

## The case for foreign stocks: An Australian investor's perspective

August 2011

As an Australian resident, you'd be forgiven for having largely forgotten about the opportunities that exist in overseas stock markets. Over the 11 years since June 2000 major markets have largely gone nowhere; while the Australian dollar (AUD) has appreciated by almost 80%. Meanwhile, the Australian share and property markets have both boomed. The table below highlights the performance differential.

Performance (incl. dividends) June 2000 to June 2011	
ASX 200	+159%
Median Australian Manager	+141%
AUD	+78%
MSCI World (AUD)	-30%

**The prospects for positive returns in overseas shares markets over the coming decade are, in all likelihood, much greater than they were in 2000.**

Our belief though, is that the next decade will be quite different to the last. One reason for our optimism is that the starting point today is quite different from where we stood in 2000. Figures 1 and 2 below show the development of the price to book ratio for the S&P 500 and for the Australian dollar over this period. In 2000, we began the new decade with an expensive stock market and depressed currency. In hindsight, it is perhaps not surprising that over the next 10 years the S&P in AUD declined by over 50%.

Figure 1

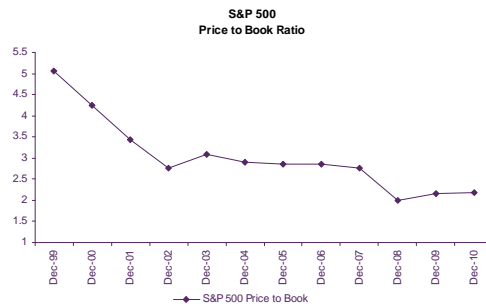
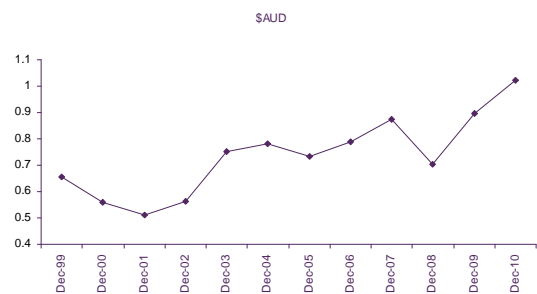


Figure 2

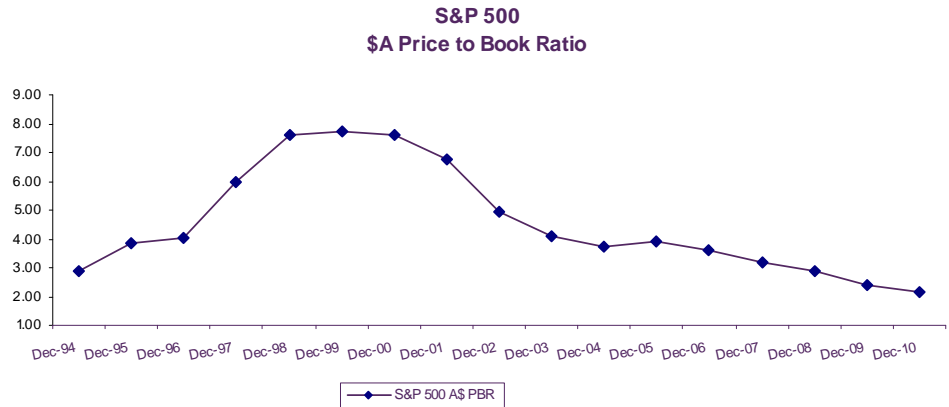


In 2011 however, the rating on the S&P 500 is 50% lower than it was in 2000; while the AUD is 83% higher. By bringing figures 1 and 2 together in figure 3, to show the price to book multiple on the S&P 500 expressed in Australian dollars, you can see that the S&P 500 is trading 72% below the valuation accorded to it at the end of 1999 and it has retraced all of the revaluation that occurred during the 1990s. Unto themselves these charts don't indicate that you buy the S&P 500 nor sell the Australian dollar, but they should serve to highlight that the prospects for positive returns in overseas share markets over the coming decade are, in all likelihood, much greater than they were in 2000.

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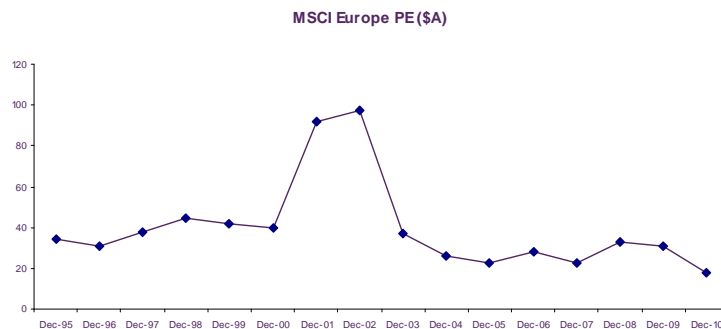
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Figure 3



The same analysis can be applied to European stock markets, overlaying the movements in the Euro versus the Australian dollar. While the absolute levels of valuation today are not as compelling as they are in the US, the unwinding of the valuation of European earnings (in AUD) has been just as dramatic as shown in figure 4 below.

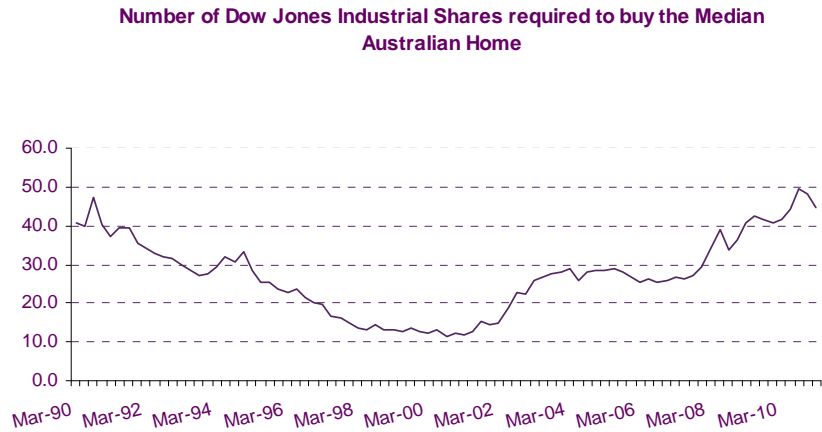
Figure 4



If we bring Australian residential property into the picture and make a comparison with the Dow Jones Industrial Average, we get a similar picture. Figure 5 below graphs the number of shares in the Dow Jones Industrial Average required to purchase the median Australian home. In June 2011, 44 shares of the Dow Jones Industrial were required to purchase the median Australian home<sup>1</sup>. This compares to a figure of just 11.2 shares being required to purchase the median Australian home in June 2000. In other words, the value of the Dow Jones Industrial Index (in AUD) relative to Australian residential property has declined by 76% over the past 11 years and is now back to levels last seen in 1990.

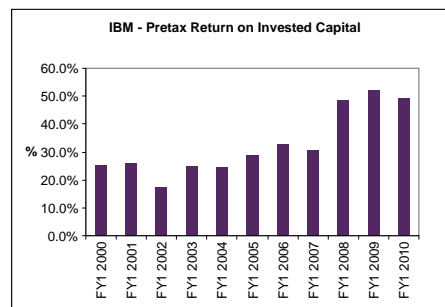
<sup>1</sup> This figure is calculated using a Dow Jones Industrial Average of 12,414, \$A of \$1.07 and Median Australian home price of \$532,700 i.e.,  $\$532,700 \div (12,414 \div 1.07) = 46$ .

**Figure 5**



As an active investor, we think it is instructive to look at this analysis on individual companies to further amplify the opportunity. Taking the case of IBM, figures 6 and 7 highlight the terrific operational improvements the company has achieved over the past 10 years. Margins and returns on invested capital have, in each case, moved to record high levels, as the company have transformed its business model away from commodity segments. Over the past 5 years, this has allowed IBM to grow its earnings per share and dividends at 18% and 27% per year respectively. It is probably fair to say that IBM is a fundamentally better business than it was a decade ago.

**Figure 6:**



**Figure 7:**

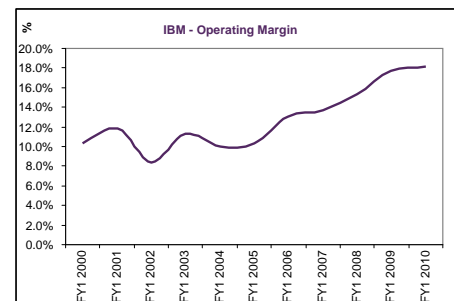
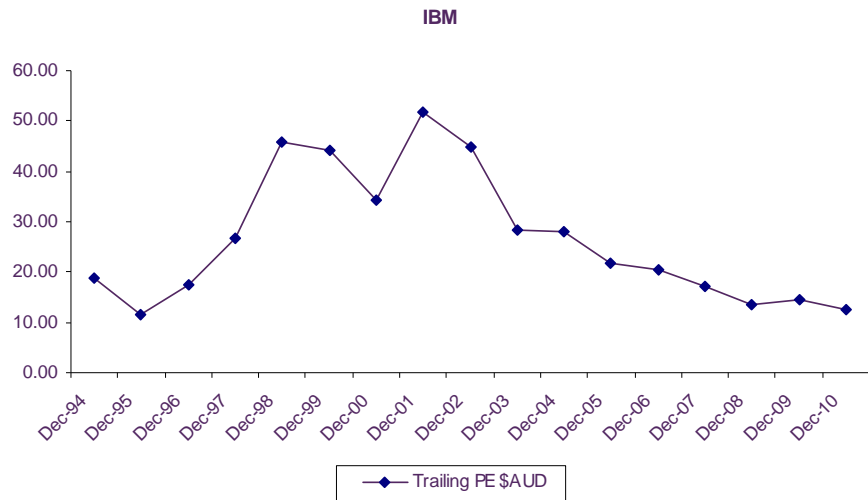


Figure 8 below plots IBM's PE ratio over the past 20 years, in Australian dollars. In other words, how many Australian dollars would it take to purchase a dollar of IBM's earnings. Looking at figures 6 and 7 above might suggest that IBM's shares would be pricey; given the operational improvements in its business, stellar EPS and dividend growth. For an Australian investor though, one dollar of IBM's earnings has not been this cheap in almost 20 years. This phenomenon reflects both the depressed multiple of earnings being applied to IBM's shares and the supercharged performance of the Australian dollar.

Figure 8:

**For Australian investors though, one dollar of IBM's earnings has not been this cheap in almost 20 years.**



To further illustrate this, figures 9 and 10 below show the quality of healthcare and consumer products company Johnson & Johnson's performance over the last decade. The company has delivered positive EPS, in all by one of the last 10 years and raised its dividend consistently over the period. Margins have been more variable, however, at the end of 2010, they were almost 6% above the levels of 2000.

Figure 9:

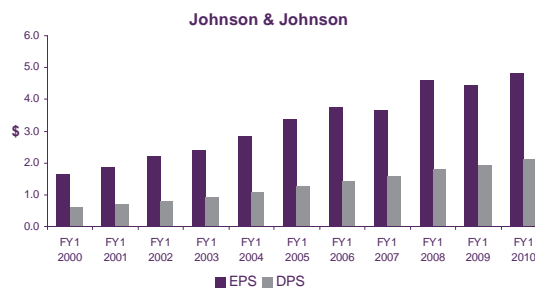
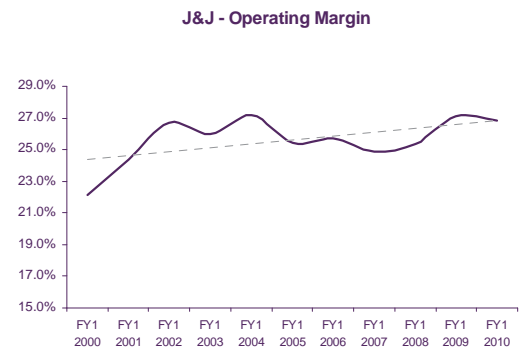


Figure 10:

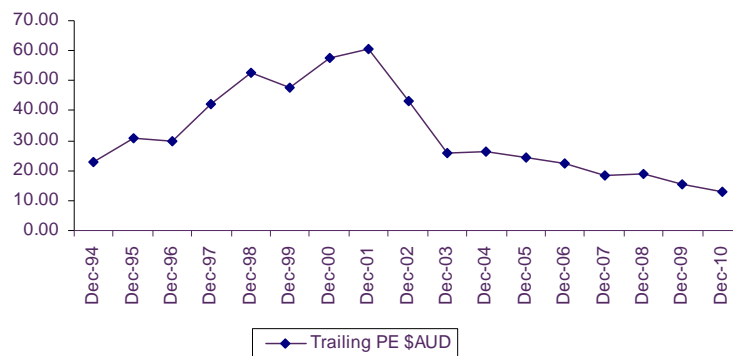


Similar to IBM though, when we look at the Australian dollar valuation of Johnson & Johnson's shares, we see that the shares are cheaper today than at any time in the past 20 years. Figure 11 shows its trailing PE from December 1994 to the end of December 2010. Johnson & Johnson's return in Australian dollar over this period has been just 7%, with dividends reinvested, woefully underperforming both the Australian share market and property markets.

Figure 11:

**With currently depressed multiples and a strong Australian dollar, overseas equities look more attractive today than at any time in the past 20 years.**

**Johnson & Johnson**



These examples should serve to highlight that the component of returns for an Australian investor is one part share price and one part currency. With currently depressed multiples and a strong Australian dollar, overseas equities look more attractive today than at any time in the past 20 years. The late Sir John Templeton once remarked "bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria". The great euphoria of 1999 is now in the rear view mirror, with markets caught somewhere between pessimism and scepticism. We believe now is an interesting starting point for Australian investors to revisit the opportunities in overseas share markets.