Earning or Yearning?

The S&P/ASX 100 (XTO) is a stock market index capturing Australia's top 100 companies by market capitalisation. It accounts for 63 per cent (at April 2016) of the Australian equity market, however it might surprise investors to learn that for 10 years to 8 June 2016, the S&P/ASX 100 has returned just 1.1 per cent per annum. Why has a portfolio of so called "blue chips" delivered investors such poor returns? In this paper we review the ten largest companies listed on the ASX.

Most investors have their equity portfolio's heavily skewed to the largest ten companies. Is that you? Do you think yours is a "blue chip" portfolio? Think again.

Perhaps surprisingly, the vast bulk of the largest companies aren't growing, are otherwise challenged or are in cyclical industries that provide little to no net long-term growth.

Another growing group of investors have elected to avoid trying to select the very best companies and believe that low cost index funds are the answer, to the often unjustified claim that fees are not worth paying.

The problem with this strategy of course is that the major Australian indices are dominated by the same challenged companies. It should therefore be little surprise that the S&P/ASX 100 has returned just 1.1 per cent per annum for 10 years to 8 June 2016. And in February this year it had produced no return at all since 8 June 2006. The aphorism, *'you get what you pay for'* seems as apt in investing as anywhere else.

Putting aside the individual industry themes that might currently be affecting banks, resource companies and supermarkets, driving their behaviour and subsequent returns, there is a simple arithmetic reason that many large companies are failing to growth the wealth of their shareholders. As you will discover, it comes back to dividends and capital allocation.

This time last year, investors saw their million-dollar term deposits earning only a few per cent in interest, and hurt by their own private income recession, chased high dividend-yielding, so-called, blue chip stocks.

The chase pushed the shares of large but mediocre companies like the National Australia Bank to almost $40 and Telstra to $6.60. As the more recent declines accelerated it revealed the hunt for yield was merely another one of the stock market's conga-line of fads.

Where did baby boomers go wrong? A portfolio of conventional blue chips, many that dominate the major Australian stock market indices, will only ever provide investors with mediocre long-term returns unless they speculate successfully on an expansion of the price to earnings ratio.

Most of the large cap companies in Australia are mature businesses with little ability to retain any sizeable proportion of their annual profits to reinvest at an attractive rate of return.

We have previously employed Table 1. (on the next page) to describe everything from how management should allocate capital to the uselessness of the P/E ratio as a guide to value.

Table 1. High ROE Company paying out 100 per cent of earnings

	Year 1	Year 2	Year 3
Equity (b)	$10.0	$10.00	$10.00
ROE	20%	20%	20%
EPS	$2.00	$2.00	$2.00
POR	100%	100%	100%
DPS	**$2.00**	$2.00	$2.00
Equity (e)	$10.0	$10.00	$10.00
P/E	10	10	10
Share Price	$20.00		$20.00
Cash Flows	**-$20.00**	$2.00	$22.00
IRR			**10%**

Yield = 10%

Here we use Table 1. to demonstrate the poor total return that will ultimately result for those investors who chase high yielding companies but whose management have elected to distribute the bulk of corporate earnings as a dividend.

We first assume the business described in Table 1 is able to generate a return on equity (ROE) of 20 per cent sustainably. Second, we assume to be able buy and sell the shares on the same price earnings (P/E) ratio of 10 times. The final assumption is that management distribute all earnings as dividends.

An investor who purchases and sells shares in a company with an attractive rate of return on equity, a constant P/E ratio and a payout of 100 per cent will receive, as their return, an internal rate equivalent to the dividend yield at the time the shares are purchased.

A company with $10 of equity, earning consistent and assumed 20 per cent returns on that equity, will generate earnings of $2.00 per share in Year 1. Buying the shares on a P/E ratio of ten times next year's earnings of $2.00 means an outlay of $20.00.

The investor will then receive $2.00 of dividends in each of the subsequent years. The reason the dividend doesn't grow is because the company has retained none of its previous years' profits – they're all paid out – and so the equity doesn't grow. Additionally, as we've assumed the company's return on equity never changes, the earnings cannot grow and because the payout ratio does not rise above 100 per cent, the dividends do not grow either.

If the investor pays $20.00 for these shares, subsequently receives $2.00 a year in dividends, and then sells the shares at $20.00 (remember the P/E ratio remains unchanged and the earnings haven't grown) the return to the investor is a pre-tax 10 percent per annum, which is equal to the dividend yield at the time the investor purchased the shares.

And this is the important conclusion. That dividend yield is the maximum return an investor will receive.

The dividend yield is the best outcome they can expect, unless they speculate successfully on an expansion of the P/E ratio. For that to occur, sentiment or popularity towards the company's shares would have to change and be correctly predicted.

At Montgomery we consider ourselves investors rather than speculators so we would not buy shares presuming a market 'rerating' of the desirability of a company and its shares.

In simple terms, if you chase a high yield and the company pays all of its earnings out as a dividend, the yield is about all you should expect.

Investors have been very successful at insisting the companies they own shares in distribute earnings. As the Chairman of Blackrock noted in 2014; "It concerns us that, in the wake of the financial crisis, many companies have shied away from investing in the future growth of their own companies. Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks."

All over the world, company boards are acquiescing to shareholder demands for dividends. According to the Commonwealth Bank, three quarters of all companies surveyed maintained or increased dividends even though revenue growth was flat and aggregate net profits fell.

A 2015 study by Goldman Sachs noted $122 billion of free cash flow was generated by non-financial firms between 2010 and 2014 but those same companies returned $177 billion to shareholders through dividends and buy-backs.

When companies pay out more than they earn they don't grow. Remember Ben Graham observed the market is a 'voting machine' in the short-term but a 'weighing machine' in the long-run. So it should be no surprise that if a company doesn't grow, neither does it's share price.

This is not the best outcome for investors. Even income investors need growth. Why? Because without growth in earnings, there can be little growth in dividends and without growth in dividends, a retiree's income and purchasing power will be eroded by inflation.

Only by retaining a large portion of profits and redeploying those profits at high rates of return, can a business increase in value. And in the long-run share prices always follow the change in value.

To help navigate between the companies in the Top 10 that are earning and those that are merely yearning, Montgomery offers the following list. Keep in mind that here we discuss the economics of each business. Importantly, the share price of an extraordinary business can fall and the share price of a mediocre business can rise. We do not purport to be able to successfully predict what share prices will do in the next week, next month or next year. Over the very long-run however, share prices do a good job of reflecting the economic performance of the underlying business.

#1 Commonwealth Bank of Australia

Market Cap: A$132.65B

Despite being the best performing bank in Australia and this country's largest listed company, one might be surprised that the economics of CBA are attractive but not earth-shattering. Since 2006 shareholder's equity invested in the company has tripled from $19B to $60B. Despite this growth, earnings have not tripled. Earnings have little more than doubled. In other words as the company grows it appears to be finding it tougher to maintain the very high levels of profitability it once enjoyed. In the very long run a doubling of the Australian population will ensure that the company will be earning much more than it is today. The only difficulty is knowing what interest rates might be then and whether the boost to share prices currently the result of ultra low interest rates will exist then. One suspects not, in which case multiples might be lower and offset the growth that ensues. In the foreseeable future the bank's profitability is hampered by the requirement to hold additional CET1 capital and employ a lower Mortgage Risk Weighting ratio. In other words, and this applies to all of the big four Australian banks, the companies are required to hold more capital and cannot lend as much as they once could for every dollar held. On top of those internal pressures, it appears credit growth may be hampered by a slowing of the property construction industry in the medium term.

As we move into 4Q16, the bank's net interest margin (NIM) is likely to come under renewed pressure from the decision to pass on the most recent full rate cut to variable mortgages, as well as higher wholesale funding spreads. The impact of NIM pressure on earnings is likely to be partially offset slightly by an acceleration in loan book growth on the back of lower rates.

Adding to this, the headwinds for fees will increase over the next few months with further regulations capping interchange fees expected to come through.

When we compare these growing headwinds to the acceleration of cash earnings growth in 4Q16 implied by consensus analyst forecasts, there is a disconnect.

#2 BHP Billiton

Market Cap: A$105.25B

In the last ten years, shareholders have effectively contributed, either directly or via retained earnings, A$52B over and above the A$32B of equity that existed in 2006. The company has also borrowed an additional A$38B above the A$12B of debt in 2006. Despite all the extra money at its disposal the company's earnings had grown only marginally to A$15.9B in 2015 from A$13.6B in 2006. However in 2016 the company is forecast to earn just A$1.3B and A$2.8B in 2017. Unsurprisingly the share price is as cyclical as the business performance and it currently trades at a level less than it traded in 2006.

#3 Westpac Banking Corporation

Market Cap: A$101.77B

Like the CBA, Westpac shareholders have effectively invested more than 4 times the $14B in equity held a decade ago. Despite this, profits have grown just over 2.5 times. Like the CBA, Westpac appears to becoming less profitable as it grows.

In the most recent first half 2016 profit announcement, the bank reported results lower than expected due to lower than expected non-interest income and higher specific provisions. We were most concerned about the lower commission & fees revenue given that this is a high return source of income. This was down 7 per cent year on year due to lower credit card revenue resulting from the changes to the interchange fee regulations from 1 November (-A$52m) as well as lower institutional lending fees. The lower commissions & fees revenue from credit cards will have a negative impact on future earnings and returns.

#4 Rio Tinto

Market Cap: A$82.79B

Like BHP, this business is cyclical and lacks the competitive advantages we value most – the ability to charge a higher price for its products even in the face of excess supply. Despite a near seven-fold increase in the debt it has drawn on over the last decade and a more than doubling of equity effectively contributed by shareholders over the same period, the company's profits have fallen by 75 per cent.

#5 Australia and New Zealand Bank

Market Cap: A$72.52B

As with both of the previously mentioned banks, we have a near tripling of equity but only a doubling of profit. The trading update for the first quarter of 2016 was generally a little disappointing. Cash profit was up 5 per cent on the average of the June and September quarter results from 2015, and up 4 per cent on the previous corresponding period. Our main concerns are a slight fall in the net interest margin, despite the previous mortgage rate rises and the rationalisation of low margin loans in Asia. It appears a combination of higher funding costs and mix/discounting in the business lending and mortgage front book have offset the early benefits of the above drivers. ANZ expects BDD charges to be in excess of A$800m in 1H16. This appears to be due to a jump in specific provisions in Asia, and South East Asian manufacturing in particular. ANZ called out Indonesia as problematic.

#6 National Australia Bank

Market Cap: A$70.34B

The NAB is arguably the worst performing bank in this group and this is reflected ultimately in the fact that, despite its blue chip status, its share price is lower today than it was in 1999. The poor performance is due to a litany of large losses made on the overseas reinvestment of profits and capital generated domestically. In 1987, under CEO Don Argus, the NAB bought the Clydesdale Bank, the Northern Bank in Northern Ireland and the National Irish Bank in the Republic of Ireland. In 1990 NAB purchased the Yorkshire Bank, in 1992, the Bank of New Zealand (BNZ) and in 1995 the US-based Michigan National Corporation (MNC).

In the 1997 Annual Report, the NAB shared its goal to be "the world's leading financial services company". Then, in 1998 the bank acquired the Florida-based mortgage originator HomeSide Inc. In 1999 Don Argus left the NAB for BHP. While a billion-dollar profit was eventually booked on the sale of MNC to ABN-AMRO, and another billion on the sale Northern Bank and National Irish Bank to the Danish Danske Bank Group, the NAB lost $2 billion on Homeside and over $4.1 billion on Clydesdale.

The stability of the banking oligopoly in Australia suggests that NAB's market share and profitability aren't expected to change dramatically enough to recoup the company's historical losses. Unless a demonstrated improvement in performance becomes visible, NAB is worth the least among its peers. In the latest quarter, the Australian Banking operations generated an improved margin with earnings higher even before the drop in provisions. NAB is the only bank showing a worsening arrears and impairments at the moment, and although it is due to specific issues, it demonstrates that there are particular pockets of concern in the Australasian market (ie mining, oil and NZ dairy) resulting from the fall in commodity prices.

#7 Telstra

Market Cap: A$68.1B

Telstra pays a sizeable proportion of its earnings out as a dividend. This high payout ratio is what has made its shares so attractive to income investors. The corollary of a high payout ratio however is that the company retains relatively little for growth. To illustrate, Telstra recently reported its half yearly results for 2016. For the six months ending December 31, 2015, the company reported EBITDA of $5.4 billion, net profit after tax of $2.1 billion and earnings per share 17.2 cents. Go back ten years and for the six months to December 31, 2005 Telstra reported EBITDA of $5.3 billion, net profit after tax $2.1 billion and earnings per share 17.3 cents. In other words, after a decade of operations, the company has not grown earnings at all.

#8 CSL

Market Cap: A$54.2B

Over the last decade CSL has retained $7B of the profits it has generated. As the equity has grown so have the returns and the company now generates a return on owners' equity of almost 50 per cent. As a result of retaining profits and redeploying them at very attractive rates for a decade, the company has grown profits from $116 million to $1.8B today. Consequently, the share price has risen from $9.00 ten years ago to over $104 today.

And those seeking income needn't have been dissuaded by the relatively low dividend yield CSL displayed ten years ago. An investor who put $100,000 into CSL in 2005 not only enjoys more than a million dollars of equity working for them now, but their income has grown to $18,600 – a yield of nearly 19 per cent per annum on their original investment.

#9 Wesfarmers

Market Cap: A$51.42B

The owner of Coles supermarkets and Bunnings hardware has recovered impressively since the overpayment for Coles. But that acquisition permanently reduced the company's return on equity from over 30 per cent prior to the acquisition to 6.6 per cent at the lows and nearly 9 per cent today. Mostly due to the purchase of Coles, equity has increased ten fold from the $3.1B in 2006 and debt is up fourfold over the same period. Profits have tripled.

The company has done an excellent job of growing the Bunning franchise and the failure of Woolies to gain a toehold in Australia's $46.7 billion home improvement sector, even with the backing of the US titan Lowe's suggests the company has built an enviable competitive advantage that is enduring. The strength of this franchise however is offset by the declining position of Coles as the more efficient and more profitable Aldi reaches its tipping point in Australia.

#10 Woolworths

Market Cap: A$27.65B

A near tripling of equity has resulted in virtually no increase in profits over a decade. Stories of arrogance, nepotism and conflicts of interest may or not be true but it doesn't matter. This company will never generate the margins and profitability it once did. And that is simply the result of the entrance and growing influence of the hard discounter Aldi. We have written extensively on the Rogermontgomery.com website about Aldi since we sold all shares in Woolworths shares at more than $32 in late 2014. In July 2006 Woolworths shares were trading at just over $20. They now trade below $22 and we do not believe the erosion of margins has run its course.

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With the exception of CSL, which is a company whose shares have been owned by Montgomery Funds for several years, there isn't a company in the Top 10 that we can safely say exemplifies our first prize of value, quality and strong growth prospects. That is not to say we object to, for example, owning some of the banks. At the right price, even a bond-like, flat and stable earnings stream can provide an adequate return.

The problem for most investors however is that low interest rates have caused them to push share prices to heights that produce returns that generally may prove to be inadequate in preserving purchasing power.

While investors may yearn for something more, they probably won't earn it from this group of so-called blue chips.

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