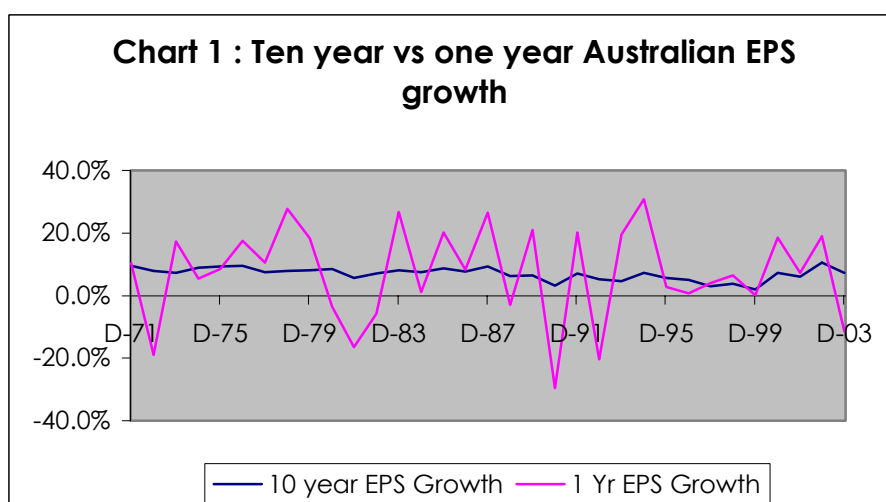


## AUSTRALIAN EQUITIES-OUTLOOK FOR THE NEXT DECADE

15 March 2004

Why do most market commentators spend their time forecasting short-term market moves, which is tough and largely irrelevant to planners, when forecasting long-term returns is both more accurate and relevant to the real needs of financial planners?

Key drivers of sharemarket performance, such as Earnings Per Share (EPS) growth, are much easier to forecast for the long term rather than the short term as Chart 1 clearly shows.



Source: Farrelly's

### A long term approach to forecasting

The heart of the **farrelly's** forecasting process, which is described in this article, derives from the observation that over long periods of time equity market returns can be broken down into three components

- Dividend yields today
- Growth in earnings
- Change in valuation multiple

If these are annualized and added together they provide an excellent approximation of the total return of the market. Table 1 shows how, over the past four decades, dividends, earnings growth and changes in PE ratios have contributed to returns of the All Ordinaries index.

The approach is an approximation and will rarely provide a perfect answer, even if viewed after the fact, due to takeovers, stocks coming in and out of the index and changes in dividend payout ratios. Nonetheless it is an excellent framework for reviewing the past and, more importantly, thinking about the future. It is a very sound basis for making asset allocation decisions.

Table 1 : Contributions to All Ordinaries Index returns over four decades					
	Dividend yield at start	EPS growth %pa	PE change %pa	Total %pa	Actual Return %pa
1963-73	3.8	7.3	-4.9	6.2	6.3
1973-83	5.1	8.0	1.9	15.0	16.1
1983-93	3.5	4.6	6.0	14.1	15.4
1993-2003	2.9	7.2	-2.7	7.4	8.6

Source: ASX Data & Farrelly's

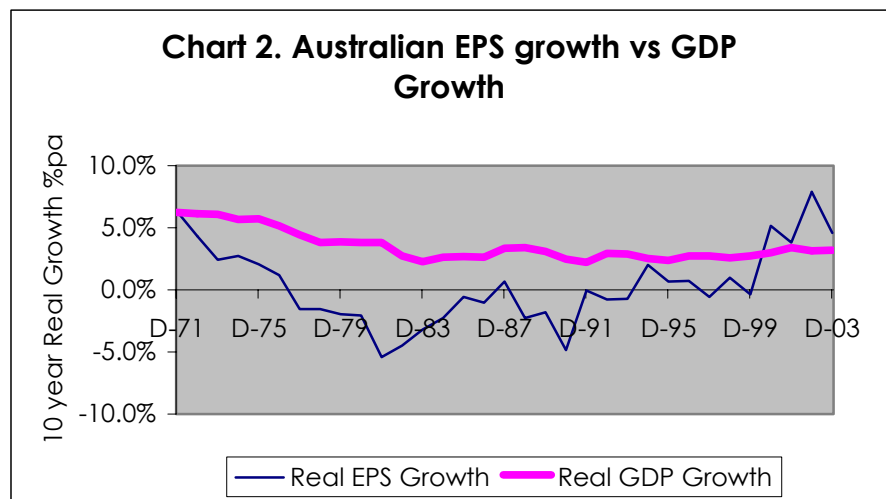
What does this mean for the outlook for Australian equities today?

The key data points today are a dividend yield for Australian equities of 5.1%pa, which includes the effect of franking credits, and a PE ratio of 16.5. The key questions for the future are, how fast can Australian companies grow earnings, and where will PE ratios be in ten years time?

By posing central, optimistic and pessimistic forecasts for EPS growth and PE ratios in 10 years time we can get both an central forecast and a range of expectations about where the actual performance might be.

## How fast can Australian companies grow earnings?

When one looks back over the last 40 years Australian companies' long term record of earnings growth is patchy. Generally growth has been well below that of GDP growth, although that record has been substantially better in the past decade as is illustrated in Chart 2. This chart shows 10 year rolling real EPS growth and real GDP growth where the first data point is for the decade ending 1971.

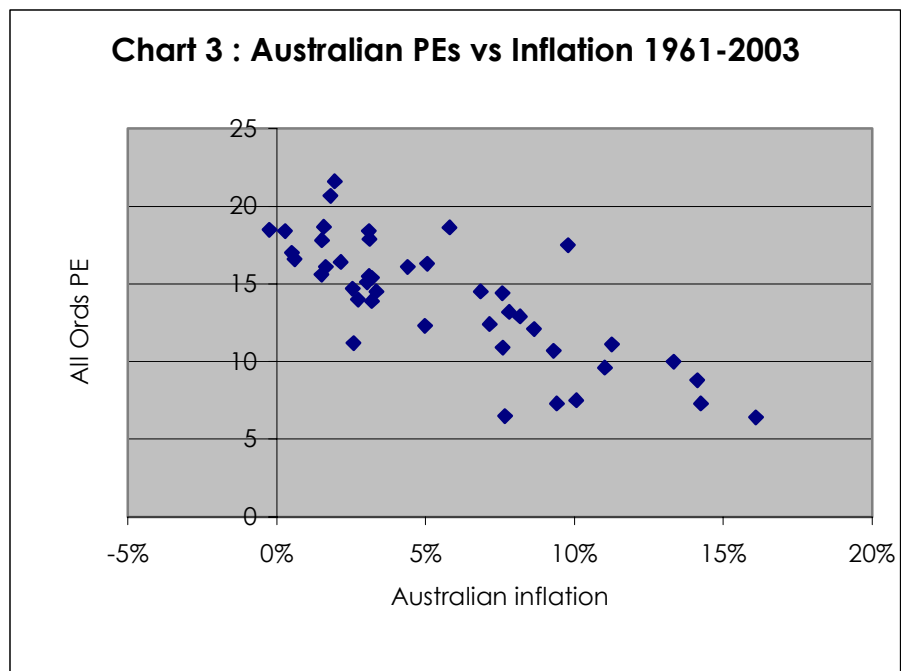


Source: ASX, RBA & Farrelly's

What about the next decade? My expectation is for EPS growth of around 5% (or 3% real), with an optimistic case of around 8%pa, and a pessimistic case of 1%pa.

## Where will PE ratios be?

The key issue is where will inflation be? Most market economists and fund managers expect it will remain low and, if so, you should expect the PE to be around 16.5 where it is today. An optimistic assessment of PEs could have them as high as 20, with a pessimistic assessment as low as 13. And if inflation were to re-emerge then do not be surprised to see PE ratios below 10.



Source: ASX data & Farrelly's

### Putting it all together

By adding together current yields, expected growth rates and the effects of PE growth or contraction one can arrive at sensible long-term forecasts for the equity markets.

Table 2 : Ten Year Forecasts for Australian Equities			
	Central Forecast	Optimistic Case	Pessimistic Case
Dividend now +	5.1	5.1	5.1
EPS growth +	5.0	8.0	1.0
Effect of PE change	0.0	1.9*	-2.4**
<b>Forecast return</b>	<b>10.1%pa</b>	<b>15.0%pa</b>	<b>3.8%pa</b>
PE in 2014	16.5	20.0	13.0

\*PE of 20 in 2014 represents a 1.9%pa growth rate over 10 yrs

\*\*PE of 13 in 2014 represents a -2.4%pa growth rate over 10 yrs

## **Implications for Investors**

Australian equities currently seem attractively priced compared to bonds, but having said that, they may not necessarily outperform bonds over the next decade. The case for well diversified portfolios remains strong.