVICH
TECHNOLOGY

TELSTRA is pushing into the networked home automation market with an offering that will allow customers to open their front doors or turn on the heating remotely.

The nation's biggest telco is looking to the technology space for future earnings and yesterday unveiled 10 smart devices controllable using a smartphone, tablet or desktop computer through an app.

Australian households are on the brink of a digital revolution that will transform the way people interact with their homes, according to Telstra executive John Chambers.

Mr Chambers said the average household was expected to have 29 connected devices by 2020, up sharply from about nine now.

The networked home industry was expected to be worth more than $1 billion a year in Australia over the next five years, he said.

"The key to Australians embracing smart technology in the home is to make it easy and simple to use."

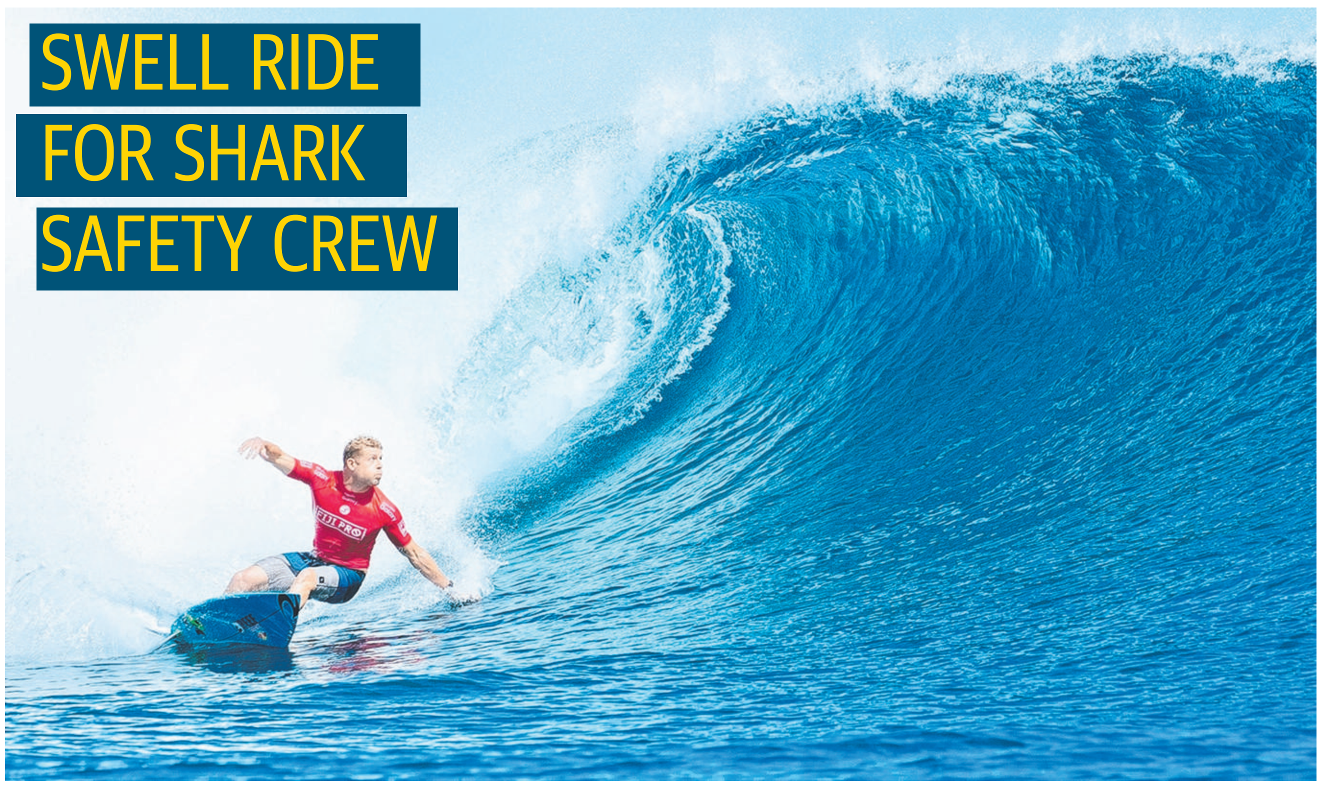
Telstra has been working with US-based Icontrol Networks to build a user-friendly platform that will work across various devices and operating systems.

Foad Fadaghi, principal analyst at research company Telsyte, said the telco was trying to tap a market that had traditionally only targeted very affluent households.

But the industry had changed in recent years with the arrival of do-it-yourself products, Mr Fadaghi said, which meant Telstra had its work cut out convincing customers to take its products on lengthy contracts. "Today, most home automation products that consumers look at are purchasable at retail outlets like JB Hi-Fi," he said.

Telstra's push into home automation could also be about tying customers to its mobile and broadband operations, especially as the National Broadband Network rolls out.

Telstra will release its smart home packages before Christmas with the two initial offerings both requiring 24-month contracts. Mr Chambers said the monthly cost would be equivalent to "a couple of movie tickets". AAP



Mick Fanning competes in the Fiji Pro at Cloudbreak earlier this month.

JOHN CONROY
INNOVATION

SHARES in a group developing shark detection technology have soared after it was awarded a contract at the pro surf event where Mick Fanning was attacked last year.

Shark Mitigation Systems, which listed in May, has been given the go-ahead to deploy its shark-detecting Clever Buoy next month at the J-Bay Open at Jeffreys Bay on South Africa's rugged Eastern Cape. The company's share price jumped 3c, or 15 per cent, yesterday after it announced the deal.

Shark Mitigation says the Clever Buoy uses sonar transducers to scan for marine life, relaying information in real time to surf authorities when a target is determined to be a shark.

"We are very excited to be working with the pro surfing league to showcase our technology," co-founder Craig Anderson said.

"This will help place our technology on the world stage, showing what it can do to keep surfers and other ocean users safe in the water."

It marks the first international deployment of the company's buoy, which also produces patterned wetsuits designed to be perceived as unpalatable or dangerous to sharks.

Shark Mitigation said the Clever Buoy deployment followed international interest in the wake of a "highly successful" pre-commercialisation trial at Bondi Beach earlier this year.