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## The right pathway to profits in 2007

Shares and non-residential property may be the place to be this year, **James Dunn** reports

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SUCH has been the rich vein of form mined by the Australian share market since 2003 that decisions on where to invest money have been made easy.

The Australian share market has racked up four consecutive years of double-digit gains. It has earned 25 per cent a year for the past three calendar years, its best run since the 1987 crash.

Local shares (as measured by the benchmark S&P/ASX 200 index) have more than doubled since 2003.

If you add in the healthy flow of dividends generated by the outstanding profitability of Australian companies, the share market since February 2003 has delivered a total return of 130 per cent.

This heady period for shares has largely been driven by company profitability. According to Wren Research, profit growth for the S&P/ASX 300 stocks has averaged 19.1 per cent compound over the past three financial years, compared with the average of earnings growth since 1975, at 9.3 per cent a year.

Wren Research expects market profit growth to fall to 7.9 per cent in the 2006-07 financial year, which would represent a seven-year low.

Thus, a decision on where to put your money in 2007 - your asset allocation - revolves around whether you think the Australian share market can continue its stellar form.

### \* Australian shares

THE key theme for investors is trying to second-guess whether the share market can continue to boom, AMP investment strategy head and chief economist Shane Oliver says.

"Australian shares managed to come in way ahead of most investors' expectations - including mine - last year, thanks to profit growth of 15-20 per cent, still reasonable valuations, and mergers and acquisitions activity. All of those factors remain in place."

The market has run very strongly, Oliver says, but the usual signs of a major market top are not present yet.

"Valuations are OK, sentiment towards shares is not euphoric, capital raisings and M&A activity are still modest relative to market capitalisation and share market gains have been broadly based - and hence far healthier than was the case in 2005, when they were far more narrowly based on resources stocks.

"Profit growth is likely to slow towards 10 per cent - and thus the capital growth from the market will fall - but the risk to company earnings is just as much on the upside as on the downside."

While an acceleration in price-earnings multiples and M&A activity is an upside risk

for shares in 2007, there is also the fact that the Government's \$32 billion Future Fund will start to invest this year, he says.

High commodity prices have been a major driver of the local share market in recent years, and Oliver expects high prices to prevail this year.

Renewed strength is unlikely until the second half of 2007, when global and Chinese growth starts to pick up again.

"By the end of the year, we expect prices for metals such as copper and nickel - along with oil - to be at new record highs," Oliver says.

Yet, even with earnings growth slowing, an environment of low interest rates and confidence in the medium-term profits outlook could lead to investors pushing PE ratios higher, Russell Investment Group investment strategist Andrew Pease says.

"The Australian forward (prospective) PE ratio is currently 14.2 times, below its 10-year average of 15.9 times.

"A rise to 15.2 times, on unchanged earnings, would deliver a 7 per cent capital gain in equities and still leave the PE ratio below its 10-year average."

Pease says Australian shares are fair value. However, small capitalisation stocks are trading at a PE premium to large capitalisation stocks, signalling that small-cap underperformance is likely over the next 12 months.

Oliver adds that the dividend yield on Australian shares is "half the battle" in securing a decent return. "It's about 3.7 per cent and with franking credits, that gets you up to 5 per cent.

"You don't need much capital growth to get a decent return. Half the battle is won for Australian investors because the dividend yield is so high."

The prospective earnings numbers remain attractive, but "you have to wonder just how much better can things get", MLC Investment Management investment strategist Brian Parker says.

"Return on equity is at an all-time high, profits as a share of the economy are at an all-time high, so how much more profit growth are you going to get?"

"That's a real risk. If you think about it in terms of PEs, you wouldn't have a problem with price, as long as you believed the earnings. If you don't believe the E number in the models, you've got a problem.

"I don't see a lot of value in domestic shares. I'd want to be tilting money offshore, but that's what I would have said 12 months ago, and it hasn't worked."

#### \* **Global shares**

GLOBAL shares are usually the only asset class that can compete with Australian shares on a consistent basis, but the Morgan Stanley Capital International (MSCI) index has struggled to compete in recent years with a rampant Australian share market.

Last year was the sixth of seven in which Australian shares outperformed international shares.

"Global shares should provide decent returns over the next year," Oliver says.

"Valuations remain reasonable, profit growth should be OK, shares are likely to re-rate through higher PE multiples as the global interest rate cycle turns down, and there is still plenty of cash looking for a home. Asian shares are likely to outperform thanks to better valuations and growth prospects, and US shares are likely to outperform European and Japanese shares as US interest rates fall." Russell's latest Investment

Manager Outlook indicates that fund managers consider international shares to be the pick of the asset classes in 2007. In December, 65 per cent of Australian fund managers were bullish on international shares, with only 16 per cent bearish.

But the mood towards Australian shares is not nearly so optimistic, with only 28 per cent of managers stating that they are bullish on local shares.

#### **\* Fixed interest**

BONDS have not set the world on fire for several years now and they are not expected to do so in 2007 either.

AMP Capital's Oliver says bonds offer relatively poor returns, reflecting their low running yields.

"But with economic growth slowing, bond yields are likely to fall a bit further, helping to boost returns a bit above running yield alone."

With yields on 10-year bonds sitting below that offered on overnight cash, sentiment remains resoundingly bearish on Australian bonds. The Russell Investment Manager Outlook shows that only 5 per cent of fund managers are bullish on bonds this year (a record low for the survey), while 60 per cent are bearish.

#### **\* Listed property trusts**

THE listed property trust (LPT) sector returned 34 per cent in 2006 - including a stellar 14 per cent over the December quarter - but that appears to have pushed them into overvalued territory.

Pease says LPTs look expensive compared with the broader market.

The Russell Investment Manager Outlook indicates that sentiment on the LPT sector has deteriorated, with only 12 per cent of managers bullish on the sector - down from 15 per cent in the September quarter - while 65 per cent are bearish, up from 59 per cent.

"It's not that often that LPT yields fall below cash, but the sector has run really hot," Parker says.

"You're just not getting the yield advantage that you might expect, and they're not really worth buying.

"The better opportunities in property securities are offshore, where Britain, for example, is just about to open up its REIT market.

"Those offshore markets are going to grow a lot faster than our fairly mature market and the US market."

#### **\* Non-residential property**

NON-RESIDENTIAL property "might almost push shares" as a return this year, Oliver says. It has benefited from a lot of investment by traditional residential investors fleeing from the poor prospects of residential property.

"Buying a small shop or a warehouse instead of a couple of flats has been quite a sensible thing to do, because the underlying value of the land is quite similar, but they're trading on quite different yields."

Typically, a suburban office building or shop or warehouse can yield 7 per cent-plus if you have a tenant, versus yields in housing of about 3 per cent.