



NEWSLETTER

September 2020

Introduction

Happy spring! In this edition, we take a deep dive into the Australian share market, comparing it to the US and other global markets. We do this for one main reason: we are starting to see some separation opening up between the performance of shares on the US market and the performance of shares on the Australian market.



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The Share Market

Have we seen a parting of the ways? During the month of August, the Australian share market rose by around 2.2%, as measured by the ASX 200. However, this rise paled into insignificance compared to the rise on the US market, as measured by the S&P500. On that market, the rise was 7.2% - for the month! Here are how the markets look graphically, thanks to Alphabet, the ASX and S&P:

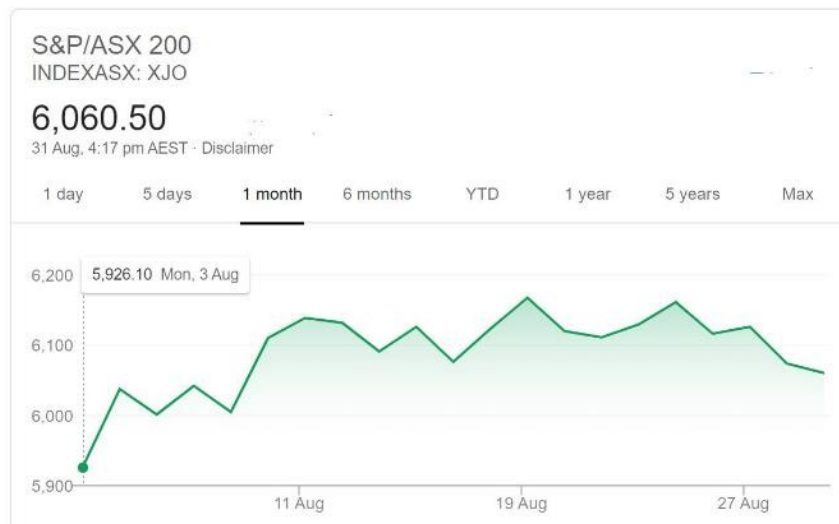


Figure 1 The Australian Share Market Price Performance, August 2020

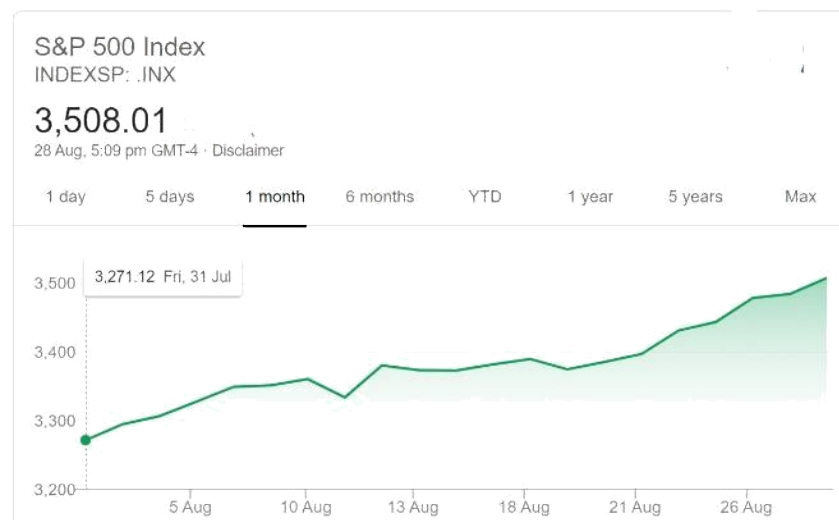


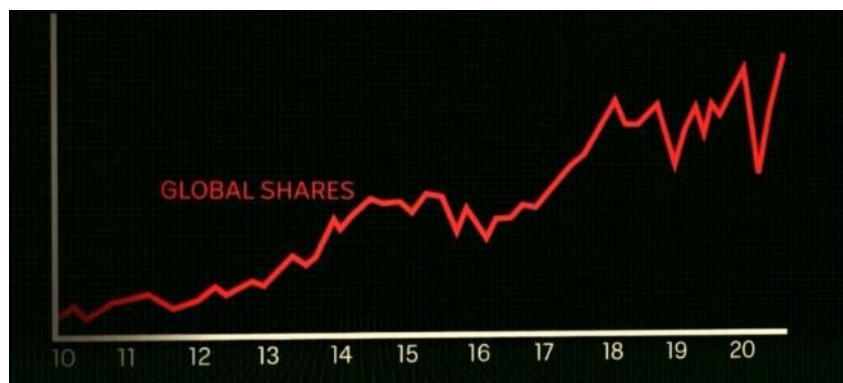
Figure 2 The US Share Market Price Performance, August 2020

The Australian experience was a lot more volatile: the market fell on 10 days during the month, whereas the US market only fell on two days of the month.

We have written before about the symmetry between the two markets. This is, however, the second month in a row that the Australian market has not performed in close concert with the US market. Hence our question: have we seen a parting of the ways?

The question is especially pertinent because globally, sharemarkets have just reached their highest levels ever. But as Alan Kohler told the world on Sunday night in [this excellent piece](#) on ABC news, the global peak is entirely due to the state of the US market.

Here is how Alan and the ABC showed us what is happening in the world and the US markets, using data from Minack Advisors. First, the state of the 'global sharemarket:'



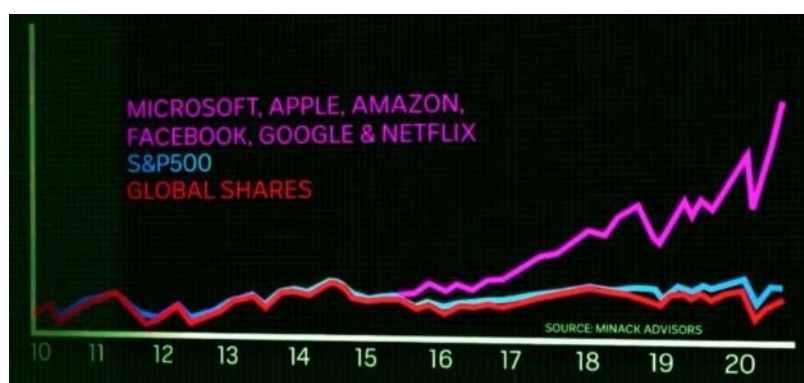
As you can see, this data goes back to 2010 and shows that prices were reaching a peak at the start of this year. In the early throes of the Covid-19 pandemic, prices gave about about a year's worth of growth. But since then, they have powered back and have reached a new all-time high.

That sounds great – until we realise the extent to which this 'global high' is completely dependent on the US market. Have a look at the US market's influence:



In this graph, we see that, in the years from 2010 to 2020, the average global price everywhere except the US has basically gone sideways. It is the US market, as measured by the S&P500, which (in the graph) has almost reached its highest point ever. (As it happens, the data in the graph is now a few days old. On August 28, the US market surpassed its previous high, which had been set on February 19 2020).

That said, Alan took the analysis even further when he next revealed the extent to which the US market's rise is really based on the price performance of shares in just six companies:



These six companies are, of course, all large tech companies. And it is true that they do enjoy truly epic reach. As it happens, we have used products from three of these companies just to prepare this newsletter. But without these companies and their outstanding price performance, we can see the the global market and the US market have operated in virtual lock-step over the last ten years – with average prices effectively going sideways.

It is the share prices of these six companies that have really gone gangbusters. From the point of view of traditional share prices analysis, prices for this 'Big Six' look to have gone way too far. Consider the following table, with data sourced from S&P (all prices in US dollars):

Company	Share Price			Profit per Share	Increase in Profit per Share	% Profit per Share
	Aug 28 2020	Aug 28 2019	Change %			
Amazon	\$ 3,401.80	\$ 1,789.84	90%	\$ 26.01	7.88%	0.76%
Google	\$ 1,639.47	\$ 1,169.55	40%	\$ 45.45	-8.26%	2.77%
Microsoft	\$ 228.91	\$ 136.04	68%	\$ 5.76	13.83	2.52%
Netflix	\$ 523.89	\$ 289.29	81%	\$ 5.93	132.55	1.13%
Facebook	\$ 293.66	\$ 182.39	61%	\$ 8.18	38.64%	2.79%
Apple	\$ 500.04	\$ 205.70	143%	\$ 13.19	12.06%	2.64%

The share price in each company has increased substantially in the past 12 months. But, very importantly, the share price has increased by substantially more than profit per share increased for the 12 months to June 2020. In Google's case, profit per share actually declined for the 2019/2020 year.

The pandemic was having an effect towards the end of the 2019/2020 year, but the market clearly expects that the impact of the pandemic will be much higher for the current and future financial years – indeed, investors are basically banking on it. They are pushing prices to a level that can only make sense if company profits are about to soar.

We can see this from the the final column in the table above. It shows the rate of return per share for each company for the current price of shares in that company. That is, it shows the potential percentage income return for someone buying shares today - if 2019/2020 profits are repeated.

In the case of Amazon, the rate of return is less than 1%. This is incredibly low. Amongst other things, it means that, if Amazon's profits *double* in the current twelve months, the rate of return per share for people buying shares today would still only be 1.52%. Granted, this is more than those people will get if they put their money in the bank. But it is a very small return for shares in a company whose profits have doubled.

And, when you are already very big, *doubling* profit is no mean feat.

All this is to say that prices of these large six companies are currently very high. People buying shares in those companies at these prices are taking a very large risk for what will struggle to be much of a return.

It seems to be taking a while for the Australian experience to detach itself from the US one. Consider the following headlines, observed in the Fairfax Press online media on August 18 2020:

BUSINESS >

LIVE **MARKETS LIVE**

ASX set to rise after tech surge boosts Wall St
55 minutes ago by Alex Druce and Lucy Battersby

EARNINGS SEASON

Coles swings to profit growth thanks to COVID panic-buying
56 minutes ago by Dominic Powell

UPDATED **EARNINGS SEASON**

Westpac scraps dividend due to uncertain outlook
Westpac will not pay shareholders a first-half dividend due to the uncertain economic environment, the bank said as it reported third-quarter profits of \$1.32b.
1 hour ago by Clancy Yeates

COMMENT **WORKPLACE CULTURE**

One story, two versions. AMP must release Pahari inquiry
by Elizabeth Knight

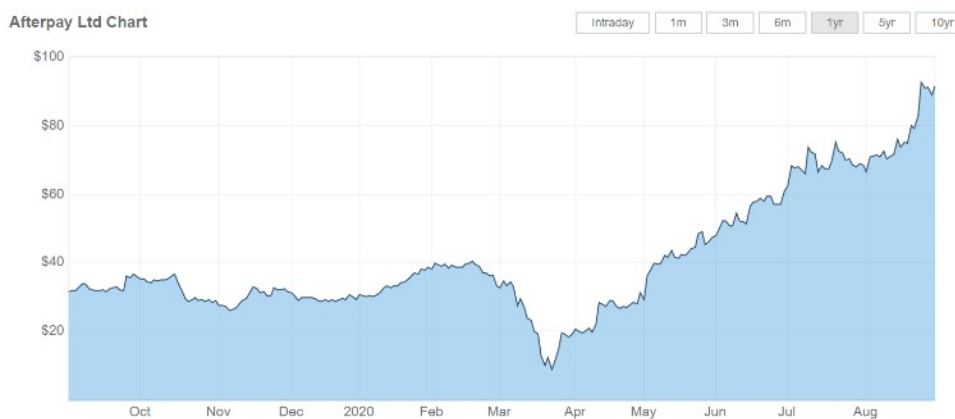
The two headlines that we were drawn to are the one for Westpac, where it scraps its first half dividend, and the one for the Markets Live article, where the ASX is set to rise – because tech stocks had boosted Wall Street. Westpac is Australia's fourth largest company by market capitalisation. Yes, the market probably expected the dividend to be scrapped. But still, we would expect its professed uncertainty to at least counter-act the influence of the US market. (For the record, the Australian market did follow the US market up on August 18).

Our market may not be growing to the same extent as the US market, but as the experience in mid-August showed, nor are we completely immune from its ebullience. As we see in the three graphs above, when you remove the Big Six, the price of the average company share in global markets over the last ten years has basically gone sideways. Not so in Australia. Here, prices have most definitely risen. Here is our ten year performance, this time with thanks to www.marketindex.com.au:



On average, prices are about 33% higher than they were this time ten years ago. And we have clawed back about half of the precipitous drop in prices that we saw in March and April of this year. Australia has not done as well as the US market. But we have done better than most of the world.

Within the Australian market, there have also been some really optimistic individual share price moves. One company that you might have seen being mentioned is Afterpay. Interestingly, Afterpay is considered to be a 'tech stock' here in Australia. And it is certainly performing like one on the share market. Here is the 12 month price performance for Afterpay to the end of August 2020, again thanks to Market Index:



In late March, prices fell to a low of \$8.90 per share. As at 31 August, they were trading at \$91.44 – an increase of more than 1000%! We would love to tell you what this price movement means for the likely profit per share, but we can't: Afterpay has never made a profit and so we can't do the calculation.

An increase of 1,000% in a company that does not make a profit can only mean one thing. The market is punting on the potential of this company – either to make large profits in the future or to be bought out by a larger company. Bear in mind that the market capitalisation (the value of every share on issue multiplied by the current market price) is almost \$25 billion. Against that, for the year ended 30 June 2020, the company had total income of just \$519 million (and made an actual loss of \$22 million). Investors clearly expect the future to differ greatly from the past.

And we sincerely hope that it does. After all, it took Amazon many years to make a profit. Amazon shares are now trading at \$US3,400 per share – having floated in 1997 at an effective price of \$US1.54 per share (there have been three 'stock splits' since the initial float. That means that an initial investment of \$US1,000 would today be trading at \$US2,207,792. Afterpay is a market leader in point of sale 'buy now, pay later' schemes and is clearly aiming to become intrinsic to the purchasing transaction in the same way that Amazon has become intrinsic to buying online.

(That said, for completeness, we must point out that Afterpay also charges retailers a whopping 4.17% commission ([Smart Company](#)) – compared to less than 1% for a standard credit card. Basically, this means that Afterpay is adding in an extra layer of costs which will ultimately be paid by the consumer. Amazon took layers out and made products cheaper. Expect retailers, especially brick and mortar ones for whom conditions are already difficult, to balk at Afterpay becoming too dominant, at least at these prices. And, again unlike Amazon, Afterpay will always need retailers).

The comparison to Amazon brings us back very neatly to one of our favourite themes as advisers: the benefits of **diversification**. Let's say you had \$1,000 and invested 100% of it in Amazon in 1997. Well, you are now worth \$2,207,792. You are very wealthy and all you had to do was know that Amazon was the one company that listed that year that would, despite more than a decade of losses yet to come, make you your fortune.

Now let's say you invested your \$1,000 in a fund that put 1% of its money into each of 100 companies, including Amazon. *Even if all the other companies in your fund went bust*, you are still worth more than \$22,000 today.

You can see our point: putting all your eggs into the Amazon basket was fine as long as you knew it was the right basket. If it was the wrong basket, you lost all your money. A diversified investment will 'catch' a small portion of the Amazons (and hopefully the Afterpays) of this world. This is the best way to ensure you have a stake in the next truly big thing.

So, at the end of the strangest winter our market has seen for a long time, we see six US companies dominating world markets as investors clearly predict huge increases in profitability for each of them. The great news is that diversified investors probably hold some shares in those companies – and, here in Australia, a diversified portfolio can catch our next big thing, as well.

The Legal Stuff

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