



Market Returns

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Betting on a Sure Thing

The financial media constantly tells investors that in volatile markets, they need to pick the best companies with the strongest balance sheets. Sort of like backing Italy in a World Cup soccer match against New Zealand?

Soccer is the national sport of Italy, and the New Zealand team are virtual unknowns in their own country.

It was no surprise that most fans picked top-ranked Italy as the favourite to win this pool match in South Africa against the 78th-ranked side in the world. Betting on an Italian win offered the skinniest of odds with the bookmakers. The point spread was substantial, meaning that even if you bet on the favourites you had to cover the spread to make a return on your outlay.

As it turned out, though, the cellar-dwelling New Zealanders managed to hold the four-times world champion Italians to a one-all draw in what was one of the biggest upsets of the competition.

In investment terms, the Italian side was a growth stock - an entity that was very familiar, highly popular and with a good track record. But these solid prospects were reflected in a low expected return, as revealed in the outright odds and point spreads offered by online bookmakers.

In contrast, the Kiwi team was a value stock - largely unknown and untested, a risky proposition that as compensation offered high expected returns.

The huge online betting market surrounding the World Cup is an example of a highly competitive market in which information is quickly baked into prices. To be able to make a consistent profit on your bets, it is not enough to know who the best teams are. You need to know how the odds offered are "wrong".

Taking a bet even on a "sure thing" is still no guarantee of a return. And the fewer bets you make, the more you leave yourself open to specific events that can blow your strategy to bits.

Take France as another example. The other finalists with Italy at the last World Cup, the French national team were highly favoured this time, but imploded in the early stages of the competition in South Africa. Their star striker was sent home for abusing the coach, triggering a player boycott and a subsequent humiliating loss to the tournament hosts.

The sheer unpredictability of sport and the difficulty of beating the bookmakers is an analogy worth reflecting on when you look at media stories recommending concentrated stock portfolios to get you through volatile times.

One magazine in Australia, for instance, has put together a list of "10 Must-Have Shares in a Tricky Market". The list includes picks that "provide a mix of balance sheet strength, exposure to upside growth potential and an ability to weather any further erosion in economic conditions".¹

The chosen stocks were all well-known, highly reputable, blue-chip companies. But don't you think all that good news is in the price? The market already knows that these are solid companies with good prospects. But does that make them good investments?

It's not often appreciated that building a portfolio around glamour blue chips (the equivalent of Italy's blue chip soccer side) often means accepting a much lower expected return for the supposed surety they provide. A good company often is

¹ '10 Must-Have Shares in a Tricky Market', BRW Magazine, June 17-23, 2010

priced at a premium to the market. As we've seen, there's no guarantee anyway that idiosyncratic risk will not mess up your "safe" blue chip gamble.

Take, for instance, the recent story of Australia's second largest department store chain, David Jones Ltd. This was the glamour stock of retailing, a former dowdy company that had risen fourfold since 2003 under the stewardship of visionary chief executive Mark McInnes.

But then, out of the blue, McInnes resigned amid a scandal over his behaviour toward a female employee at company events. Analysts spoke about damage to the David Jones brand and the market discounted the company.²

This is why a concentrated portfolio of blue-chip stocks provides no guarantees. You are simply taking non-systematic risks that you are not rewarded for.

The answer is to diversify, accept that good prospects are almost always in the price already and to understand that low prices relative to fundamental factors mean higher expected returns. The mix of "good" and "bad" companies in your portfolio will depend on your appetite for risk.

The Octopus v The Economist

A "psychic" octopus correctly predicted Germany's path through the soccer World Cup and Spain's victory in the final over the Netherlands.

The attribution of the power of divination to an octopus, however ridiculous, is not that different to how many people attribute to economists the power to accurately and consistently forecast the paths of stocks, interest rates and currencies.

Q. What's the difference between an octopus and an economist?

A. The octopus gets it right more often.

Economists can deal with the professional hazard of inaccurate predictions in a number of ways – by making forecasts continuously to give themselves the flexibility to change their minds, by making forecasts so far into the future that no-one can remember what they said or, more sensibly, by pointing out that their predictions are really just assumptions subject to significant variation.

Fortunately, in this internet age, we can trace back to discover what the various experts were saying about the outlook this time last year. Take for instance, the economists polled a year ago by The Australian Financial Review (AFR). They tipped that the Reserve Bank of Australia, having cut benchmark interest rates to historic lows in April, 2009, would most likely sit on its hands for the rest of that year and possibly even cut rates further.³

As it turned out, not only did the RBA fail to cut interest rates again in the financial year just passed, it began raising them from October and did so another five times in the ensuing seven months.

So what about the equity market forecasts? The AFR asked a panel of six strategists their projections for the Australian share market's benchmark S&P/ASX 200 index by the end of June 2010. The consensus was a gain of 21.4 per cent over 12 months. As it turned out, the index rose only 8.8 per cent and all but one of the expert panel was too optimistic.

² 'David Jones Faces Brand Damage After Losing Chief', Bloomberg, June 21, 2010

³ 'Economists Don't See Rises on the Cards', Australian Financial Review, July 3, 2009

One could legitimately ask that if analysts are so off in their broad market forecasts, how they can possibly pick individual stocks with any accuracy. But that clearly doesn't stop them from trying.

Business Review Weekly magazine⁴ at the end of the 2008/09 financial year asked "some of Australia's largest and best performing investors" for some "blue chip stock picks" for the coming 12 months.

They came up with a list of 10 stocks – Asciano, Australian Securities Exchange, BHP Billiton, CSL, Harvey Norman, Rio Tinto, Toll Holdings, Westpac, Woodside Petroleum and Woolworths. These, we were told, were "attractively priced shares for the new financial year".

But maybe they weren't priced attractively enough, because only two of those stocks – Rio Tinto and Asciano – beat the wider market on a total return basis. Another two performed broadly in line with the market (BHP, Westpac), four delivered single digit returns (Woolworths, Harvey Norman, CSL and Woodside) and a couple posted negative returns over the year (Toll Holdings and the ASX). The median return of the 10-stock portfolio was 6.7 per cent, just over half the total market return of 13.1 per cent.

One has to feel for economists and bottom-up share analysts. It's a tough business making forecasts. As smart and as well qualified as they are, there are just so many ways their assumptions can go awry.

The great mystery is why, despite their patchy overall record, these end-of-financial-year supplements and features turn up in the media year after year and people go on buying them and reading them.

Maybe go ask the octopus.

Market Returns is based on articles written by Jim Parker of DFA Australia

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⁴ 'Smart Investing in Tough Times', BRW magazine, July 1, 2009