PHILO VANTAGE POINT

PHILO CAPITAL ADVISERS

"BUY & HOLD" OR "BUY & HOPE"?

SEPARATING FACT FROM FICTION FOR INVESTORS IN THE AUSTRALIAN STOCK MARKET

Ashley Owen, CFA

Philo Capital Advisers

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Contact us:

Philo Capital Advisers Pty Ltd
Level 11, 37 York Street, Sydney NSW 2000 Australia
ABN 70 119 185 974 AFSL 301808
www.philocapital.com.au

Brett Sanders or Ashley Owen
P: 1300 303 323
P: +61 2 9112 2800
E: enquiries@philocapital.com.au

Introduction

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?

It is tempting to look back nostalgically and say “I wish I had bought shares (or property, or gold, etc) years ago – I would be much richer by now!” It seems that just holding on to shares or property or other investments is the secret to success because, after all, “time cures all ills”. That is the message of the “buy & hold” or “time-in-the-market” strategy. According to that strategy, as long as you buy quality companies with quality management, if you hold for long enough you will ride out short term ups and downs in the market, and compounding returns over time will lead to great wealth.

That is the theory, but does it actually work in real life? 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?

The facts show that the “buy & hold” or “time-in-the-market” theory does not work - not even with so-called “blue-chip” stocks and not even with the overall market index - unless you are prepared to wait up to 30 or 40 years at a time to get your money back!

This paper will demonstrate this in the case of Australian shares. Other separate papers demonstrate similar conclusions for other asset classes including international shares, property, cash, bonds, and commodities including precious metals.

The main lessons are:

- “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 20 years or more to wait for a decent 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). Making money generally involves doing the opposite of what the media and the herd and 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.

First we will look at some well known individual Australian "blue chip" companies and then we consider the performance of the Australian stock market as a whole.

BHP

I first became interested in money in 1968 when I was 9 years old. My family had just moved from Adelaide to Canberra and my parents gave me my first watch, my first bank account to save pocket money, and a calculator (my dad was an accountant). I learned how to check the interest calculations in my passbook and this was how I started out on my journey of discovery into the world of saving and investing. That was a great start – I had a bank account with some money in it and I had time on my side, plus I had a calculator to keep track of the money and a watch to keep track of time.

Thirty five years later in 2003, when my daughter was also nine years old, and my son was three, I started buying shares in several mining companies (including BHP) as I had formed the view that mining was going to be the "next big thing".

It is tempting look back and imagine how much richer I would be now if I had bought BHP shares back when I was just 9 years old in 1968 instead of waiting until my daughter was 9 in 2003. Just imagine: That extra 35 years of compounding returns would turn even a small sum into a veritable fortune! Sure, there have been ups and downs in the market every few years, but you would think that a 35 year of extra "time in the market" would be long enough to well and truly ride over those minor bumps on the long road to wealth.

In 1968 BHP was the king of the "blue chip" stocks. It was the largest listed stock in Australia then and it still is now. It has also grown into one of the 20 largest listed public companies in the world today. If only I had started with $100 invested in BHP shares in 1968 when I was nine instead of waiting until my daughter was nine.

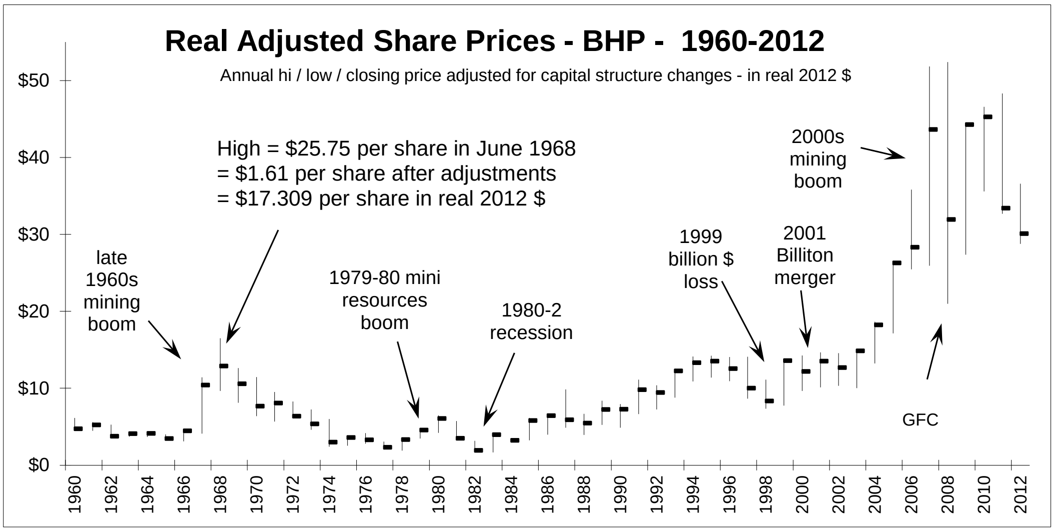
What did I miss out on by not investing for that extra 30+ years? Nothing! $100 invested in BHP shares in 1968 would still have been worth just $100 (after inflation) 35 years later! Zero real growth in value after more than 30 years – nil, zip, naught, nothing, zilch! In fact I would have been lucky to get the real value of my money back at all because for the entire time between 1968 and 2003 my investment would have made a loss. It is only thanks to the recent mining boom that the BHP shares would have managed to claw back to their original in 1968.

This sounds incredible, so let's look at the facts. On my birthday in July 1968 the BHP share price closed at $23.20. (That was not the high price for the year. One investor paid $25.75 on 27th June 1968, so I would have got a "bargain" at $23.20 per share). The capital structure of BHP has changed over the years and each share has been split into more shares. After all of the share splits, bonus issues and capital reconstructions over the years including the Billiton merger in 2001, each single BHP share in 1968 has turned into a fraction over 16 shares today, so my 1968 purchase price of $23.20 per 1968 share (which is 16-and-a-bit of today's shares) is the equivalent of $1.45 per share in 1968. That sounds cheap doesn't it? I could have bought BHP shares for $1.45 in 1968 (adjusted for capital structure changes) instead of paying $12 per share in 2003.

The problem is that $1.45 in 1968 dollars is equivalent to $12.22 in 2003 dollars after inflation, because inflation in Australia (as measured by the Consumer Price Index) averaged 6.2% per year over the 35 year period.

So the 2003 BHP share price of $12 was the same equivalent price that I would have paid 35 years before back in 1968, after adjusting for capital structure changes and after inflation. The value of my investment in BHP shares would at least have kept pace with inflation over the 35 years (only just), so it was better than putting my money under the bed, and it was also is better than putting money in the bank (which would have been eaten up by bank fees long ago). But I would have been no better off had I bought BHP shares in 1968 rather than 2003. So much for "time curing all ills" or "buying & holding" to make a fortune!

The first chart shows BHP share prices since 1960, after adjusting for changes in capital structure and after inflation – ie expressed in today's dollars. The vertical lines show the high and low share price ranges each year, and the horizontal marks are the closing share prices each year.



(Note that the value of the free shares in OneSteel and BlueScope steel that were spun off BHP in 2000 and 2001 respectively would add about $1 per BHP share, or just 2%, to the total value).

This chart makes it clear why there has been no real growth in share prices during those 35 years. The problem was that 1968 was in the middle of the late 1960s mining boom. The BHP share price peaked in mid 1968 and was clearly over-priced at the time. It traded on a dividend of yield of less than 1% (as it paid a dividend of 19 cents per share in 1968), which was a ridiculously low dividend yield for a low-growth steel maker like BHP (it had stopped mining in Broken Hill and was primarily a steel maker in Newcastle and Port Kembla by the 1960s, with some "blue sky" in the oil/gas discoveries in the Bass Strait). The share price at the time meant that people were happily paying 120 times the current year's dividend, and 50 times earnings to buy a share. Those were crazy days – similar to the late 1990s "dot-com" bubble and the many other speculative booms we have had in the past.

BHP and other large resources stocks peaked in 1968, but hundreds of small speculative mining stocks floated in the late 1960s without any earnings, dividends or any business at all, kept surging upward in price at progressively higher levels during 1969 and finally peaked in early 1970. Like all other speculative booms before or since, the bubble burst soon after - in the early 1970s, taking the BHP share price down with it.

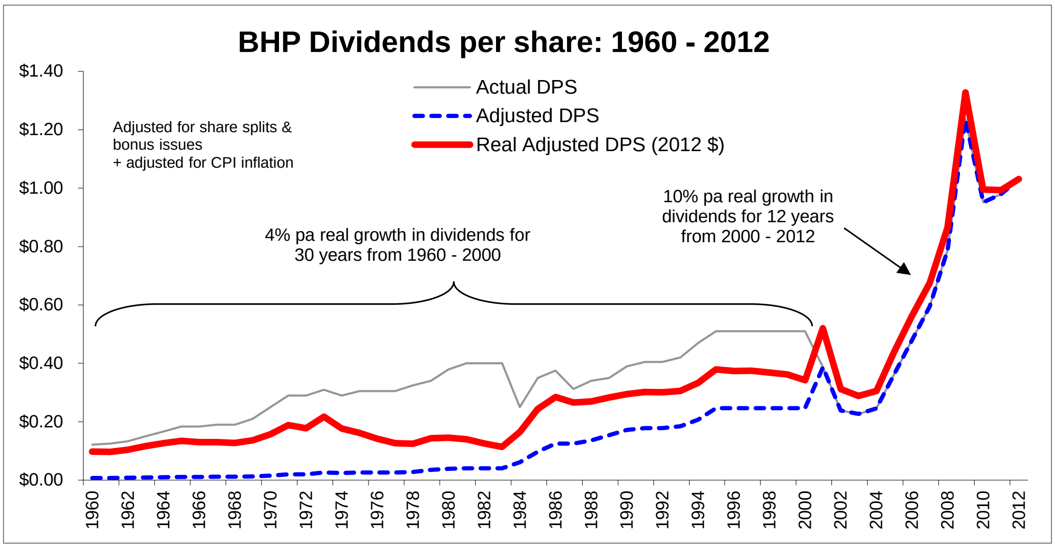
BHP is unusual in that it has survived a number of booms and busts since it was formed in 1885 and investors have at least got their money back if they waited long enough. On the other hand, the vast majority of companies that are floated in booms disappear without a trace and investors lose the lot. For example, in the mining frenzy in 1968-1969, 242 new mining companies were floated, raising $443m ($4.4b in today's dollars) from gullible investors caught up in the frenzy, and another $433m ($4.3b in today's dollars) was raised by existing listed mining companies to capitalize on the mining boom fever. It was nothing but a massive transfer of wealth from retail investors to the promoters and brokers of the stocks (as with the many other speculative bubbles before and since).

All but a handful of the new floats collapsed in the early 1970s crash, with investors losing the lot. For the few companies that did survive after raising capital in the boom (notably CRA, Hamersley, New BH, Peko, Gold Fields, WMC and Woodside), investors have had to wait decades (as with BHP) to get their money back, let alone make any actual returns on their investments.

The problem is that these major booms are "once in a lifetime" occurrences, and if you buy in a boom it may be literally a lifetime before you get your money back if you are a "buy & hold" investor.

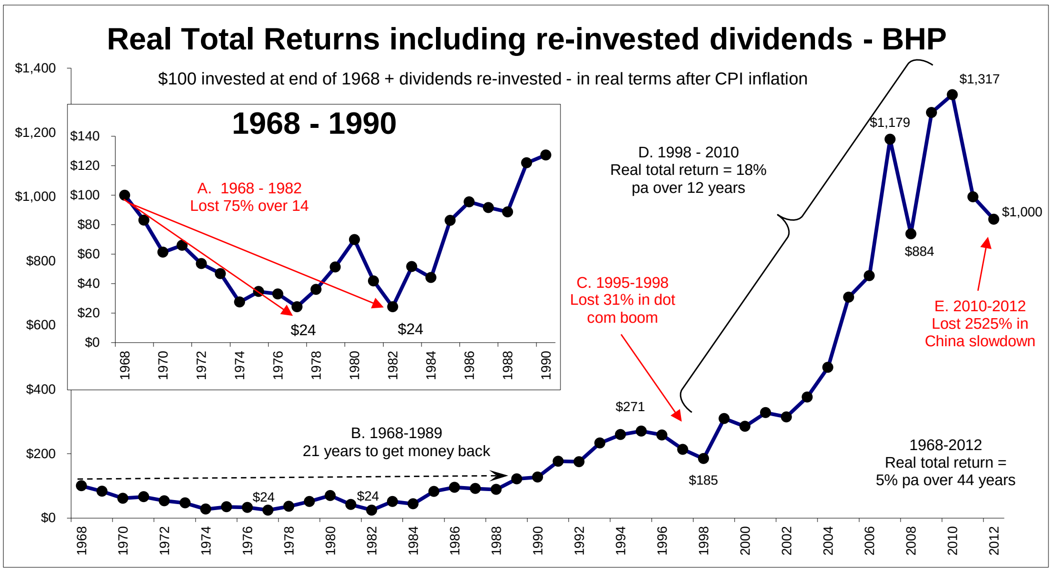
What about dividends?

So far we have talked about share prices, but total returns to shareholders include dividends as well as share price growth. What we find is that, even when dividends are included in the equation, it doesn't improve the picture much at all. The next chart shows BHP dividends per share each year, in actual terms, after adjusting for changes in capital structure, and after inflation.



Real dividend growth from BHP shares (after adjusting for capital structure changes and inflation) was 4% pa for 30 years from 1960 to 2000, which is in line with Australia's overall real economic growth rate. BHP had primarily been a steel maker and steel product maker since 1915, and it only increased dividends significantly when it abandoned steel-making and returned to digging up rocks in the 2000s boom.

The next chart shows total returns to BHP shareholders (including share price growth plus re-invested dividends) after inflation, starting with $100 invested at the end of 1968.



Total returns from 1968 to 2012 (including re-invested dividends) was only 5% pa in real terms ("D" on the chart) – quite a very poor result over such a long period for a supposedly "blue chip" stock.

If an investor who bought in the 1968-69 mining boom finally gave up hope and sold out in the depths of recession of 1982, they would have lost 75% of their money (even after dividends) over the 14 years from 1968 to 1982 ("A" on the chart). A really committed "buy & hold" investor who hung on grimly through all the years of falling share prices would finally have got their money back only 21 years later, in 1989 (“B”).

On the other hand, investors who bought in 1998 would have seen 18% pa real returns (above the inflation rate) over the 12 years from 1998 to the end of 2010 (“D”).

It was hard making the decision to buy mining stocks in the “dot com” era, and it took me two years to overcome my natural dislike of miners that just dig up rocks and load them onto a ship without adding any value. In the dot-com boom everybody including taxi drivers and waiters were giving stock tips on the latest dot-com float. The last thing investors were interested in was “old-economy” companies like BHP. Commodity prices were at multi-decade lows and BHP had just announced a billion dollar loss - its first loss since strikes closed down its Newcastle steelworks in 1923, and only the second loss in BHP’s 114 year history up to that time. You couldn’t give away BHP shares, they were so unpopular. But those brave investors who did buy BHP shares in the late 1990s and early 2000s have achieved spectacular returns since then.

So, there is money to be made from BHP shares, but the timing is absolutely critical. “Buy & hold” / “time-in-the-market” has only worked if you have a couple of decades or more to wait before making any real returns after inflation, even after including re-invested dividends – if you buy at the wrong time.

The above example is based on an arbitrary starting point, 1968, because that’s when I started out on my journey in saving and investing. On the other hand, what if a “buy & hold” investor bought before the boom took off in 1967? If a “buy & hold” investor bought BHP shares at any time between 1960 and 1966, and if they didn’t sell in the 1968-69 boom (because it is very hard to sell when everyone around you is caught up in a buying frenzy), then they would have seen no real growth on they investment until the 1990s, which is still 30 years to wait before seeing any real returns.

The lesson is clear: whether you buy shares in booms, before the booms, in the busts, or even if you do all three by buying regularly every month (the so-called “dollar-cost-averaging” theory), if you follow a “buy & hold” / “time-in-the-market” strategy, you would have had to endure 20+ years of negative or zero returns before seeing any real returns. For most people, including me, 20+ years is far too long to wait to see any returns if you just “buy & hold”.

Structural shifts

The other big message is that share prices are affected by big, multi-decade structural shifts, beyond the usual ups and downs of business cycles that last a couple of years or so. In the case of BHP its best years were in the 1885-1892 silver/lead mining boom. After the highest grade ores at Broken Hill mine were exhausted and commodities prices collapsed in the 1890s global depression, BHP shifted to processing zinc from the tailings in 1900 and by 1910 it was doing more smelting than mining, firstly in Broken Hill and then in Port Pirie. From 1915 the primary focus shifted to steel making in Newcastle. Its mining operations (iron ore in South Australia and coal in the Hunter valley) were secondary operations to supply raw materials (iron, coke and flux) to its main business which was steel making.

Then, after international trade routes and markets were closed off during the First and Second World Wars, BHP led Australia's drive for self-sufficiency in manufacturing. BHP not only made steel and steel products, it also started making components for ships, cars, trucks and even aircraft. The steel and manufacturing businesses continued in the post-war decades behind high protection barriers, but when the protection barriers came down in the 1980s and 1990s, steel making and manufacturing couldn't compete. BHP closed down the steel mills and spun off the remaining steel product manufacturing plants in Newcastle and Port Kembla as separate companies – as OneSteel in 2000 and BlueScope in 2001 - which continue to struggle to this day. BHP returned to digging up rocks, which is what it started out doing in 1885, and what it can do profitably without high protection barriers – as long as commodities prices remain high, supported this time by the China/India urbanisation boom.

These structural shifts in global conditions and fundamental changes in corporate direction over the past 125 years have had dramatic impacts on BHP's performance for investors. One cannot simply "buy & hold" because the company and the conditions within which it operates may undergo massive structural changes that take decades to play out. During the 1880s mining boom BHP was a high growth bubble stock (the share price gained 4,500% between the float in 1885 and the peak in February 1888), but the board was smart enough to switch strategies as conditions changed:- in the late 1890s toward smelting and re-processing, switching again in the mid 1910s toward steel, and then again switching in the 1940s to steel product manufacturing. During the 1950s to the 1990s it was a low-debt, low-growth stock, but the board was smart enough to switch again and return to being a miner in the late 1990s and 2000s.

"Buy & hold" does not work unless you have a couple of decades or more to wait before getting any returns. On the other hand, success relies not just on picking good companies with good management, it also relies on understanding the big-picture changes in the underlying economic, social, and political conditions, and in changing strategies and investments accordingly.

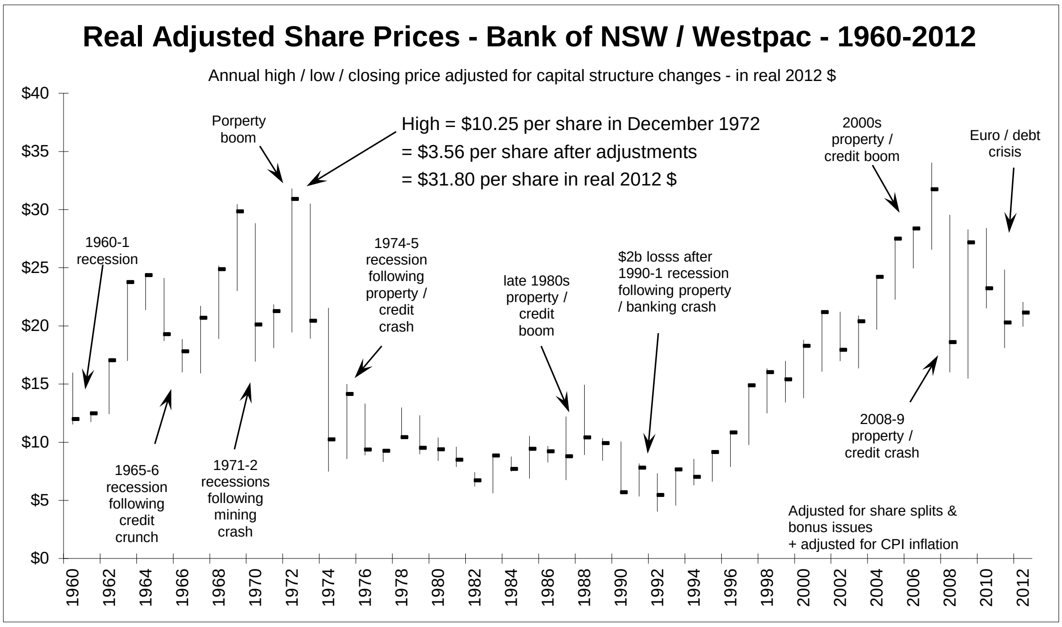
(In BHP's first phase as a miner, its share price peaked in February 1888 at £413 per share after floating for just £9 in August 1885. £413 was still "only" 21 times earnings and a dividend yield of 3.7% because BHP was profitable and cash-flow positive from day one, and was producing one third of the world's silver by then. Back then one BHP share was the equivalent of 3,374 of today's shares, and the peak 1888 price is the equivalent of $12.50 in today's dollars per share after adjustments and after inflation, compared to $30 today, 124 years later. Investors who bought in the frenzy at the top of the late 1880s boom would have had to wait 75 years until 1967 for the share price to get back to the 1888 boom price. That's a long time between drinks if you buy shares in a bubble!

BHP has been a great stock if you got the timing right, but it has been a very ordinary long term "buy & hold" investment, especially if bought in the booms, as most investors do. But the long term story of BHP and mining investment in Australia is another story for another day!)

Banks

I chose BHP for the first example because it was the biggest listed stock in Australia for most of the past 50 years and it is still the biggest stock today. What about other companies? Let's look at another stock – Westpac. For most of our history from the early colonial days, the Bank of NSW (known as the "Wales") has been the very epitome of a stable, reliable, dependable, "blue-chip" company. It was Australia's first bank, opening its doors in 1817, it was the first company to list on the Sydney Stock Exchange when it commenced in 1871, and it remained the largest bank and largest listed company in Australia for much of the time since. In October 1981 it took over the Commercial Bank of Australasia, and in October 1982 it changed its name to Westpac.

The following chart shows the share price of the Wales / Westpac over the past half century, adjusted for changes in capital structure and adjusted for inflation – ie expressed in today's dollars.



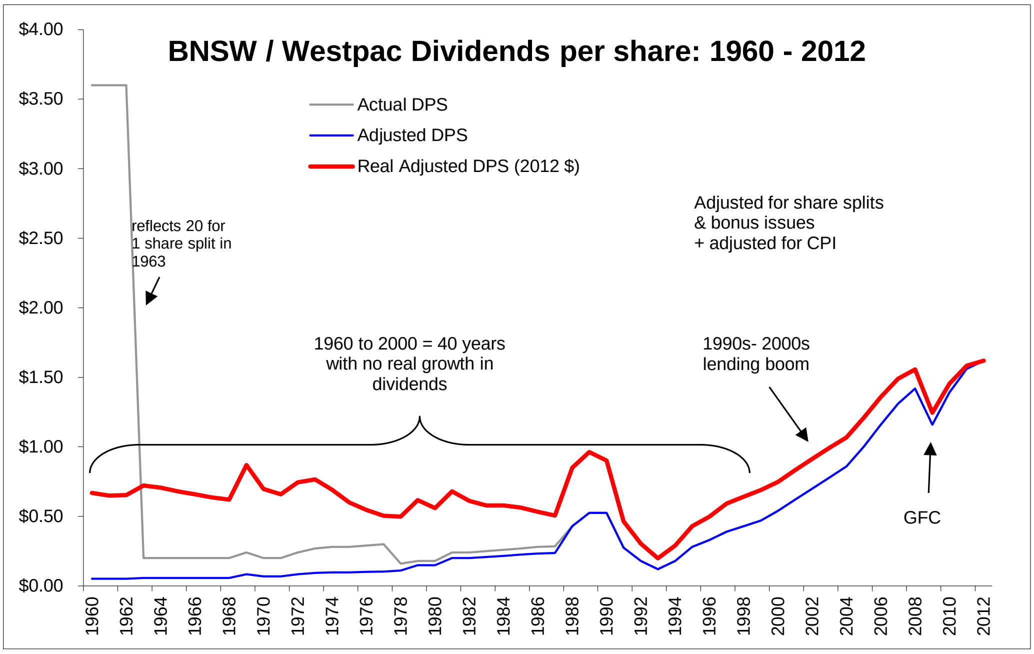
Once again we see a series of massive booms and busts. Since banks are highly geared and highly leveraged to business cycles, bank share prices swing wildly as credit booms regularly turn into credit crashes and recessions. These cycles have affected the "Wales", as with all other banks - it survived catastrophic near-death experiences in the 1820s (twice, including a Supreme Court winding up order it ignored), the 1840s depression, the 1890s depression, and the 1930s depression (where many other banks failed in each of those depressions), and it also suffered large price swings in every boom and bust cycle over the entire period, including the recent "global financial crisis".

In the above chart we can see the 1960s credit booms and busts clearly. After the late 1960s mining bubble collapsed in 1970-1, the fast money moved into property (just as it did after the 1880s mining boom collapsed), which in turn collapsed in the 1974-5 property & credit crash. Wales shares peaked in late 1972 and then plummeted over the rest of the 1970s.

One optimistic investor bought Wales shares for the peak price of $10.25 in December 1972, which is the equivalent of $3.56 per share after adjusting for share splits, and this is the equivalent of $31.80 in today's dollars after allowing for CPI inflation. That's 30% *more* than the share price is today, 40 years later. For that "buy & hold" investor who bought at the peak in 1972, there was only one single day during the next 40 years on which they could have got their money back (adjusted for splits and after inflation). That day was Thursday 1st November 2007, the very top of the 2000s credit boom. If they didn't manage to sell on that single day, they would have seen the share price plummet 54% in the GFC. They will probably have to wait for many more years for prices to get that high again.

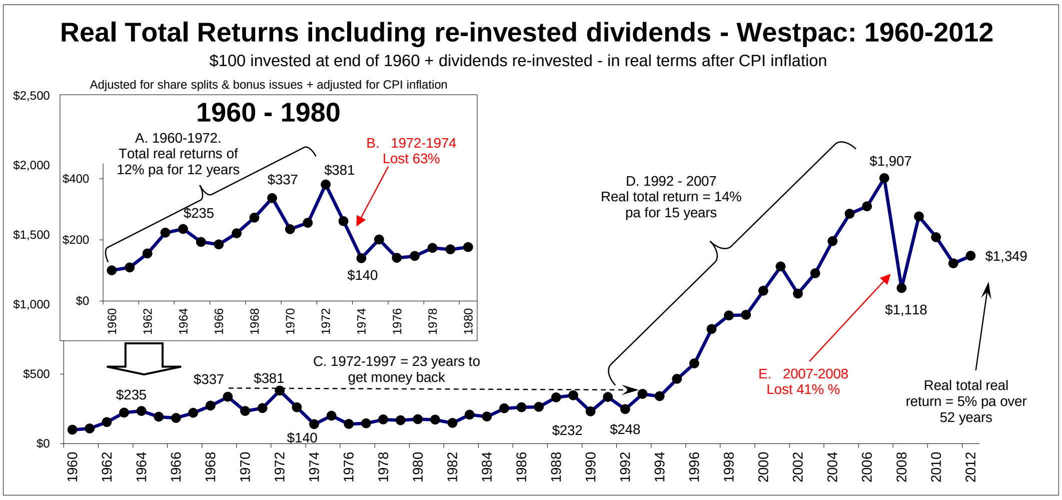
In fact, anybody who bought Bank of NSW shares at *any* time during the 10 years between 1963 and 1972 would still be waiting to get their money back today – after 50 years! (after adjusting for capital structure changes and inflation)

As for dividends, here is the dividend performance of Bank of NSW / Westpac since 1960:



Shareholders didn't see any real growth in dividends per share for 40 years from 1960 until dividends were finally increased rapidly during the 2000s credit boom. Even today, dividends are still only double their level 50 years ago (after adjusting for capital structure changes and inflation).

The next chart shows the total return performance including share price growth plus re-invested dividends, after adjusting for changes in capital structure and for inflation:



A "buy & hold" investor who bought Bank of NSW shares way back in 1960 would have received real total returns of just 5% per year above inflation over the 52 years to the 2012, even with dividends re-invested. And yet to get these modest returns they would have had to buy in the middle of the 1960 recession when prices were relatively cheap!

Unfortunately, most people don't buy shares when they are cheap in recessions – most investors run for the exits when share prices are low and fear is in the air. Unfortunately, most people buy in the booms when share prices are already high and rising strongly. Investors who bought during the booms in either 1963-4, 1968-9 or 1972 would have seen their value crash by more than 50% in the 1974 crash ("B"). On a variety of measures, Wales shares were over-priced in those booms. Dividend yields were below 3% in each of the booms, and got down to just 2.3% in 1972. On that basis alone, the shares were probably double or triple their "fair value" in those booms.

Many of those shareholders would have given up hope after waiting 20 years and would have finally sold out in despair in the depths of the 1974-5 recession, in the early 1980s recession or in the early 1990s recession. In 1992 Westpac announced the biggest ever corporate loss in Australia's history up to that time, due to massive write-offs from an orgy of bad property lending in the late 1980s boom, mainly through its property finance subsidiary AGC. Westpac came close to insolvency, before being raided by Kerry Packer and then rescued by Lend Lease / MLC.

For those truly committed "buy & hold" investors who bought in any of the booms in the 1960s or early 1970s and who had hung on grimly during the 1980s and 1990s recessions and even through the GFC, had to wait until the lending boom in the late 1990s and 2000s to get their money back and start to make real returns ("C") on their investments. On the other hand, those brave shareholders who bought in the depths of despair in the face of the $2 billion losses and fears of insolvency, were rewarded with real total returns of 14% per year above inflation over the next 15 years to the top of the credit bubble in 2007 ("D").

Whether buying in booms or in busts or both (via dollar cost averaging), "buy & hold" or "time-in-the-market" only worked if investors had 20-30+ years to wait. As was the case with BHP, there is good money to be made, but timing is absolutely critical. Share prices don't magically "come back" to some mythical straight upward trend line after a few short years.

Also as with the mining industry, big structural shifts in underlying economic, social and political conditions affect returns in the banking industry for decades at a time, beyond mere short term business cycles. In the case of banking, what produced the tremendous profit growth for Westpac and the other banks in the 1990s and 2000s was the long lending boom brought about by a number of global factors (largely mirrored in Australia) that combined to produce a bonanza for banks globally and in Australia.

These factors included: declining structural inflation rates, central bank independence, falling interest rates, the shift to smaller government and privatizations, lower tax rates, high population growth, bank de-regulation, lower/looser bank capital ratios, declining credit standards, lending “innovations” (like low-doc, “no-doc” loans, “100%” loans), new global sources of securitized credit funding, and household spending that rose even more quickly than household incomes due to lower household savings rates.

These conditions combined to produce tremendous gains for banks and bank shareholders while the boom lasted in the 1990s and 2000s. But those conditions are not constant or permanent. Nothing is in real life. Most, if not all, of those favourable conditions have now weakened, disappeared or even reversed. Since the GFC we are now into the next big structural shift globally, and this is again largely mirrored to varying degrees in Australian conditions:

- Instead of declining structural inflation rates we have rising inflation;
- instead of central bank independence we have more government interference with monetary policy;
- instead of structurally falling interest rates we are facing structurally rising interest rates;
- instead of smaller government and privatizations we now have bigger government and more government involvement in the economy and society;
- instead of lower tax rates we will need to see higher taxes to pay off the GFC-induced government debt, and the rapidly rising welfare cost of aging populations;
- instead of high population growth we are seeing xenophobic backlashes pointing to lower immigration rates in the future;
- instead of bank de-regulation we now have bank re-regulation;
- instead of lower/looser bank capital ratios we have rising/tightening capital ratios with the Basel 3 reforms;
- instead of declining credit standards we are seeing tighter credit standards;
- instead of unsustainable lending “innovations” (like low-doc, “no-doc” loans, “100%” loans) we are seeing new lending restrictions;
- instead of new global sources of securitized credit funding these have largely dried up or disappeared; and
- instead of declining household savings rates as people spent more than they earned and borrowed the difference, we now have much higher household savings rates as households (sensibly) are opting to save and pay off debt instead of borrowing more.

All of this means that the happy days of 20%+ pa growth in bank profits globally and in Australia are gone, and we are now into a new structural phase. “Buy & hold” investors who buy now are highly unlikely to see share prices continue in the same steep upward path that we saw in the 1990s to 2000s credit boom.

I have used the Bank of NSW / Westpac as the example here as it was the oldest and largest of the “blue chip” banks for most of the period. The picture for the other large Australian listed banks has been virtually the same as for BNSW / Westpac over the past 50 years. NAB handled the 1980s lending boom much better than the others and consequently suffered fewer bad debts in the early 1990s recession, resulting in it taking the mantle as the biggest bank in the 1990s. But it lost its way with a string of failed foreign adventures. ANZ fared only marginally better than Westpac in the late 1980s lending boom and in the 1990s recession but it sold off its Asian network (which included the largest foreign bank network in India) just when Asian growth was about to accelerate, and it has been spending a fortune trying to get back into Asia ever since.

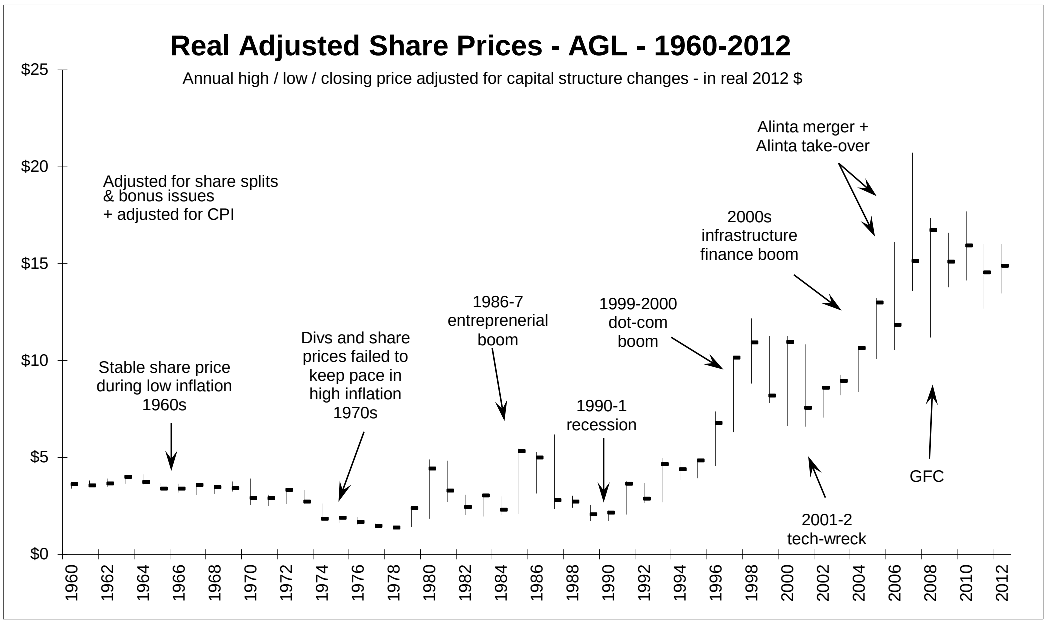
Although the banks followed different strategies, these paled into insignificance compared to the big picture structural shifts that delivered booming share prices in the 1960s, savage declines in the 1970s and 1980s, then meteoric growth in the 1990s and 2000s. Because of the big shifts in underlying structural conditions, the story for “buy & hold” investors was the same in all three of the big banks: 40 to 50 years to see any real returns, whether investors bought in the booms or in the busts.

Commonwealth Bank is a new-comer on the block and was only listed in 1991, which was right at the bottom of the 1990-1 recession, so its performance to date only reflects the massive growth in share prices, dividends and total returns since then. Comm Bank is often cited as one of the most successful of the government floats, but its success was largely due to the *timing* of the float and the structural shifts that affected the whole banking industry in the 1990s and 2000s.

AGL

Next we look at the Australian Gas Light Company, Australia's oldest energy utility (formed in 1837) and the second company to list on the Sydney Stock Exchange in 1871. As a boring and reliable distributor of town gas, then natural gas and then electricity, it has been the ultimate defensive "blue chip" company for 170 years.

The first chart shows the share price adjusted for changes in capital structure and inflation since 1960.

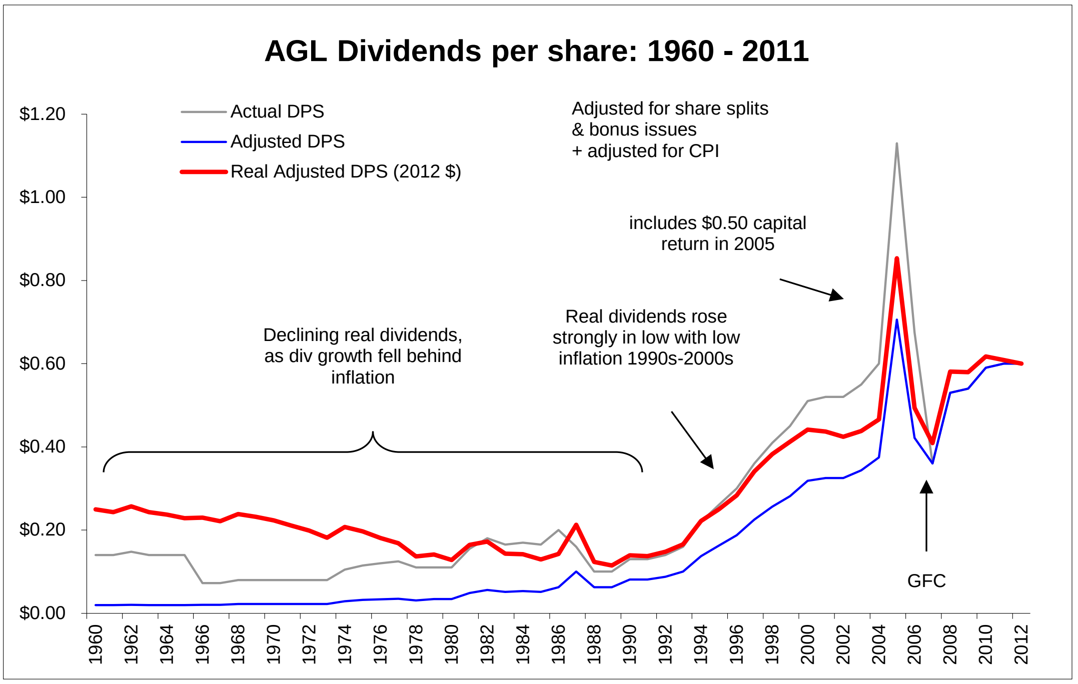


Share prices failed to keep pace with inflation during the high inflation period from the mid 1960s to the end of the 1970s. There was a brief flurry in the 1986-7 boom which saw shares in virtually every stock double, without any basis, only to halve again in the 1987 crash. AGL shares even rose during the dot-com boom. In the 1990s the company expanded into electricity generators (coal and hydro).

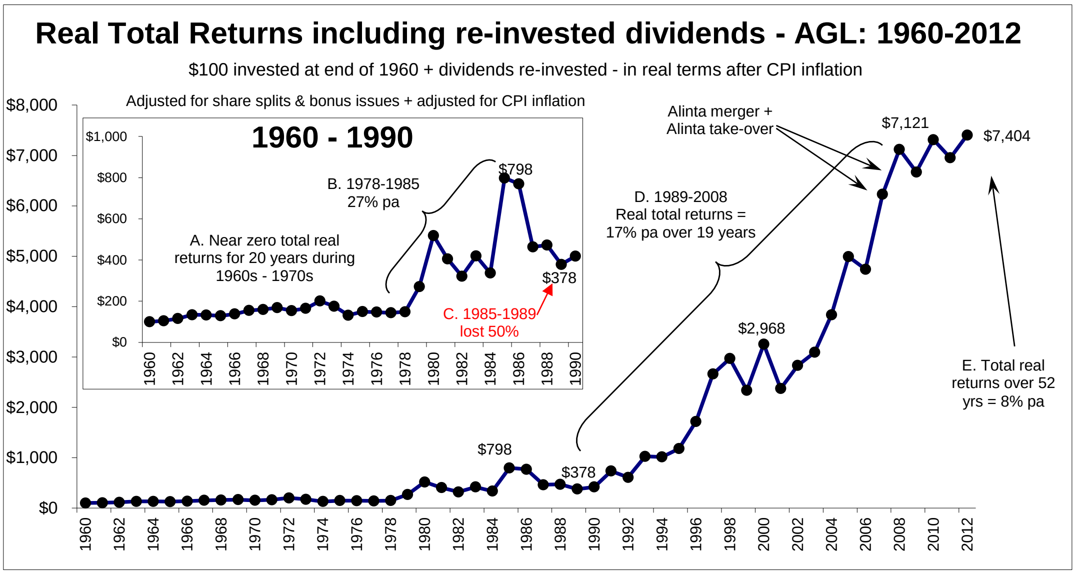
Then came the 2000s which saw a flood of cheap credit and spivvy investment bankers. "Infrastructure" suddenly became the latest fad. Investment bankers ran amok buying up "boring" infrastructure assets everywhere, chopping them up, loading them up with debt, shuffling assets and paper around a dizzy array of convoluted structures at ever-increasing prices, at ever-increasing speeds, and in ever-decreasing circles, adding layers of complexity along the way and ripping out massive fees at each stage. Yield-chasing retail "investors" snapped up the units in a host of new infrastructure trusts, lured by artificially high yields conjured up with smoke and mirrors.

AGL shareholders had hit the jackpot with the merger with Alinta in October 2006 followed by the take-over of Alinta in August 2007, both inspired and engineered by those benevolent folk at Babcock & Brown. (The charts for AGL here are based on the assumption that AGL shareholders took the "maximum cash" option in the take-over, and reinvested the cash in AGL Energy (AGK) shares, but unfortunately this still involved taking some units in the ill-fated Babcock & Brown trusts, to which I have ascribed no value).

The following dividend chart reflects the two distinct periods – first the boring period of gas distribution – with declining real dividends until around 1990, and then the rapid expansion phase during the 1990s and 2000s.



The total real returns picture shows a similar pattern:



This shows near zero real total returns (including re-invested dividends) for 20 years during the 1960s and 1970s, followed by a wild ride in the 1980s. Then shareholders were rewarded with tremendous returns averaging 17% per year above inflation from the bottom of the 1990-1 recession to the top of the credit boom in 2008.

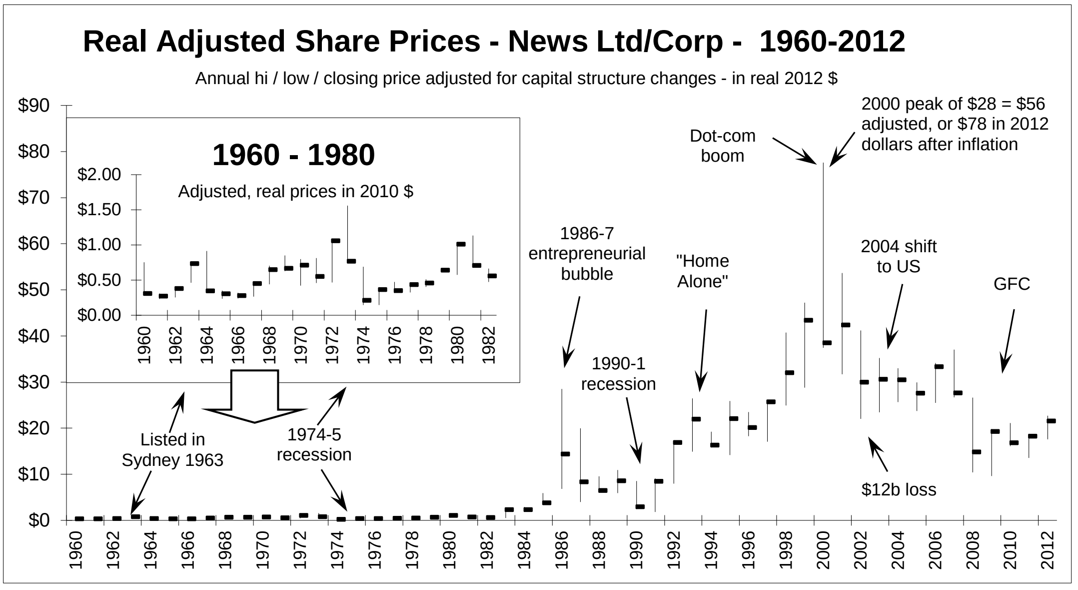
As with mining and banking, these are not mere short term business cycles, these are long periods of enormous structural change in the industry that resulted in very different patterns of returns to investors.

The AGL story also shows that the inflation protection characteristics of utilities are often more fiction than fact. AGL's shareholder returns were poorest in the high inflation mid 1960s to late 1970s, and were greatest during the relatively low inflation 1990s and 2000s. One of the main reasons for this is the fact that low inflation leads to low interest rates, which in turns encourages gearing and speculation – or in this case, debt-fuelled speculation, which in turn leads to explosive booms and busts.

News Ltd / News Corp

So much for so-called "blue chip" banks, miners and "boring"utilities. 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 (Quintex), John Spalvins (Adsteam), John Elliott (Elders), George Herscue (Hooker), Eddie Groves (ABC Learning), Stephen 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. The following chart 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).

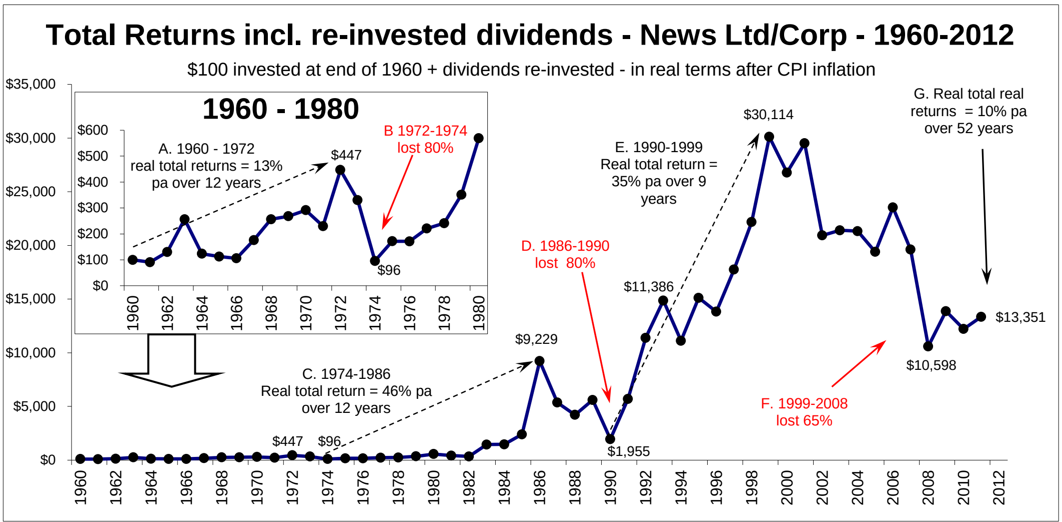


Rupert has taken the company on a grand global adventure into all sorts of businesses and markets. He has re-defined the concepts of corporate greed, nepotism, shareholder oppression and gutter journalism, but has he made money for shareholders?

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 (not to be confused with Pixar’s Toy Story). 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 more than 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.

The total return picture including re-invested dividends and adjusted for inflation shows an extraordinary pattern over the past 50 years:



The overall real total return (including re-invested dividends, after inflation) since 1960 has been 10% pa, which is respectable for long term equity investments, but barely acceptable in light of the extreme volatility and often very high levels of debt. 1960 to 1972 say 13% pa real returns (“A”), but then shareholders lost all of these gains in the 1974 crash (“B”).

This was followed by another period of even more explosive returns averaging 46% pa (“C”) before losing 80% once again in the crash that followed (“D”). Then another 9 years of 35% pa returns between 1990 and the top of the dot com bubble (“E”), followed by big losses over the next 9 years to 2008 (“F”).

Each explosive boom attracted many thousands of first time “investors” lured by rapidly rising share prices and the promise of easy money. 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 in early 2009) is still waiting to get their money back today, even after re-invested dividends, after inflation.

News has never been a “buy & hold” investment. 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.

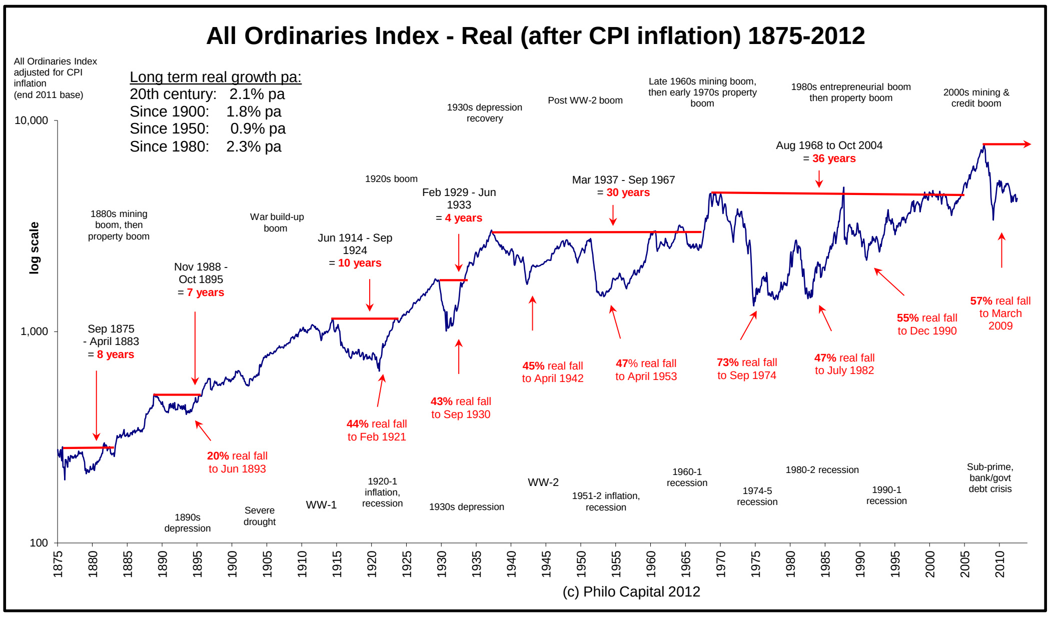
Diversification – the stock market as a whole

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.

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 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.

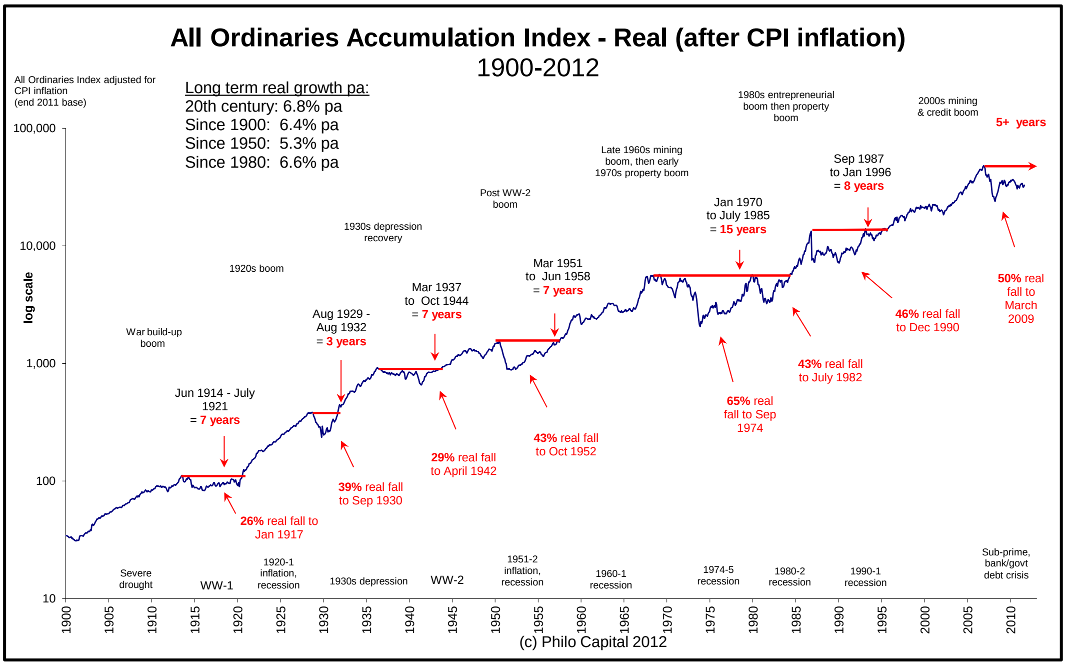
The next chart shows the All Ordinaries index since 1875 in real terms after CPI inflation.



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:

- 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 and property booms in the late 1960s and early 1970s, 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:



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 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 terms) 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 and busts

The observation that in the past it has taken 20-30+ years for prices to recover (for individual stocks or 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 capitalize on the buying frenzy, stockbrokers 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.

Most investors lose most or all of their money because most people 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 time 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. Even if you buy quality companies with quality management and you get the boom/bust timing right by buying when prices are cheap (usually in recessions when everybody else is selling), it can still take up to 30+ years to see any real returns, as we have shown above.

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 20-30+ 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 and 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 do wait to get any real returns after inflation. High returns come from 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 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 and as conditions change.

Ashley Owen, CFA

Philo Capital Advisers

August 2012

Post-script and disclosures

A large proportion 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 had a brilliant 20 year run to 2007, and the miners and mining services had a brilliant 10 year run to 2010. The structural landscape for the banking industry has now changed (as I have described above), so the high-growth days are over, and the issue 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 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".

Disclaimer

"**Philo Vantage Point**" – is a research series intended for serious long term investors interested in exploring and understanding big picture events, developments and structural shifts and their impacts on investment markets.

Philo Capital Advisers Pty Ltd

Level 11, 37 York Street Sydney NSW 2000 Australia

P: 1300 303 323

P: +61 2 9112 2800

E: enquiries@philocapital.com.au

ABN 70 119 185 974 AFSL 301808

www.philocapital.com.au