Quay Real Estate Advisors
Preserve + Create

Investment Perspectives

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Key Points

After inflation returns can deliver a real improvement in an investors' standard of living

Long term real EPS growth has been much lower than most people think

A long-term real return of 5% per annum will be a good result from risk assets

Benchmarking total returns

What is an appropriate long term real return?

Investing is about deferred consumption. The reward for deferred consumption is the ability to consume more in the future. Beating an index, cash or bonds may deliver this outcome but is not a guarantee; however, consistently 'beating inflation' is more likely to deliver on this objective.

Risk assets (Real Estate and Equity) tend to always outperform inflation over time, so inflation by itself is not much of a benchmark. At Quay, we aim to exceed inflation by 5% per annum. Here's why.

Real Returns

Real (after inflation) returns allow for greater future consumption relative to today – or said another way – delivers higher future standard of living all other things being equal. For Quay, that is the true goal of investing.

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Yield is important along with long-term real increases in per share cash-flows

At Quay, we understand that real long term returns are a function of;

- Initial yield, plus
- Real long term dividend growth - supported by real long term earnings per share growth

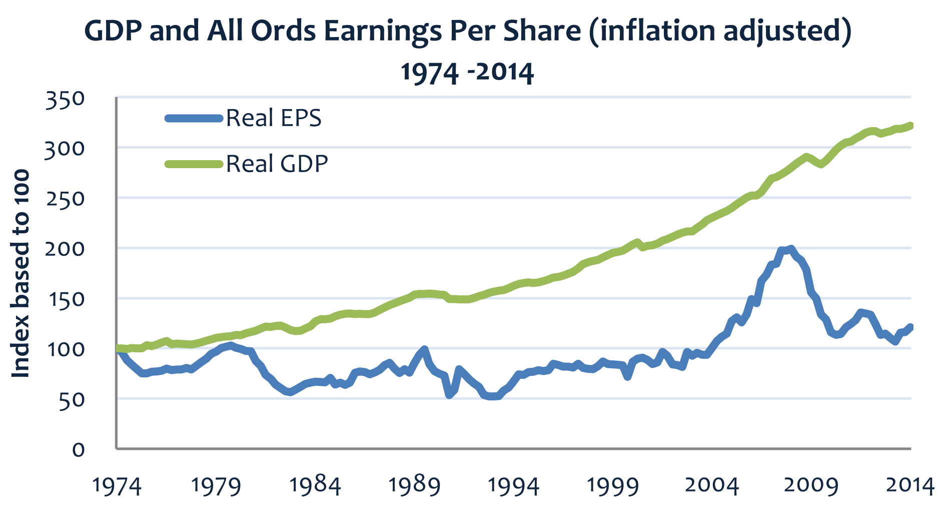
Readers may be interested why we have excluded "change in price earnings rating (PE)" from this equation. This factor is important for short and medium term investing and for a Day Trader; it is generally the entire return.

However, for a long-term investor, it is far less meaningful. For example, an investor who bought the Dow Jones Industrial Average on Jan 1, 1900 at 66.4 today sees an index value of ~17,800. That equates to an annual capital gain of 5.0%. Including dividends the total return is closer to 8.0%. If the PE of the Dow halved today, the total annualised return would still be +7.3%.

Long-term real growth

We know the dividend yield of equities in Australia today is around 4.7%. That's the easy part – but what about the long-term real growth prospects in earnings and therefore dividends?

History may surprise you. **In Australia, for the 30 years between 1974 and 2004, the real increase in earnings per share for the market was on average zero and significantly lagged real GDP growth.**

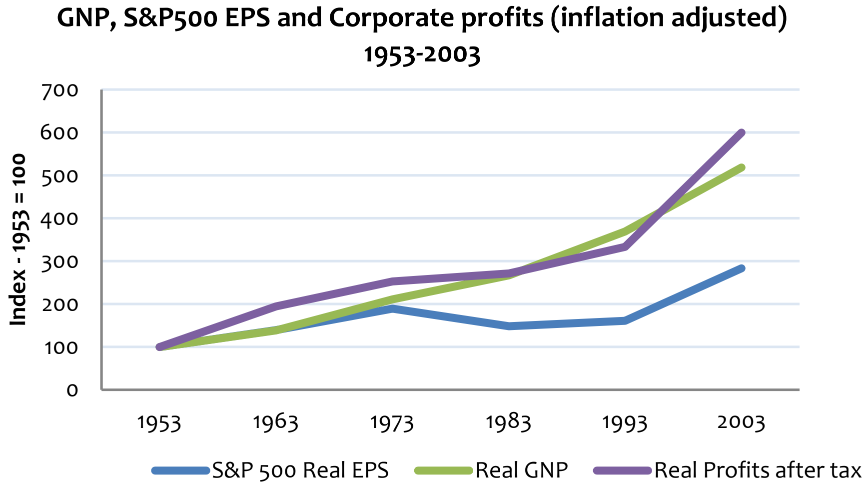


Between 2004 and 2008 real EPS almost doubled as the combined effect of the mining and credit cycle took effect. The impact of the GFC normalised this cycle in 2009. Today, current real EPS is around 25% higher compared to 1974, reflecting a growth rate of just 0.5% per annum, still significantly lagging real GDP growth.

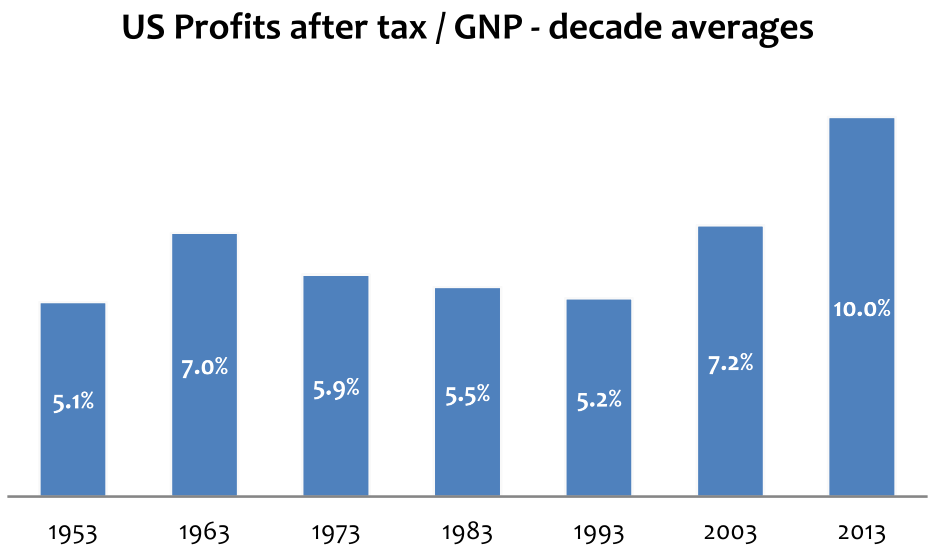
If the future is anything like the past (recognising the mining and credit booms are now probably behind us), real total returns are likely to be around 5.0-5.5% per annum, comprising of yield (4.7%) and real long term growth (0.0-0.5%).

The US experience

The undisputed home of capitalism, the USA, has had a similar, albeit slightly better experience. Between 1953 and 2003, real EPS growth measured 2.1%. per annum (no doubt assisted by lower pay-out ratios).



Including the decade to 2013, real EPS growth is slightly higher at 2.6% per annum. However, it should be noted that in last ten years US equities have benefited from a significant lift in operating margins – now at a level higher than at any other time in the last 60 years.



Corporate profit growth cannot outperform economic growth forever. Otherwise companies eventually become the economy, and customers (wage earners) lose the ability to buy company output. Therefore, real long term earnings growth of 3% per annum should not surprise.

Allowing for ongoing share issuance and new companies replacing old, then low real EPS growth is understandable.

Concluding thoughts

At a time when investors are focused on the "end of QE" and normalised interest rates, at Quay, we prefer to think about real long-term growth in dividends and returns, because that is what will deliver a real improvement in the standard of living for investors.

When thinking about total return we try to find opportunities that can offer total real returns of at least 5% per annum and we believe we will deliver competitive returns to investors.

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