Cuffelinks
Connecting investors with ideas

Edition 8, 29 March 2013

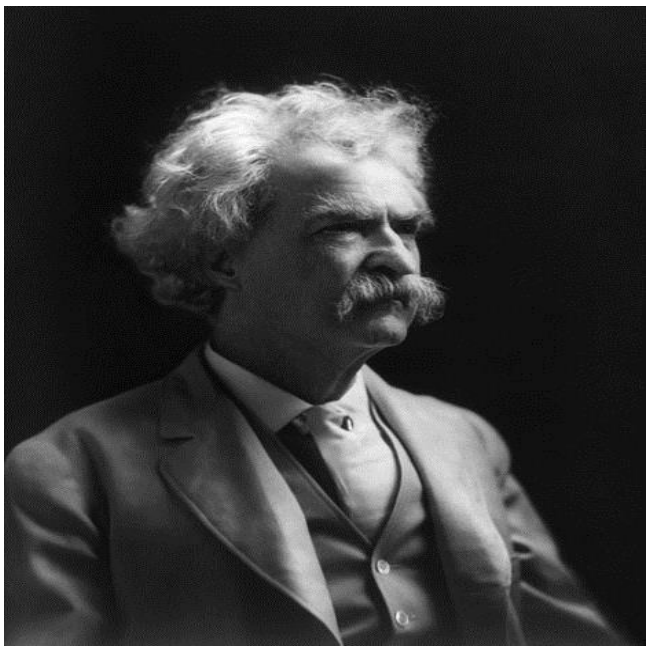
This Week's Top Articles

- **Jumping frogs and rhyming markets** *Kieran Kelly*
- **Lessons from 32 years of investment performance** *Rick Cosier*
- **So you think you think rationally. Think again** *Graham Hand*
- **If the small cap fits, wear it** *Chris Stott*
- **A new vision for retirement** *Harvard Business Review*

Jumping frogs and rhyming markets

Kieran Kelly

Who is the greatest market analyst of all time? Some will nominate Benjamin Graham. Some may opt for his student Warren Buffett. I liked Ron Brierley in his day, although his lustre has faded.



But towering above them all is Mark Twain. *Mark Twain*, you may ask? Wasn't he a writer and a Mississippi riverboat poker-shark? What does he know about markets? Well, everything apparently.

"The Celebrated Jumping Frog of Calaveras County" is an 1865 short story by Twain, his first great success as a writer, bringing him to national attention. In it the narrator tells a story about a gambler betting on a jumping frog.

In this story, Twain pens an immortal line for stockmarket scholars about his favorite theory: "that no *occurrence* is sole and solitary, but is merely a repetition of a thing which has happened before, and perhaps often ..."

Like Twain, we have asked ourselves, "Haven't I seen this all before?" At an individual level this is usually called déjà vu and can strike with incidents in life, memories triggered by visits to different places, smells or sounds.

On a bigger canvas, this is called historic recurrence and is the repetition of similar events in history often separated by long periods of time. The concept of historic recurrence has been applied particularly to the rise and fall of empires and the continual and relentless wars that erupt between tribes and nation states. Nowhere is this better observed than in the history of Afghanistan. Since the time of Alexander the Great, this beautiful but blighted region has been subjected to continual periodic invasions where the invader always and inevitably loses and goes home with its tail between its legs. If G.W. Bush had been a student of historic recurrence, much American blood and treasure (and a not inconsiderable amount of Australian) could have been saved. Alas, he doesn't appear to have been much of a student of anything!

While people often say, "History repeats itself" in cycles, this is never *exactly* true. This was also appreciated by Twain, obviously a student of the long cycle, when he wrote, "History does not repeat itself, but it does rhyme."

Recurrences take place due to sometimes subtle and not readily identifiable circumstances. Some of these factors may not be understood at the time the event is occurring and may only become apparent years later. The reason for the recurrence will often be hotly debated. Nowhere is this better evidenced than in the stockmarket.

As the chart below shows the stockmarket may not be repeating history but it's rhyming, with all the exuberance of a Wordsworth poem.

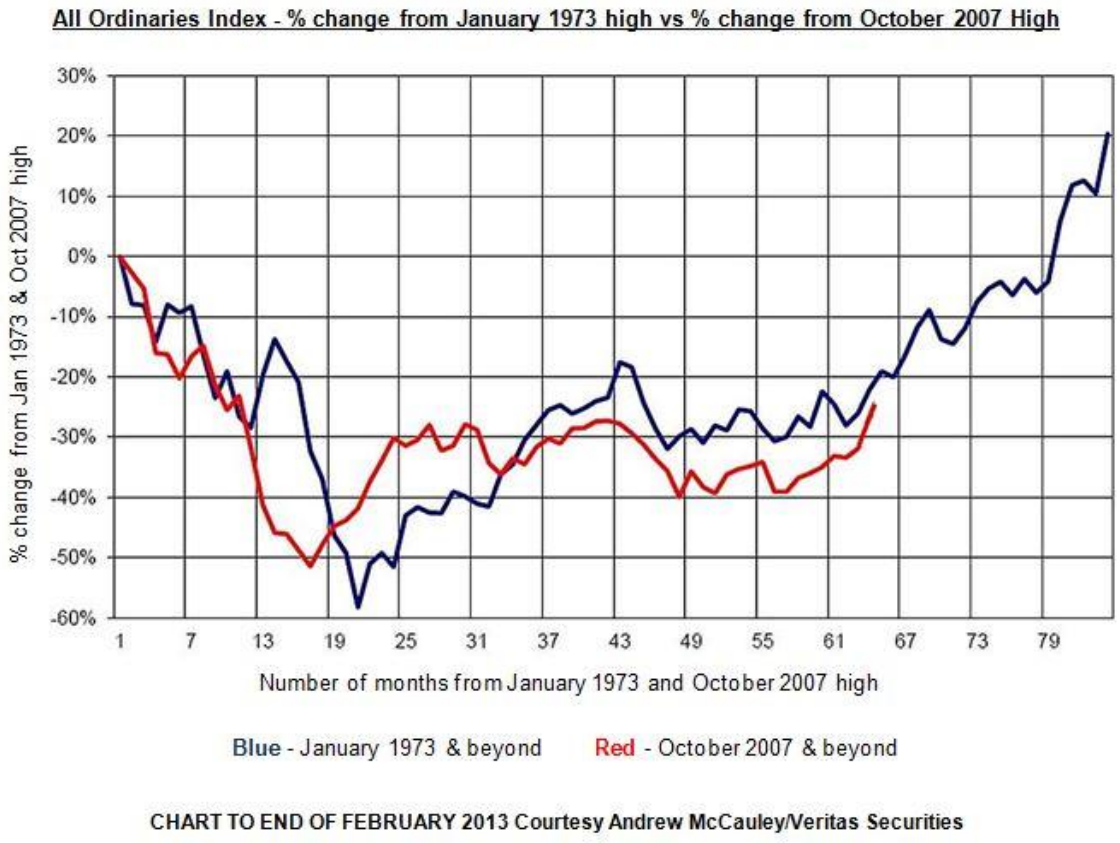


CHART TO END OF FEBRUARY 2013 Courtesy Andrew McCauley/Veritas Securities

The Australian equity market is presently repeating a performance pattern similar to the mid 1970's recovery. It's not performing exactly the same way, but it's close. It is now 65 months with a 25% decline since the Australian equity market peaked in late 2007. Over the same time frame (65 months) from the pre-decline peak in January 1973 to March 1978, the All Ordinaries Index had fallen by approximately the same amount as shown in the chart. Both periods experienced peak to trough reversals of more than 50%.

The chart shows the returns from the All Ordinaries Index post the 1973 and 2007 peaks. As is readily observable, the moves in the two periods tend to mirror each other. Let's say it is not repeating itself but it sure is rhyming.

"So what?", you may ask. The model, if it is a true example of historical recurrence, may predict the course of the sharemarket over the next couple of years. Or it may not.

Why would this rhyming model work? Simple. The stockmarket is a barometer of human emotion and particularly human frailty. It registers them all … fear, greed, lust, paranoia, confusion, panic, herd-mentality, envy and disappointment. It's a big human stew but the ingredients never change so the taste is the same, although it comes to the boil at different times. "Gee haven't I tasted this somewhere before?" The ingredients never change because people never change. Not really. Not even over long periods of time.

The herd always charges off together in one direction then just wait, what's that sound you hear? It's the herd charging back again in the opposite direction. They head off over the hill. What is the only thing you know for sure? That given time you will see them all come thundering over that same hill heading in the direction they first came from. Humans, like jumping frogs and migrating wildebeest, never change. The graphs from 1973 and 2007 demonstrate this.

Writing novels and playing poker on riverboats, while consuming large quantities of whisky, does not a great market analyst make! Or does it? I think I'll try it.

Kieran Kelly is Managing Director of Sirius Fund Management and has over 30 years' experience in fund management and sharebroking.

Lessons from 32 years of investment returns

Rick Cosier

'Past performance is no guarantee of future performance'. How many times have we heard that? The Australian Securities & Commission (ASIC) insists that fund managers and financial planners include it in practically every piece of communication they produce.

The Australian sharemarket is more than 20% up in this financial year, and there is much discussion between pundits on everything between an imminent crash, a 'plateau' and a brief correction before an onward march.

So it was with interest that I looked at a table sent to me by a fellow financial planner, Dejan Pekic of Newealth. It shows returns from different investment types (asset classes) for each calendar year since 1981. The data is considered robust over this period because before 1979 there were various proxies for the 'Australian' sharemarket index, which often excluded major companies. In the table below:

- the best performing asset class in a particular year is highlighted in green, and recessions are in orange
- 'Property' refers to Australian listed property trusts not residential property

- Fixed Interest refers to government and corporate bonds, not term deposits
- returns from International Shares are in Australian dollars and unhedged.

Asset Class Calendar Year Returns, 1981- 2012

Year to 31 Dec...	Cash	Fixed Interest		Shares		Property	CPI
		Australian	International	Australian	International		
1981	15.9%	1.4%		-12.9%	0.3%	**32.1%**	
1982	18.4%	**34.3%**		-13.9%	27.2%	5.2%	
1983	13.1%	8.6%		**66.8%**	32.3%	50.2%	
1984	12.6%	12.0%	15.4%	-2.3%	**15.5%**	10.1%	2.6%
1985	15.6%	8.1%	54.9%	44.1%	**72.2%**	5.2%	8.2%
1986	18.1%	19.0%	26.1%	**52.2%**	46.6%	35.4%	9.8%
1987	14.4%	**18.1%**	9.1%	-7.9%	7.5%	5.7%	7.1%
1988	12.8%	9.1%	7.1%	**17.9%**	4.7%	16.1%	7.6%
1989	18.4%	14.4%	9.1%	17.4%	**26.9%**	2.3%	7.8%
1990	16.2%	**19.1%**	7.0%	-17.5%	-14.6%	8.7%	6.9%
1991	11.2%	24.7%	14.9%	**34.2%**	20.9%	20.1%	1.5%
1992	6.9%	10.4%	**9.7%**	-2.3%	5.4%	7.0%	0.3%
1993	5.4%	16.3%	14.5%	**45.4%**	24.6%	30.1%	1.9%
1994	**5.3%**	-4.7%	-3.5%	-8.7%	-7.6%	-5.6%	2.5%
1995	8.0%	18.6%	17.1%	20.2%	**26.5%**	12.7%	5.1%
1996	7.6%	11.9%	7.6%	**14.6%**	6.8%	14.5%	1.5%
1997	5.6%	12.2%	9.5%	12.2%	**41.7%**	20.3%	-0.2%
1998	5.1%	9.5%	10.1%	11.6%	**32.6%**	18.0%	1.6%
1999	5.0%	-1.2%	-1.2%	16.1%	**17.5%**	-5.0%	1.8%
2000	6.2%	12.0%	8.3%	3.6%	2.5%	**17.8%**	5.8%
2001	5.3%	5.5%	5.2%	10.1%	-9.4%	**14.6%**	3.1%
2002	4.8%	8.8%	8.5%	-8.1%	-26.9%	**11.8%**	3.0%
2003	4.9%	3.0%	2.2%	**15.9%**	0.0%	8.8%	2.4%
2004	5.6%	7.0%	4.9%	27.6%	10.8%	**32.0%**	2.6%
2005	5.7%	5.8%	3.7%	**21.1%**	17.6%	12.5%	2.8%
2006	6.0%	3.1%	0.8%	25.0%	12.3%	**34.0%**	3.3%
2007	6.8%	3.5%	4.0%	**18.0%**	-1.6%	-8.4%	3.0%
2008	7.6%	**14.9%**	9.2%	-40.4%	-24.9%	-54.0%	3.3%
2009	3.5%	1.7%	3.6%	**39.6%**	5.0%	7.9%	2.1%
2010	4.4%	6.0%	**8.8%**	3.2%	-0.7%	-1.1%	2.7%
2011	5.0%	**11.4%**	11.1%	-11.4%	-6.7%	-8.3%	3.5%
2012	3.8%	7.7%	9.7%	20.3%	14.1%	**32.8%**	2.0%
Best	18.4%	34.3%	54.9%	66.8%	72.2%	50.2%	9.8%
Worst	3.5%	-4.7%	-3.5%	-40.4%	-26.9%	-54.0%	-0.2%
Average #	**8.9%**	**10.4%**	**9.9%**	**12.9%**	**11.8%**	**12.0%**	**3.6%**

Source: Morningstar, S&P, Mercer, Iress, DataStream & Investment Solutions

Orange Colour-	Denotes Australian Recessions	**Shares - Aust.-**	S&P/ASX 200 TR
Cash-	RBA Bank accepted Bills 90 Days	**Shares- Int'l-**	MSCI World Ex Australia NR AUD
Fixed Int.- Aust.-	UBS Composite 0+ Yr TR AUD	**Property- Aust.-**	S&P/ASX 300 A-REIT TR
Fixed Int.- Int'l-	BarCap Global Aggregate TR Hdg AUD	**CPI-**	Based on "All Groups CPI" - ABS

Sourced from Newealth Financial Services.

Here are a few observations:

1. In 11 out of the 32 years, the sharemarket has risen by more than 20% in a calendar year. In fact, in more than half of these occasions the rise has been 34% or greater. So rises of 20%+ in a year are not unusual.
2. Nine times out of ten, a negative year in the Australian share market has been followed by a positive year, and that positive year was more than 17%. This supports the notion of sticking to your guns after a bad year.
3. Returns from international shares have been relatively poor compared with Australian shares for many years. International shares have not been the best performing asset class since 1999. But over the last 32 years as a whole, Australian shares have only delivered annual returns of 1.1% more than international shares. Exchange rates are a major factor.
4. In almost 80% of the years, the difference in performance between Australian and international shares was greater than 10%. 25% of the time one was negative and the other was positive. This challenges the popular belief that returns from Australian shares and international shares are highly correlated.
5. Cash has only been the best performer once, in 1994. If you had all your money in cash in that year you would have felt pretty good, because everything else went down. But if you had stayed in cash for the following years you would have missed the 20.2%, 14.6%, 12.2%, 11.6% and 16.1% returns delivered by Australian shares.
6. However, in 'real' terms, cash returns have been pretty good over the past 32 years. The average annual return is 8.9% which is 5.3% more than inflation (CPI). This implies that cash is a good investment when inflation is high, which is contrary to what we are often told. Currently, we have a different situation, as interest rates are barely covering inflation.
7. CPI has been below 3.6% for 20 out of the last 22 years. Many market commentators say that low inflation means low share market returns. However, in 15 of those years the Australian sharemarket delivered returns that were more than 10%, with the average return being 12%.
8. Fixed interest has only delivered a loss once in 32 years, with average returns comfortably above inflation. However, interest rates have been declining for practically the whole time. This has been good for fixed interest returns because falling interest rates mean capital gains. The only time fixed interest delivered negative returns was in 1994 when interest rates went up.
9. Listed property has been the best performing asset class in six of the last thirteen years. However, much like Pluto is no longer considered a planet because of its small size, I believe listed property should be considered a sector of the sharemarket. I am waiting for somebody to replace listed property with residential property in a chart like this. Then we can really have a discussion about performance and diversification.

Some will argue that the 1980s is no longer relevant because inflation and high interest rates have been well and truly beaten. But how far back should we go? According to AMP, which has analysed statistics from the Australian Bureau of Statistics and the Real Estate Institute of Australia, the average annual returns from cash, Australian bonds and Australian shares since 1926 are 5.7%, 7% and 11.4% respectively. Australian residential property has delivered 11.1%.

Each of you will have your own opinion, but the figures are what they are. So, whilst past performance is indeed no guarantee of future performance, it's all we've got.

So you think you think rationally. Think again

Graham Hand

Nobel Prize winner Daniel Kahneman published *Thinking, Fast and Slow* in 2011, and it shot to the top of bestseller lists. The reviewers often sounded as if Kahneman were reporting on new research or putting out a fresh idea, like a Michael Lewis or Malcolm Gladwell insight. But this did an injustice to Kahneman. His book was nothing less than a summary of a lifetime's work. His Nobel Prize was awarded in 2002, and he traces his work back to 1969 at the Hebrew University of Jerusalem, when he met Amos Tversky. Together, they would bring behavioural finance out of the margin and into the mainstream, such that over 40 years later, it is an accepted part of understanding how investors and markets behave.

But this article is not another review of his book. Rather, Kahneman reports on dozens of studies he and his colleagues have done on how we make decisions, and explains our irrational behaviour. The reader is drawn in to take the tests and judge their own weaknesses in logic, which is why this book can be so humbling to read.

Kahneman divides our thought processes into System 1, which is automatic, effortless and unconscious, but answers questions quickly and gullibly based on intuition. And System 2, which is controlled, deliberate and requiring effort, but often only engages when circumstances require it.

So here we go. I've taken 10 examples from Kahneman's book, and I will give the questions first, followed by the answers and a brief explanation. Try not to peep.

1. A bat and a ball cost $1.10. The bat costs one dollar more than the ball. How much does the ball cost?

2. If it takes 5 machines 5 minutes to make 5 widgets, how long would it take 100 machines to make 100 widgets? Here's a clue: is the answer 100 minutes or 5 minutes?

3. How many animals of each kind did Moses take into the ark?

4. A man has been described by a neighbour as follows: "Steve is very shy and withdrawn, invariably helpful but with very little interest in people or in the world of reality. A meek and tidy soul, he has a need for order and structure, and a passion for detail."

   Is Steve more likely to be a librarian or a farmer?

5. Consider three possible sequences of boys and girls born in a hospital: BBBGGG, GGGGGG, BGBBGB. Which of these sequences is least likely?

6. Is the height of the tallest redwood in the United State more or less than 1,200 feet? What's your best guess about the height of the tallest redwood?

7. It's a fact that people with a PhD are more likely to subscribe to *The New York Times* than people who did not go to college.

   You see a lady reading *The New York Times* on a New York subway. Which of the following is more likely?

   a) She has a PhD
   b) She does not have a college degree.

8. The most famous and controversial experiment involves a lady called Linda:

   "Linda is 31 years old, single, outspoken, and very bright. She majored in philosophy. As a student, she was deeply concerned with issues of discrimination and social justice, and also participated in antinuclear demonstrations."

   The question is, which alternative is more probable?

   a) Linda is a bank teller
   b) Linda is a bank teller and is active in the feminist movement.

9. What if you were given a choice between the following:

   a) A gamble with 80% chance to win $100 and 20% chance to win $10.
   b) A sure payment of $80.

   Which would you choose based on your personal preferences? Which would you choose based on the expected value of the outcomes?

10. Consider these two problems:

    Problem 1. Which do you choose?
    Get $900 for sure or 90% chance to get $1,000.

    Problem 2. Which do you choose?
    Lose $900 for sure or 90% chance to lose $1,000.

So what are the logical or rational answers and what is happening in your decision-making?

1. It's difficult to stop the answer 10 cents jumping into your mind. More than 80% of university students give this first intuitive answer. But it's wrong, and Kahneman highlights our failure to check the answer as we simply follow the law of least effort. The correct answer is 5 cents.

2. Again, there is an intuitive response, but the correct response is 5 minutes. Kahneman also reports that students are far more inclined to make a mistake if given the puzzle in normal font, but do better in a small, washed-out font. The cognitive effort of reading the question produces a better result.

3. Very few people detect what is wrong with this question. Look again. Holy Moses! Oh Noah!

4. Most people reply that Steve is more likely to be a librarian than a farmer. But there are at least five times more farmers than librarians in the United States, and the majority of the librarians are women. So it is far less likely that Steve is a librarian.

5. Intuitively, we don't expect a sequence of six girls, but since each event is independent of the one before it, they are all equally likely.

6. When the question is asked like this, the mean estimate given by respondents was 844 feet. But when it is asked like this:

   "Is the height of the tallest redwood more or less than 180 feet? What's your best guess about the height of the tallest redwood?"

   … the mean answer is 282 feet. This 'anchoring' effect has many examples in investing.

7. It's more likely to be the second because far more non graduates ride the subway than PhDs.

8. People think Linda is a very good fit for an active feminist. But the set of feminist bank tellers *must* be wholly included in the set of bank tellers. Therefore, the probability that Linda is a feminist bank teller *must* be lower than the probability she is a bank teller. When a possible event is specified in increasingly greater detail, you only lower its probability. People are confusing intuition with the logic of probability. In tests of undergraduates at top universities, 85% to 90% chose the second, incorrect option.

9. Most people dislike risk and almost everyone prefers the sure thing. The expected value of the gamble is $82 (0.8 X 100 + 0.2 X 10), which is more than the sure thing. But few people evaluate risks in this way. Most people would choose the sure thing even if it were only $50.

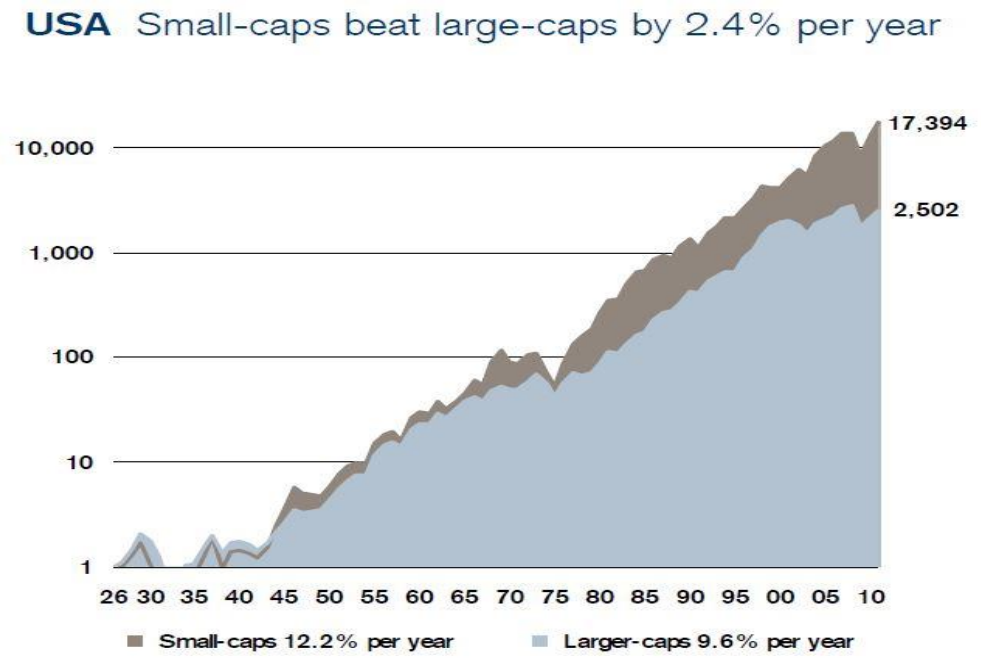
10. You were probably risk-averse in problem 1, as for the great majority of people, a $900 gain is much better. But then in problem 2, you probably chose the gamble. The thought of losing $900 encourages you to take the gamble. People become risk-seeking when all their options are bad, and you probably dislike losing more than you like winning.

Kahneman hopes his examples improve our ability to identify and understand errors of judgement. If we make mistakes in these simple questions where the logic is obvious, we are likely to be missing critical information or focussing on the wrong issues in many of our investment decisions. Each day, we respond to problems quickly and automatically, giving undue attention to details that stand out easily. Critical information is often ignored. The best investors are those who can hear through the noise.

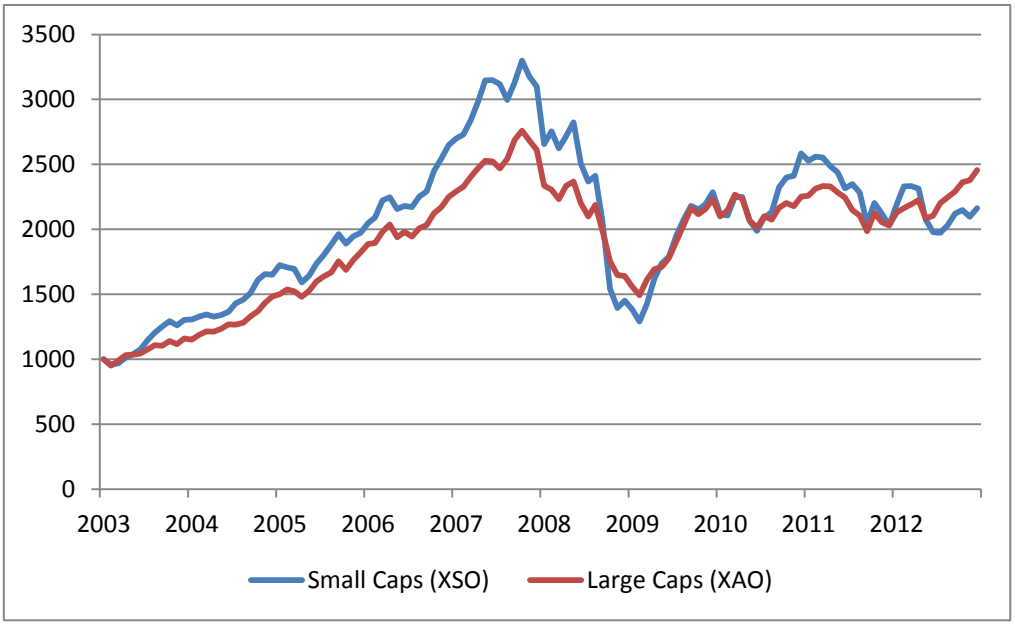
If the small cap fits, wear it

Chris Stott

In *Cuffelinks Edition 4*, Chris Cuffe's article mentioned that over long time periods, companies with small market capitalisation ('small caps') have outperformed large caps. The pioneering academic work most often cited is from Fama and French in the United States, and their work has been further developed by Elroy Dimson and colleagues from the London Business School, who provided these return metrics looking back since the 1920's:



We should note however that this phenomenon has diverged in recent times in Australia. The following chart for the last decade shows that at various times both small and large caps have had their times in the sun.



The dominant factor in relative performance is the market's appetite for risk. In the mid 2000's bull market, appetite for risk saw small caps surge and outperform sharply until about 2008. Since the GFC, the insatiable investor appetite for defensive yields has seen larger companies do well. It should also be noted that the small resources stocks which represent around 40% of the small cap index have been on a slide for the last two years, dragging the averages down in Australia, something not so much relevant when looking at offshore small cap outperformance.

Why small caps traditionally outperform

Smaller companies in Australia are defined as stocks being outside the ASX100 Index. The Small Ordinaries Accumulation Index is what most small cap managers focus on which represents around 7% of the Australian market's capitalisation. These companies are generally higher growth businesses in their infancy looking to become the next big household name in Australia. A large portion of top 100 companies in Australia are in the maturity phase of their life cycle, and growth rates of 5% are commonplace. These types of returns would be considered measly in the smaller end of town. As investors, we generally find that earnings growth has the highest correlation to share price movements overtime. This partly explains why small caps have outperformed large caps over such a long time period.

Smaller companies are under-researched, which creates the opportunity. Fund managers and stockbrokers scour this part of the market far less than with large companies. Over time, smaller companies that succeed become more noticed by analysts. When fund managers and the market 'discover the stock' this creates natural buying and pushes the price and rating up. This can be a good point to take profits given this point of the stock's rerating generally comes with an expansion of its price to earnings ratio, a dangerous indicator to watch for.

A key part of small cap investing is having access to the senior management of the company. This is critical in understanding the dynamics of the business and what makes the leaders of the business tick. On the other hand, it's incredibly hard for the majority of investors to contact Ian Narev, the CEO of the largest bank in Australia, Commonwealth Bank.

As an aside, a piece of advice which rings true when interrogating a company's CEO is would you be happy to introduce that executive as your parent. As an investor in that company you are giving your money to the CEO to manage on your behalf.

The ideal small cap investment would have the following characteristics:

- strong free cash flow
- net cash on the balance sheet
- strong management team
- strong industry position
- low price to earnings ratio
- earnings growth at 1.5-2x price to earnings ratio
- a catalyst or event that will rerate the share price
- no other fund managers on the share register

One other advantage of small cap investing is the higher propensity for merger and acquisition activity. A few examples of this in recent years are Count Financial (acquired by CBA), Crane Group (acquired by Fletcher Building) and conglomerate Alesco (acquired by Dulux Group). Smaller companies are more likely to have targets on their backs. If successful, they attract the attention of their larger listed peers who are looking to generate earnings per share growth via acquisitions, when organic growth in their existing business can be anaemic. This can be a boon for investors providing excellent returns in the right circumstances.

Small cap prices are more volatile

Small caps are more volatile and less liquid in trading and are generally higher risk investments. They usually have more focused business lines compared with their larger counterparts, and therefore have a less diversified revenue stream.

The higher risk can be seen when things go wrong with the business, such as profit downgrades or a structural change in the industry. Recent examples of this include the 'old media' businesses such as Fairfax and APN News and Media. These companies have been too slow to adapt to the new digital age and have experienced rapid declines in their share prices when compared to the overall market's return. Negative news flow in small caps generally creates a much higher level of volatility. An earnings downgrade from a company can see a stock fall in excess of 20% when the equivalent for a larger company may see a 5-10% move. This impact generally holds true on the upside with positive news. Higher risk, higher reward.

Large cap investments can provide a more steady return in the form of fully franked dividends. Generally these mature businesses are expected to pay back to shareholders each year a portion of their earnings. A smaller company which is going through a growth phase can require ongoing capital investment. Investors are generally happy for a smaller company to retain capital and invest given the superior return it can potentially generate. As companies grow and become more mature, they can then be expected to provide more income growth. Capital growth on the other hand is generally higher in small caps given the increased propensity to provide larger earnings growth.

Overall small caps have provided a higher return over the long term compared with their larger peers. While they come with added risk, they are an important part of a portfolio allocation decision and selecting the correct small cap investments can provide many happy returns over time.

Chris Stott is Chief Investment Officer and Portfolio Manager at Wilson Asset Management.

Also on the website this week

A new vision for retirement: productive and meaningful

Harvard Business Review blog link

This extract from Harvard Business Review looks at how meaningful work for retirees can help avoid the problems that a rapidly rising dependency ratio will cause.