



CENTRIC Wealth

Investment Insights

October 2011

About this report

Investment Insights is Centric's publication for the communication of our view on economic and investment matters. Each edition carries Centric's assessment of the current value and direction of investment markets, as well as in-depth analysis on one or two key issues that really drive outcomes for investors.

Part 2 concludes the Australian Shares edition and challenges some of the "buy & hold" and "time-in-the-market" investment theories.

The ideas and views explored in *Investment Insights* are key inputs into Centric's client portfolio management process.

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Sources for all data and charts (pages 1-7) from Ashley Owen, Centric Wealth, and the ASX

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Buy & Hold or “Buy & Hope”? Australian Shares - Part 2

In Part 1 (May/June edition) of this story we posed the questions: For “buy & hold” investors, how long do you need to hold to get a decent return? Does “time-in-the market” really work better than “timing the market”, and how much “time in the market” does it take to actually make money? We often read that shares are a “long term” investment and “long term” is often defined as 7 or 10 years. But is 7 or 10 years really enough time for share prices to “come good” and make a decent return?

Part 1 of the story demonstrated that the “buy & hold” or “time-in-the-market” theory does not work - not even with so-called “blue-chip” stocks - unless you are prepared to wait up to 30 or 40 years at a time to get your money back, let alone make any real returns on investment.

We demonstrated this by looking at the actual share price performance (including dividends) of some of the oldest and largest companies in Australia – BHP, Westpac, and AGL.

In Part 2 of the story we ask the same questions of News Corp, and ask the same question about the Australian stock market as a whole.

The main lessons from Part 1 were that “buy & hold” investors in even the most stable and reliable “blue chip” shares have had to wait several decades to get their money back if they bought at the wrong time – let alone make any real returns. This has been the case whether they bought shares during the booms, before the booms, in the busts, or all three (using “dollar cost averaging”).

In the case of BHP we saw that if I bought \$100 of shares in BHP when I was nine years old in 1968 when I first starting saving money, my \$100 investment would still have been worth just \$100 (after inflation and allowing for reinvestment of dividends and changes in capital structure) thirty years later. That's zero real total return after 30 years.

We also saw that for the shareholders who got caught up in the frenzy and bought BHP shares at their peak in the 1892 silver/lead mining boom, they had to wait 75 years to get their money back (after inflation, after reinvesting dividends and after changes in capital structure).

We then looked at Westpac (formerly the Bank of New South Wales), Australia's oldest bank and its largest listed company for more than a century, and we arrived at similar conclusions. Here we saw that the share price has gyrated wildly through numerous booms & busts, including falling up to 80% at times. In fact, anybody who bought shares in the bank in the 1960s or 1970s may be waiting for 40 to 50 years to get their money back in real terms after inflation.

Shareholders in AGL, Australia's oldest and largest utility, have also suffered through decades of nil returns, and have also experienced explosive speculative booms and busts.

It has not all been bad news for shareholders of these so-called “blue chip” companies of course. We also saw that there have been many periods in which shareholders made money out of these stocks, but only if they got the timing just right. One message from Part 1 of the story was that most companies don't last long enough to be studied for long term returns, but even the oldest and largest companies across a range of industries rarely make money for “buy & hold” investors unless they get the timing right.

Now in Part 2 of the story we look at News Corp, and then ask the same questions of the Australian stock market as a whole.

News Ltd / News Corp

So much for “blue chip” banks, miners and utilities covered in Part 1 of the story. What about the great entrepreneurs and business builders? Australia has produced plenty, but most have failed in spectacular crashes, taking their shareholders' money with them. The less said about so-called “entrepreneurs” like Alan Bond, Chris Skase (Quitex), John Spalvins (Adsteam), John Elliot (Elders), George Herscue (Hooker), Eddie Groves (ABC Learning), Phil Green (Babcock & Brown stocks), David Coe (Allco), John Kinghorn (Allco & RAMS), etc the better. The great survivor of the “entrepreneurs” has been Rupert Murdoch. Surely that has made money for shareholders, and not just for the Murdoch family?

Rupert took over the Adelaide News on his father's death and has turned it into a global media giant, listing News Ltd in Adelaide in 1956, and on the Sydney Stock exchange in 1963. For a brief period in the dot-com boom of the late 1990s it was Australia's largest listed company.

Chart 1 on the following page shows share prices since 1960, adjusted for capital structure changes and for inflation. (The data relates to voting ordinary shares in the original News Ltd prior to 1979, transformed into News Corp (NCP) voting shares between 1979-2004, and into NWS voting B class common shares since 2004).

Rupert has taken the company on a grand global adventure into all sorts of businesses and markets, and for while he appeared to be a master deal-maker. After 20 years of low growth, he expanded into UK and US newspapers in the late 1970s, into Hollywood movie-making in the early 1980s, US network TV and UK satellite TV in the mid-late 1980s, satellite TV in Hong Kong/China and US cable TV in the mid-late 1990s, and even into social media (MySpace) in the 2000s.

The share price rocketed in the 1986-7 “entrepreneurial” bubble before collapsing 90% in the early 1990s recession. The 1992 peak was due to the box office success of News' first big budget Hollywood hit - Home Alone - only to crash the next year on box office flops Hoffa and Toys. Then there was the “dot-com” boom in which speculators and traders bid up the share price to astronomical levels, then he followed up with the

disastrous investments in OneTel and then MySpace, and continued to buy up media assets all over the world.

The share price has been extremely volatile and the shares have been massively over-priced for decades. Since 1982 the shares have rarely traded at dividend yields of more than 1% (meaning that people have been happy to pay 100 times the current year's dividend!), apart from briefly in recessions, and it has often traded at price/earnings multiples of more than 20 and 30 and sometimes even 50 times earnings. The journey has been an amazing roller-coaster ride through a succession of massive debt-funded expansions followed by colossal write-offs and losses. News still holds the record for Australia's biggest ever corporate loss.

Chart 2 shows total returns including re-invested dividends and adjusted for inflation. It shows an extraordinary pattern over the past 50 years: The overall real total return over the past 50 years has been 9% pa, which is respectable for long term equity investments, but barely acceptable in light of the extreme volatility and high levels of debt.

Chart 1

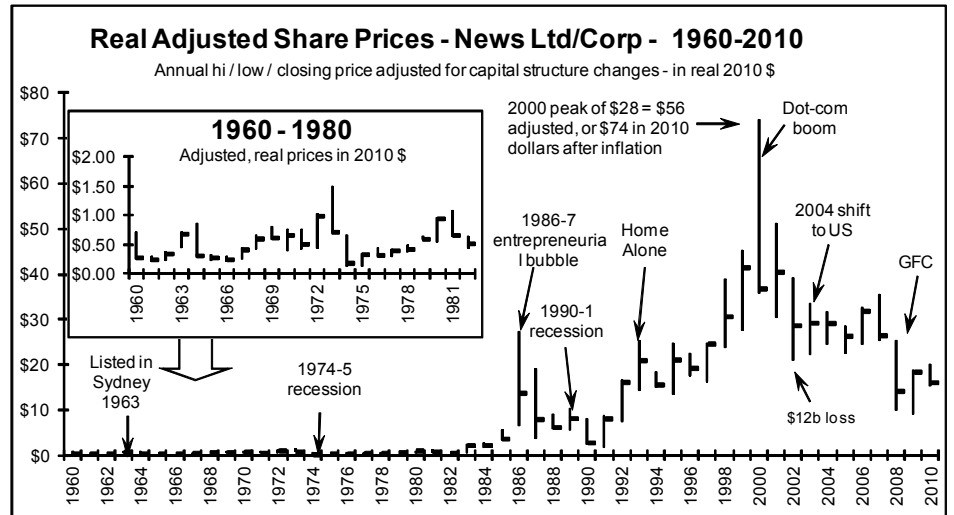
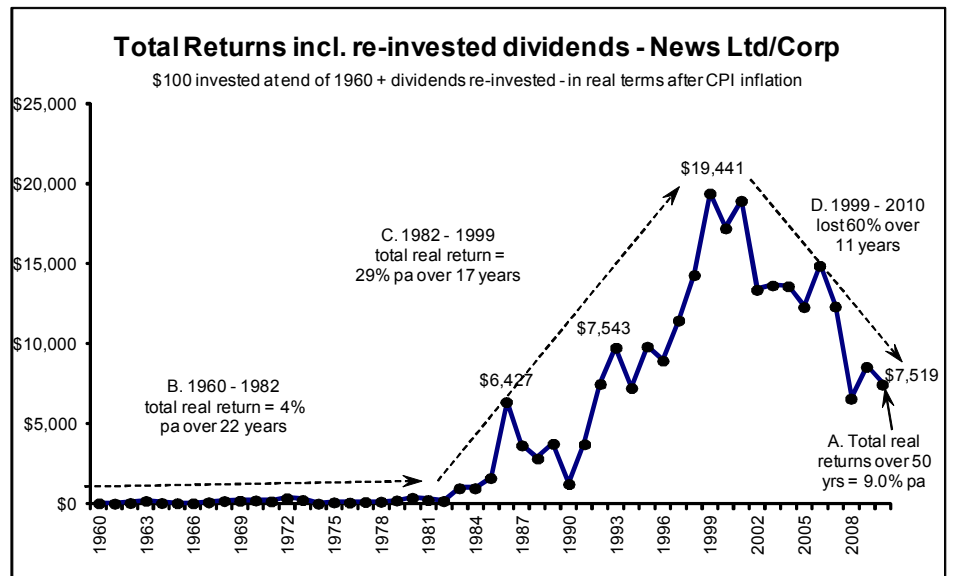


Chart 2



Returns were very low during the 1960s and 1970s, but the 17 years between 1982 and 1999 saw explosive real total returns averaging 29% per year to the top of the dot-com bubble, when many first-time investors were lured in by the rapidly rising share price and the promise of easy money. In the 11 years since the top of the dot-com boom they have lost 60% of their money. In fact, any 'buy & hold' investor who bought News Ltd/Corp at any time during the past 20 years (except if they bought right at the bottom of the GFC) is still waiting to get their money back today in real terms after inflation.

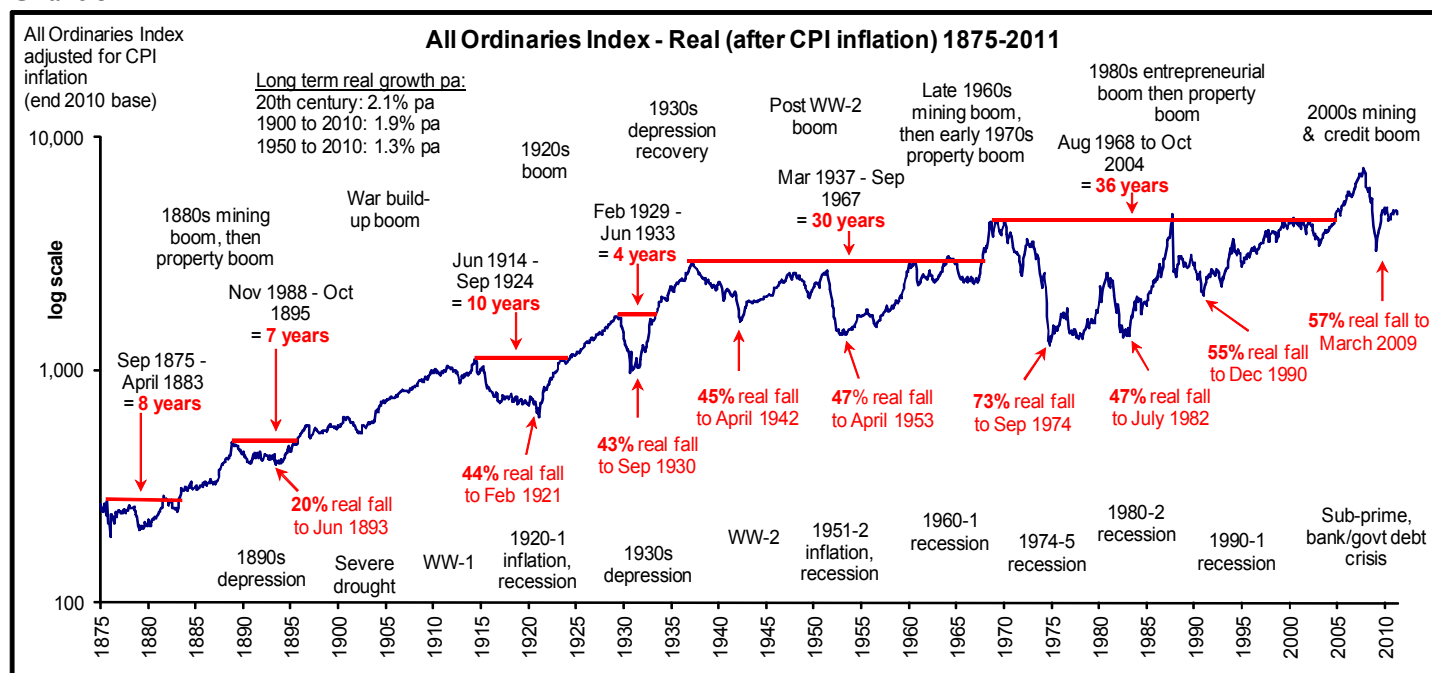
News has never been a "buy & hold" investment for anybody with less than 30+ years to wait. On the other hand, many fortunes have been made and lost trading News shares, but trading is not "investing", it is speculation.

As with the banks, miners and utilities, returns to News Corp shareholders have been affected not just by the short term ups and downs of business cycles, but by massive multi-decade structural shifts as well. The old newspaper industry is certainly dying as a viable business model, and Murdoch has jumped onto every new fad that has come along. But he hasn't found the answer yet. Who knows, he may pull another rabbit out of the hat, spinning another wild tale using another convoluted structure to conjure up another spike in the share price. Anything is possible.

At least News has lasted five decades as a listed company. For every Murdoch there have been many hundreds of other "entrepreneurs" whose companies, along with their shareholders' money, have disappeared without a trace.

On the other hand there have also been many real companies with real businesses that started out small and delivered handsome returns to early shareholders. Finding these small growing companies is one of the great challenges and the source of great satisfaction and rewards for investors, but it requires intensive on-going research and highly active management, and is certainly not a passive "buy & hold" strategy.

Chart 3



Diversification – the stock market as a whole

So far we have looked at the performance of some of the oldest and largest listed companies in Australia from four different industries. Surely if we buy shares in several companies across a range of industries, this will “smooth” out the decade-long ups and downs and provide regular reliable returns?

Unfortunately, Australia is a relatively small country with a relatively narrow economic base and a very narrow stock market. The stock market here has always been dominated by a few large banks and miners, interspersed with periods when manufacturing prospered behind tariff walls, and the occasional “entrepreneurs”, plus a few large utilities.

As a measure of the broad Australian stock market as a whole, we use the “All Ordinaries” index, but it is important to note that the performance of the All Ordinaries index significantly over-states the actual returns made by most retail investors for two main reasons.

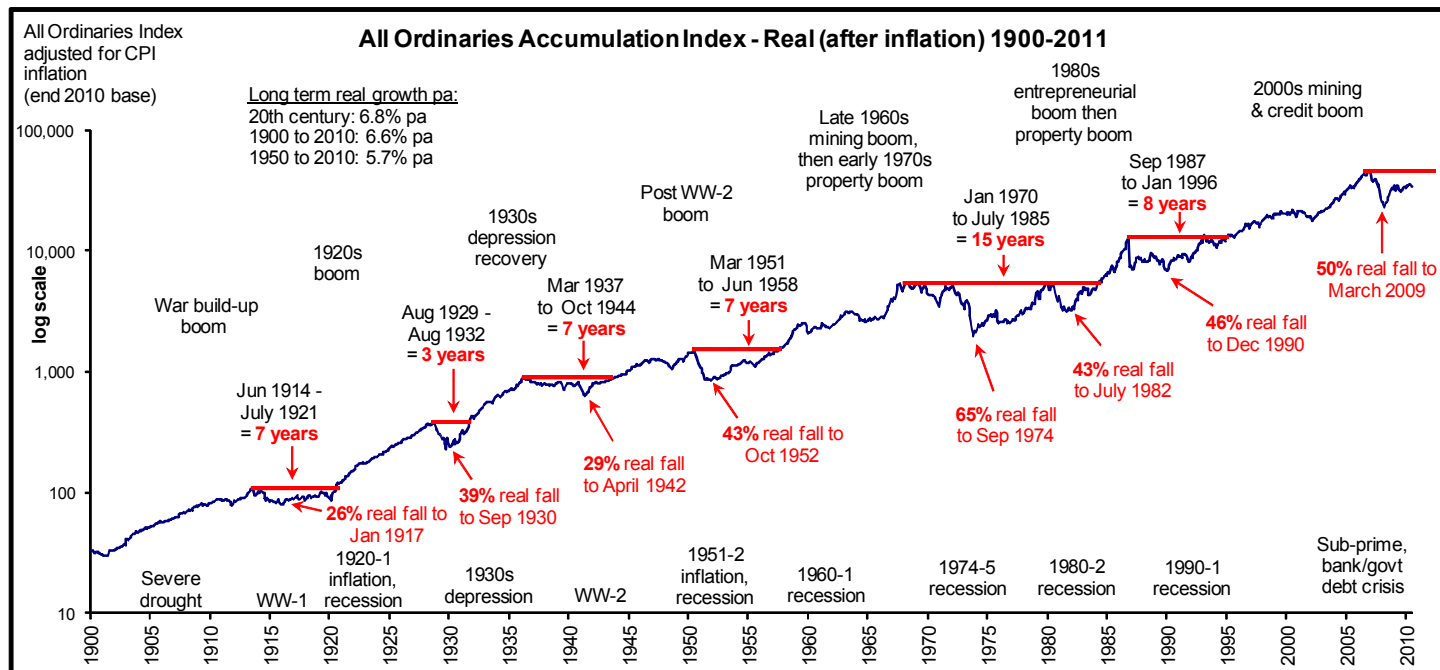
The first is that the All Ordinaries index prior to 1980 was not a very accurate measure of the actual stocks listed on the stock exchange. Prior to 1936 the main market index only included 28 large “blue chip” stocks. It didn’t include BHP during the 1880s mining bubble, nor any of the many dozens of other speculative mining stocks. Then, between 1936 and 1979 the index only comprised 150-170 of the larger established stocks (out of 1,000+ listed stocks). In addition, the industry sectors that made up the index didn’t reflect the actual market weighted industry sectors of listed stocks, and the index didn’t include any speculative companies at all, not even the large ones like Poseidon, Western Mining or Hamersley during the late 1960s mining boom. If the market index had included the industry sectors and speculative stocks at their relative market value weights, the index would have been significantly more volatile than it was without them.

The second reason why the broad market index over-states actual returns made by most individual investors is that most individual investors don’t invest the stocks that make up most of the weight in the index. The prospect of a quick buck from the speculative stocks is what lures most people into the market – usually at or near the peaks after prices have been rising strongly for some time.

Because small speculative stocks attract a disproportionate share of money from small investors, the actual experience of most small investors is probably significantly worse than the overall market index, which primarily measures the performance of the very large, more established stocks.

Chart 3 shows the All Ordinaries index since 1875 in real terms after CPI inflation. Here we can see that there have been several long periods of negative or zero growth between the booms in which prices reached new highs before collapsing again for many years before recovering. Eg:

Chart 4



- Following the post depression market peak in 1937, it took 30 years until 1967 for prices across the market index stocks to recover in real terms after inflation.
- If investors bought market index basket of shares in the late 1960s, it took another 36 years from 1968 to 2004 to achieve any real growth in share prices.
- In fact, if an investor bought the market index basket of shares in 1937 (and kept adjusting their holdings as the market index changed), they would still have seen no real growth in share prices even in 1995, some 58 years later.
- The market index today in 2011 is no higher than it was at the peak of the mining boom in 1968 and the property boom in 1971, some 40 years ago, after adjusting for inflation.

When we add re-invested dividends to the returns, the total return picture looks a little better (Chart 4). Although the real total return picture (including dividends) looks better than the real price index picture, there have still been very long periods of up to 15 years to recover from the busts that followed the booms.

These charts also show that the price falls suffered in the recent “global financial crisis” were not unusual at all. Although the overall market price index fell 50% in the GFC, there have been several collapses in the past where the overall market index has suffered falls of similar magnitude.

We have had a “GFC”-like collapse every decade or so, and it has generally taken around 7 to 15 years to recover the losses with dividends re-invested, and up to 30 years or more for share prices to recover (if dividends are spent and not re-invested).

In the current cycle, share prices peaked in late 2007 and prices are still well below their peak four years after the boom. Share prices will not magically jump back within a year or two. If history is any guide it may take another 10 to 15 years before prices recover in real terms to where they were in 2007, or another half a decade before total returns (including dividends re-invested) recover.

The only cycle in which share prices bounced back more quickly in real terms was in the 1930s after the 1929 crash. In that case the main reason share prices in real terms (after inflation) bounced back so quickly was that inflation was negative, with consumer prices in Australia falling 25% during the deflationary spiral in 1931-1933.

While the real total return picture (including dividends) looks better than the real price index picture, many investors, especially retirees, are spending the dividends, rather than re-investing them. In those cases the price charts are more relevant to how their portfolio balance would look over time, rather than the total return charts which assume all dividends are re-invested.

Timing in booms & busts

The observation that in the past it has taken 30+ years for prices to recover (for individual stocks and also for the market index) is only relevant of course for people who bought in the booms. Timing is critical. Unfortunately the booms are when most people buy. Most people only build up the confidence to buy shares after they have seen share prices rising for some time, preferably in a nice straight upward line. The longer and steeper the upward path of share prices, the more confident investors become that the “trend” will continue and that there is easy money to be made jumping on the bandwagon, often first-time investors, and often using debt.

To capitalise on the buying frenzy, stockbrokers quickly cobble together hundreds of new floats and launch them onto the market to capture the cash being thrown around. The flood of new floats and the stampede of new “investors” into the market creates a self-fulfilling buying frenzy which pushes prices even higher for a while before the speculative boom inevitable collapses. This has been the pattern for as long as stock markets have existed, and Australia is no exception.

Many investors lose most or all of their money because they are lured into the bubble stocks with the fastest rising share prices, and the new floats with the fanciest names, most of which have no assets, no business, no cash-flows, nothing at all except hype. Saddest of all is the fact that many “investors” borrow to buy in the booms, and many end up losing their house as well as their money in the busts that follow. Even investors who avoid the bubble stocks and opt for the “blue chips” get burned, because shares in “blue chip” stocks rise in the booms way beyond sensible levels, and can then take 30+ years to recover in real terms after inflation, as we have seen.

Just as it is difficult to convince people not to buy into a boom, it is also extremely difficult to convince people to buy when prices are cheap. This is usually in the depths of recession, when share prices have been falling for some time, the media is full of pessimism and tales of woe, and it seems as if it's the end of the world – again! That is when most investors are selling out of sheer panic (or being forced to sell by margin lenders), which drives prices even lower, causing a downward spiral fuelled by negative media stories and doomsayers everywhere. That is precisely when investors should be looking to buy quality companies, not sell.

What about making money?

So far we have talked about the decades it has taken to recover from losses and just “get back” to square one. But as investors we want to do more than just get our money back, we want to build real wealth for the future. Investors in listed shares should expect total returns of a minimum of about 6% to 7% above the inflation rate over the long term in order to compensate for the risks, and Australian shares as a whole have delivered these returns over the past century.

The problem is that most retail investors don't achieve these returns because most buy in the booms when shares are over-priced. Even if they avoid the hundreds of dud floats in the booms and instead buy shares in legitimate companies with earnings and dividends, not only will they need to wait many years or decades to get their money back, but they are unlikely to ever achieve acceptable positive returns in the long term. The only way to achieve acceptable long term returns (or better) is to buy when prices are cheap, which is usually in the busts, when there is doom and gloom everywhere and everybody else is panicking and selling.

Timing and big-picture structural shifts

It is not just about picking quality companies with quality management and getting the boom/bust timing right by buying when prices are cheap.

It is also necessary to get the big picture structural timing right. There are no magical pre-determined straight “trend lines” around which share prices miraculously oscillate. The underlying economic, social, political, regulatory, demographic, technological, and environmental conditions of every country including Australia are not constant or static, but are always changing.

Changes in these underlying conditions can give rise to fundamental structural shifts that last decades, well beyond the short term ups and downs of the regular business cycles. The structural shifts can affect the performance of companies and their share prices for decades at a time, and investors must change strategies accordingly. If they “buy & hold” in the hope that prices will magically “come good” they may be waiting for decades.

Conclusions

There are several lessons that become apparent:

- “buy & hold” investors in even the most stable and reliable “blue chip” shares have had to wait several decades to get their money back – let alone make any real returns. This has been the case whether they bought shares during the booms, before the booms, in the busts, or all three (using “dollar cost averaging”)
- Share prices don’t magically “come good” and revert to some mythical upward straight line “trend” after a few short years of under-performance.
- Buying quality companies with quality management is critical but it is not enough. If you don’t have 30-40 years to wait for a return, then timing is also critical to making money with shares.
- Timing and boom/bust cycles:- investors need to buy when prices are cheap (usually when everybody is panicking and selling out of fear or despair), and then sell, or at least not buy, in the booms (when everybody else is frantically buying). The boom & bust cycles cause the share prices of even good companies to be overly expensive in the booms and overly cheap (ie bargains) in the busts. Making money generally involves doing the opposite of what the media and the herd are saying and doing.
- Timing and long term structural change:- investors need to understand timing in relation to big-picture structural shifts in the underlying economic, social, political, regulatory, demographic, technological and environmental conditions that can affect company performance and shareholder returns for several decades at a time, and investors need to change strategies and investments as these conditions change.
- High returns can be made by investing in Australian shares, but it is not from a passive “buy & hold” approach, unless they have 30-40 years to wait to get any real returns after inflation. High returns come from active management in picking great companies and getting the timing right – timing in relation to short term business cycles, and timing in relation to longer term shifts in the underlying structural conditions.
- Because the Australian stock market is dominated by a small number of large companies in a few concentrated industries, investors need to look to other countries to buy into companies in different industries in countries with different structural conditions and cycles. This is the subject of separate papers.
- Investors can also diversify into other asset classes, but, as with Australian shares, all other asset classes suffer long periods of negative real returns after inflation, including international shares, property, commodities, bonds and even cash (yes, even cash in the bank goes backward in real terms after inflation for many years at a time). Other asset classes are covered in separate papers. Investors must remain vigilant at all times and be prepared to change asset allocations as conditions change.

Post-script & disclosures

Most of the long term holdings in my personal funds are in bank shares bought in the early & mid 1990s and miners and mining services companies bought in the early 2000s. I owned News Corp in the 1990s, but have never owned AGL, and I have never bought shares in any float.

Banks have had a brilliant 20 year run, since the early 1990s, and the miners and mining services have had a brilliant 10 year run since the early 2000s. The structural landscape for the banking industry has now changed (as I have described in Part 1), so the high-growth days are over, and the issue for me now is when and how much to sell. For the mining and mining services companies, many were taken over in the pre-GFC boom (at crazy boom prices) but I still have the BHP shares along with several others. The structural landscape for mining is still positive for the time being as the China/India growth story still has some time to run. But the tide is starting to turn as the rapid growth in new supply will soon over-take demand growth, causing commodities prices to fall (as they do after every boom), and rising production costs eat into profits, so I am currently gathering my thoughts on the “next big thing”

The four stocks discussed in this paper (BHP, Westpac, AGL and News) are still among the largest listed companies in Australia and all four are included in the Centric “Core Equity Portfolio” (“CEP”) at present. However, their inclusion is not taken for granted and may change over time. As illustrated in this paper, each of the four companies has generated tremendous returns for investors from time to time, and our portfolio managers are constantly reviewing and assessing their performance, and are also monitoring changes to their strategy, management, competitive environment and changes in the industry in which they operate. The CEP is managed to a strict set of policies and procedures to ensure the optimal mix of companies are blended into the portfolio at appropriate weights. Each stock is reviewed regularly and the list of companies included changes several times per year as circumstances evolve..

Market indices to 30 September 2011

Source: Vanguard, Perennial, Bloomberg

Index*	1 Mth %	3 Mths %	6 Mths %	1 Yr %	2 Yrs % pa	3 Yrs % pa	5 Yrs % pa	7 Yrs % pa	10 Yrs % pa
Australian Equities	-6.3	-11.3	-15.5	-8.4	-3.5	0.0	-0.4	5.8	7.5
International Equities	0.7	-8.0	-10.6	-4.2	-3.2	-6.3	-6.7	-0.9	-2.6
International Equities (Hedged)	-6.3	-14.7	-15.1	-3.7	1.3	-2.3	-4.2	1.4	2.0
Australian Real Estate Investment Trusts (REITs)	-4.5	-8.0	-8.5	-6.2	-5.2	-11.8	-13.3	-4.6	0.9
International Real Estate Investment Trusts (REITs)	-10.5	-15.5	-13.0	-4.5	6.5	-2.6	-5.3	—	—
International Bonds (Hedged)	1.6	5.2	8.1	7.4	8.6	9.1	8.3	7.8	7.9
Australian Bonds	0.9	4.6	7.1	9.0	8.2	7.8	7.1	6.5	6.2
Cash	0.4	1.2	2.4	4.9	4.7	4.4	5.4	5.5	5.3

*ASX All Ordinaries Accumulation Index; MSCI World Acc Index; MSCI World Index (Hedged) in \$A; ASX 200 Property Trusts Index; FTSE EPRA/NAREIT Global Real Estate Dev. TR Index (Source data did not provide 7yr & 10 yr data); Citigroup World Gov Bond (Hedged); UBS Composite 0+; Australian 90 Day Bank Accepted Bill.

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