

M&CO Newsflash

The Curious Case Of Banks

Will you, as the "Sage of Omaha" & reportedly America, hence the World's richest man, Warren Buffet, encouraged, re-seek exposure to Australian equities – to ensure that you avoid "waiting for the robins (lest) the Spring be over"? Or, will you settle for second best and allow yourself to succumb to the stagnation of Mr/Mrs average, whose views were summarised in a recent IFA Magazine – which predicted that "the events of 2008 are likely to make the average investor content to select a lower strategic allocation to growth assets." (IFA Issue 441, page 22) As far as we can see, smarter investors are rejecting the "wait and see" approach. Let's turn to the reality of valuations of shares in the Australian banking sector – one of the key "defensive" sectors and an example of a style of stock picking.

Why haven't the banks kept falling (like the brokers were telling us)?

Supposed victims of our ravaged economy, the Australian banks' current crop of earnings announcements have surpassed the pessimists, triggering share price recoveries in the sector as well as – perhaps – in the broader index. The cynics were almost belligerent in their recent predictions of the demise of the sector's long history of growth, and many investors have shunned the banks on the strength of this. The sector's resilience may be a presage of things to come across the broader market or it may just show the relative impregnability of the "Four Pillars" – but either way this is a central issue to understand for any investor working through the highly conflicting signals coming from analysts and brokers right now.

Analysis shows consistently how it's vital to avoid being exposed to short term share price volatility. Personal investors should build share portfolios to suit their longer term needs and aspirations; SMSF increasingly is being used to facilitate this in the context of retirement savings. History shows us that moving in and out of shares in a time frame less than 12 months is unwise. The charts shows that investing in shares for one year could see your returns vary between a loss of 40 percent and a gain of nearly 90 percent. Historically, investing for 20 years has resulted in the range of annualised return narrowing to between a gain of 9 percent at worst and 20 percent at best. Why then invest in traditional Australian managed funds which turnover their portfolio by as much as 60% or more per annum – or rely on broking analysts which endorse the high levels of trading which their main customers (the managed funds) rely on?

Brian Johnson of Credit Lyonnais has recently been the leading advocate of selling the Aussie banks. Brian is the doyen of Australian banking analysts, and notably was previously the head of research at JP Morgan where he was routinely rated the top institutional banking analyst. In a recent report for institutional clients, Credit Lyonnais predicted banking share price falls of between 26% to 41% resulting from weaker earnings.

By any measure the CLSA report spooked the market and many clients worried whether they should feed the research into a more pessimistic view of Aussie shares for this year...

This report was issued in January 2009, prior to the release of earnings guidance by CBA and the ANZ and WBC.

The CL approach seems largely to be driven by their "top down" view of the sector, namely that:

- ✍ provisions for bad debts would rise in first half earnings well beyond 1990 levels;
- ✍ loan margins and earnings would fall;
- ✍ ANZ and NAB would cancel their dividends next year;
- ✍ and that as a result investors should sell their bank stocks.

In February CBA announced that its first half 2009 cash NPAT would be around \$2B, an astoundingly good number, although 16% lower than for last years comparable period, it is more than 20% above market expectations. The result shows strong revenue growth, particularly from the banking division which has seen revenue growth of around 20%. However, funds management revenue is lower due to the weaker equity markets. Expenses have also been kept down which assists the earnings number. Significantly, although provisions for bad debts are much higher, they are massively lower than predicted by CL. In fact other banking analysts viewed the announcement positively as it demonstrates the strength of the CBA's underlying franchise e.g. a flight to quality by depositors, the demise of non-bank mortgage lenders, and the retreat of overseas banks. A key mistake in the CLSA approach was to assume that bad debts would rise to the same levels as in the early 1990's. Maybe they will surprise on the upside but gauging them by reference to the 1990's experience is not based on any empirical evidence...the early 1990's had interest rates of nearly 20%, whereas in Australia rates are now at their lowest levels in decades. It's important when using top down analytics to get their selection right.

Has the market bottomed? One often cited measure of the bottom of the market is when shares don't fall even when bad news emerges. CBA's profit guidance triggered a sharp rise in its share price, even though its results will be worse than last year.

Watcher's of the market will find solace in this, and should keep a keen eye for further examples of shares rising after bad news emerges... Its too early to call the market bottoming – although as we previously have noted, the structural damage done to the global financial system is now being repaired and this has taken the heat out of the free fall experienced last year. We are well on the way to the bottom of the eps decline when compared to previous cycles: Equity markets are leading indicators of economic recovery & it's expected by most analysts that global GDP growth will resume in the latter part of 2009 and into 2010. Indicators have in all previous cycles in the modern economy coincided with share price recoveries, with often steep appreciations following massive GDP and eps declines. It's therefore vital when building share portfolios for long term wealth creation, to avoid the spruikers of short term trading. (rapid buy and sell orders feed stockbrokers commission pools); and instead to focus on the fundamentals.

Acknowledgement: Edited from Dr Tony Rumble, LPAC Online P/L ('LPAC'). 02 09

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